IT 18-0003-GIL (10/23/2018) ALTERNATIVE APPORTIONMENT

Alternative Apportionment Not Allowed unless Taxpayer Shows Sales Factor does not Fairly Reflect Market for Goods or Services. (This is a GIL).

October 23, 2018

Re: Petition for Alternative Apportionment

Dear Xxxxx:

This is in response to your letter dated April 9, 2018 in which you request permission to use an alternative method of allocation or apportionment. Department of Revenue ("Department") regulations require that the Department issue only two types of letter rulings, Private Letter Rulings ("PLRs") and General Information Letters ("GILs"). 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 against the Department, but only as to the taxpayer issued the ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of Department policy that apply, interpret or prescribe the tax laws and are not binding against the Department. See 2 Ill. Adm. Code 100.1200(b) and (c). For the reasons discussed below, your petition cannot be granted at this time.

Your letter states as follows:

> We are writing on behalf of the above taxpayer to petition for an alternative allocation and apportionment method for tax year ending December 31, 2017 and all future years on the basis described below.
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> COMPANY focuses on the development of products with minimally invasive therapies for bone repair. The corporation began operations in 20XX and was headquartered in CITY, California. COMPANY was not required to file an Illinois Corporation Income Tax return until it began generating revenue from Illinois sources during tax year ending December 31, 20XX. During the tax year ending December 31, 20XX, the corporation moved its headquarters to CITY 1, Illinois and has timely filed Corporate Income Tax returns since that time.
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> On June 30, 20XX, COMPANY executed a purchase agreement to sell substantially all of its assets. According to Illinois Admin Code 100.3220(b)(2) and (b)(3), capital gains from the sale or exchange of tangible personal property and intangible property are allocated to Illinois if the taxpayer has its commercial domicile in Illinois at the time of sale. Because COMPANY moved its commercial domicile to Illinois during the tax year ending December 31, 20XX and was domiciled in Illinois during 20XX, capital gain would be subject to Illinois Corporate Tax in 20XX and all future years COMPANY recognizes a gain from the sale.
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> Based off the Agreement between the Buyer (COMPANY 1) and the Seller (COMPANY), a majority of the goodwill (Milestone or Earnout payments), relates to the performance of "F&A" products (see attached pages from the contract agreement). The potential future payouts and criteria are as follows:
> 2018: $$ Performance of F&A products
> 2019: $$ Performance of F&A products
> 2020: $$ Performance of F&A products

2018-2028 (Earnout): $$ Max 5% of F&A Products Gross Receipts & 2.5% of Additional Products.

F&A products are defined in the attached contract as the PRODUCT and the PRODUCT 1 product lines. Based on the dates of FDA approval, these products were developed while the taxpayer was domiciled in California and not Illinois (see attached PRODUCT and PRODUCT 1 articles for dates). The taxpayer has incurred significant R&D and overhead costs (see Exhibit 1) relating to the development of these products while the taxpayer was domiciled in California; therefore, the taxpayer respectfully requests the Illinois Department of Revenue for special apportionment to equate income earned (future payments for goodwill on products developed in California) with the expenses and net operating losses incurred to develop the product in the past. If the taxpayer continued to follow the single sales-factor in 2017 and future years, the Illinois apportioned tax base would be grossly distorted and would not fairly represent where the taxpayer earned its taxable income. Therefore, we hereby request that the taxpayer be allowed to use a zero percent apportionment percentage on the sale of the corporation's intangible assets for tax year ending December 31, 2017 (and any future years, to the extent that the gain is reported on the installment method pursuant to IRC Sec. 453).

In addition to the above argument, since the corporation began operations in 20XX, the corporation has created almost $$ million in federal net operating losses for which it can utilize against the gain on the sale of its assets. However, because COMPANY recently moved its commercial domicile from California to Illinois, the corporation cannot equitably utilize state net operating losses. The attached exhibit shows a summary of Illinois and California net operating losses as reported on COMPANY's tax returns since inception. As shown on Exhibit 2, Illinois only accounts for 8% of the total state net operating losses. Illinois Admin. Code 100.3390(a)(4) states that a taxpayer may petition for an alternative apportionment method if the employment of any other method doesn't represent an equitable allocation and apportionment of the taxpayer's income. The gain on the sale of the assets should not be entirely sourced to Illinois because the majority of the company's goodwill (discussed above) created since the corporation's inception was generated in California. Therefore, if the first argument above is insufficient, we hereby request that the taxpayer be allowed to use an eight percent apportionment percentage for the tax year ending December 31, 2017 (and any future years, to the extent that the gain is reported on the installment method pursuant to IRC Sec. 453).

Furthermore, Exhibit 3 shows the allocation of gross sales between California and Illinois since the inception of COMPANY in 20XX. The exhibit expresses a gross disparity between sales sourced to each state and is evident that the majority of taxpayer's business activity (75% per Exhibit 3) has occurred in California over the lifespan of the corporation. This further exemplifies that the single sales-factor would unfairly tax the gain on COMPANY's asset sale in 2017. Therefore, if the two arguments above are insufficient, we hereby request that the taxpayer be allowed to use a twenty-five percent apportionment percentage for tax year ending December 31, 2017 (and any future years, to the extent that the gain is reported on the installment method pursuant to IRC Sec. 453).

RULING

Section 304(f) of the Illinois Income Tax Act ("IITA" 35 ILCS 5/304(f)) states:

If the allocation and apportionment provisions of subsections (a) through (e) and of subsection (h) do not, for taxable years ending before December 31, 2008, fairly represent the extent of a person's business activity in this State, or, for taxable years ending on or after December 31, 2008, fairly represent the market for the person's goods, services, or other sources of business income, 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 v business activities or market in this State; or

(4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

IITA Section 304(a) provides that when a nonresident derives business income from Illinois and one or more other states, such income shall be apportioned to Illinois by multiplying the income by the taxpayer's apportionment factor. For taxable years ending on and after December 31, 1998, except in the case of an insurance company, financial organization, transportation company, or federally regulated exchange, the apportionment factor is equal to the sales factor. IITA Section 304(a)(3) defines the sale factor as a fraction, the numerator of which is the total sales of the person in Illinois during the taxable year, and the denominator of which is the total sales of the person everywhere during the taxable year.

In applying Section 304(a), Department Regulations Section 100.3380(c)(2) provides the following special rule:

> When gross receipts arise from an incidental or occasional sale of assets used in the regular course of the person's trade or business, those gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded. Gross receipts from an incidental or occasional sale of stock in a subsidiary will also be excluded. Exclusion of these gross receipts from the sales factor is appropriate for several reasons, more than one of which may apply to a particular sale, including:
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> A) incidental or occasional sales are not made in the market for the person's goods, services or other ordinary sources of business income;
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> B) to the extent that gains realized on the sale of assets used in a taxpayer's business are comprised of recapture of depreciation deductions, the economic income of the taxpayer was understated in the years in which those deductions were taken. The recapture gains that reflect a correction of that understatement should be allocated using a method approximating the factors that were used in apportioning the deductions. If the business otherwise remains unchanged, including the gross receipts from the sale in the sales factor numerator of the state in which the assets were located would allocate a disproportionate amount of the recapture gains to that state compared to how the deductions being recaptured were allocated;

C) to the extent the gain on the sale is attributable to goodwill or similar intangibles representing the value of customer relationships, including the gross receipts from the sale in the sales factor will not reflect the market for the taxpayer's goods, services or other ordinary sources of business income to the extent the sourcing of the receipts from that sale differs from the sales factor computed without regard to that sale; and

D) in the case of sales of assets that are made in connection with a partial or complete withdrawal from the market in the state in which the assets are located, including the gross receipts from those sales in the sales factor would increase the business income apportioned to that state when the taxpayer's market in that state has decreased.

Your petition for alternative apportionment is based on the assertion that the gain from the sale of substantially all of COMPANY's assets is allocated to Illinois pursuant to Department Regulations §§ 100.3220(b)(2) and (b)(3), and that such allocation does not fairly reflect where the taxpayer earned its taxable income.

As indicated above, for taxable years ending or after December 31, 2008, alternative apportionment under IITA Section 304(f) is appropriate in cases where the allocation and apportionment provisions under IITA Sections 304(a) through (e) do not fairly represent the market for the taxpayer's goods, services, or other sources of business income. Your petition contains no information relative to the market for the taxpayer's goods, nor does it contain information by which a determination can be made as to whether the apportionment resulting under IITA Section 304 fails to fairly reflect that market.

In addition, note that Department Regulations § 100.3220 provides rules for the allocation of items of *nonbusiness* income. In this case, the gain on the sale of taxpayer's assets likely constitutes *business* income and, as such, is not allocated according to the rules under Regulations § 100.3220. Note also that IITA Section 1501(a)(1) allows taxpayers, for each taxable year beginning on or after January 1, 2003, to make an election to treat all income as business income. Finally, as indicated above, business income is apportioned using the sales factor. In computing the sales factor, Department Regulations § 100.3380(c)(2) requires that gross receipts from an incidental or occasional sale of assets used in the regular course of business shall be excluded from the sales factor. Based on the information contained in your letter, § 100.3380(c)(2) likely applies to exclude from COMPANY's sales factor the gross receipts derived from the sale of substantially all of its assets (including its goodwill).

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 Stocker
Associate Counsel (Income Tax)