IT 11-0001-PLR 01/31/2011 ALTERNATIVE APPORTIONMENT

Private Letter Ruling: Settlement proceeds from antitrust litigation are excluded from the numerator and denominator of the financial organization apportionment formula under 86 Ill. Adm. Code Section 100.3380(c)(4).

January 31, 2011

Dear:

This is in response to your letter dated November 9, 2010, in which you request a Private Letter Ruling on behalf of COMPANY 1 ("COMPANY1") and its subsidiaries. Review of your request for a Private Letter Ruling indicates that all information described in paragraphs 1 through 8 of subsection (b) of 2 Ill. Adm. Code 1200.110 is contained in your request. This Private Letter Ruling will bind the Department only with respect to the combined group that includes COMPANY1. Issuance of this ruling is conditioned upon the understanding that COMPANY1 and/or any related taxpayer(s) is not currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them are as follows:

COMPANY2 LLP, as an authorized agent for COMPANY1 ("COMPANY1" or "taxpayer") requests a Private Letter Ruling in accordance with 2 Ill. Adm. Code 1200.110 to the effect that COMPANY1 must exclude from the numerator and denominator of its sales factor the proceeds from an antitrust settlement pursuant to 86 Ill. Adm. Code 100.3380(c).

DISCLOSURES

In accordance with 2 Ill. Adm. Code 1200.110(b)(3), the subjects of this request are not being examined as part of an audit by the Illinois Department of Revenue ("Department") and they are not pending in litigation in a case involving the taxpayer or a related taxpayer.

In accordance with 2 Ill. Adm. Code 1200.110(b)(4), to the best of the knowledge of both the taxpayer and the taxpayer's representative, the Department has not previously ruled on the same or a similar issue for the taxpayer or a predecessor. In addition, the taxpayer and its representatives have not previously submitted the same or a similar issue to the Department and withdrawn it before a letter ruling was issued.

TAXPAYER

COMPANY1 for purposes of this request, includes itself and all of its subsidiaries included in its combined federal income tax return as outlined in the "Statement of Facts" section below. COMPANY1 is submitting this Private Letter Ruling request in accordance with 2 Ill. Adm. Code 1200.110(a)(3)(A)(i), which permits one ruling request by the designated agent of a group of taxpayers filing a combined federal income tax return.

TAX YEAR

This ruling is requested for the tax year ended XXX.

STATEMENT OF FACTS

COMPANY1 is a publicly-traded holding company. COMAPNY1 is organized under the laws of STATE1, and is commercially domiciled in CITY, Illinois. COMPANY1 has two principal lines of business. First, it engages in BUSINESS taking through its wholly-owned depository institution subsidiary BANK, a STATE1 state nonmember bank regulated by the Federal Deposit Insurance Corporation ("FDIC") and the STATE1 office of the State Banking Commissioner. Second, it provides SERVICES through: (1) COMPANY3, (2) COMPANY4, and (3) COMPANY5.

On December X, XXXX, COMPANY1 filed an application to become a bank holding company with the Federal Reserve. As a result of COMPANY1 becoming a bank holding company, COMPANY1 and all of its unitary subsidiaries are treated as a financial organization for Illinois corporate income tax purposes for the tax year ending XXX.

On October X, XXXX COMPANY1 filed a lawsuit, XXXXXXXXXXX. Through this lawsuit COMPANY1 sought to recover substantial damages and other appropriate relief in connection with COMPANY6's and COMPANY7's anticompetitive practices that foreclosed COMPANY1 from providing Services. The lawsuit followed the COURT1's denial of COMPANY6's and COMPANY7's petition for review of the decision of the COURT2'S decision in a case in which the court found that COMPANY6 and COMPANY7's exclusionary rules violated the antitrust laws and harmed competition and consumers by foreclosing COMPANY1 from offering SERVICES.

The court concluded that these exclusivity rules were anticompetitive and violated Section 1 of the Sherman Act. As a result of these exclusionary rules, COMPANY9 and COMPANY1 were effectively foreclosed from the business providing SERVICES. The court ruled that COMPANY6 and COMPANY7's exclusivity rules violated the Sherman Act.

On October X, XXXX, COMPANY1 executed an agreement to settle the lawsuit with COMPANY7 and COMPANY6. The agreement became effective on November X, XXXX upon receipt of the approval of COMPANY6's shareholders. Under the settlement, COMPANY6 and COMPANY7 agreed to pay up to $X in exchange for COMPANY1's agreement to dismiss the lawsuit and release all claims. In accordance with the agreement, COMPANY7 paid COMPANY1 $X in the fourth quarter of XXXX. COMPANY1 met all the financial performance measures to which they were subject under the settlement agreement and, as a result, COMPANY1 received the maximum amount of $X, plus interest, in four quarterly payments from COMPANY6 in fiscal year XXX.

RULING REQUESTED

1. For purposes of filing its fiscal year XXX Illinois corporate income tax return can COMPANY1 classify the $X in receipts from the settlement of the anti-trust lawsuit against COMPANY6 and COMPANY7 as an incidental or occasional sale and therefore, exclude it from the numerator and denominator of the sales factor? COMPANY1 requests the Department to issue a ruling that permits COMPANY1 to exclude the antitrust settlement receipts from its sales factor for the tax period XXX.

DISCUSSION

COMPANY1 files a combined Illinois Corporation Income and Replacement Tax Return (Form IL-1120) in accordance with 35 Ill. Comp. Stat. 5/1501(a)(27) as a financial corporation. For purposes of computing its Illinois corporation income and replacement tax liability, COMPANY1 is electing, and has historically elected, to treat all income and business income in accordance with 35 Ill. Comp. Stat. 5/1501(a)(1). Under such election, all receipts from the antitrust settlement will be included in the Illinois business income base and subject to apportionment in Illinois. However, such proceeds should be excluded from the numerator and denominator of the sales factor as an occasional sale under 86 Ill. Adm. Code 100.3380(c)(2) because the antitrust settlement receipts are not a part of COMPANY1's usual and ordinary course of business. There is however, a lack of guidance as to how litigation settlement receipts are treated for Illinois income tax purposes, specifically whether it is included or excluded from the sales factor.

Business income of a financial organization is apportioned to the state by multiplying the income by a fraction, the numerator of which is gross receipts from sources in this State and the denominator is gross receipts everywhere during the taxable year. ILCS Sec. 5/304(c)(3). Gross receipts for purposes of this subparagraph means gross income, including net taxable gain on disposition of assets, including securities and money market instruments, when derived from transactions and activities in the regular course of the financial organization's trade or business. For example, receipts from the lease or rental or real or tangible personal property, interest income, commissions, fees, gains on disposition and other receipts from assets in the nature of loans, receipts from the performance of services, receipts from investment assets, etc. 86 ILAC 100.3380(c)(2) states "where gross receipts arise from an incidental or occasional sale of assets used in the regular course of the person's trade or business, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded."

The Department has provided guidance in various general information letters and private letter rulings with regards to occasional sales. For example, in Illinois Private Letter Ruling No. IT 07-0001, the Department ruled that sale of stock in a subsidiary would be treated as business income pursuant to the election afforded by IITA § 1507(a)(1) but the gross receipts received from the sale of stock must be excluded from the numerator and denominator of the sales factor as it is a unique event and the resultant stock transactions are not part of the company's usual and ordinary course of business. The gain from these incidental transactions falls under IITA Reg. § 100.3380(c)(2). See also PLR IT 01-0009 and GIL IT 08-0032.

Unlike these rulings, COMPANY1 is receiving receipts from a settlement of a lawsuit and not selling assets; tangible or intangible. 86 ILAC 100.3380(c)(2) does not address receipts received due to a settlement and whether it can be treated as an incidental or occasional sale. But, the purpose of this regulation is to exclude the incidental or occasional receipt from the sales factor in order to prevent a distortive result.

There is no question that the settlement of an antitrust settlement is an isolated and occasional occurrence. The receipts from the antitrust settlement do not constitute a transaction or activity arising in the ordinary course of COMPANY1's business. Furthermore, the inclusion of these receipts in COMPANY1's sales factor would not depict an accurate account of COMPANY1's

business activities and therefore should be excluded from COMPANY1's sales factor.

DEPARTMENT RULING:

As explained below, COMPANY1 must exclude from its apportionment factor the settlement proceeds described in your letter pursuant to Department Regulations pursuant to Department Regulations § 100.3380(c)(4). Therefore, we do not determine whether or not the settlement proceeds would also be excluded from the factor under Regulations § 100.3380(c)(2).

IITA Section 304(f) allows for relief from the otherwise designated statutory apportionment method under Sections 304(a) through (e) in cases where application of such method does not fairly represent the extent of a person's business activity in this State. Pursuant to Section 304(f), the Department promulgated Regulations § 100.3380, which sets forth modifications to the statutorily prescribed property, payroll, and sales factors. Section 304(f) relief is available to a taxpayer required to apportion business income under IITA Section 304(c).

Under IITA Section 301(c)(1), the business income of a nonresident is allocated to Illinois to the extent provided in IITA Section 304.

The term business income is defined in IITA Section 1501(a)(1) as follows:

> The term "business income" means all income that may be treated as apportionable business income under the Constitution of the United States. Business income is net of the deductions allocable thereto. Such term does not include compensation or the deductions allocable thereto. For each taxable year beginning on or after January 1, 2003, a taxpayer may elect to treat all income other than compensation as business income. This election shall be made in accordance with rules adopted by the Department and, once made, shall be irrevocable.

For taxable years ending on and after December 31, 2008, the apportionment formula for a financial organization is set forth in IITA Section 304(c)(3). The section states, in part:

> For taxable years ending on or after December 31, 2008, the business income of a financial organization shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is its gross receipts from sources in this State or otherwise attributable to this State's marketplace and the denominator of which is its gross receipts everywhere during the taxable year. "Gross receipts" for purposes of this subparagraph (3) means gross income, including net taxable gain on disposition of assets, including securities and money market instruments, when derived from transactions and activities in the regular course of the financial organization's trade or business.

In Pennzoil Co. v. Dep't of Rev., 33 P.3d 314 (Or. 2001), the Oregon Supreme Court considered whether proceeds that Pennzoil received in settlement of a tort judgment should be considered business income under the transactional test contained within Oregon's business income definition. Pennzoil had entered into an agreement to acquire stock of Getty Oil in order to gain access to Getty's oil reserves. However, before Pennzoil could complete the acquisition, a third party, Texaco, stepped in to purchase all of Getty's stock. Pennzoil then sued Texaco for tortious interference with its contract, and ultimately obtained a judgment of more than $11.1 billion. Pennzoil would later agree

to accept from Texaco a settlement of $3 billion, of which $2.1 billion was included in taxable income.

Pennzoil classified the settlement proceeds as nonbusiness income, arguing that Texaco's interference with its contract with Getty was not a transaction or activity in the ordinary course of business. The court rejected Pennzoil's argument, identifying Pennzoil's contract with Getty as the transaction or activity giving rise to the settlement proceeds. The court stated that, in determining the tax consequences of income received through litigation or settlement, courts have asked "in lieu of what were the damages awarded." In Pennzoil's case, its recovery against Texaco was intended as compensation for the loss of its contract with Getty. Therefore, the court determined that the income-producing activity with respect to the settlement proceeds was Pennzoil's contract with Getty. It followed that the settlement proceeds would be business income under the transactional test if Pennzoil's agreement with Getty was entered into in the regular course of business. Because the purpose of the Getty agreement was to acquire established oil reserves, the court found the contract to be a transaction or activity occurring in the regular course of business even if the stock acquisition itself was a transaction in which Pennzoil rarely engaged. Accordingly, the settlement proceeds were business income under the transactional test.

In this case, applying the "in lieu of" test to determine the character of COMPANY1's settlement proceeds received from COMPANY6 and COMPANY7, the proceeds must be considered business income. Your request cites XXXXXXXXXX, in which COURT2 found COMPANY6's and COMPANY7's "exclusivity" rules to violate the Sherman Antitrust Act (XXXXXXXXXX). In particular, the court found these exclusivity rules to be anticompetitive because they restricted the ability of COMPANY9 and COMPANY1 to market their SERVICES to banks. In fact, the court noted that COMPANY9 and COMPANY1 had been effectively foreclosed from the business of providing SERVICES.

Although you have not provided a copy of the October X, XXXX settlement agreement, your letter indicates that COMPANY1's lawsuit against COMPANY6 and COMPANY7 sought to recover damages incurred in connection with the anticompetitive practices of COMPANY6 and COMPANY7 at issue in the antitrust case. On this basis, the $X settlement award may be viewed as compensation to COMPANY1 for profits lost due to its inability to provide SERVICES. Such profits, had they been received directly rather than recovered through litigation, would be considered gross income derived from transactions and activities in the regular course of COMPANY1's trade or business. Accordingly, whether or not COMPANY1 makes the election provided under IITA Section 1501(a)(1), the settlement proceeds constitute business income and included in the apportionment factor under IITA Section 304(c)(3).

Having determined that the settlement proceeds are included in the apportionment factor, it is necessary to determine what portion of those receipts should be considered from sources in this State or otherwise attributable to this State's marketplace, and thereby included in the numerator of COMPANY1's apportionment formula. Department Regulations § 100.3405(c) provides sourcing rules for this purpose, stating that gross receipts from sources in Illinois shall be the sum of the amounts described in paragraphs (1) through (9) of that section. The proceeds from settlement of a lawsuit or other legal cause of action are not literally described in paragraphs (1) through (8) of Regulations §100.3405(c). However, paragraph (9) states:

> Any receipts that are includable in the denominator of the fraction in subsection (a) and that are not governed by subsection (c)(1) through (8) are from sources within this State to the

> extent the receipts would be characterized as "sales in this State" under IITA Section 304(a)(3) and Sections 100.3370 and 100.3380 of this Part, except that the provisions of in IITA Section 304(a)(3)(B-2) (excluding gross receipts from the licensing, sale or other disposition of patents, copyrights, trademarks and similar items from the numerator and denominator of the apportionment factor, unless those items comprise more than 50% of the taxpayer's gross receipts) do not apply.

IITA Section 304(a)(3)(C-5) states:

> For taxable years ending on or after December 31, 2008, sales, other than sales governed by paragraphs (B), (B-1), (B-2), (B-5), and (B-7), are in this State if any of the following criteria are met:
>
> …
>
> (iii) In the case of interest, net gains (but not less than zero) and other items of income from intangible personal property, the sale is in this State if:
>
> (a) in the case of a taxpayer who is a dealer in the item of intangible personal property within the meaning of Section 475 of the Internal Revenue Code, the income or gain is received from a customer in this State …
>
> (b) in all other cases, if the income-producing activity of the taxpayer is performed in this State or, if the income-producing activity of the taxpayer is performed both within and without this State, if a greater proportion of the income-producing activity of the taxpayer is performed within this State than in any other state, based on performance costs.

In this case, the settlement proceeds would be governed under IITA Section 304(a)(3)(C-5)(iii) as non-dealer income from intangible personal property. Under that section, if the income-producing activity with respect to the settlement proceeds is performed in Illinois, or the greater proportion thereof is performed in Illinois than in any other state, the settlement proceeds must be included in the numerator of COMPANY1's apportionment formula.

In Polaroid Corp., 2003 WL 21403288 (Cal. St. Bd. Eq.), the California State Board of Equalization considered the question whether proceeds from a patent infringement lawsuit should be included in the sales factor of Polaroid's apportionment formula. Under California law, sales other than sales of tangible personal property are assigned to California if the income-producing activity is performed in California. The Franchise Tax Board argued that the settlement proceeds should be excluded from the sales factor because the receipts could not readily be attributed to any income-producing activity. The taxpayer argued that the litigation was the income-producing activity that generated the settlement proceeds, and that because the litigation took place outside California none of the settlement proceeds could be included in the California numerator.

The Board rejected both arguments. Relying on the North Carolina Supreme Court's decision in Polaroid v. Offerman, 349 N.C. 290 (N.C. 1998), the Board concluded that the litigation could not be considered the income-producing activity. Instead, the Board looked to the claim underlying the lawsuit, Kodak's unlawful use of Polaroid's patents to sell cameras and film, and pointed to that activity as the income-producing activity. Since the settlement proceeds were intended to

compensate Polaroid for the lost profits such sales would have generated, the Board attributed that income-producing activity to Polaroid upon its receipt of such profits through the legal process as opposed to the marketplace. The Board stated, “In our view, the lost sales of tangible personal property should be treated as the actual income-producing activity giving rise to the income at issue.” Finally, as some of those sales would have occurred in California, the Board directed that a proportionate share of the settlement proceeds be assigned to the California numerator based on Polaroid’s average California sales factor over the patent infringement years.

In contrast to Polaroid, the claim underlying COMPANY1’s lawsuit does not clearly identify the income-producing activity. As indicated above, as a result of COMPANY6’s and COMPANY7’s exclusivity rules, COMPANY1 was completely foreclosed from issuing cards through banks. Therefore, applying the settlement proceeds based on COMPANY1’s historical average Illinois sales factor does not satisfactorily approximate where COMPANY1’s lost profits would have occurred.

Department Regulations § 100.3380(c)(4) states in part:

> Where business income from intangible personal property cannot readily be attributed to any income-producing activity of the person, the income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor.

Because the settlement proceeds at issue here cannot readily be attributed to any particular income-producing activity of COMPANY1, application of § 100.3380(c)(4) is appropriate in this case. Accordingly, COMPANY1 must exclude from its apportionment formula the settlement proceeds described in your letter. As a result, the settlement proceeds will be taxed in Illinois based on COMPANY1’s apportionment formula otherwise computed under IITA Section 304(c).

This ruling shall bind the Department for the taxable year ending XXX, except as limited pursuant to 2 Ill. Adm. Code 1200.110(d) and (e). The facts upon which this ruling is based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Very truly yours,

Terry D. Charlton
Chairman, Private Letter Ruling Committee