IT 11-0010-GIL 06/20/2011 ALTERNATIVE APPORTIONMENT

General Information Letter: Petition for alternative apportionment cannot be granted based on the information supplied.

June 20, 2011

Dear:

This is in response to your letter dated April 15, 2011, in which you request permission to use an alternative apportionment method, rather than the statutorily-mandated apportionment formula, pursuant to Section 304(f) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 101 *et seq.*). The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. *See* 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www.revenue.state.il.us. For the reasons discussed below, your petition cannot be granted at this time.

In your letter you have stated the following:

> COMPANY1, LLP (“COMPANY1”) as authorized agent for FUND Inc. (“Fund” or “taxpayer”) petitions the Illinois Department of Revenue (“Department”) for the right to use an Alternative Apportionment Method, in accordance with Illinois Income Tax Act (“IITA”) Section 304(f) and 86 Ill. Adm. Code 100.3390.
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> DISCLOSURES
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> TAX YEAR
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> The petition is requested for tax year ended October 31, 2010. The extended due date for filing this corporate income and replacement tax return is August 15, 2011.
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> TAXPAYER
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> Fund, for purposes of this request, includes only Fund, as it does not file a combined Illinois income tax return.
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> STATEMENT OF FACTS
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> Fund
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> Fund is incorporated under the laws of STATE1 and registered with the United States Securities and Exchange Commission (“SEC”) under the Investment Company Act of 1940 as a closed-end diversified management investment company. Fund’s books and records are maintained in CITY1, STATE2 by a third-party service provider that acts as Fund’s accounting agent. Fund is taxable as a “C” corporation for federal income tax purposes.
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> Fund seeks a return on investment by investing substantially all of its net assets in a portfolio of master limited partnerships (“MLPS”) that operate in the energy sector. Fund holds non-managing units in such MLPs. The MLPs, which are publicly traded and treated as partnerships for federal income tax purposes, consist of domestic and international entities engaged in the exploration, production, processing, transmission, marketing, storage, or

delivery of energy-related commodities, including natural gas, coal, and crude oil. The MLPs conduct business throughout the United States and around the world. Fund does not manage or control the MLPs.

Fund has 18 officers, all of which are also employees of COMPANY2 (the “Advisor”, described more fully below). Fund appointed new officers when Advisor assumed its role as Advisor (described below). With the exception of one individual, Fund’s officers operate from Advisor’s office, located in CITY2, Illinois. The sole remaining Fund officer operates from CITY3, STATE3. Fund has no employees apart from its officers. Fund has 10 members on its Board of Directors. Fund’s officers conduct Fund business in Illinois.

General investment strategy and standards are established by the Fund. Fund holds Board of Directors meetings quarterly, each of which is attended in-person by Fund’s Directors, and also holds an annual performance review meeting. Generally, three of the quarterly Board meetings are held in CITY2, as is the annual performance review meeting. The remaining quarterly Board meeting is held outside of Illinois. Board meetings are not specific to Fund business; Directors sit on the Boards of numerous entities. The business address of all of Fund’s Directors is Advisor’s office address in CITY2, Illinois. Each Board meeting addresses Fund matters in conjunction with matters involving numerous other entities. Fund’s Board is in charge of corporate governance and management oversight such that Directors have ultimate veto authority over decisions made by COMPANY3 LLC (the “Sub-Advisor,” described more fully below). Occasionally, telephonic and/or special meetings are held throughout the year, as needed. For such telephonic meetings, the participants call in from many states, including Illinois. Special in-person meetings may take place outside of Illinois (e.g. such a meeting most recently occurred outside of Illinois during December 2010).

Additionally, to enhance Fund’s Directors’ ability to focus on the broader issues related to fund governance, Fund’s Board meets annually in October to discuss governance related issues during a multi-day meeting. This meeting is convened separately from the usual quarterly meetings and typically occurs away from the COMPANY2 offices. In the past, the timing and location of these governance meetings had been coordinated with due diligence visits to Advisor and Sub-Advisor. Generally, at the annual governance meeting, the Board discusses industry-wide practices and developments, reviews its compensation relative to multiple peer groups, reviews the charter for each Board committee, assesses the Board’s interactions and relationships with various Advisor Departments, discusses the aggregate results of a self-assessment questionnaire, considers alternative Board or committee structures, and other relevant topical issues. Some limited non-governance issues may be discussed (e.g. new fund approvals), but the focus remains on Fund governance. Certain governance topics may also be discussed during Fund’s quarterly Board meetings, depending on the specific nature and timing of the issue. Regular quarterly meetings, however, typically deal with standard required quarterly and annual items, and business-driven topics (e.g. leverage management, new fund approvals, educational workshops, presentation by investment teams, etc.).

Fund generally receives the following discrete categories of income: (1) capital gain/loss from the sale of MLP interests, (2) IRC Section 751 recapture, generally related to depreciation recapture, triggered on Fund’s sale of MLP interests or intangible asset sales by the underlying MLPs themselves, (3) its distributive share of business and nonbusiness income from MLP activities, (4) dividend income, and (5) interest income related to short-term investments in cash equivalents. Over 90 percent of Fund's income is derived from (1) and (2).

The activities of Fund include the signing of contracts, the receipt and payment of Fund invoices, and the oversight of Advisor and Sub-Advisor.

Advisor (COMPANY2)

On MONTH X, 2010, management of Fund was assumed by the Advisor, a corporation legally domiciled in STATE4. Prior to MONTH X, 2010, Fund was managed by COMPANY4 LLC, from COMPANY4 LLC's STATE5 offices.

Advisor is responsible for managing Fund's overall strategy and implementation, though day-to-day operational and investment decisions are made by Sub-Advisor. Advisor oversees Fund's use of leverage, performs various administrative and reporting responsibilities on behalf of Fund, and monitors Sub-Advisor's performance. Advisor also defines operating guidelines for trades to which Sub-Advisor must adhere, in line with Fund's investment guidelines and to which Fund holds ultimate veto authority. Advisor provides similar investment advisory services to numerous other funds unrelated to Fund.

Sub-Advisor (COMPANY3)

On MONTH X, 2010, Fund also retained the services of the Sub-Advisor to furnish investment advisor services to the Fund, subject to the supervision of Advisor and the Fund's Board.

Sub-Advisor is a STATE6 Limited Liability Company and a federally registered investment advisor. Advisor and Sub-Advisor are unrelated third parties. Sub-Advisor makes day-to-day decisions with respect to investment placement, though such decisions are required to fall within the operating guidelines established by Advisor and Fund. They must, for example, comply with the provision of Fund's Articles of Incorporation and Bylaws. Sub-Advisor, however, makes all day-to-day investment decisions- pre-clearance is generally not required – and places purchase and disposition orders for the portion of Fund's investment portfolio managed by Sub-Advisor (typically over 95% of the Fund's assets). Sub-Advisor is authorized to select the brokers and dealers that will execute the purchases and sales of portfolio securities for the Fund and is required to use commercially reasonable efforts to obtain favorable results and execution of Fund's orders. Sub-Advisor also provides such day-to-day operating services to numerous parties unrelated to Fund. Sub-Advisor may occasionally identify special investments that do not fall within the stated guidelines established by COMPANY2. Such proposed special investments require pre-clearance from Advisor and Fund.

Other than infrequent visits to CITY2 to attend meetings with Fund's Board of Directors and/or the Advisor, Sub-Advisor employees and officers conduct activities in CITY4, STATE6. Sub-Advisor employees and officers working on Fund related business spend the majority of their time on Fund rather than Sub-Advisory's other clients. These individuals occasionally travel outside STATE6 to attend conferences. The vast majority of such travel is, however, outside Illinois.

ALTERNATIVE APPORTIONMENT REQUESTED

1. Fund is a “financial organization” as defined in IITA Section 1501(a)(8)(A).

2. Fund is not unitary with the MLPs. A corporation that is a financial organization cannot be unitary with non-financial partnerships. The business income/loss of the nonunitary partnership is apportioned at the partnership level and then is allocated to the corporate partners.

3. Fund should be granted alternative apportionment, pursuant to IITA Section 304(f), and be permitted to apportion gain from Fund’s sale of the MLP interests, including the IRC Section 751 recapture, using the apportionment factors from the MLPs. That is Fund should apply Illinois’ apportionment rules from the perspective of the underlying entity sold.

DISCUSSION

Part I. Illinois Apportionment of Fund Income

Fund is a financial organization

IITA Section 1501(a)(8) defines “financial organization”:

> The term “financial organization” means any bank, bank holding company, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency exchange, cooperative bank, small loan company, sales finance company, investment company, or any person which is owned by a bank or bank holding company. For the purpose of this Section a “person” will include only those persons which a bank holding company may acquire and hold an interest in, directly or indirectly, under the provisions of the Bank Holding Company Act of 1956 (12 U.S.C. 1841, et seq.), except where interests in any person must be disposed of within certain required time limits under the Bank Holding Company Act of 1956. (Emphasis added) See also 86 Ill. Adm. Code 100.9710(a).

Illinois regulations define the term “investment company” in 86 Ill. Adm. Code 100.9710(d)(11):

> The term “investment company” means an entity that comes within the meaning of 15 USC 80a-3 and is predominantly engaged in the business of investing, reinvesting and trading in securities.
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>> A) Characteristic Services. In the Investment Company Act of 1940, 15 USC 80a-3 defines an investment company as an entity engaged in the business of investing, reinvesting and trading in securities. Accordingly, the characteristic services of an investment company are the raising of capital from investors in order to purchase capital securities of other entities. Gross income from the characteristic services of an investment company includes interest, dividends and gains from sales of securities.

> B) Regulation. In order to be characterized as an investment company under the IITA, an entity doing business in the United States must be registered as an investment company with the Securities and Exchange Commission under the Investment Company Act of 1940. Any entity that is not doing business in the United States must be subject to the equivalent authority (if any) in its country of formation or commercial domicile.

Fund is registered as an Investment Company with the SEC, under the Investment Company Act of 1940. It is engaged in the business of investing, reinvesting, and trading in securities, as described in the facts above and further evidenced by its SEC registration status as an Investment Company. Thus, Fund should be considered a financial organization for Illinois apportionment purposes.

Combined Filing with Funds/MLPs Not Permitted

IITA Section 304(e) provides that whenever two or more persons are engaged in a unitary business, as described in IITA Section 1501(a)(27), a part of which is conducted in Illinois by one or more members of the group, the business income attributable to Illinois is apportioned by means of the combined apportionment method. See also *86 Ill. Adm. Code 100.3380(d).* The respective shares of partners other than residents in the business income of a partnership is allocated or apportioned to Illinois in the possession of the partnership is taken into account by the partners pro rata in accordance with their respective distributive shares of the partnership income for the partnership's taxable year and allocated to this State. *IITA Section 305(a).*

Irrespective of the relationship of the partner and partnership (i.e. whether or not they are unitary), combined apportionment does not apply to a partner's shares of business income and apportionment factors from any partnership that cannot be included in a unitary business group. The partner and partnership must apportion their business income using different apportionment formulas under IITA Section 304, and therefore cannot be members of a unitary business group under IITA Section 1501(a)(27). *86 Ill. Adm. Code 100.3380(d)(3)(A).*

Fund is a financial organization and, therefore, subject to Illinois' special apportionment rules for financial organizations. In contrast, the MLPs in which Fund invests are not investment companies, banks, or any of the other types of businesses that fall within the ambit of "financial organization" described in IITA Sections 304(c) and 1501, and 86 Ill. Adm. Code 100.3405, and 100.9710. Thus, Fund cannot apportion on a combined basis with the MLPs.

Illinois apportionment of Fund receipts, absent alternative apportionment

(a) Capital gain/loss from the sale of MLP interests – Generally

Illinois provides apportionment rules for financial organizations in IITA Section 304(c)(3) and 86 Ill. Adm. Code 100.3405 (attached as Addendums A and B, respectively). For taxable years ending on or after December 31, 2008, a financial organization multiplies its apportionable income by a fraction, the numerator of which is the taxpayer's gross receipts from sources in Illinois or attributable to the State's marketplace, while the denominator includes the taxpayer's gross receipts everywhere during the taxable year. "Gross receipts" means gross income, including net taxable gain on disposition of assets, including securities and money market instruments, derived from transactions and activities in the regular course of the financial organization's trade or business. *IITA Section 304(c)(3).*

IITA Section 304(c)(3)(i)-(vii), mirrored in 86 Ill. Adm. Code 100.3405(c)(1)-(7), lists receipts factor sourcing rules for various items of financial organization income, but is inapplicable to the types of income Fund derives from its interests in the MLPs. Illinois provides a rule, however, that broadly applies to income related to "[i]nterest, dividends, net gains (but not less than zero) and other income from investment assets and activities from trading assets and activities," that is applicable. *IITA Section 304(c)(3)(viii)(1); 86 Ill. Adm. Code 100.3405(c)(8).*

With respect to such income, the Illinois receipts factor numerator includes gross interest and dividends and net gain (but not less than zero), and other income from investment assets and activities from trading assets and activities that are attributable to the State." *IITA Section 304(c)(3)(viii)(2); 86 Ill. Adm. Code 100.3405(c)(8)(B).* Such amounts are attributable to Illinois if "properly assigned to a fixed place of business of the taxpayer within this State." *IITA Section 304(c)(3)(viii)(2); 86 Ill. Adm. Code 100.3405(c)(8)(B).* These amounts are presumed properly assigned to Illinois if Illinois is the fixed place of business with which the taxpayer has a preponderance of substantive contacts. *IITA Section 304(c)(3)(viii)(2)(E), 86 Ill. Adm. Code 100.3405(c)(8)(B)(iv).*

Illinois provides a statutory definition of "fixed place of business" in IITA Section 1501(9.5):

> The term "fixed place of business" has the same meaning as that term is given in Section 864 of the Internal Revenue Code and the related Treasury regulations.

IRC Section 864(c)(5) and Treasury Regulation 1.864-7 (attached as Addendum C and D, respectively) define "fixed place of business" for federal income tax purposes. 86 Ill. Adm. Code 100.3405(b)(1) parallels the federal definition and provides further details in identifying a "fixed place of business" for Illinois purposes:

> A) As a general rule, a fixed place of business is a fixed facility, that is, a place, site, structure or other similar facility, through which the taxpayer engages in a trade or business. (See 26 CFR 1.864-7(b)(1).)
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> B) A taxpayer is not considered to have a fixed place of business merely because the taxpayer uses another person's fixed place of business, whether or not the other person and the taxpayer are related persons, through which to transact a trade or business, if the trade or business activities of the taxpayer in that fixed place of business are relatively sporadic or infrequent, taking into account the overall needs and conduct of that trade or business. (See 26 CFR 1.864-7(b)(2).)
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> C) A fixed place of business of an agent of the taxpayer who is not an independent agent is not a fixed place of business of the taxpayer unless the agent has the authority to negotiate and conclude contracts in the name of the taxpayer, and regularly exercises that authority. (26 CFR 1.864-7(d)(1)(i).)
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> D) A fixed place of business of an independent agent of the taxpayer shall not be

treated as the office or other fixed place of business of the taxpayer, irrespective of whether the agent has authority to negotiate and conclude contracts in the name of the principal and regularly exercises that authority. (See 26 CFR 1.864-7(d)(2).)

E) For purposes of this subsection (b)(1), "independent agent" means a general commission agent, broker or other agent of an independent status acting in the ordinary course of his or her business in that capacity. (See 26 CFR 1.864-7(d)(3).)

Net gain from activities related to investment assets fits within the rule of IITA Section 304(c)(3)(viii) and 86 Ill. Adm. Code 100.3405(c)(8). Presumably, if a loss is generated, such loss is excluded entirely from the Illinois receipts factor. Net gain from the sale of MLP interests, however, is assigned to Illinois if Illinois is the fixed place of business with which the taxpayer has a preponderance of substantive contacts.

Illinois is likely the Fund's "fixed place of business." While Fund's books and records are maintained in CITY1 by a third-party service provider that acts as Fund's accounting agent and where the annual Governance Meeting is located, the majority of factors point toward Illinois as the fixed place of business. Moreover, the vast majority of Fund's activities take place in Illinois. For example, Fund has 18 officers, 17 of which operate from Advisor's office in CITY2. Fund's officers conduct Fund business in CITY2. Three of Fund's quarterly Board meetings are held in CITY2 each year, as is the annual performance review meeting. The business address of all Fund Directors is Advisor's office address, in CITY2. Advisor, which operates in CITY2, Illinois, manages Fund's overall strategy and implementation, performs administrative and reporting responsibilities on behalf of Fund, oversees Fund's use of leverage and monitors Sub-Advisor's performance primarily from Illinois.

Sub-Advisor, which makes all day-to-day investment decisions, and places orders for the purchase and disposition of securities for the portion of Fund's investment portfolio to which Advisor allocates to Sub-Advisor, in contrast, is based almost exclusively in STATE6. Sub-Advisor is authorized to select the brokers and dealers that will execute the purchases and sales of portfolio securities for the Fund and is required to use its commercially reasonable efforts to obtain favorable next results and execution of Fund's orders. Sub-Advisor also provides such day-to-day operating services to numerous parties unrelated to Fund. Nevertheless, Sub-Advisor is independent of Fund and Advisor and, therefore, despite the fact that Sub-Advisor is Fund's de facto operational manager, its activities are excluded from consideration, pursuant to 86 Ill. Adm. Code 100.3405(b)(1). Thus, despite the fact that Sub-Advisor possesses the authority to negotiate and conclude contracts in the name of Fund and regularly exercises such authority, Sub-Advisor is an independent contractor and, therefore, Sub-Advisor's STATE6 fixed place of business cannot be attributed to Fund. Had Sub-Advisor been a dependent agent of Fund, Sub-Advisor's STATE6 fixed place of business would have been considered the fixed place of business for Fund because all the day-to-day activities take place in STATE6.

(b) Illinois Apportionment of IRC Section 751 recapture

Illinois provides special rules for the proration of and recapture of business expenses on the disposition of a non-business capital asset (IITA Section 203(e)(3); 86 Ill. Adm. Code 100.3010(d), 100.2405(d)). However, Illinois does not expressly provide special receipts factor apportionment rules for recapture. Thus, the IRC Section 751 recapture appear to be governed by the broad provisions of IITA Section 304(c)(3)(viii)(1) and 86 Ill. Adm. Code 100.3405(c)(8).

Applying these broad rules, net gain on the sale of MLP interests – the event triggering IRC Section 751 depreciation recapture, would presumably be apportioned under the Illinois financial organization rules in the same fashion as discussed in (a), above. Thus, such amounts would be sourced to Illinois irrespective of the fact that they relate to depreciation recapture.

(c) Illinois Apportionment of Fund's distributive share of MLP income

IITA Section 304(e) provides that when two or more persons are engaged in a unitary business, as described in IITA Section 1501(a)(27), a part of which is conducted in Illinois by one or more members of the group, the business income attributable to Illinois is apportioned by means of the combined apportionment method. See also 86 Ill. Adm. Code 100.3380(d). In contrast, partners who are not engaged in a unitary business with a partnership are required to include their shares of the partnership's business income apportioned to Illinois in their Illinois net incomes under IITA Section 305(a). 86 Ill. Adm. Code 100.3380(d)(1).

The respective shares of partners other than residents in the business income of a partnership is allocated or apportioned to Illinois in the possession of the partnership is taken into account by the partners pro rata in accordance with their respective distributive shares of the partnership income for the partnership's taxable year and allocated to this State. IITA Section 305(a).

Thus, the Fund's distributive share of the MLPs income is allocated in accordance with the allocation and apportionment of income determined by the MLPs. The Fund's distributive share of Illinois source income from the MLPs will be allocated to Illinois.

Part II. Request for alternative apportionment

Illinois' authority for requesting alternative apportionment resides in IITA Section 304(f):

> If the allocation and apportionment provisions of subsections (a) through (e) and of subsection (h) do not fairly represent the extent of a person's business activity in Illinois, they may petition for, if reasonable
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> (1) Separate accounting;
> (2) The exclusion of any one or more factors;
> (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or
> (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

As elaborated in Illinois regulations, departure from the required apportionment method is permitted where the default method does not accurately and fairly reflect business activity in Illinois. If the application of the statutory formula leads to a grossly distorted result, a fair and accurate alternative method is appropriate. The party seeking alternative apportionment, however, has the burden of going forward with the evidence and proving by clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this State. In addition, the party seeking to use an alternative apportionment formula must go forward with the evidence and prove that the proposed alternative apportionment method fairly and accurately apportions income to Illinois based upon business activity in this State. 86 Ill. Adm. Code 100.3390(c).

Fund respectfully requests the Department to grant the use of an alternative apportionment with respect to (a) IRC Section 751 recapture of ordinary income triggered on its sale of MLP interests and (b) any gain on the sale of MLP interests because, as explained below, the broad, default sourcing rules do not accurately or fairly reflect Fund's business activity in Illinois, are inconsistent with Illinois' policy on recapture and would lead to a grossly distorted result.

Generally, under IRC Section 741, gain or loss recognized upon the sale or exchange of a partnership interest is characterized as capital gain, except to the extent IRC Section 751 applies. IRC Section 751 provides:

> The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to –
> (1) unrealized receivables of the partnership, or
> (2) inventory items of the partnership,
> Shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

That is, IRC Section 751(a) is concerned with a selling partner's underlying partnership's unrealized receivables or inventory, which are properly recharacterized as ordinary income, while the balance of the sale is treated as the sale of a capital asset. Generally, "unrealized receivables" include the right to payment for past or future sales of goods or services not previously included as income, though – as is the case here – it may also include depreciation recapture. Thus, IRC Section 751 prevents partners from converting partnership ordinary income into capital gain income via a timely sale of a partnership interest. IRC Section 751 accomplishes this by permanently fixing the character of property distributed to its character in the hands of the partnership prior to distribution. See, e.g. Clarence A. Luckey, 41 TC 1 (1963), aff'd, 334 F2d 719 (9th Cir. 1964) (developed lots distributed to partner by partnership in business of developing lots, subsequent sale yields ordinary income); J. Thomas Requard, 25 TCM 732 (1966) (sale by partner of distributed ground rents held for sale by partnership yields ordinary income); cf. Baker v. Commissioner, 248 F2d 893 (5th Cir. 1957) (prior law) The reclassification is needed to ensure that partnership ordinary income treatment is not avoided when a partnership is subsequently disposed.

A literal reading of IITA Section 304(c)(3)(viii)(1) and 86 Ill. Adm. Code 100.3405(c)(8) appears to indicate that Fund level gain on the sale of MLPs, including IRC Section 751 recapture, would be sourced to Illinois because Illinois is the relevant fixed place of business for Fund (as well its place of commercial domicile). However, when a partnership with "hot assets" (i.e. unrealized receivables or inventory) is sold by its partner(s), IRC Section 751 "recaptures" this portion of the gain *from the perspective of the MLP sold* to ensure that ordinary income is not accorded capital gain treatment.

In the present case, IRC Section 751 recapture is attributable to depreciation deductions taken by the MLPs against their (the MLPs) ordinary income. Throughout the duration of Fund's ownership of the MLP interests, ordinary income/loss derived by the MLPs was apportioned by the MLPs and then allocated to Fund to various states *in an amount determined by the MLP"s apportionment calculation*. Under this "matching" principle, income related to previously deductible ordinary business expenses should be sourced applying the same method used to apply correlative deductions originally taken. To do otherwise treats ordinary gains and losses inequitably. When Fund sells the MLP and has IRC Section 751 recapture, such gain is sourced to Illinois. It is inequitable to require Illinois taxpayer to source IRC Section 751 gain recapture to Illinois while being unable to source such losses to the state.

The requested approach is consistent with Illinois' approach to the proration and recapture of business expenses on the disposition of a nonbusiness asset. IITA Section 203(e)(3); 86 Ill. Adm. Code 100.3310(d), 100.2405(d). These Illinois rules are designed to ensure that a partner does not, for example, benefit from taking an ordinary deduction if an item of income is later characterized as nonbusiness income. They must recapture a portion of the deductions so claimed as business expenses.

To apportion gain on Fund's sale of the MLPs to Illinois based solely on the fixed place of business of the Fund in no way fairly or accurately represents the extent of Fund's business conducted within Illinois. Fund invests in numerous MLPs operating throughout the US and internationally. The MLPs' business operations give rise to apportionment factors, the amount of which they then report to their various partners (including Fund). The MLPs' various partners (including Fund), in turn, allocate whatever amount the MLPs have determined through apportionment at the MLP level to many states other than Illinois. Absent alternative apportionment, however, Illinois would receive 100 percent of gain on the sale of the MLPs, much of which is obviously unrelated to Illinois. Indeed, throughout the life of the partnership, numerous states other than Illinois were deprived of ordinary income due to MLPs depreciation deduction, and would now miss out on the recapture entirely. This is, presumably, not the intent of Illinois' receipts factor sourcing rule, particularly when considering the state's special rules for the proration of and recapture of business expenses on the disposition of a nonbusiness asset. Clearly, Illinois contemplated the matching function served by recapture.

Fund is taxed twice on the gain on the sale of the MLPs by some states. For example, with respect to the disposition of a non-unitary partnership, California provides:

> Gain or loss on the sale of a partnership interest is allocable to this State in the ratio of the original cost of partnership tangible property in the state to the original cost of partnership tangible property everywhere, determined at the time of the sale. In the event that more than 50 percent of the value of partnership's assets consist of intangibles, gain or loss from the sale of the partnership interest is allocated to this state in accordance with the sales factor of the partnership for its first full tax period immediately preceding the tax period of the partnership during which the partnership interest was sold. *Cal. Rev. & Tax Cd. § 25125(d)*

Minnesota provides:

> Gain on the sale of a partnership interest is allocable to this State in the ratio of the original cost of partnership tangible property in the state to the original cost of partnership tangible property everywhere, determined at the time of the sale. In the event that more than 50 percent of the value of partnership's assets consist of intangibles, gain or loss from the sale of the partnership interest is allocated to this state in accordance with the sales factor of the partnership for its first full tax period immediately preceding the tax period of the partnership during which the partnership interest was sold. *Minn. Stat. § 290.17, Subd.(2)(c)*

Similarly, Oregon provides:

> Gain or loss on the sale of a partnership interest is allocable to this State in the ratio of the original cost of partnership tangible property in the state to the original cost of partnership tangible property everywhere, determined at the time of the sale. In the event that more than 50 percent of the value of partnership's assets consist of intangibles, gain or loss from the sale of the partnership interest is allocated to this state in accordance with the sales factor of the partnership for its first full tax year immediately preceding the tax period of the partnership during which the partnership interest was sold. *Or. Rev. Stat. § 314.635(4)*

Additionally, Louisiana provides:

> Other interest, dividends and profits from sales and exchanges of capital assets consisting of incorporeal property or rights shall be allocated to the state in which the securities or credits producing such income have their situs, which shall be at the business situs of such securities or credits if they have been so used in connection with the taxpayer's business as to acquire a business situs, or, in the absence of such a business situs, shall be at the legal domicile of the taxpayer in the case of an individual or at the commercial domicile of the taxpayer in the case of a corporation; provided that dividends upon stock having a situs in Louisiana received by a corporation from another corporation which is controlled by the former, through ownership of fifty percent or more of the voting stock of the latter, shall be allocated to the state or states in which is earned the income from which the dividends are paid, such allocation to be made in proportion to the respective amounts of such income earned in each state; and provided, further, that interest on securities and credits having a situs in Louisiana received by a corporation from another corporation which is controlled by the former through ownership of 50% or more of the voting stock of the latter, shall be allocated to the state or states in which the real or tangible personal property of the controlled corporation is located, on the basis of the ratio of the value of such property located in Louisiana to the total value of such property within and without the state. *La. Rev. Stat. Ann.* § 47:243(a)(4)

Other examples where states "look-through" to the non-unitary partnership sold for purposes of sourcing gain/loss from the sale of the non-unitary asset include Vermont (*Code of Vt. Rules 1.5833-1(e)*), Oklahoma (*Okla. Stat. Section 2358(A)(4)(b)(2)*), and Mississippi (*Miss. Admin. Code* 35.III.8.06(303)(05)).

> Equally significant, granting Fund's petition for alternative apportionment would avoid distortion or misattribution of income that would otherwise result. As the US Supreme Court stated in *Hans Rees' Sons, Inc. v. North Carolina*, 283 US 123 (1931), "evidence may always be received which tends to show that a state has applied a method, which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction." *Hans Rees* is relevant in that it involved a disparity of a taxpayer's connection to a state (taxpayer derived 17% of its income from North Carolina) to the amount of tax attributed to the state (roughly 250 percent more than activity actually conducted as demonstrated by separate accounting). However, *Hans Rees* is also analytically distinct from the present facts in that it involved the division of unitary income. Under the present facts, partner and partnership are non-unitary.
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> Since the US Supreme Court's decision, *Butler Bros. v. McColgan, 315 US 501 (1942),* there are, admittedly, a dearth of instances where taxpayers are granted relief even when a state's apportionment methodology is demonstrated to result in taxpayer paying tax on more than 100 percent of its income. However, Illinois' receipts factor sourcing rule would subject Fund to double taxation, effectively convert non-unitary income to unitary income, undermines the intent behind IRC section 751, and is inconsistent with Illinois' treatment of recapture of non-business assets.
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> Fund should be permitted the use of an Alternative Apportionment Method for all of the above stated reasons.

Response

Regulations § 100.3390(c) provides:

> A departure from the required apportionment method is allowed only where such methods do not accurately and fairly reflect business activity in Illinois. An alternative apportionment method may not be invoked, either by the Director or by a taxpayer, merely because it reaches a different apportionment percentage than the required statutory formula. However, if the application of the statutory formula will lead to a grossly distorted result in a particular case, a fair an accurate alternative apportionment method is appropriate. The party (the Director or taxpayer) seeking to utilize an alternative apportionment method has the burden of going forward with the evidence and proving by clear and cogent evidence that the statutory formula results in taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this State. In addition, the party seeking to use an alternative apportionment formula must go forward with the evidence and prove that the proposed alternative apportionment method fairly and accurately apportions income to Illinois based upon business activity in this State.

Your petition fails to show that the statutory method does not accurately and fairly reflect business activity in Illinois.

In general, a partner acting in his capacity as such derives income from a partnership from the partner's distributive share of the partnership's income. But a partner may also generate income from a partnership by selling or otherwise disposing of the partnership interest itself. IITA Section 305 provides the apportionment rule in regard to a partner's distributive share of the income of the partnership. Apportionment under this section is based directly on the activities of the partnership, both to determine whether the income is business or nonbusiness income, and then to apportion the income. If the income is business income in the hands of the partnership, it is apportioned by the partnership according to the partnership's apportionment factor. Each partner is required to include in Illinois net income the partner's distributive share of the partnership's business income apportioned to Illinois.

In contrast, where a partner realizes gain from a sale or other disposition of his partnership interest, IITA Section 305 does not apply because the income at issue is not income of the partnership. Rather, the income is solely the income of the partner. Accordingly, the IITA adopts an entity approach whereby the activities of the partner are examined to determine whether the gain is business or nonbusiness income and then to allocate or apportion the income. Under IITA § 303(b)(3), where a taxpayer realizes nonbusiness income on the sale of a partnership interest, the gain or loss is allocated to Illinois only if taxpayer/partner's commercial domicile is Illinois. Similarly, under the general sales factor apportionment rule of IITA Section 304(a), gross receipts from the sale of a partnership interest must be included in the numerator of the sales factor if the income-producing activity of the taxpayer/partner is performed in Illinois. IITA § 304(a)(3)(C-5).

The apportionment formula for a financial organization under IITA Section 304(c) adopts a similar approach. As you correctly indicate, net gain from sales of partnership interests must be included in the Illinois gross receipts numerator under IITA Section 304(c)(3)(viii) if the investment asset or activity is properly assigned to an Illinois fixed place of business of the taxpayer. An investment asset or activity is properly assigned to an Illinois fixed place of business if the fixed place of business has a preponderance of substantive contacts with respect to the asset or activity. We agree with your conclusion that the taxpayer's Illinois fixed place of business has the preponderance of substantive contacts with the taxpayer's partnership investments. The question is whether the resulting statutory apportionment does not fairly represent the extent of the taxpayer's business activities in Illinois.

IITA Section 304(f) provides:

> If the allocation and apportionment provisions of subsections (a) through (e) and of subsection (h) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may, without a petition, permit or require, in respect of all or any part of the person's business activity, if reasonable:
>
> (1) Separate accounting;
> (2) The exclusion of any one or more factors;
> (3) The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or
> (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

Section 304(f) relief is proper where the income allocated to the State by the otherwise applicable statutory formula is unfairly disproportionate to the business activity conducted in the State. But there is nothing inherently distortive or unfair in sourcing gross receipts from sales of partnership interests based on the activities of the partner in managing its investment in the partnership. This would be particularly true in the case of a financial organization engaged in a business of investing in a portfolio of partnerships. Your petition requests that taxpayer's gain from sales of partnership interests be apportioned using the apportionment factors of the underlying partnerships. Indeed, such an approach may produce a fair and rationale allocation of income. However, nothing in your petition demonstrates that the statutory apportionment formula fails to achieve an apportionment that reflects the business activities *of the taxpayer*. In fact, your petition explicitly concedes that the vast majority of Fund's activities take place in Illinois.

In support of your petition to apportion gain according to the apportionment factors of the underlying partnerships, you cite IRC Section 751. You indicate that IRC Section 751 applies to the taxpayer's sales of partnership interests in order to recharacterize gain from such sales as ordinary income. Although IRC Section 751 may be intended to prevent taxpayers from using partnerships to convert income from ordinary to capital, we do not see that the provision necessitates a departure from the apportionment approach under the IITA. First, IRC Section 751 does not convert the sale of the partnership interest into a deemed asset sale by the partnership. If the transaction was deemed an asset sale under the IRC, the IITA would automatically couple onto such treatment by virtue of its incorporation of federal definitions and federal taxable income. See Department Regulations § 100.9750(b)(2)(B). Rather, IRC Section 751(a) merely requires that some portion of the amount realized on the sale of a partnership interest must be considered to be from property that is not a capital asset. Second, if the failure of the IITA to adopt a "look-through rule" in the case of sales of partnership interests is distortive of the true source of the gain, then distortion results whether or not IRC Section 751 applies. Indeed, the same distortion argument could be made where the asset sold is the stock of a corporation. Finally, IITA Section 304(f) historically has not served to remedy the mismatched apportionment of income and related deductions, which can occur frequently and in multiple contexts. For example, a taxpayer's Illinois apportionment percentage may be very high in the taxable years in which the taxpayer is claiming substantial depreciation deductions under IRC Section 168, and very low in the taxable years in which taxpayer is required to recognize recapture income under IRC Section 1245. The Department has not invoked IITA Section 304(f) in such cases to apportion IRC Section 1245 recapture income.

Therefore, based on the information you have provided, your petition cannot be granted at this time as its sole basis for support rests on the fact that an alternative apportionment reaches a different apportionment percentage than the required statutory formula.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you still believe that your petition should be granted, please supplement the petition in accordance with the provisions of 86 Ill. Adm. Code Section 100.3390. If you have any questions, you may contact me at (217) 524-3951.

Sincerely,

Brian L. Stocker
Associate Counsel (Income Tax)