IT 20-0003-GIL 01/21/2020 ALTERNATIVE APPORTIONMENT

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

January 21, 2020

Re: Petition for Alternative Apportionment

Dear Xxxx:

This is in response to your request to use an alternative method of allocation or apportionment for your taxable year ending May 31, 2018. 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:

> As provided by 35 ILCS §5/304(f) and 86 ILAC 100.3390, TAXPAYER hereby petitions for an alternative method of apportionment for its 20XX tax year for purposes of its Corporate Income Tax liability in Illinois. Specifically, Taxpayer asks for permission to exclude, from the numerator and denominator of its sales apportionment factor, the gross proceeds (and net gains) from the inventory component of its 20XX sale of an entire division. This method would avoid distorting the Taxpayer's Illinois source income, which is generated from the day-to-day sale of inventory to wholesalers, and would be consistent with how Illinois law treats the proceeds and gains from all of the other components of this sale.
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> Facts
> Taxpayer is a group of three unitary, affiliated corporations with a DATE fiscal year end and files Form 1120 for federal income tax purposes on a consolidated basis. During its 20XX tax year (fiscal year ending DATE), Taxpayer sold %%% of the assets of its NAME Illinois grain division, all of which were located in Illinois. The sale consisted of three different classes of assets: accounts receivable, inventory, and fixed assets (collectively, the NAME Division Assets). During the 20XX tax year, Taxpayer received $$$ in gross proceeds in exchange for these assets, allocated as follows: $$$ to accounts receivable, $$$ to inventory, and $$$ to fixed assets.
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> Law and Application
> The Illinois sales factor is a fraction that generally includes total sales in Illinois in the numerator, and total sales everywhere in the denominator. 35 ILCS 5/304(a)(3)(A). Sales of tangible assets are sourced to Illinois if they are delivered to a purchaser in the state. 35 ILCS 5/304(a)(3)(b)(i). Because Taxpayer's NAME Division Assets were all located in Illinois and were thus delivered to the purchaser in Illinois immediately upon their sale, all gross receipts from this sale would be included in the numerator and denominator of Taxpayer's Illinois sales factor absent contrary guidance.

However, under 86 ILAC 100.3380(c)(2), gross receipts from an "incidental or occasional sale of assets used in the regular course" of a seller's trade or business are excluded from the seller's sales factor, both numerator and denominator, and this regulation further provides that "For example, gross receipts from the sale of a factory or plant will be excluded." As a result, Taxpayer's receipts from the sale of the NAME Division Assets are excluded from its Illinois sales factor to the extent they qualify as an occasional sale of assets used in the regular course of business. Under Illinois's general regulatory framework, Taxpayer's $$$ gross receipts from the sale of the fixed asset component of its NAME Division Asset sale are excluded from its Illinois sales factor because Taxpayer is clearly not in the business of selling its fixed assets and because the sale of a "factory or plant" is specifically provided as an example of the type of assets subject to Illinois' exclusionary rule.

Illinois does not appear to have published any guidance interpreting whether the bulk sale of inventory would be considered an "occasional sale" of assets "used" in the regular course of a person's trade or business assets under 86 ILAC 100.3390(c)(2). As a result, Illinois' guidance regarding other tax types may be instructive in interpreting these sales apportionment factor concepts.

For Illinois Retailer's Occupation Tax (ROT) purposes, it is generally not possible for a taxpayer engaged in the business of selling tangible personal property at retail to make an occasional sale of that same tangible personal property. Isolated or occasional sale treatment for the Illinois ROT generally only applies to companies who do not habitually engage in selling tangible personal property at retail. 35 ILCS § 120/1; 86 ILAC 130.110(a). Further, if a taxpayer takes an item out of inventory to use in its trade or business, then that taxpayer is generally required to pay Illinois Use tax on that item of inventory. Taxpayer has not used any of these inventory items in its business and is thus not required to pay Illinois Use Tax on them. As a result, absent guidance to the contrary, it seems likely that for Illinois sales apportionment purposes a company could not have an "occasional" sale of its own inventory, and would not be considered to "use" its own inventory in its business unless it paid Use Tax on it.

Because Illinois's sales factor clearly requires corporations' sales factors to generally include the proceeds from their sale of inventory (35 ILCS §5/304(a)(3)(B)), Illinois's statutes and regulations do not generally appear to allow or require the receipts of bulk inventory sales to be excluded from the sales factor using the occasional sale or isolated sale rule. As a result, even though the regular/ordinary course of Taxpayer's business is to sell inventory on a day-to-day basis to wholesalers within and outside Illinois, unless the proceeds from the sale of this inventory are excluded from the Taxpayer's sales factor, the resulting apportionment would fail to fairly represent the market for Taxpayer's goods simply because the inventory happened to be located in Illinois at the time that the buyer stepped into Taxpayer's shoes and took over the operations of its NAME Division.

Under 35 ILCS §5/304(f), however, Illinois provides alternative apportionment as a remedy for situations like the one faced by Taxpayer; specifically, ones in which the application of Illinois' general allocation and apportionment laws do not "fairly represent the market for [Taxpayer's] goods." In fact, one of the statutory justifications specified in Illinois's regulations for the exclusion of gross receipts from an occasional or isolated sale from the sales factor under 86 ILAC 100.3390(c)(2)(D), is that, "in the case of asset sales 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. This is the exact situation Taxpayer is facing here: Taxpayer has exited its business market in NAME Illinois by selling its entire NAME Illinois grain division.

86 ILAC 100.3390, which provides the procedural framework for making Illinois alternative apportionment petitions, provides that "the party …seeking to utilize apportionment method has the burden of going forward with the evidence and proving by clear and convincing evidence that the statutory formula … operates unreasonably and arbitrarily in attributing to Illinois a percentage of income that is out of all proportion to … the market for the taxpayer's goods, services, and other sources of business income in this State." 86 ILAC 100.3390(c).

In this case, the Taxpayer's situation clearly meets its burden or proof for being granted an alternative method of apportionment. Because the Taxpayer is selling its entire line of business in NAME Illinois, it is fully exiting that business market. This is expressly listed in 86 ILAC 100.3380 as a justification for using Illinois's alternative apportionment power to require the sales factor exclusion of receipts from occasional sales of assets used in a taxpayer's business, such as the accounts receivable and fixed asset components of the sale of its NAME Division Assets. Because there does not appear to be any principled reason for not extending this same treatment to the inventory component of that same sale, that same treatment should be extended to the inventory in this case.

RULING

Section 304(a) of the Illinois Income Tax Act ("IITA"; 35 ILCS 5/304) 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.

Section 304(f) of the IITA 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:
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> (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 applying Section 304(f), 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;
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> 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
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> 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.

As indicated above, the special rule under Regulations Section 100.3380(c)(2) applies only in the case of an incidental or occasional sale of assets used in the regular course of the person’s trade or business. It does not apply to gross receipts from the sale of property that is properly included in the inventory of the taxpayer. The sale of inventory is the quintessential source of a taxpayer’s business income, the sale of which serves to primarily establish the market for the taxpayer’s sources of business income. Gross receipts from the sale of inventory property, whether or not a bulk sale, are not excluded from the sales factor under Regulations Section 100.3380(c)(2).

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. Department Regulations Section 100.3390 allows taxpayers to petition the Department for application of an alternative apportionment method. Section 100.3390(c) sets forth the taxpayer’s burden of proof, as follows:

> Burden of Proof. A departure from the required apportionment method is allowed only when those methods do not accurately and fairly reflect business activity in Illinois (for taxable years ending before December 31, 2008) or market in Illinois (for taxable years ending on or after December 31, 2008). 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 or going forward with the evidence and proving by clear and convincing evidence that the statutory formula results in the taxation of extraterritorial values or operates unreasonably and arbitrarily in attributing to Illinois a percentage of income that is out of all proportion to the business transacted in this State (for taxable years ending before December 31, 2008) or the market for the taxpayer's goods, services or other sources of business income in this State (for taxable years ending on or after December 31, 2008). In addition, the party seeking to use an alternative apportionment formula must go forward with the evidence and prove that the proposed alternative apportionment method fairly and accurately apportions income to Illinois based upon business activity in this State (for taxable years ending before December 31, 2008) or the market for the taxpayer's goods, services or other sources of business income in this State (for taxable years ending on or after December 31, 2008).

In any event, your petition fails to meet this burden. Even assuming, *arguendo*, the sales at issue do not reflect the market for the taxpayer's business income, the difference between the taxpayer's Illinois market applying the statutory method and the Illinois market under your proposed method is approximately 7%. Therefore, your petition would have nonetheless failed to demonstrate that the statutory method would lead to a grossly distorted result in attributing to Illinois a percentage of income that is out of all proportion to the market for the taxpayer's goods, services or other sources of business income in this State. See *Lakehead Pipe Line Co. v. Dep't of Rev.,* 192 Ill. App. 3d 756 (1st Dist. 1989); *Miami Corporation v. Dep't of Rev.,* 212 Ill. App. 3d 702 (1st Dist. 1991); *AT&T Teleholdings, Inc. v. Dep't of Rev.*, 978 N.E.2d 371 (Ill. App. Ct. 2012).

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)