

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

January 7, 2020

Re: Petition for Alternative Apportionment

Dear Mr. Xxxx:

This is in response to your letter dated January 11, 2019 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 petition states as follows:

REPRESENTATIVE, as authorized agent for COMPANY ("COMPANY" "Company" or "taxpayer"), requests the use of an alternative apportionment by amending COMPANY's Corporate Income and Replacement Tax return for the period ending December 31, 2014 as authorized by 86 Ill. Admin. Code Section 100.3390(e)(2). The original amended return was filed with Department of Revenue's ("Department") Business Processing Unit and a copy of the amended return is attached.

In accordance with 86 Ill. Admin. Code 100.3390(e)(2), the taxpayer has never filed a petition for alternative apportionment as provided under 86 Ill. Admin Code Section 100.3390(e)(1), or whose subsection (e)(1) petition has been rejected. The explanation section of the amended return states that the amended return is being filed based on a petition for alternative apportionment and the Department's Processing Unit should refer the amended return to the Legal Service Bureau/Income Tax.

The Petition for alternative apportionment is for tax years ended on or after December 31, 2014.

COMPANY is a limited liability company that has elected to be treated as a corporation for federal and Illinois income tax purposes.

COMPANY is a Chicago based proprietary trading firm. As a proprietary trading firm, COMPANY uses its own capital to fund its trading activities for the sole benefit of the company (also referred to as trading for its own account). In addition, COMPANY is registered with various exchanges as a market maker in several listed instruments. As a market maker it quotes both a buy and sell price in a financial instrument or commodity that it holds; hoping to

make a profit on the turn. Although COMPANY is based in Chicago, it trades on numerous electronic exchanges located in and outside of Illinois.

For federal income tax purposes, COMPANY is a dealer as defined under Internal Revenue Code Section 475.

For the tax year ending December 31, 2014, COMPANY apportioned 100% of its receipts to Illinois. Back in April 2017, the Department audited this return and made no adjustments to the apportionment factor, but did make a minor adjustment to the tax base which resulted in a small tax increase.

COMPANY and the Department have executed a waiver to the statute of limitation until January 15, 2019 for the tax year ending December 31, 2014. Attached is a copy of the executed waiver.

COMPANY requests the Department grant the use of an alternative apportionment method as more detailed below.

For tax years ending on or after December 31, 2008, Illinois Income Tax Act ("IITA") Section 304(a)(3)(C-5)(iii) provides:

In the case of interest, net gains (but not less than zero) and other items of income from intangible personal property, the sale is in this State if:

(a) in the case of a taxpayer who is a dealer in the item of intangible personal property within the meaning of Section 475 of the Internal Revenue Code, the income or gain received from a customer in this State. For purposes of this subparagraph, a customer is in this State if the customer is an individual, trust, or estate who is a resident of this State and, for all other customers, if the customer's commercial domicile is in this State. Unless the dealer has actual knowledge of the residence or commercial domicile of a customer during a taxable year, the customer shall be deemed to be a customer in this State if the billing address of the customer, as shown in the records of the dealer, is in this State;

On August 3, 2017, the Department updated its administrative regulation related to the sales factor for changes related to the adoption of market based sourcing. In particular 86 Ill. Adm. Code Section 100.3370(c)(6)(C)(i) was added to provide additional guidance to the provisions of IITA Section 304(a)(3)(C-5)(iii). The new administrative provision provides:

(i) in the case of a taxpayer who:

is a dealer in the item of intangible property within the meaning of 26 USC 475, the income or gain is received from a customer in this State. A taxpayer is a dealer with respect to an item of intangible personal property if the taxpayer is a dealer with respect to the item under 26 USC 475(c)(1), or would be a dealer with respect to the item under 26 USC 475(c)(1) if the item were a security as defined under 26 USC 475(c)(2). For purposes of this subsection (c)(6)(C)(i), a customer is in this State if the customer is an individual, trust or estate who is a resident of this State and, for all other customers, if

the residence or commercial domicile of a customer during a taxable year, the customer shall be deemed to be a customer in this State if the billing address of the customer, as shown in the records of the dealer, is in this State. A dealer shall treat the person with whom it engages in a transaction as the customer, even when that person is acting on behalf of a third party, unless the dealer has actual knowledge of the party on whose behalf the person is acting. If a taxpayer is a dealer with respect to an item of intangible personal property and recognizes gain or loss with respect to that item other than in connection with a transaction with a customer (for example, unrealized gain or loss from marking the item to market under 26 USC 475), that gain or loss shall be excluded from the numerator and denominator of the sales factor (IITA Section 304(a)(3)(C-5)(iii)(a)).

IITA Section 304(f) Alternative allocation 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, service 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 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.

On August 3, 2017, the Department modified its regulations for petitioning alternative apportionment 86 Ill. Admin. Code Section 100.3390. Under 86 Ill. Admin. Code Section 100.3390(e) Timely Filed Petitions.

A taxpayer petition for use of a separate accounting method or any other alternative apportionment method will not be considered by the Director unless such petition has been timely filed. A taxpayer who petitions the Director for an alternative apportionment formula does so subject to the Department's right to verify, by audit of the taxpayer's return and supporting books and records within the applicable statute of limitations, the facts submitted as the basis of the petition. A petition for alternative allocation or apportionment is timely filed if the petition is filed:

(e)(1) 120 days prior to the date of the tax return (including extensions) for which permission to use such alternative method is sought. A taxpayer who does not petition more than 120 days prior to the due date of the original return must file their return and pay tax according to the statutorily approved allocation or apportionment method.

(e)(2) As an attachment to a return amending an original return which was filed using the statutory allocation and apportionment rules. A taxpayer who has not filed a petition for alternative apportionment under section (e)(1) above, or whose (e)(1) petition has been rejected, may thereafter file such petition with an amended return and the Department will consider the petition along with any other issues raised in the claim for refund pursuant to the procedures set forth at Section 100.9110 of this Part.

COMPANY has historically sourced 100% of its trading receipts to Illinois. This sourcing method was primarily based on where COMPANY's trading activities were controlled from. Upon closer analysis of the Illinois sourcing provisions, in particular IITA Section 304(a)(3)(C-5)(iii)(a), the sourcing of income from a dealer in an intangible within the meaning of IRC Section 475 is the location of the customer. This provision applies to all taxpayers that sell intangibles to customers in their regular course of their trade or business. In COMPANY's case, they are a dealer as defined by IRC Section 475 and Illinois market based sourcing is the location of the dealer's customers.

The challenge in applying the sourcing provisions of IITA Section 304(a)(3)(C-5)(iii)(a) to COMPANY is that COMPANY does not have knowledge of who the counterparties are to its transactions. Arguably, the counterparties of COMPANY are located throughout the United States or even other countries. However, due to the nature of the COMPANY's trading transactions, COMPANY is unable to identify the ultimate counterparty. While COMPANY is unable to identify the ultimate counterparty, it does have knowledge of the nature of the transactions, including the volume and the location of the execution of the transactions on servers/matching engines.

Last year, the Department amended 86 Ill. Admin. Code Section 100.3370(c)(6)(i) to provide additional guidance on how dealers in intangibles should source income or gain from transactions with its customers. One of the areas that was addressed in the amended regulation was to cover a situation where the dealer did not know who the customer was. In particular the amended regulation provides "a dealer shall treat the person with whom it engages in a transaction as a customer, even when that person is acting on behalf of a third party, unless the dealer has actual knowledge of the person on whose behalf the person is acting." Although this provision is intended to cover agency relationships, it is a recognition by the Department that a seller may not know who the ultimate customer is but does know who they are engaged with to facilitate the transaction.

COMPANY primarily trades securities on electronic exchanges located in Chicago and New Jersey. Since a single strategy is a series of trades; i.e. various options, puts, calls, outright purchases and sales, tracking revenue on a single transaction is not appropriate. The most appropriate indicator of the activities that COMPANY has on a particular electronic exchange is the trading volume. COMPANY keeps detailed records of the volume of execution of trades on servers/matching engines.

Attached Exhibit A summarizes COMPANY's trading activities for 2014, listing the volume of trades and the location of execution of the trades. Also listed is the full name of the exchanges. Based on the volume of trading activities in 2014, 50.19% of COMPANY's revenue from trading activities would be apportioned to Illinois. One could argue that this percentage overstates the actual location of COMPANY's ultimate counterparties located in Illinois. It is highly unlikely that the location of COMPANY's ultimate counterparties in Illinois are anywhere near this percentage. COMPANY views the market for its trading revenue as the location of the exchanges. By applying the 50.19% factor to the 2014 trading revenue of \$\$\$ results in \$\$\$ of COMPANY's receipts sourced to Illinois. COMPANY's trading activities on the various exchanges are maintained and can easily be reviewed from an audit perspective.

Attached Exhibit B reflects COMPANY's trading activities for 2015, 2016, and 2017. Although our current request for alternative apportionment is for the 2014 tax year, COMPANY is prepared to use this trading volume methodology to determine the sourcing of its trading revenue for all open periods and file appropriate amended returns.

COMPANY has filed an amended return with the Department's Processing Unity that references this Petition for alternative apportionment as required by 86 Ill. Admin. Code Section 100.3390(e)(2). It is our understanding that the Processing Unit will not process the amended return until it is so authorized by the Legal Services Bureau/Income Tax.

COMPANY maintains that the use of its volume trading activities on the various exchanges during 2014 is a reflection of the market for the revenue they earn from trading activities and should be used to source the revenue from these activities. All other revenue that COMPANY earns should be properly sourced as provided for in IITA Section 304(a)(3).

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 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.

In order to make a determination under IITA Section 304(h) as to whether or not the apportionment provisions of subsections (a) through (e) and of subsection (h) reflect the market for the person's goods, services, or other sources of business income, it is necessary that the taxpayer first determine its apportionment under such sections. If the apportionment under such sections does not fairly reflect the taxpayer's market, then an alternative apportionment method may be permitted. In this case, your letter represents that Taxpayer's trading gross receipts are sourced for apportionment purposes applying the provisions of IITA Section 304(a)(3)(C-5)(iii)(a). That section provides as follows:

- (iii) In the case of interest, net gains (but not less than zero) and other items of income from intangible personal property, the sale is in this State if:

(a) in the case of a taxpayer who is a dealer in the item of intangible personal property within the meaning of Section 475 of the Internal Revenue Code, the income or gain is received from a customer in this State. For purposes of this subparagraph, a customer is in this State if the customer is an individual, trust or estate who is a resident of this State and, for all other customers, if the customer's commercial domicile is in this State. Unless the dealer has actual knowledge of the residence or commercial domicile of a customer during a taxable year, the customer shall be deemed to be a customer in this State if the billing address of the customer, as shown in the records of the dealer, is in this State

Your letter indicates that the Taxpayer has not determined its apportionment under Section 304(a)(3)(C-5)(iii)(a), but rather included 100% of its trading gross receipts in its Illinois sales factor on the basis that its trades are controlled in Illinois. Because the Taxpayer has failed to determine its apportionment under IITA Sections 304(a) through (e) and subsection (h), your petition for an alternative method of apportionment cannot be granted at this time.

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)