

IT 14-0004 PLR 6/04/2014 Apportionment – Sales Factor
Method proposed by taxpayer to allocate sales of telecommunications services is reasonable under IITA Section 304(a)(3)(B-5)(vii)(d), and therefore may be used.

June 4, 2014

Re: Request for Private Letter Ruling
COMPANY

Dear Xxxx:

This is in response to your letter dated November 22, 2013, in which you request a Private Letter Ruling on behalf of COMPANY (“COMPANY”). 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 COMPANY. Issuance of this ruling is conditioned upon the understanding that COMPANY and/or any related taxpayer(s) is not currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

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

Pursuant to Administrative Code section 1200.110 and on behalf of our captioned client, which we refer to below as X, we request a private letter ruling with respect to the Illinois corporate income tax. As will be seen from the body of this ruling request, there is no need to identify the particular tax period at issue. We also provide a discussion of authorities with respect to the issue presented for resolution.

Facts

X is a STATE corporation engaged in business as an international telephone company which provides international long-distance voice, data and internet protocol (“IP”) traffic services on a wholesale basis. It is licensed by the Federal Communications Commission as an international facilities-based carrier and resale carrier between the United States (“US”) and other countries. X is not engaged in the business of either intrastate or interstate telecommunications services.

As a wholesale distributor of telecommunications services, X’s business activities include the purchase and resale of: (1) International long-distance voice traffic switching and termination services; (2) Data transmission services; and (3) IP services.

When an end user places an international call from a location in the US to an international location, the local telephone carrier at the point of the call’s origination, directly or indirectly, switches the call to X’s facilities. X’s switching equipment transmits the call outside the US where it is, directly or indirectly, switched to a local telephone carrier to the point of termination. Thus X is an intermediate carrier, a telephone company through whose facilities international calls pass.

X owns or rents switches, cables and other telecommunications equipment through which telecommunications are transmitted. Its telecommunications equipment network consists primarily of points of presence (“POPs”), submarine cable capacity, and links connecting the POPs and the landing stations for the submarine cables. X’s POPs are located in CITY 1 and CITY 2, STATE 1; CITY, STATE 2; CITY, STATE 3; CITY, Illinois; CITY, STATE 4; CITY, STATE 5, CITY, STATE 6; and CITY, STATE 7.

X's main activity from which it earns the majority of its revenue is from its international long-distance voice business. However, X also has an agreement with its NATIONALITY parent company to provide data traffic conveyance services ("DTA" Agreement"). It is the services provided by the DTA Agreement that use the POP equipment located in Illinois and throughout the country.

X recently obtained a new customer, Y, with a business located in Illinois. Y sells prepaid calling cards. Y purchases telecommunications traffic or capacity for its calling card users from X. When a Y customer uses the calling card, Y's switch in Illinois interconnects with X's switch in STATE 4 via a public internet virtual voice over internet protocol ("VOIP") interconnection to transmit the call outside the United States. X has no involvement with the end user of the prepaid card service. Its Illinois equipment has no part in the services provided to Y's customers.

In all types of telecommunications services provided by X, the end user customer does not know whether his call is carried by X or another international provider of telecommunications services.

As X does not deal directly with the end user customers, it has no information as to where in the US the calls originate. It also does not know the billing or service address of US end users. Although it is possible that some calls X carries originate in Illinois, we do not know how many of these calls there are or how much revenue they generate. Although it might be possible to determine the area code of the termination of calls it would be extremely rare for any calls to terminate in Illinois since X's main business is to provide international service for calls that terminate outside the US. We also do not know the service addresses. To the extent that this information is available, it is held by the end users' carriers, not with intermediate international carriers, such as X.

Issue

How should X's gross receipts be apportioned to Illinois?

Discussion

The income of a non-Illinois corporation is sourced to Illinois based upon a single factor, gross receipts. The Illinois General Statutes ("Statute") and Administrative Code ("Code") provide the rules for apportioning the receipts from the sale of telecommunications services ["Service" or "Services" as the context requires].

X is engaged in the business of selling Services for resale. That is, X sells capacity to other telecommunications providers which, in turn, resell the capacity either to other carriers or to end user customers.

The Statute and Code provide specific rules and regulations for the sourcing of receipts to Illinois when accessing a carrier's network or from the sale of Services or ancillary services for resale in the state. These rules contained in Code section 100.3371(h) provide:

- 1) 100% of the receipts from the access fees attributable to intrastate Services that both originate and terminate in Illinois;
- 2) 50% of the receipts from access fees attributable to intrastate service if the interstate call either originates or terminates in Illinois;
- 3) 100% of the receipts from interstate end user access line charges, if the customer's service address is in Illinois;

4) Gross receipts from sales of [Services] or from ancillary services for [Services] sold to other [Service] providers for resale shall be sourced to this State using the apportionment concepts used for non-resale receipts of [Services] if the information is readily available to make that determination. If the information is not readily available, then the taxpayer may use any other reasonable and consistent method.

Since X does not provide intrastate or interstate services, paragraphs 1 through 3, above, do not apply. Instead, since X is engaged in the business of selling Services to other providers for resale, Paragraph 4 provides the proper sourcing rules.

Code section 100.3371(d) and (e) provide the relevant apportionment rules for non-resale receipts of Services with concepts that could apply are as follows:

d) Receipts from the sale of postpaid services at retail are in this State if the origination point of the telecommunications signal, as first identified by the service provider's telecommunication system or as identified by information received by the seller from its service provider if the system used to transport telecommunications signals is not the seller's, is located in this State. ["Paragraph D"].

e) Receipts from the sale of prepaid [Services] or prepaid mobile [Service] at retail are in this State if the purchaser obtains the prepaid card or similar means of conveyance at a location in this State. Receipts from recharging a prepaid [Service] or mobile [Service] [are] in this State if the purchaser's billing information indicates a location in this State. (Emphasis added). ["Paragraph E"].

Applying Paragraph D to X's facts and circumstances, assume another carrier, Z, is the seller of Services and X is its service provider. The sale is sourced to Illinois if the origination point of the signal is in Illinois. Since X's service only involves its switch in STATE 4, it does not have the capacity to identify the signal's origination point and the rules of Paragraph D do not apply.

Applying Paragraph E to X's facts and circumstances, the means of conveyance are not from the Service that X provides in Illinois. The Service X provides with respect to Y's cards is not until the call reaches its switch in STATE 4.

Therefore, since the rules used for non-resale receipts of Services do not apply, X must develop a reasonable and consistent method to source its receipts to Illinois.

We propose two possible methods for sourcing X's receipts to Illinois.

1. Property Method

In the first method, the receipts sourced in Illinois are determined by multiplying its total receipts by a fraction. The numerator is the net book value of X's property located in Illinois. The denominator of the fraction is the net book value of its total property. ("Property Method").

The following example illustrates the application of the Property Method:

For 2012, the net book value of X's total property was approximately \$XX million. The net book value of its Illinois property was approximately \$100,000 or approximately .3% of total property. Therefore, 0.3% of X's taxable income would be apportioned to Illinois. Applying .3% against X's 2012 taxable income of approximately \$5 million would be \$15,000.

2. Revenue Method

In the second method, the receipts sourced in Illinois are determined by multiplying Illinois receipts by another fraction. The numerator of this fraction is the gross revenue attributed to X's property located in Illinois (the income X earns from its DTA Agreement from property located in Illinois). The denominator of the fraction is X's total gross revenue. ("Revenue Method").

The following example illustrates the application of the Revenue Method:

For 2012, the income X earned from its DTA Agreement related to its Illinois equipment was approximately \$300,000. This divided by X's total receipts for 2012 of approximately \$178 million is 0.17%. Therefore 0.17% of X's \$5 million of 2012 taxable income, or approximately \$8,500, would be apportioned to Illinois.

We believe that either the Property Method or the Revenue Method is a reasonable method to apportion X's receipts to Illinois. Either method can be applied consistently.

We request that X be allowed to use either the Revenue Method or the Property Method to apportion its receipts to Illinois.

No audit or litigation is pending between COMPANY and the Department. To the best of the knowledge of COMPANY and the undersigned representatives, the Department has not previously ruled on the same or similar issue for COMPANY or a predecessor, or whether COMPANY or any representatives thereof previously submitted the same or a similar issue to the Department but withdrew it before a letter ruling was issued.

RULING

Section 304(a)(3)(B-5) of the Illinois Income Tax Act ("IITA" 35 ILCS 5/304(a)(3)(B-5)) states:

For taxable years ending on or after December 31, 2008, except as provided in subsections (ii) through (vii), receipts from the sale of telecommunications service or mobile telecommunications service are in this State if the customer's service address is in this State.

Section 304(a)(3)(B-5)(i) defines the terms "telecommunications service" and "service address" as follows:

"Telecommunications service" means the electronic transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals to a point, or between or among points. The term "telecommunications service" includes such transmission, conveyance, or routing in which computer processing applications are used to act on the form, code or protocol of the content for purposes of transmission, conveyance or routing without regard to whether such service is referred to as voice over Internet protocol services or is classified by the Federal Communications Commission as enhanced or value added. "Telecommunications service" does not include:

- (a) Data processing and information services that allow data to be generated, acquired, stored, processed, or retrieved and delivered by an electronic transmission to a purchaser when such purchaser's primary purpose for the underlying transaction is the processed data or information;
- (b) Installation or maintenance of wiring or equipment on a customer's premises;
- (c) Tangible personal property;
- (d) Advertising, including but not limited to directory advertising;

(e) Billing and collection services provided to third parties;

(f) Internet access service;

(g) Radio and television audio and video programming services, regardless of the medium, including the furnishing of transmission, conveyance and routing of such services by the programming service provider. Radio and television audio and video programming services shall include but not be limited to cable service as defined in 47 USC 522(6) and audio and video programming services delivered by commercial mobile radio service providers, as defined in 47 CFR 20.3;

(h) "Ancillary services"; or

(i) Digital products "delivered electronically," including but not limited to software, music, video, reading materials or ring tones."

"Service address" means:

(a) The location of the telecommunications equipment to which a customer's call is charged and from which the call originates or terminates, regardless of where the call is billed or paid;

(b) If the location in line (a) is not known, service address means the origination point of the signal of the telecommunications services first identified by either the seller's telecommunications system or in information received by the seller from its service provider where the system used to transport such signals is not that of the seller; and

(c) If the location in line (a) and line (b) are not known, the service address means the location of the customer's place of primary use.

The "place of primary use" is defined as:

"Place of primary use" means the street address representative of where the customer's use of the telecommunications service primarily occurs, which must be the residential street address or the primary business street address of the customer. In the case of mobile telecommunications services, "place of primary use" must be within the licensed service area of the home service provider.

Section 304(a)(3)(B-5)(vii)(d) provides a special rule for receipts from the sale of telecommunications service to other telecommunication service providers for resale:

Gross receipts from sales of telecommunication services or from ancillary services for telecommunications services sold to other telecommunication service providers for resale shall be sourced to this State using the apportionment concepts used for non-resale receipts of telecommunications services if the information is readily available to make that determination. If the information is not readily available, then the taxpayer may use any other reasonable and consistent method.

In this case, based on the facts described in your letter, COMPANY provides telecommunication services that fall within the special rule in Section 304(a)(3)(B-5)(vii)(d). In particular, COMPANY transmits the calls or data of customers of other telecommunication service providers between the United States and points outside the United States. Therefore, gross receipts from such telecommunication services are sourced for sales factor purposes using the apportionment concepts used for non-resale receipts of telecommunication services. However, if the information necessary to

apportion receipts based on non-resale concepts is not readily available, then the taxpayer may use any other reasonable and consistent method to apportion such receipts.

Apportionment concepts for non-resale receipts of telecommunications services include:

(1) the location of the service address, which includes the location of the telecommunications equipment to which a call is charged and from which a call originates and terminates, the origination point of the signal of the telecommunications services first identified, and the location of the customer's primary place of use (35 ILCS 5/304(a)(3)(B-5)(i), (iii), (vii));

(2) the state where a call originates and/or terminates (35 ILCS 5/304(a)(3)(B-5)(ii), (vii));

(3) the state where the purchaser obtains the prepaid card or similar means of conveyance, or the state of the purchaser's billing information if that information indicates a location (35 ILCS 5/304(a)(3)(B-5)(iv)); and

(4) the location of the channel termination point(s) (i.e. the location where the customer either inputs or receives the communication), or the mileage between channel termination points (35 ILCS 5/304(a)(3)(B-5)(v)).

Your letter indicates that, with respect to telecommunication services in which the call originates in the U.S. and terminates outside the U.S, COMPANY does not possess information as to the location of the end user. COMPANY has no information as to where in the U.S. a call originates, and also does not know the billing address or the service address of U.S. end users. Instead, this information is maintained by the local carrier. Accordingly, with respect to such receipts, the information necessary to apply apportionment concepts for non-resale receipts is not readily available, and COMPANY may apply any reasonable and consistent method to apportion such receipts. Your letter does not, however, provide sufficient information to conclude that the information necessary to apply non-resale apportionment concepts with respect to receipts from the DTA Agreement is not readily available. Information maintained by COMPANY's NATIONALITY parent company may be considered readily available to COMPANY. Therefore, based on the information provided, it cannot be concluded that any reasonable and consistent method may be used to source receipts from the DTA Agreement.

Your letter proposes two possible methods for sourcing COMPANY's gross receipts from telecommunications services. The first method proposed, the "property method," assigns gross receipts to the sales factor based on the ratio of the net book value of the COMPANY's property located in Illinois over the net book value of its property everywhere.

IITA Section 304(a)(1) defines the property factor:

(A) The property factor is a fraction, the numerator of which is the average value of the person's real and tangible personal property owned or rented and used in the trade or business in this State during the taxable year and the denominator of which is the average value of all the person's real and tangible personal property owned or rented and used in the trade or business during the taxable year.

(B) Property owned by the person is valued at its original cost. Property rented by the person is valued at 8 times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the person less any annual rental rate received by the person from sub-rentals.

(C) The average value of property shall be determined by averaging the values at the beginning and ending of the taxable year but the Director may require the averaging of monthly values during the taxable year if reasonably required to reflect properly the average value of the person's property.

Department Regulations Section 100.3350 provide rules with respect to the property factor, including the following:

(a) In general. The property factor of the apportionment formula for each trade or business of a person shall include all real and tangible personal property owned or rented by such person and used during the tax period in the regular course of such trade or business. The term "real and tangible personal property" includes land, building, machinery, stocks of goods, equipment, and other real and tangible personal property but does not include coin or currency. Property used in connection with the production of nonbusiness income shall be excluded from the property factor. Property used both in the regular course of a person's trade or business and in the production of nonbusiness income shall be included in the factor only to the extent the property is used in the regular course of the person's trade or business. The method of determining that portion of the value to be included in the factor will depend on the facts of each case. The property factor shall include the average value of property includable in the factor. See subsection (g), below.

...

(e) Valuation of owned property. Property owned by the person shall be valued at its original cost. As a general rule "original cost" is the basis of property for federal income tax purposes at the time of acquisition and will not reflect any federal adjustments thereafter for deductions for depreciation, depletion, amortization and the like.

...

(f) Valuation of rented property

(1) Property rented by the person is valued at eight times the net annual rental rate. The net annual rental rate for any item of rented property is the annual rental rate paid by the person for such property, less the aggregate annual subrental rates paid by subtenants of the person. (See Section 100.3380(a) for special rules where the use of such net annual rental rate produces a negative or clearly inaccurate value or where property is used by the person at no charge or rented at a nominal rental rate.) Subrents are not deducted when the subrents constitute business income because the property which produces the subrents is used in the regular course of a trade or business of the person when it is producing such income. Accordingly there is no reduction in its value.

...

(g) Averaging property values

(1) As a general rule the average value of property owned by the person shall be determined by averaging the values at the beginning and ending of the tax period. However, the Director may require or allow averaging by monthly values if such method of averaging is required to properly reflect the average value of the person's property for the tax period. Averaging by monthly values will generally be applied if substantial fluctuations in the values of the property exist during the tax period or where property is acquired after the beginning of the tax period or disposed of before the end of the tax period.

In this case, a reasonable method of allocating gross receipts from telecommunication services in which the call originates in the U.S. and terminates outside the U.S. (other than gross receipts from the DTA agreement) would be to base such allocation on the Illinois property factor. COMPANY may allocate such gross receipts to the numerator of the Illinois sales factor in the same proportion as COMPANY's property in Illinois bears to its property everywhere. In computing the property factor for this purpose, however, COMPANY should apply the rules set forth in IITA Section 304(a)(1) and Department regulations Section 100.3350, including the rules mentioned above. Thus, only property used in COMPANY's telecommunications business should be included in the computation, the property should be valued at original cost or 8 times the net annual rental rate, as applicable, and the average value of property should be determined in accordance with Regulations Section 100.3350(g). In addition, COMPANY must apply this method consistently.

This ruling shall bind the Department for COMPANY's 2012 taxable year and subsequent taxable years, except as limited pursuant to 2 Ill. Adm. Code 1200.110(d) and (e). The facts upon which this ruling is based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited and incorporated 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.

Sincerely,

Brian L. Stocker
Chairman, PLR Committee (Income Tax)