IT 12-0012-GIL 05/15/2012 CREDITS – ENTERPRISE ZONE INVESTMENT CREDIT

General Information Letter: Deemed contribution of property on which an enterprise zone investment credit has been claimed to another taxpayer when sale of an interest in a disregarded entity that made the investment requires the separate existence of the entity to be recognized is an event requiring recapture of the credit.

May 15, 2012

Dear:

This is in response to your letter received March 5, 2012 regarding the Illinois investment credit. The nature of your letter and the information provided require that we respond with a General Information Letter (GIL). A GIL 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 accessed from the Department's web site at www.ILtax.com.

Your letter states as follows:

> We are writing to request a General Information Letter regarding the Illinois Investment Credit under 35 ILCS 5/201(f)(6) for property placed into service within an Enterprise Zone during calendar year 2009 and more fully described below.
>
> Statement of Facts
>
> The specific facts on which this ruling is based are stated below.
>
> 1. LLC1 is a limited liability company with operations located in an Enterprise Zone in COUNTY, Illinois.
> 2. LLC1 was created for the purpose of constructing and operating a large scale wind farm to produce electricity.
> 3. Prior to December of 2009, LLC1 was a single member limited liability company wholly owned by LLC2.
> 4. LLC2 is treated as a partnership for Federal and Illinois income tax purposes for all periods.
> 5. Prior to December 2009 LLC1 was disregarded for Federal and Illinois income tax purposes.
> 6. In October of 2009, LLC1 placed "qualified property" as defined in 35 ILCS 5/201(f)(2) into service within an enterprise zone located in COUNTY, Illinois.
> 7. The qualified property was "placed in service" within the meaning of 35 ILCS 5/201(f)(5).
> 8. LLC2 as deemed owner of the qualified property was eligible for an Enterprise Zone Investment tax credit.
> 9. In December of 2009, after LLC1 placed the qualified property in service within an Enterprise Zone, LLC2 sold an 88% interest in LLC1 to an unrelated party.
> 10. Upon the sale of the LLC1 interest to the unrelated party LLC1 was recognized as a partnership for federal and Illinois income tax purposes.
> 11. LLC2 was deemed to have contributed the qualified property to LLC1 upon the sale of the LLC1 interest to outside investors.
> 12. LLC1 continues to operate its business and owns and uses the assets in the Enterprise Zone.
> 13. LLC2 maintains a 12% ownership interest in LLC1.
>
> Ruling Request

We respectfully request a ruling under 2 Ill. Adm. Code 1200.110 as follows:

Does the change in the federal and Illinois income tax status of a previously disregarded entity, under the facts described, constitute a disposition of qualified property and subject a taxpayer to an investment tax credit recapture under 35 ILCS 5/201(f)(6)?

Conclusion

In the absence of Illinois regulation and authoritative case law on this subject, the Internal Revenue Code is the appropriate authority. The recognition of a previously disregarded entity for federal and Illinois income tax purposes does not constitute a disposition of qualified property provided the property is retained in use in the Enterprise Zone by the recognized entity and the former sole owner retains a substantial investment in the recognized entity.

Analysis

Qualified Investment Property

35 ILCS 5/201(f)(1) provides that a taxpayer shall be allowed a credit against tax imposed by subsections (a) and (b) for "investment in qualified property which is placed in service in an enterprise zone pursuant to the Illinois Enterprise Zone Act." Qualified property is defined under 35 ILCS 5/201(f)(2) as property which:

> (A) is tangible, whether new or used, including buildings and structural components of buildings;
> (B) is depreciable pursuant to section 167 of the Internal Revenue Code, except that "3-year property" as defined in Section 168(c)(2)(A) of that code is not eligible for the credit provided by this subsection (f);
> (C) is acquired by purchase as defined in Section 179(d) of the Internal Revenue Code;
> (D) is used in the Enterprise Zone or River Edge Redevelopment Zone by the taxpayer; and
> (E) has not been previously used in Illinois in such a manner and by such a person as would qualify for the credit provided by this subsection (f) or subsection (e).

35 ILCS 5/201(f)(6) provides that if "during any taxable year, any property ceases to be qualified property in the hands of *the taxpayer* (emphasis added) within 48 months after being placed in service, the tax imposed under subsections (a) and (b) shall be increased."

However, the statute is silent with respect to the application of this provision when the historical owner of the assets and the operator of the business is unchanged but whose status changes for federal and Illinois income tax purposes.

The Illinois Income Tax Act provides guidance in the absence of regulation and authoritative case law. 35 ILLS 5/102 states that "Except as otherwise expressly provided or clearly appearing from the context, any term used in this Act shall have the same meaning as when used in comparable context in the United States Internal Revenue Code of 1954 or any successor law or laws relating to federal income taxes and other provisions of the statutes of the Unites States relating to federal income taxes as such Code, laws and statutes are in effect for the taxable year."

Section 50 of the Internal Revenue Code provides guidance with respect to transfer of qualified investment property and credit recapture. IRC Sec. 50(a)(1)(A) states that if "during any taxable year, investment credit property is disposed of, or otherwise ceases to be investment credit property with respect to the taxpayer, before the close of the recapture period, then the tax under this chapter for such taxable year shall be increased by the recapture percentage of the aggregate decrease in the credits allowed…" This recapture provision is similar to the recapture language contained in 35 ILCS 5/201(f)(6).

However, IRC Sec. 50(a)(4)(B) states that "property shall not be treated as ceasing to be investment credit property with respect *to the taxpayer* (emphasis added) by reason of a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as investment credit property and the taxpayer retains a substantial interest in such trade or business."

LLC1 is one of several entities owned and operated by LLC2 to operate large scale alternative energy projects with financing from outside investors. LLC2 has a track record of developing alternative energy projects in conjunction with outside investors. It is often the case that the outside investors require evidence that the project is operational and producing electricity before they invest in the project. It was thus necessary that the qualified property was placed in service by LLC1 in such a manner that it qualified for the investment tax credit prior to the investment by the outside investors. The investment occurred a few days after the project was operational. Because LLC1 is disregarded for federal and Illinois income tax purposes LLC2 is deemed to have placed the qualified property in service and earned the investment tax credit.

Upon the purchase of a portion of LLC1 interest from LLC2, LLC1 became regarded as a partnership for federal and Illinois income tax purposes. After LLC1 became regarded as a partnership LLC1 continued to utilize the property at the same location and in the same manner. LLC1 continued to operate its historical business. LLC2 continues to manage and direct the operations of LLC1. While the purchase of the LLC1 interest caused LLC1 to become a recognized partnership the substance of the transaction is that the outside investors replaced start-up financing in place by LLC2 during the construction phase of the project.

The Enterprise Zone investment credit was enacted with the hope and intent that it would encourage investment in qualified property within the zone. LLC2 was at all times the manager of LLC1 and was responsible for the design, construction and completion of the investment in the Enterprise Zone. The Federal income tax fiction caused by the admission of the new partner should not constitute a disposition of qualified property by LLC2. The transfer of interest to Outside Investors was effectively a mere change in the form of conducting the trade or business of LLC2 and served primarily as permanent financing. Under Federal law, the enterprise zone credit property would remain qualified and not subject to recapture.

LLC2 respectfully requests that the Illinois Department of Revenue rule on whether the Internal Revenue Code should govern here as well. In the absence of Illinois guidance and under 35 ILCS 5/102, we believe that it should.

Supporting Authority

35 ILCS 5/102

"Except as otherwise expressly provided or clearly appearing from the context, any term used in this Act shall have the same meaning as when used in comparable context in the United States Internal Revenue Code of 1954 or any successor law or laws relating to federal income taxes and other provisions of the statutes of the United States relating to federal income taxes as such Code, laws and statutes are in effect for the taxable year."

IRC Sec. 50(a)(4)(B)

"Property shall not be treated as ceasing to be investment credit property with respect to the taxpayer by reason of a mere change in the form of conducting the trade or business so long as the property is retained in such trade or business as investment credit property and the taxpayer retains a substantial interest in such trade or business."

IRS Rev. Rul. 99-5

The IRS provided guidance regarding the federal income tax consequences when a single member domestic limited liability company that is disregarded for federal tax purposes becomes an entity with more than owner that is regarded for federal tax purposes. The ruling provides examples involving an LLC with a single owner, A, that is disregarded as an entity separate from its owner for federal tax purposes under section 301.7701-3. Below is an example from the revenue ruling:

"Situation 2. In this situation, the LLC is converted from an entity that is disregarded as an entity separate from its owner to a partnership when a new member, B, contributes cash to the LLC. B's contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest."

Contradicting Authority

To the best of our knowledge, there exists no contradicting authority.

Taxpayer Representation

LLC1 and LLC2 are represented in making this ruling request by COMPANY, LLP. A power of attorney appointing Mr. Z of COMPANY, LLP for purposes of pursuing this ruling has been attached.

To the best of LLC1, LLC2 and its representative's knowledge, the Department has not previously ruled on the same or similar issue and LLC1, LLC2 nor its representatives have previously submitted the same or similar issue to the Department.

RULING

Section 201(a) of the Illinois Income Tax Act ("IITA"; 35 ILCS 5/201) imposes a tax measured by net income on every individual, corporation, trust and estate on the privilege of earning or receiving income in or as a resident of Illinois. In addition, IITA Section 201(c) imposes the Personal Property Tax Replacement Income Tax measured by net income on every corporation (include Subchapter S corporation), partnership, and trust.

Section 1501(a)(24) of the IITA defines the term "taxpayer" to mean "any person subject to the tax imposed by this Act." IITA Section 1501(a)(18) defines the term "person" to include an individual, a trust, estate, partnership, association, firm, company, corporation, limited liability company, or fiduciary. Therefore, as used in the IITA, the term "taxpayer" includes a corporation, partnership, or limited liability company that is subject to income tax under IITA Section 201.

IITA Section 201(f)(1) allows a taxpayer a credit against the tax imposed under Section 201(a) equal to .5% of the basis of qualified property which is placed in service by the taxpayer in an Enterprise Zone created pursuant to the Illinois Enterprise Zone Act. Section 201(f)(5) sets forth circumstances in which that credit must be recaptured as additional tax:

> If during any taxable year, any property ceases to be qualified property in the hands of the taxpayer within 48 months after being placed in service, or the situs of any qualified property is moved outside the Enterprise Zone or River Edge Redevelopment Zone within 48 months after being placed in service, the tax imposed under subsections (a) and (b) of this Section for such taxable year shall be increased. Such increase shall be determined by (i) recomputing the investment credit which would have been allowed for the year in which credit for such property was originally allowed by eliminating such property from such computation, and (ii) subtracting such recomputed credit from the amount of credit previously allowed. For purposes of this paragraph (6), a reduction of the basis of qualified property resulting from a redetermination of the purchase price shall be deemed a disposition of qualified property to the extent of such reduction.

Under Department Regulations Section 100.9750, the entity classification rules under federal Treasury Regulations Section 301.7701 apply for Illinois income tax purposes. Accordingly, Department Regulations Section 100.9750(b) defines the term "corporation" as follows:

> 1) [A]ny entity treated as a corporation for federal income tax purposes must be treated as a corporation for all purposes of the IITA, and no entity (other than a cooperative) that is not treated as a corporation for federal income tax purposes may be treated as a corporation for purposes of the IITA. Thus, any entity electing to be taxed as a corporation under 26 CFR 301.7701(a) is a corporation for all purposes of the IITA, and any entity that elects not to be treated as a corporation separate and distinct from its owners is not a corporation separate and distinct from its owners. For example:
>
> > (A) An entity that has elected to be disregarded as an entity separate from its corporate owner for any federal income tax purposes pursuant to 26 CFR 301.7701-3(a) and its corporate owner are a single corporation for the equivalent purpose of the IITA.
> > ….
>
> 2) An entity that, despite its uninterrupted existence, is treated as a new corporation for purposes of the Internal Revenue Code shall also be treated as a new corporation separate

and distinct from its deemed predecessor, for all purposes of the IITA. For example:

A) An entity that has elected to be disregarded as an entity separate from its corporate owner for any federal income tax purpose pursuant to 26 CFR 301.7701-3(a), and subsequently elects to be taxed as a corporation, is treated under 26 CFR 301.7701-3(g)(1)(iv) as a new corporation to which the assets of the entity were transferred by the corporate owner in exchange for the stock of the new corporation. Accordingly, prior to the date of the subsequent election, the entity and its corporate owner are a single corporation for the equivalent purpose of the IITA, while after that election the two entities will be separate corporations.

B) A corporation that is treated as two separate corporations (as a corporation that has sold all of its assets and as a new corporation that has purchased all of the assets) pursuant to 26 USC 338 is similarly treated as two separate corporations, one in existence before the 26 USC 338 transaction and one in existence subsequent to the transaction, for all purposes of the IITA.

Likewise, Department Regulations Section 100.9750(d) defines the term “partnership” by reference to the entity’s federal classification:

1) [E]very entity treated as a partnership for federal income tax purposes is a partnership for purposes of the IITA. For example,

A) An entity that elects to be treated as a partnership for federal income tax purposes under 26 CFR 301.7701(a) is a partnership for purposes of the IITA.

Your letter indicates that as the result of the sale by LLC2 of an 88% interest in LLC1, an entity previously disregarded for federal income tax purposes, LLC1 became a new partnership for federal income tax purposes. Therefore, under Department Regulations Section 100.9750(d), LLC1 became a new partnership for purposes of the IITA.

Your letter references Revenue Ruling 99-5, 1999-6 I.R.B. Situation 2, as describing the federal tax consequences that attend the conversion of an LLC from an entity that is disregarded as an entity separate from its owner to a partnership. The Ruling states, in part:

Situation 2. In this situation, the LLC is converted from an entity that is disregarded as an entity separate from its owner to a partnership when a new member, B, contributes cash to the LLC. B’s contribution is treated as a contribution to a partnership in exchange for an ownership interest in the partnership. A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.

Under § 721(a), no gain or loss is recognized by A or B as a result of the conversion of the disregarded entity to a partnership.

Under § 722, B’s basis in the partnership interest is equal to $10,000, the amount of cash contributed to the partnership. A’s basis in the partnership interest is equal to A’s basis in the assets of the LLC which A was treated as contributing to the newly created partnership.

Applying Revenue Ruling 99-5 to the facts in this case, LLC2 is deemed to have contributed the qualified property to LLC1, a new partnership. This deemed contribution clearly implicates the recapture language of IITA Section 201(f)(5). Upon the deemed transfer, the qualified property ceases to be qualified property *in the hands of the taxpayer*, here LLC2, because the property comes into the hands of a different taxpayer, namely, LLC1.

Your letter indicates that Section 50(a)(1)(A) of the Internal Revenue Code, relating to the federal investment credit, contains similar recapture language as IITA Section 201(f)(5). IRC Section 50(a)(1)(A) states:

> If during any taxable year, investment credit property is disposed of, or otherwise ceases to be investment credit property with respect to the taxpayer, before the close of the recapture period, then the tax under this chapter for such taxable year shall be increased by the recapture percentage of the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from reducing to zero any credit determined under this subpart with respect to such property.

You letter also indicates that IRC Section 50(a)(4) contains an additional rule that states that for purposes of the recapture provision of (a)(1)(A) property shall not be treated as ceasing to be investment credit property with respect to a taxpayer where there is a mere change in the form of conducting the trade or business. Treasury Regulations Section 1.47-3(f) set forth the conditions necessary for Section 50(a)(4) to apply:

> (1) General rule. (i) Notwithstanding the provisions of § 1.47-2 relating to “disposition” and “cessation”, paragraph (a) of § 1.47-1 shall not apply to section 38 property which is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing the taxpayer’s qualified investment, by reason of a mere change in the form of conducting the trade or business in which such section 38 property is used provided that the conditions set forth in subdivision (ii) of this subparagraph are satisfied.
> (ii) The conditions referred to in subdivision (i) of this subparagraph are as follows:
> (a) The section 38 property described in subdivision (i) of this subparagraph is retained as section 38 property in the same trade or business,
> (b) The transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) of such section 38 property retains a substantial interest in such trade or business,
> (c) Substantially all the assets (whether or not section 38 property) necessary to operate such trade or business are transferred to the transferee to whom such section 38 property is transferred, and
> (d) the basis of such section 38 property in the hands of the transferee is determined in whole or in part by reference to the basis of section 38 property in the hands of the transferor.

Your letter indicates that, for federal income tax purposes, the deemed transfer of qualified property from LLC2 to LLC1 would fall within the provisions of IRC Section 50(a)(4) and Treas. Reg. § 1.47-3(f) as a mere change in the form of conducting the trade or business. You assert that under IITA Section 102, the use of the term “taxpayer” in both IITA Section 201(f)(5) and IRC Section 50(a) means that the provisions of IRC Section 50(a)(4) should apply the same for Illinois income tax purposes, with the result that Illinois recapture would not apply to a mere change in form under Treas.

Reg. § 1.47-3(f).

However, the rule in IRC Section 50(a)(4) is not an application of the term “taxpayer.” Instead, as the Treasury regulations referenced above indicate, the rule is an exception to the consequences of a “disposition” or “cessation” as otherwise causing recapture of the federal investment credit. Although IITA Section 201(f)(5) contains both the terms “disposition” and “ceases,” this does not mean that the rule in IRC Section 50(a)(4) applies to the Illinois investment credit. As you indicate, the general recapture language in IITA Section 201(f)(5) is very similar to the recapture language in IRC Section 50(a)(1)(A). However, IITA Section 201(f)(5) contains no similar language as in IRC Section 50(a)(4). Moreover, IRC Section 50(a)(4) is not a definitional provision, but an exception to recapture for certain types of dispositions or cessations that may be considered a mere change in form. This is evident from the language in Treas. Reg. § 1.47-3(f)(1), which states, “the provisions of § 1.47-2 relating to “disposition” and “cessation”, paragraph (a) of § 1.47-1 shall not apply to section 38 property which is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer … by reason of a mere change in the form of conducting the trade or business in which such section 38 property is used.” IITA Section 102 incorporates certain federal definitions, but it does not incorporate IRC rules that do not appear in the provisions of the IITA itself.

Accordingly, under the facts you describe, the recapture provisions of IITA Section 210(f)(5) apply.

As stated above, this is a GIL. A GIL does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department.

Sincerely,

Brian L. Stocker
Associate Counsel (Income Tax)