

Nonresident partner that sells its share of non-unitary partnership allocates nonbusiness capital gain from the sale under Section 303 of the Illinois Income Tax Act. (This is a GIL.)

May 10, 2022

NAME
ADDRESS

Re: Illinois income tax

Dear NAME:

This is in response to your letter dated January 21, 2021, in which you request information regarding Illinois income tax. The nature of your request and the information you have provided require that we respond with a General Information Letter ("GIL"), which is designed to provide general information, is not a statement of Department policy, and is not binding on the Department. See 2 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www.tax.illinois.gov.

Your letter states as follows:

On behalf of our client, COMPANY1 (FEIN: ##-#####), hereinafter referred to as "Taxpayer," we respectfully request the issuance of a private letter ruling ("PLR") by the Illinois Department of Revenue ("Department") pursuant to 2 Ill Adm. Code 1200.110.

General Information

1. This Private Letter Ruling ("PLR") is not requested with regard to hypothetical or alternative proposed transactions.
2. The Taxpayer is not currently engaged in litigation with the Department in regard to this or any other tax matter.
3. The Taxpayer is not currently under audit by the Department in regard to this matter.
4. The Taxpayer requests that certain information be redacted from the PLR prior to dissemination to others.
5. The Taxpayer requests that its name, all contractual parties' names, its exhibits, and the name of its representative be redacted.
6. The Taxpayer knows of no authority contrary to the authorities referred to and cited below.
7. To the best of the knowledge of both Taxpayer and Taxpayer's representative, the Department has not previously ruled on the same or a similar issue for the Taxpayer or predecessor, nor has any representatives previously submitted the same or a similar issue to the Department but withdrew it before a letter ruling was issued.

Tax Year

The ruling is requested for the tax year ending MONTH DAY, YEAR.

Statement of Facts

Taxpayer, commercially domiciled in CITY, STATE, is a subsidiary of COMPANY1 in COUNTRY1. Based on its activities in Illinois, Taxpayer currently has Illinois corporation income and replacement tax nexus. Taxpayer manages intellectual property outside of COUNTRY2 and is responsible for brand management, licensing, marketing, the PRODUCT1, the animated TV series, home entertainment, and the official PRODUCT2 website. Its primary revenue streams include marketing and sales of trading card games, brand management, licensing, animated TV series, home entertainment, and income from a revenue sharing arrangement for intellectual property used in the PRODUCT3. Taxpayer files Form IL-1120 in Illinois for corporation income and replacement tax purposes.

On MONTH DAY, YEAR, Taxpayer acquired a %% minority and limited partner interest in a partnership, COMPANY2 (“COMPANY2”), headquartered in CITY, STATE. (It should be noted, for purposes of this PLR request, Taxpayer represents that it is not unitary with COMPANY2).

COMPANY2 generated operational losses during each tax period in which Taxpayer owned its limited partner interest in COMPANY2. Taxpayer treated the losses reported on the federal K-1 it received from COMPANY2 as “business income or loss included from non-unitary partnerships” and removed these losses from its Illinois business income before apportionment on its Form IL-1120. Taxpayer allocated the losses from COMPANY2 to STATE and STATE, the two states where it received state K-1s from COMPANY2. Based on COMPANY2’s representations to Taxpayer that COMPANY2 did not have nexus in Illinois from MONTH YEAR to MONTH YEAR. COMPANY2 did not provide an Illinois K-1-P to Taxpayer.

In MONTH YEAR, Taxpayer sold its entire limited partnership interest in COMPANY2 for a gain of approximately \$\$\$ million. On its YEAR federal Form 1120, Taxpayer treated the sale of the partnership interest as a long-term capital gain computed on Schedule D. For the short period prior to the sale, Taxpayer received a federal K-1 from COMPANY2 and included this income as ordinary income for federal income tax purposes.

Requested Rulings

1. For purposes of Taxpayer’s YEAR Illinois corporation income and replacement tax return, if Taxpayer does not have a unitary relationship with COMPANY2, and COMPANY2 did not have nexus in Illinois from MONTH YEAR to MONTH YEAR, would the gain on the sale of Taxpayer’s non-unitary partnership interest in COMPANY2 be treated as allocable income sourced to Taxpayer’s commercial domicile outside Illinois?

Analysis

For purposes of the corporation income and replacement tax, Illinois classifies income as business income or nonbusiness income. Business income, as defined under 35 ILCS 5/1501(a)(1), is:

“...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.”

Business income of persons other than residents is apportioned in accordance with the rules in 35 ILCS 5/304.

Nonbusiness income, defined under 35 ILCS 5/1501(a)(13), means all income other than business income or compensation. Nonbusiness income is allocated in accordance with the allocation rules in 35 ILCS 5/303.

Based on the representations that Taxpayer held a non-unitary partnership interest in COMPANY2, and COMPANY2 did not have nexus in Illinois from MONTH YEAR to MONTH YEAR, the allocation rules in 35 ILCS 5/303 should apply to allocate the capital gain on Taxpayer’s sale of its limited partnership interest in COMPANY2.

Since the sale of the non-unitary partnership interest is treated as a capital gain for federal income tax purposes, 35 ILCS 5/303(b), which governs the allocation of capital gains and losses, is the appropriate provision to be used to allocate Taxpayer’s capital gain. 35 ILCS 5/303(b) creates allocation rules for three categories of nonbusiness capital gains, including: (1) gains from the sale or exchange of real property; (2) gains from the sale or exchange of tangible personal property; or (3) gains from the sale or exchange of intangible personal property. As a partnership interest is intangible personal property, Taxpayer’s sale of its interest in COMPANY2 qualifies as the sale of intangible personal property.

With respect to allocating the capital gain, 35 ILCS 5/303(b)(3) requires that capital gains and losses from sales or exchanges of intangible personal property be allocated to the location of the taxpayer’s commercial domicile at the time of such sale or exchange. 35 ILCS 5/1501(a)(2) defines the term “commercial domicile” to mean the principal place from which the trade or business of the taxpayer is directed or managed. Taxpayer’s commercial domicile is in CITY,

STATE, and on this basis, the capital gain from the sale of Taxpayer's limited partnership interest should be allocated to STATE.

Conclusion

Based on the representations that Taxpayer held a non-unitary partnership interest in COMPANY2, and COMPANY2 did not have nexus in Illinois from MONTH YEAR to MONTH YEAR, the gain on the sale of Taxpayer's non-unitary partnership interest in COMPANY2 in MONTH YEAR should be treated as allocable income under 35 ILCS 5/303 and sourced to Taxpayer's commercial domicile in STATE.

We respectfully request a private letter ruling from the Department regarding this matter. Should you disagree with this opinion, please contact me to discuss this opinion prior to issuing a ruling. If you have any further questions or require any additional information, please contact me at (###) ###-####.

RULING

Section 1501(a)(1) of the Illinois Income Tax Act ("IITA", 35 ILCS 5/1501) defines "business income" as follows:

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.

Business income is explained in greater detail in the Illinois Administrative Code, including how the definition has evolved over the years. A person's income is business income unless clearly classifiable as nonbusiness income. 86 Ill. Adm. Code 100.3010(a)(3)(C).

Section 1501(a)(13) of the IITA defines "nonbusiness income" as follows:

The term "nonbusiness income" means all income other than business income or compensation.

Section 1501(a)(27) of the IITA defines "unitary business group" in pertinent part as follows:

The term "unitary business group" means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other.

Section 301(c)(1) of the IITA states that any item of income or deduction which was taken into account in the computation of base income for the taxable year by any person other than a resident and which is referred to in Section 302, 303 or 304 (relating to compensation, nonbusiness income and business income, respectively) shall be allocated to this State only to the extent provided by such section.

Section 303 of the IITA governs the allocation of nonbusiness income. Section 303(a) provides:

Any item of capital gain or loss, and any item of income from rents or royalties from real or tangible personal property, interest, dividends, and patent or copyright royalties, and prizes awarded under the Illinois Lottery Law, and, for taxable years ending on or after December 31, 2019, wagering and gambling winnings from Illinois sources as set forth in subsection (e-1) of this Section, and, for taxable years ending on or after December 31, 2021, sports wagering and winnings from Illinois sources as set forth in subsection (e-2) of this Section, to the extent such item constitutes nonbusiness income, together with any item of deduction directly allocable thereto, shall be allocated by any person other than a resident as provided in this Section.

Section 303(b) of the IITA outlines when capital gains and losses are allocable to this State. For real property, capital gains and losses are allocable to this State if the property is located in this State (35 ILCS 5/303(b)(1)). Capital gains and losses from sales or exchanges of tangible personal property are allocable to this State if, at the time of the sale or exchange, the property had its situs in this State or the taxpayer had its commercial domicile in this State and was not taxable in the state in which the property had its situs (35 ILCS 5/303(b)(2)). Capital gains and losses from sales or exchanges of intangible personal property are allocable to this State if the taxpayer had its commercial domicile in this State at the time of the sale or exchange (35 ILCS 5/303(b)(3)).

Section 1501(a)(2) of the IITA defines “commercial domicile” as follows:

The term “commercial domicile” means the principal place from which the trade or business of the taxpayer is directed or managed.

Section 304 of the IITA governs the allocation and apportionment of business income of persons other than residents. In general, pursuant to Section 304(a), the business income of a person other than a resident shall be allocated to this State if such a person’s business income is derived solely from this State. For tax years ending on or after December 31, 1998, Section 304(h) of the IITA provides if a person other than a resident derives business income from this State and one or more other states, then the apportionment factor shall be equal to the sales factor.

When a partner and partnership meet the criteria of being engaged in a unitary business, Section 304(e) requires that combined apportionment be utilized, as stated below:

Where 2 or more persons are engaged in a unitary business as described in subsection (a)(27) of Section 1501, a part of which is conducted in this State by one or more members of the group, the business income attributable to this State by any such member or members shall be apportioned by means of the combined apportionment method.

Section 305 of the IITA governs the allocation of partnership income by partnerships and partners other than residents. In general, the income generated by a partnership is to be allocated to Illinois pursuant to Section 305(a):

The respective shares of partners other than residents in so much of the business income of the partnership as is allocated or apportioned to this State in the possession of the partnership shall be taken into account by such partners pro rata in accordance with their respective distributive shares of such partnership income for the partnership's taxable year and allocated to this State.

The allocation of partnership nonbusiness income by partners other than residents is governed by Section 305(b):

The respective shares of partners other than residents in the items of partnership income and deduction not taken into account in computing the business income of a partnership shall be taken into account by such partners pro rata in accordance with their respective distributive shares of such partnership income for the partnership's taxable year, and allocated as if such items had been paid, incurred or accrued directly to such partners in their separate capacities.

86 Ill. Adm. Code Section 100.3380(d)(1) distinguishes the treatment of a partner that is unitary versus non-unitary with the partnership:

IITA Section 304(e) provides that whenever 2 or more persons are engaged in a unitary business as described in IITA Section 1501(a)(27), a part of which is conducted in this State by one or more members of the group, the business income attributable to this State by any member or members shall be apportioned by means of the combined apportionment method. Because partnerships may be members of a unitary business group within the meaning of IITA Section 1501(a)(27), this provision requires a partnership to use combined apportionment when it is engaged in a unitary business with one or more of its partners. However, partners who are not engaged in a unitary business with the partnership are required to include their shares of the partnership's business income apportioned to Illinois in their Illinois net incomes under IITA Section 305(a), and those partners' business activities in Illinois would not be represented fairly by their shares of partnership income computed by combining

the business income and apportionment factors of the partnership with the business income and apportionment factors of its unitary partners.

The gain on the sale of a partnership interest must be classified as either business income or nonbusiness income. If the gain is business income, nonresidents must include the gain in income apportioned under Section 304 of the IITA. Business income of the partnership flows through to nonresident partners as business income in accordance with Section 305(a) of the IITA. If the gain is nonbusiness income, nonresidents must include the gain in income allocated under Section 303 of the IITA. Capital gains on sales of intangible assets are allocated to the state of commercial domicile under Section 303(b)(3) of the IITA. Nonbusiness income of a partnership is taxed to the partner or shareholder as if that partner or shareholder had received the income directly, rather than through the entity, as provided in Section 305(b) of the IITA.

You have represented that you are not in a unitary business group with COMPANY2 and COMPANY2 did not have nexus in Illinois from MONTH YEAR to MONTH YEAR. You also represented taxpayer's commercial domicile is in CITY, STATE. Further, you represented the losses shown on the federal K-1 you received from COMPANY2 were reported as "business income or loss included from non-unitary partnerships" and removed those losses from your Illinois business income before apportionment on your Form IL-1120.

If the gain on the sale of the partnership interest is not business income as defined in IITA Section 1501(a)(1), then it is nonbusiness income pursuant to Section 1501(a)(13).

Assuming, *arguendo*, that the gain on the sale of the partnership interest is classified as nonbusiness income, then the capital gain would not fall under the provisions of IITA Section 304, but rather Section 303. The sale of ownership interest in a non-unitary partnership is not pass-through income from said partnership and is not subject to the provisions of pass-through income. Accordingly, the gain on the sale of the partnership interest would be treated as allocable income under IITA Section 303(b) and sourced to the Taxpayer's commercial domicile.

As stated above, this is a GIL which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department.

Sincerely,

Jennifer Uhles
Associate Counsel (Income Tax)