

General Information Letter: Petition to use separate accounting cannot be granted merely because separate accounting reaches a different tax liability than the statutory apportionment method.

August 17, 2012

Dear:

This is in response to your letter dated January 20, 2011 which has been forwarded to me for a response. In your letter you request permission to use an alternative method of apportionment, rather than the statutorily-mandated apportionment formula pursuant to Section 304(f) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *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.Admin.Code 1200.120(b) and (c), which may be found on the Department's web site at [www.revenue.state.il.us](http://www.revenue.state.il.us). For the reasons discussed below, your petition cannot be granted at this time.

Your letter states as follows:

The following entities, which constitute a unitary group, hereby petition for alternative apportionment under Ill. Admin. Code 86 Section 100.3390(a)(4) (IITA Section 304(f)).

COMPANY1, LP (EIN X)  
COMPANY2 (EIN X)  
COMPANY3, Inc. (EIN X)  
COMPANY4 (EIN X)

*Ruling Requested*

The above entities request alternative apportionment under Ill. Admin. Code 86 Section 100.3390(a)(4) (IITA Section 304(f)). Specifically, the entities request that they be permitted to apply the sales factors from its BUSINESS1 operations to the income generated from its BUSINESS1 operations while applying the sales factors from its BUSINESS2 operations to the income generated from its BUSINESS2 operations.

*Statement of Facts*

COMPANY1 is a limited partnership which is owned 100% in total by three S corporations. COMPANY2 and COMPANY3 are the limited partners while COMPANY4 is the general partner. All four entities are headquartered in CITY1, Illinois. All four entities report their income on a calendar year.

COMPANY1 is the operating entity, while COMPANY3 and COMPANY4 are holding companies whose only assets consist of the interest in COMPANY1 plus operating cash. COMPANY2's major asset is its interest in COMPANY1, but it does own a PROPERTY in CITY2, STATE. The operations of COMPANY1 consist of BUSINESS2 operations as well as BUSINESS1 holdings. The BUSINESS1 holdings consist of X OF BUSINESS1, primarily in CITY2, STATE. Mr. Z (SSN: X), an Illinois resident, owns 100% of COMPANY2, COMPANY3 and COMPANY4. The four entities are considered

a unitary business group under ILCS Chapter 35 Section 5/1501(a)(27) and Ill. Admin. Code 86 Section 100.3010(b). As a result, the apportionment factors of the three S corporations are each S corporation's proportionate share of the apportionment factors of COMPANY1. COMPANY2 also adds to these apportionment factors the factors related to its PROPERTY in CITY2, STATE.

The above entities are requesting the private letter ruling under Regulation 1200.110(a)(3)(A)(ii) which permits members of a unitary group to file a request for letter ruling with reference to issues common to it and other members of the unitary group.

This request is being made on behalf of the above entities by the taxpayer's representative. A signed power of attorney is attached pursuant to Regulation 1200.110(a)(1).

COMPANY1 operates two distinct businesses. First, it has a BUSINESS2 which is conducted from two Illinois locations, CITY3 and CITY4. Its administrative offices are located in CITY1, Illinois. Second, COMPANY1 conducts a BUSINESS1 with the majority of the properties located in CITY2, STATE. Its administrative offices are in CITY1, Illinois at the same location as the BUSINESS2 operations.

The BUSINESS2 operations employee [sic] approximately X employees and have an accounting department, a purchasing department, managers, engineers and a labor force. The BUSINESS1 operations employee [sic] approximately X employees and have an accounting department, managers and a labor force. Other functions of each operation such as legal, insurance, advertising and financing are provided by third parties. COMPANY's controller, Mr. Y, oversees each accounting department, which includes the consolidation of the financial information for its audited financial statements as well as tax returns. Mr. Z as CEO oversees both operations.

The sales and income of each business for the calendar years 2007 through 2009 are summarized below:

**2007**

	Sales Everywhere	Illinois Sales	Income (Loss)	Income %
BUSINESS2	X	X	X	39.7%
BUSINESS1	X	X	X	60.3%
Total	X	X	X	100.0%

**2008**

	Sales Everywhere	Illinois Sales	Income (Loss)	Income %
BUSINESS2	X	X	X	73.3%
BUSINESS1	X	X	X	26.7%
Total	X	X	X	100.0%

**2009**

	Sales Everywhere	Illinois Sales	Income (Loss)	Income %
BUSINESS2	X	X	X	0.00%
BUSINESS1	X	X	X	100.0%
Total	X	X	X	100.0%

COMPANY2 and COMPANY3's Illinois income tax returns (Forms IL-1120-ST) were examined for the tax year 2006 by the Illinois Department of Revenue (the Department). At issue was the apportionment of business income. The Department determined that COMPANY1 engaged in a single trade or business while COMPANY2 and COMPANY3 have always been treated as two trades or businesses. After weighing the cost benefits of litigation along with the availability of the amnesty program, COMPANY2 and COMPANY3 decided to pay the proposed deficiency under the amnesty program.

The entities represent under Regulation 1200.110(b)(3) that no returns for the above entities are currently under examination by the Department, nor is any litigation pending on the issues in this ruling request. Further, the tax period for which this request is made is for tax years beginning January 1, 2010.

The entities also represent under Regulation 1200.110 (b)(4) that to the best of the knowledge of both the taxpayers and the taxpayers' representatives the Department has not previously ruled on the same or similar issue for the taxpayers or a predecessor. In addition, neither the taxpayers nor any representatives have previously submitted the same or a similar issue to the Department and withdrew it before a letter ruling was issued.

*Law*

ILCS Chapter 35 Section 5/304(f) provides that if the normal allocation and apportionment methods do not fairly represent the extent of a person's activities in Illinois, the person can petition the Director of Revenue to permit separate accounting or the use of any other method to create an equitable allocation and apportionment of the taxpayer's business income.

Ill. Admin. Code 86 Section 100.3390(a)(c) (IITA Section 304(f)) reads as follows:

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 and accurate alternative method is appropriate.* The party (the Director or the 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 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 evidence and prove that the proposed alternative apportionment method fairly and accurately apportions income to Illinois based upon business activity in this State (Emphasis added).

The Appellate Court of Illinois held in *Miami Corp v. Dept. Rev.* (212 Ill App 3d 702, 156 Ill Dec 820, 571 NE2d 800) that use of the statutory method was inappropriate. It was determined that the taxpayer was entitled to utilize separate accounting. The statutory apportionment formula (the three-factor method) did not fairly represent activities in Illinois with respect to Louisiana oil and gas reserves which generated in excess of 80% of the taxpayer's total income. The court found that the distortion created by the use of the statutory formula amounted to an unfair representation of the taxpayer's activities within Illinois. Part of the court's reasoning was based on the facts that intangibles (sourced to Louisiana) were not included in the property factor and substantial out-of-state independent contractors were not considered in the payroll factor.

### *Analysis*

The entities believe the use of the sales factor to apportion income from all of its operations does not fairly represent the extent of the taxpayers' activities in Illinois. The majority of the BUSINESS2 activities take place in Illinois as the above charts show, while the majority of the BUSINESS1 activity takes place in STATE. For the tax years 2007, 2008 and 2009, use of the sales factor method results in an Illinois apportionment of business income of 77%, 93% and 96%, respectively. However, the percentage of total income generated within Illinois during those years was 40%, 73% and zero, respectively.

This distortion is created by the fact that the BUSINESS2 operations are high-volume, low-margin activities, while the BUSINESS1 operations are low-volume, high-margin activities. The high-volume of the BUSINESS2 operations act to increase the Illinois apportionment factor. This is done without considering that BUSINESS1 operations have traditionally generated more income. The income generated from the BUSINESS1 activities from 2007 through 2009 was \$X. Total income generated from 2007 through 2009 was \$X. This shows that BUSINESS1 operations have accounted for 55% of income for the three year period, while the Illinois apportionment factor was a combined 89% during that same period.

The entities' proposed apportionment method would consist of applying the apportionment factor from its BUSINESS1 operations to the income generated from its BUSINESS1 operations while applying the apportionment factor from its BUSINESS2 operations to the income generated from its BUSINESS2 operations. Applying this apportionment method would have resulted in the following percentages of income being reported to Illinois compared with the statutory single factor method.

	BUSINESS2 %	Sales Factor Method	Proposed Method
2007	39.7%	76.9%	53.9%
2008	73.3%	92.6%	71.1%
2009	0.0%	95.8%	3.3%
Average	37.7%	88.4%	42.7%

See attached Exhibits A (2007), B (2008) and C (2009) which illustrate the proposed method of apportionment as applied to the activities in the three prior years. Those calculations provide the basis for the sales factor and proposed method columns above. The BUSINESS2 income percentage column is based on the tables on page 2 of this petition.

This table shows that the proposed method more accurately reflects the entities' activities in Illinois. During the three year period, the BUSINESS2 income apportioned to Illinois under the sales factor method is more than twice as much as the income which was actually derived from activities within Illinois. On the other hand, the proposed method of apportionment closely reflects the true income generated from activities within Illinois.

The criteria for employing an alternative apportionment method under ILCS Chapter 35 Section 5/304(f) is that the normal allocation and apportionment provisions do not fairly represent the extent of a person's activity. The regulations (Ill. Admin. Code 86 Section 100.3390(a)(c) (IITA Section 304(f)) further emphasize this by stating "if the application of the statutory formula will lead to a grossly distorted result in a particular case, a fair and accurate alternative method is appropriate". The apportionment of the entities' income as determined under the traditional sales factor method grossly distorts the activity within Illinois. Not only does the traditional method result in a distortion, but the proposed method results in a more fair and accurate apportionment of income to Illinois as demonstrated above.

*Miami Corp v. Dept. Rev.* further supports the entities' position. In this case the court found that the corporation's out-of-state activities were not properly represented by the traditional apportionment method (the three-factor formula which was in effect at the time). The oil and gas operations in Louisiana generated most of the corporation's income, but the traditional apportionment method did not reflect this fact.

Given the high-volume, low-margin nature of the entities' BUSINESS2 operations relative to the low-volume, high-margin BUSINESS1 operations, the entities contend the traditional apportionment method does not fairly or accurately represent its activities in Illinois. The taxpayers' proposed method first segregates the income between their two activities. Once this is done, the traditional sales factor method is applied to the income of each activity. Separating the income prevents the distortion caused by the traditional method which results in the taxation of out-of-state income based simply on a volume which is created primarily by the BUSINESS2 operation activity. The differences in the types of businesses would not create this issue if the incomes are separated. The distortion caused by the traditional method is best illustrated in 2009. In this year, the

traditional apportionment method resulted in 96% of the income from all operations being apportioned to Illinois even though the BUSINESS2 operations generated a loss. Clearly, this did not result in a fair and accurate representation of the entities activities in Illinois. The reverse would also be true. If the entities generate a loss on their BUSINESS1 operations, it is likely that the loss apportioned to Illinois would be overstated and not representative of their activities within Illinois.

The entities have determined that there are no authorities contrary to its views. This statement is made pursuant to Regulation 1200.110(b)(6).

### **Department Ruling**

You are correct that Section 304(f) of the Illinois Income Tax Act ("IITA"; 35 ILCS 5/101 et seq.) provides for alternative allocation:

**(f) Alternative allocation.** 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.

You also refer to the Department regulations found in 86 Ill. Adm. Code 100.3390 which describe the requirements of an alternative method of apportionment in greater detail, such as burden of proof:

(c) **Burden of Proof.** ... The party (the Director or the 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 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 evidence and prove that the proposed alternative apportionment method fairly and accurately apportions income to Illinois based upon business activity in this State.

Your final authority is the Illinois Appellate Court decision Miami Corporation v. IDOR, 571 N.E.2d 800 (1<sup>st</sup> Dist. 1991) which allowed the use of alternative apportionment where oil and gas reserves in Louisiana generated more than 80% of taxpayer's income. These reserves were not reflected in the property factor of the statutory three factor apportionment formula because they were "intangibles" resulting in what the court found to be a gross distortion of activities in Illinois. The Miami case is distinguishable from the facts at issue, and distinguishable in a way that requires a different result.

The statutory apportionment formula has since changed from a three factor apportionment formula (property, payroll and sales) to a one factor formula (sales). Unlike Miami, there is no failure of Illinois' current apportionment formula to recognize all elements of "sales" from each corporation of the unitary group (no intangibles and one factor formula). Your letter states the unitary group's offices and work force are located in Illinois which was not the case in Miami.

You provided us with sales and income figures for your proposed apportionment method. However, without more details we cannot grant your request for alternative apportionment. Merely showing a separate accounting statement, without any explanation of why the separate accounting is more accurate than formulary apportionment, is insufficient to meet the burden of proof imposed by that regulation on taxpayers requesting permission to use an alternative method of apportionment. As a unitary business enterprise, there are intercompany transactions that are not reflected in your calculations. Separating companies from their unitary group often creates more distortions due to intercompany pricing issues.

Accordingly, your petition fails to meet the burden of proof required by regulation Section 100.3390(c) with regard to showing distortion or showing that the proposed alternative fairly represents the group's Illinois business activity.

Please note that 86 Ill.Admin.Code Section 100.3390(e)(1) requires a petition to be filed at least 120 days prior to the due date (including extensions) for the first return for which permission is sought to use the alternative apportionment method. Your petition was filed January 20, 2011, and will allow the taxpayer to use the requested method on original returns due on or after May 20, 2011, if ultimately granted.

As stated above, this is a general information letter which does not constitute a statement of policy that either applies, interprets or prescribes tax law. It is not binding on the Department. Should you have additional questions, please do not hesitate to contact our office.

Sincerely,

Heidi Scott  
Associate Counsel -- Income Tax