

Private Letter Ruling: Receipts from deemed sale of assets comprising entire business are excluded from the sales factor as being from an occasional sale.

August 12, 2019

Re: COMPANY

Dear Xxxx:

This is in response to your letter dated December 20, 2018, in which you requested a Private Letter Ruling on behalf of COMPANY. Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of 2 Ill. Adm. Code Section 1200.110 appears to be contained in your request. The Private Letter Ruling will bind the Department only with respect to COMPANY for the issue or issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that neither COMPANY nor a related taxpayer is 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:

In accordance with 2 Ill. Adm. Code 1200.110 (the "Regulation"), we are submitting this letter to the Illinois Department of Revenue ("Department") to request consideration of a Private Letter Ruling on behalf of our client, COMPANY (the "Taxpayer"). We respectfully request the Department's consideration of the Taxpayer's situation and our conclusions regarding its recent transaction. Please let us know if further information is required regarding the below or if you have questions. Once you have reviewed this request, we would appreciate the opportunity to discuss this matter with you. In due course, the Taxpayer intends to disclose its identity as required by the Regulation and, correspondingly, we will provide our power of attorney for the Taxpayer.

I. Qualification of Taxpayer for a Private Letter Ruling under the Regulation

1. This Private Letter Ruling is made for a specific tax type, Illinois Income and Replacement Tax.
2. This Private Letter Ruling is not requested with regard to hypothetical or alternative proposed transactions.
3. This Private Letter Ruling is for a single, specific taxpayer.
4. The Taxpayer is not currently under audit by or in litigation with the Department in regard to this or any other tax matter.
5. To the best of our knowledge and the knowledge of the taxpayer, our understanding is that the Department has not previously ruled on the same or a similar issue for the taxpayer or a predecessor, nor has any prior request been submitted and withdrawn with respect to this matter.

II. Statement of Contrary Authorities

The Taxpayer has determined that there are no authorities contrary to its views, or at least the Taxpayer has been unable to locate any such authorities.

III. Request for Deletion of Names and Identifying Information

The Taxpayer requests that its name, the names of any other parties, and the name of its representative be redacted in the publicly disseminated version of any Private Letter Ruling issued. The Taxpayer also requests that the reference to any state other than Illinois be redacted along with the names of any foreign countries. The Taxpayer is unaware of any other “specific trade secret information” included in this request.

IV. Relevant Contracts, Licenses, Agreements, Instruments or Other Documents

The Taxpayer, in due course, intends to provide the Department with any documentation necessary to consider this request. We expect that the specific documents needed will be identified during discussions with the Department.

V. Statement of the Material Facts

1. Background on Taxpayer

The Taxpayer was formed as a corporation in Illinois over eighty years ago. It has undertaken the primary business of manufacturing and selling its tangible goods. For federal income tax purposes, the Taxpayer elected status as an S Corporation under Subchapter S of the Internal Revenue Code (the “Code”). The Taxpayer went through a recent transaction (the “Transaction”), described in further detail below. At the time of the Transaction, the Taxpayer had ## shareholders (the “Shareholders”). Each of the Shareholders was a trust entity, but for federal income tax purposes the income and deductions were reported on individual tax returns, Form 1040. Many of the Taxpayer’s owners also held a corporation (“Company A”) which held real property in State A, on which the Taxpayer’s only domestic manufacturing facility was located. Company A also held property in State B, and the Taxpayer used this as a facility pursuant to a 10-year lease which was prepaid. The Taxpayer also held ##% interests in each of three separate joint ventures with facilities located in three different foreign countries.

In Illinois, the Taxpayer maintained a sales, warehouse and administrative facility which it leased from a third party. In State A, the Taxpayer maintained its domestic manufacturing facility for tangible goods and it also packaged these goods there. The Taxpayer’s research and development departments were based at the State A facility. In State B, the Taxpayer maintained a sales, packaging, warehouse and administrative facility. In addition, the Taxpayer stores inventory in public warehouses in twelve other states and ships its goods to customers from these public warehouses.

The Taxpayer's senior management has been primarily based at its Illinois location, at least since it elected S Corporation status in 1987, other than a senior officer who was based at the State B location up through the end of 2017. Taxpayer has filed Form 1120S, U.S. Income Tax Return for an S Corporation, with the Internal Revenue Service. Taxpayer has filed Form IL- 1120-ST, Small Business Corporation Replacement Tax Return ("Form IL-1120-ST") with the Department as required for prior tax years.

2. Specific Transaction

On July XX, 2018, the Taxpayer along with its shareholders and a designated shareholder representative entered into a Share Purchase Agreement (the "Agreement") with Company Z (the "Buyer"). The Buyer was a third party to the Taxpayer and its shareholders. Under the Agreement, Buyer agreed to purchase all of the shares of stock in the Taxpayer and to make a joint election under Section 338(h)(10) of the Code. In addition, the Taxpayer transferred interests in the three foreign joint ventures to the Buyer or its designee, as described below. The Agreement was in negotiation for months preceding the Agreement date. The process of reviewing a potential transaction and the ultimate decision to enter into the Agreement, and to make a Section 338(h)(10) election for the transaction, was undertaken by the State B senior officer, who acted as President of the Taxpayer up through the end of 2017 and was also a director, and two other officers/directors of the Taxpayer, one a resident of Illinois and the other a resident of a state other than Illinois.

On September #, 2018, the Transaction was initiated, so control over the business operations and business assets were transferred to the Buyer. In exchange for closing payments by the Buyer, the Taxpayer's shareholder representative delivered all stock interests in the Taxpayer to the Buyer. Immediately prior to the Transaction, the Taxpayer purchased from Company A the real property it used in State A. Regarding the three foreign joint ventures, for the two joint ventures in which the Buyer was already the other 50% owner, the Taxpayer transferred its 50% interest to the Buyer or its designee. For the third foreign joint venture, the Taxpayer acquired the outside 50% interest just prior to the Transaction, so this also fully transferred to the Buyer or its designee.

Since the Taxpayer elected S Corporation status in 1987, it had not previously sold an interest in any other of the entities in which it has held an interest. Any other sales of intangible assets were only a minor part of the Taxpayer's business, as the Taxpayer's primary business focus was on the sales of the goods that it manufactured.

On its Form IL-1120-ST for the tax year ending on the date of the Transaction, the Taxpayer will make an election under 35 ILCS 5/1501(a)(1) to treat all of its income as "business income" for Illinois Income and Replacement Tax purposes.

VI. Statement of Relevant Authorities and Ruling Requested

1. Relevant Authorities

Section 338(h)(10) of the Code allows a buyer to acquire stock of an S Corporation while treating the transaction as the acquisition of all of the S Corporation's assets. The seller's tax treatment is the sale of its tangible and intangible assets. This is commonly referred to a "deemed asset sale."

35 ILCS 5/203(b)(1) provides that "...[i]n the case of a corporation, base income means an amount equal to the taxpayer's taxable income for the taxable year as modified by paragraph (2)."

35 ILCS 5/203(e)(2)(G) provides: "Subchapter S corporations. In the case of: (i) a Subchapter S corporation for which there is in effect an election for the taxable year under Section 1362 of the Internal Revenue Code, the taxable income of such corporation determined in accordance with Section 1363(b) of the Internal Revenue Code, except that taxable income shall take into account those items which are required by Section 1363(b)(1) of the Internal Revenue Code to be separately stated..."

35 ILCS 5/102 states: "Construction. 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 a 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."

35 ILCS 5/403(a) states: "Reporting. To the extent not inconsistent with the provisions of this Act or forms or regulations prescribed by the Department, each person making a return under this Act shall take into account the items of income, deduction and exclusion on such return in the same manner and amounts as reflected in such person's federal income tax return for the same taxable year."

35 ILCS 5/1501(a)(1) sets forth the statutory definition of the term "business income." This section provides that the term "business income" means all income that may be treated as apportionable business income under the Constitution of the United States. Business income is net of the deductions allocable thereto. Such term does not include compensation or the deductions allocable thereto. 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. This election shall be made in accordance with rules adopted by the Department and, once made, shall be irrevocable.

35 ILCS 5/304 sets forth the manner in which the business income of a corporation is apportioned between Illinois and one or more other states. 35 ILCS 5/304(h) states that for years ending on or after December 31, 2000, the business income of a corporation is apportioned by the sales factor. 35 ILCS 5/304(a)(3)(A) states that 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.

35 ILCS 5/304(f) states that if the allocation and apportionment provisions do not 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: (4) the employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

86 Ill. Admin. Code 100.3380(c)(2) is an exercise of the Department's authority under 35 ILCS 5/304(f) and states that 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 receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.

The Department has previously issued informal guidance in General Information Letter No. IT 01-0043-GIL (May 2, 2001) stating that "Illinois does conform to the federal treatment and rules attending an IRC section 338(h)(10) election." In addition, the Department has indicated in General Information Letter No. IT 07-0017-GIL that "...the provisions of Code section 338(h)(10) apply in determining the base income of an S corporation for Illinois replacement income tax purposes."

2. Rulings Requested

- 1) The Department will treat the sale of the Taxpayer's stock as a deemed sale of its assets for Illinois Income and Replacement Tax purposes, consistent with the treatment for federal income tax purposes.
- 2) The Department will treat all of the Taxpayer's income, including income from the Transaction, as "business income" based on the Taxpayer's business income election under 35 ILCS 5/1501(a)(1) as made on its Form IL-1120-ST for the tax year ending September XX, 2018.
- 3) Other than for the sale of inventory and other assets which the Taxpayer has sold in the regular course of its business, 86 Ill. Admin. Code 100.3380(c)(2) would apply for sales factor purposes to exclude the incidental or occasional (deemed) sale of the assets that were used in the regular course of the Taxpayer's trade or business.

Ruling of the Department

Section 338(h)(10) of the Code, 26 U.S.C. §338(h)(10) states in part:

(10) Elective recognition of gain or loss by target corporation, together with nonrecognition of gain or loss on stock sold by selling consolidated group.—

(A) In general.--Under regulations prescribed by the Secretary, an election may be made under which if—

(i) the target corporation was, before the transaction, a member of the selling consolidated group, and

(ii) the target corporation recognizes gain or loss with respect to the transaction as if it sold all of its assets in a single transaction, then the target corporation shall be treated as a member of the selling consolidated group with respect to such sale, and (to the extent provided in regulations) no gain or loss will be recognized on stock sold or exchanged in the transaction by members of the selling consolidated group.

If the Taxpayer makes this election for the tax year ending September 30, 2018, the sale of the Taxpayer's stock will be treated as a deemed sale of its assets for the purposes of the Illinois Income and Replacement taxes.

Section 304(a) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 et seq.) provides:

[...] 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.

Other apportionment formulas are provided in Section 304 of the IITA for insurance companies, financial organizations, federally regulated exchanges, and transportation companies, but the facts stated in your request indicate that the Taxpayer does not qualify to use any of these formulas.

Section 304(h)(3) of the IITA provides that, for taxable years ending on or after December 31, 2000, only the sales factor shall be used to apportion business income under Section 304(a) of the IITA.

Section 304(f) of the IITA provides:

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 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.

Section 1501(a)(1) of the IITA provides:

[...]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. This election shall be made in accordance with rules adopted by the Department and, once made, shall be irrevocable.

If the Taxpayer makes this election for the tax year ending September 30, 2018, its gain on the sale of the assets related to the Transaction, will be treated as business income, regardless of whether the gains otherwise meet the definition of business income.

Section 1501(a)(21) of the IITA defines "sales" for purposes of the sales factor to include all gross receipts of the taxpayer characterized as business income. However, pursuant to the authority granted to the Director under Section 304(f) of the IITA, the Department has adopted 86 Ill. Adm. Code Section 100.3380(c)(2), which provides:

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.

You have represented that the sale of the assets related to the Transaction is an incidental or occasional sale of assets of the Taxpayer, and that no similar sale has occurred in the history of the Taxpayer. Based on this representation, if the Taxpayer elects to treat all of its income for the tax year ending on September 30, 2018 as business income, the gain on its sale of the assets related to the Transaction is business income, the gain will be apportioned using the sales factor of the Taxpayer under Section 304(a) of the IITA, and the gross receipts from the sale will be excluded from the numerator and denominator of the sales factor under 86 Ill. Adm. Code Section 100.3380(c)(2).

The facts upon which this ruling are 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.

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Pursuant to 2 Ill. Admin. Code Section 1200.110(e), this ruling is automatically revoked as of ten years after the date of issuance, if not revoked earlier.

Sincerely,

Michael D. Mankowski
Associate Counsel - Income Tax