IT 12-0001-PLR 10/25/2012 APPORTIONMENT – SALES FACTOR

Private Letter Ruling: Receipts from sale of stock in a subsidiary corporation are not included in the Illinois numerator of the sales factor when no income-producing activities are performed within Illinois.

October 25, 2012

Dear:

This is in response to your letter dated August 31, 2012, in which you request a Private Letter Ruling (PLR) on behalf of COMPANY1. The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.tax.illinois.gov to review regulations, letter rulings and other types of information relevant to your inquiry.

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 COMPANY1 (FEIN XX). 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.

In your letter you have stated and made inquiry as follows:

Legal Authority

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. [86 Ill. Adm. Code 100.3380(c)(2)]

The term "unitary business group" means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other. The group will not include those members whose business activity outside the United States is 80% or more of any such member's total business activity. [35 ILCS 5/1501(a)(27)]

In general: The business income of a person other than a resident shall be allocated to this State if such person's business income is derived solely from this State. If a person other than a resident derives business income from this State and one or more other states, then, for tax years ending on or before December 30, 1998, and except as otherwise provided in this Section, such person's business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the sum of the property factor (if any), the payroll factor (if any) and 200% of the sales factor (if any), and the denominator of which is 4 reduced by the number of factors other than the sales factor which have a denominator of zero and by an additional 2 if the sales factor has a denominator of zero. For tax years ending on or after December 31, 1998, and except as otherwise provided by this Section, persons other than residents who derive business income from this State and one or more other states shall compute their apportionment factor by weighting their property, payroll, and sales factors as provided in subsection (h) of this Section. [35 ILCS 5/304(a)]

For tax years ending on or after December 31, 1998, the apportionment factor of persons who apportion their business income under subsection (a) shall be equal to: … for tax years ending on or after December 31, 2000, the sales factor. [35 ILCS 5/304(h)(3)]

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: … 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. [35 ILCS 5/304(a)(3)(C-5)(iii)(b)]

For the purposes of the sales factor of the apportionment formula for each trade or business of a person, the term "sales" means all gross receipts derived by the person from transactions and activity in the regular course of such trade or business. [86 Ill Admin Code 100.3370(a)(1)]

The numerator of the sales factor shall include the gross receipts attributable to this State and derived by the person from transactions and activity in the regular course of its trade or business. 86 Ill. Admin. Code 100.3370(c)]

The sales factor includes gross receipts from transactions other than sales of tangible personal property. These gross receipts are attributed to the State of Illinois if the income-producing activity which gave rise to the receipt is performed wholly within this State. Further, gross receipts are attributed to this State if, with respect to a particular item of income, the income producing activity is performed in this State, based on costs of performance. 86 Ill. Adm. Code 100.3370(c)(3)]

The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. However, such activity does not include transactions and activities performed on behalf of a person, such as those conducted on its behalf by an independent contractor. [86 Ill. Adm. Code 100.3370(c)(3)(A)]

Accordingly, the income producing activity includes, but is not limited to…the sale, licensing, or other use of intangible personal property. [86 Ill. Adm. Code 100.3370(c)(3)(A)(iv)]

The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the person. [86 Ill. Adm. Code 100.3370(c)(3)(B)]

Receipts in respect to a particular income-producing activity are in this State if … the income producing activity is performed both inside and outside this State and a greater proportion of the income producing activity is performed in this State than without this State, based on costs of performance. [86 Ill. Adm. Code 100.3370(c)(3)(C)]

Facts

COMPANY1 is a STATE1 Limited Liability Company.

COMPANY1's only activity is the investment in corporations, limited liability companies or partnerships.

COMPANY1 is not in the business of buying and selling entities and has not purchased or sold any other entities over the past three years.

COMPANY1 did repurchase a portion of the acquisition indebtedness it incurred to purchase COMPANY2 over the past three years. The initial debt agreements include several entities that are disregarded for federal and Illinois income tax purposes.

COMPANY1 owns 100% of COMPANY2, which is a COUNTRY corporation that is disregarded for US federal income tax purposes.

COMPANY1 sold its partnership equity interest, in COMPANY2, for a gain in 20XX.

COMPANY2 owned 99% of COMPANY3, which is a COUNTRY entity treated as a partnership for both COUNTRY and US tax purposes.

Since COMPANY2 is a disregarded entity, for US federal tax purposes, the transaction is treated as if COMPANY1 sold its interest in COMPANY3.

COMPANY1 has historically filed an Illinois Form 1065.

COMPANY1 is treated as a partnership for US tax purposes.

COMPANY1 does not have any employees.

COMPANY4 is an S corporation with one 100% shareholder, Mr. Y.

COMPANY4 had two employees, Mr. Y and an administrative assistant ("ASSISTANT").

Mr. Y, a STATE2 Resident, is the Chairman of the Board of Managers, Chief Executive Officer and Tax Matters partner of COMPANY1, as well as the 100% shareholder of COMPANY4.

COMPANY1 maintains a mailing address in CITY1, Illinois for administrative ease. The books and records are kept at this location.

COMPANY1's mailing address is the same as COMPANY4's office, and is located in CITY1, Illinois.

COMPANY1 does not conduct business operations from the CITY1, Illinois mailing address location.

The building where COMPANY4 had an office was sold in 20XX and COMPANY4's lease was terminated. COMPANY4 obtained temporary space in CITY1, Illinois for the ASSISTANT to perform her work responsibilities.

COMPANY3's principal business activity is plastic model kit manufacturing, sales and distribution.

All of COMPANY3's assets and business operations are located outside the United States. Substantially all of COMPANY3's assets and business operations are located in COUNTRY.

COMPANY3 has no employees located in the United States.

COMPANY3 sells and ships a small amount of products (approximately 1% of total sales) to COMPANY5, a company located in CITY2, Illinois. COMPANY3 does no other business with Illinois businesses.

COMPANY1 and COMPANY3 are not members of a unitary business group because more than 80% of COMPANY3's business activity is outside of the United States.

COMPANY1 has no other income, for federal tax purposes, other than the gain related to the sale of COMPANY3.

However, for legal purposes, COMPANY1 has interest income resulting from loans to a related entity.

Mr. Y's first meeting with the buyer of COMPANY3 was in STATE2.

COMPANY4 was paid a success based fee for Mr. Y's negotiation of the sale of COMPANY3 by COMPANY1.

Mr. Y receives a STATE2 W-2 from COMPANY4. In 20XX, his salary was approximately $X.

The ASSISTANT receives an Illinois W-2 from COMPANY4. In 20XX, her salary was approximately $X.

The member interests in COMPANY1 are held by foreign and domestic members. Approximately 51% of the members are foreign.

The majority of the members of COMPANY1 are individuals. There are a few partnership members, two trust members, and an IRA member.

Mr. Z, an Illinois resident, is the Secretary of COMPANY1 and a member of the Board of Managers.

Mr. Y as the Chairman of the Board of Managers of COMPANY1 has the power to contractually bind COMPANY1 to a sale, with the approval of the Board of Mangers.

COMPANY1's investment decisions are conducted by Mr. Y from his resident state of STATE2.

COMPANY1 has an annual meeting with its members, which occurs in COUNTRY.

The precursory negotiations of business decisions related to the sale of COMPANY3 were performed by Mr. Y.

The precursory negotiations of COMPANY3 were held by Mr. Y in STATE2 via telephone or in-person meetings with the buyer.

Once a preliminary sale agreement was reached for COMPANY3, and approved by the Board of Managers, the letter of intent was drafted and due diligence began.

The letter of intent was drafted by COMPANY6, a third party law firm, and was developed and written in the United States.

The initial structuring of the deal was performed by COMPANY7 in CITY1 and COMPANY8 in COUNTRY, both third party consulting firms.

The due diligence was completed almost exclusively on site at COMPANY3 in COUNTRY by COMPANY3's employees over a six month period.

Approximately 95% of COMPANY1's due diligence was performed by COMPANY3's senior employees and executives, as well as two additional fully dedicated employees, all of whom were tasked with the job of gathering and preparing the necessary documentation for the buyer's representatives to complete their due diligence.

Following the completion of the due diligence, the drafting of legal documents and the associated tax structuring was completed by third party contractors.

From a cost and time perspective, the due diligence related to this occurred almost exclusively in COUNTRY.

Mr. Y and Mr. Z, as well as other members of the Board of Managers, were in COUNTRY during the time frame the sale closed.

Guidance Requested

1. The taxpayer, COMPANY1, is seeking guidance on treatment of the gain recognized on the sale of COMPANY3 with regards to the numerator of COMPANY1's apportionment factor since it is an occasional sale of assets used in the regular course of business.

2. In the alternative, the taxpayer, COMPANY1, is seeking guidance on treatment of the gain recognized on the sale of COMPANY3 with regards to the numerator of COMPANY1's apportionment factor since the greater proportion of the costs of performance were incurred outside of the State of Illinois.

3. The taxpayer, COMPANY1, has a zero Illinois apportionment factor since it has no income besides the gain on the occasional sale.

4. The taxpayer, COMPANY1, has no replacement tax liability.

5. Finally, the taxpayer, COMPANY1, is seeking guidance confirming that the nonresident individual partners of COMPANY1 do not have Illinois source income as a result of the sale.

Analysis

Illinois regulations provide that "when gross receipts arise from the incidental or occasional sale of assets used in the regular course of a person's trade or business, such gross receipts shall be excluded from the sales factor." [86 Ill. Adm. Code 100.3380(c)(2)] COMPANY1 has made the business income election. COMPANY1 is in the business of investing in other entities, in the instant case COMPANY3, and is not regularly in the business of buying and selling entities. COMPANY1 has gain from the sale of COMPANY3. COMPANY3 operates almost exclusively outside of the United States, and as a result there is no unitary relationship between COMPANY1 and COMPANY3. Since the companies are not a unitary business group, pass through income of COMPANY3 is apportioned at the pass-through entity level and is excluded from the income of the owner, COMPANY1. Therefore, this sale of an investment entity by COMPANY1 was an "incidental or occasional sale" pursuant to the regulations, and the gross receipts recognized from the sale should be excluded from the sales factor of COMPANY1.

Furthermore, the only income on the books of COMPANY1 is interest income from payments received on inter-company loans. Even though COMPANY1 receives these payments of interest on loans to a related entity, from a federal taxation standpoint it has no income because the interest payments are from a related entity, which is disregarded. Therefore, since COMPANY1 has no income besides the gain on the occasional sale, it has a zero Illinois apportionment factor.

Alternatively, Illinois statutes provide that sales of intangible assets, such as a partnership interest, are in this State 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. [35 ILCS 5/304(a)(3)(C-5)(iii)(b)] The income from the sale of this partnership interest is apportionable business income pursuant to Illinois statutory code, which provides, "Business income means all income that may be treated as apportionable business income under the Constitution of the United States…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.” [35 ILCS 5/1501(a)(1)] The taxpayers have elected to treat this income as apportionable business income.

In the situation outlined above, the larger portion of the costs of performance associated with the income producing activity, in this case the sale of COMPANY3, a partnership interest, were incurred outside of the State of Illinois. Consequently, the gross receipts received from the sale of COMPANY3 are not attributable to Illinois, and should be excluded from the numerator of the sales factor when determining the apportionment formula.

The term “costs of performance” means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the person. [86 Ill. Adm. Code 100.3370(c)(3)(B)]. For the purposes of Illinois apportionment formulas, the costs of performance do not include the costs of third-party independent contractors. Amounts paid to third-party attorneys, accountants, and other professional services firms are not included in the calculation to determine where the greater proportion of costs was incurred. Therefore, the analysis rests solely on where the costs of performance incurred by COMPANY1 were incurred.

The cost of performance incurred by COMPANY1 in relation to the sale of COMPANY3 was a success based fee. The success based fee was paid for Mr. Y’s negotiation of the sale of COMPANY3. Mr. Y as COMPANY1’s Chairman of the Board of Managers and Chief Executive Officer had the power to bind COMPANY1 to a sale, which he did. The success based fee was paid to COMPANY4 because the sale was negotiated by Mr. Y, who was also COMPANY4’s 100% shareholder. Mr. Y negotiated the sale of COMPANY3 from his resident state of STATE2.

The due diligence costs associated with the sale of COMPANY3 were paid by COMPANY3. The internal due diligence work was performed by senior employees of COMPANY3 and occurred in COUNTRY.

Consequently, it is clear that the greater proportion of costs of performance of the income producing activity related to the sale of COMPANY3 were incurred outside of the State of Illinois. The gross receipts received from the income producing activity, the sale of COMPANY3, should be excluded from the numerator of the apportionment formula of COMPANY1.

Ruling Requested

We respectfully request that the Illinois Department of Revenue issue a private letter ruling confirming the following conclusion:

1. The sale by COMPANY1 of the ownership interest in COMPANY3 is an occasional or incidental sale, and as a result, the gross receipts recognized should be excluded from the sales factor of COMPANY1.

2. In the alternative, the greater proportion of the costs of performance related to the income-producing activity in the instant case occurred outside of Illinois, and therefore COMPANY1 who recognized gains from the sale of COMPANY3 should not include the gain from the sale of COMPANY3 in the numerator of their sales factor apportionment calculation when determining Illinois income tax liability.

3. COMPANY1 has a zero Illinois apportionment factor since it has no income besides the gain on the occasional sale.

4. COMPANY1 has no replacement tax liability.

5. Furthermore, the nonresident individuals of COMPANY1 do not have any Illinois source income from this transaction.

In addition, pursuant to the Department's request, you have provided the following additional information:

> [T]here is no audit or litigation pending with the Department. 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. Further, neither the taxpayer nor any representative previously submitted the same or a similar issue to the Department but withdrew it before a letter ruling was issued. To the best of the knowledge of both the taxpayer and the taxpayer's representative, we are not aware of any authorities contrary to the taxpayer's views or unable to locate such authority that is contrary to the taxpayer's views. Please redact all names.

DEPARTMENT RULING:

IITA Section 301(c)(1) states:

> Any item of income or deduction which was taken into account in the computation of base income for the taxable year by any person other than a resident and which is referred to in Section 302, 303 or 304 (relating to compensation, nonbusiness income and business income, respectively) shall be allocated to this State only to the extent provided by such section.

In the instant case, you have indicated that COMPANY1 made the election under IITA Section 1501(a)(1) to treat all of its income as business income. IITA Section 304(a) provides the manner for allocating business income:

> The business income of a person other than a resident shall be allocated to this State if such person's business income is derived solely from this State. If a person other than a resident derives business income from this State and one or more other states, then, for tax years ending on or before December 30, 1998, and except as otherwise provided by this Section, such person's business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the sum of the property factor (if any), the payroll factor (if any) and 200% of the sales factor (if any), and the denominator of which is 4 reduced by the

> number of factors other than the sales factor which have a denominator of zero and by an additional 2 if the sales factor has a denominator of zero. For tax years ending on or after December 31, 1998, and except as otherwise provided by this Section, persons other than residents who derive business income from this State and one or more other states shall compute their apportionment factor by weighting their property, payroll, and sales factors as provided in subsection (h) of this Section.

Under IITA Section 304(h), for taxable years ending on and after December 31, 2000, the apportionment factor for taxpayers apportioning business income under Section 304(a) is equal to the sales factor. The sales factor is defined under Section 304(a)(3)(A) as follows:

> The sales factor is a fraction, the numerator of which is the total sales of the person in this State during the taxable year, and the denominator of which is the total sales of the person everywhere during the taxable year.

The term "sales" is defined under IITA Section 1501(a)(21) to mean all gross receipts of the taxpayer not allocated under Sections 301, 302 and 303. However, Department Regulations Section 100.3380(c)(2) provides the following special rule in respect to the sales factor:

> 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 purpose of this rule is to exclude from the sales factor, sales that are not representative of the ordinary or typical manner in which a taxpayer generates gross income. In this case, you have stated that COMPANY1's only business activity is the investment in corporations or partnerships, but that it is not in the business of buying and selling entities and has not purchased or sold any other entities over the past three years. It is not clear from these statements that the sale of COMPANY3 qualifies as an incidental or occasional sale. Although the sale may have been the only sale transaction over a 3 year period, that fact alone does not necessarily establish that the sale does not reflect an ordinary or typical manner in which COMPANY1 generates gross income. At the same time, you indicate that COMPANY1's only business activity is the investment in corporations and partnerships. Therefore, it cannot be concluded, based on the information you have provided, that gross receipts from the sale of COMPANY3 should be excluded from the sales factor under Regulations Section 100.3380(c)(2).

IITA Section 304(a)(3)(C-5)(iii) provides that an item of interest, net gains, and other items of income from intangible personal property are included in the numerator of the sales factor 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. …; or
>
> (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.

Department Regulations Section 100.3370(c)(3)(A) defines the term “income-producing activity” as follows:

> The term “income-producing activity” applies to each separate item of income and means the transactions and activity directly engaged in by the person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a person, such as those conducted on its behalf by an independent contractor. The mere holding of intangible personal property is not, of itself, an income producing activity. Accordingly, the income producing activity includes but is not limited to the following:
>
> (i) The rendering of personal services by employees or the utilization of tangible and intangible property by the person in performing the service.
>
> (ii) The sale, rental, leasing, licensing or other use of real property.
>
> (iii) The rental, leasing, licensing or other use of tangible personal property.
>
> (iv) The sale, licensing or other use of intangible personal property.

In this case, you have not identified any income-producing activity attributable to the investment and sale of COMPANY3 that has occurred in Illinois. Mr. Y’s negotiation of the transaction appears to have been undertaken in Mr. Y’s capacity as an employee of COMPANY4. COMPANY4 was paid a success-based fee for negotiating the sale. Therefore, provided that COMPANY4 and COMPANY1 do not constitute a unitary business group, Mr. Y’s negotiation of the sale would be considered an activity performed by an independent contractor on behalf of COMPANY1, rather than an income-producing activity of COMPANY1. Similarly, due diligence and transaction structuring activities were performed by third-party independent contractors. These activities also are not considered income-producing activities of COMPANY1. Finally, it appears from the information provided that the sale transaction closed in COUNTRY. Accordingly, assuming no additional income-producing activities, gross receipts from the sale of COMPANY3 would not be included in the numerator of COMPANY1’s sales factor.

You have indicated that the gain on the sale of COMPANY3 is COMPANY1’s only item of income for the tax year that includes the sale. If so, then COMPANY1’s apportionment factor is 0%, and it would not apportion any business income to Illinois for such year. The Department cannot issue a ruling that COMPANY1 has no replacement tax liability for the taxable year. Such a determination can only be made in the context of an audit.

IITA Section 305(a) provides the manner in which nonresident partners apportion their distributive shares of partnership business income.

> The respective shares of partners other than residents in so much of the business income of the partnership as is allocated or apportioned to this State in the possession of the partnership shall be taken into account by such partners pro rata in accordance with their respective distributive shares of such partnership income for the partnership’s taxable year and allocated to this State.

Department Regulations Section 100.3015 provides the following rule in regards to the business income election:

> In the case of a partnership, estate, trust or Subchapter S corporation, for purposes of IITA Section 305, 307 or 308, respectively, an election made by the pass-through entity to treat all of its income as business income shall be binding on its partners, beneficiaries and shareholders. An election by a partner, beneficiary or shareholder to treat all income as business income shall cause all nonbusiness income received by that partner, beneficiary or shareholder from the pass-through entity to be treated as business income received directly by the partner, beneficiary or shareholder.

In this case, COMPANY1 has made the election to treat all of its income as business income. Under Regulations Section 100.3015, that election is binding on the partners. Under IITA Section 305(a), nonresident partners must include in their Illinois net income their distributive share of the business income of the partnership apportioned to Illinois in the hands of the partnership. Assuming the facts you provided are true, since none of COMPANY1's business income is apportioned to Illinois, none of the distributive share income of nonresident partners from COMPANY1 will be taxable in Illinois.

This ruling shall only bind the Department for the taxable year of COMPANY1 that includes the sale of COMPANY3. 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