IT 09-0013-GIL 04/15/2009 Alternative Apportionment

> General Information Letter: Request to combine a transportation company and an insurance company is denied.

April 15, 2009

Dear:

This is in response to your letter dated January 12, 2009 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 who is the subject of the request for 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).

Although a ruling granting an alternative allocation or apportionment has been requested, because the petition fails to sustain the burden of proof required under 86 Ill. Adm. Code 100.3390 the Department must respond by GIL denying the petition.

Your letter states as follows (footnotes omitted):

> Attached please find a Petition for Alternative Allocation or Apportionment for COMPANY1 Inc. and Affiliates for the tax year ending December 31, 2008, and for subsequent tax years.
>
> The Petition requests permission to include a related and unitary party insurance company with the COMPANY1 group. Illinois apportionment rules preclude such a combined filing.
>
> We believe the facts as stated in the Petition present a clear case for allowing this combined filing in order to avoid distortion. If you disagree, we would welcome the opportunity to meet personally and discuss the facts further.
>
> <u>Introduction and corporate structure</u>.
>
> COMPANY2 Inc. (FEIN XX-XXXXXXX) is the parent corporation of the group of companies known as COMPANY2. The COMPANY2 group includes several transportation companies. The largest transportation companies are COMPANY1 Inc. (FEIN XX-XXXXXXX), COMPANY3 Inc. (FEIN XX-XXXXXXX) and COMPANY4 Inc. COMPANY1 Inc. acts as the lead filer for the group on the annual Illinois IL-1120. Both COMPANY2 Inc. and COMPANY1 Inc. will be referred to as "the taxpayer."
>
> COMPANY2 Inc. formed COMPANY5 Limited (COMPANY5) on October 26, 1993. COMPANY2 Inc. owns 100% of COMPANY5's stock, and includes COMPANY5 in the federal consolidated income tax return filed by COMANY2 & Affiliates. The IRS has audited several cycles, and has accepted COMPANY5's insurance company status. Although, as discussed below, COMPANY5 shares a strong unitary relationship with the other members of the group, Illinois § 1501(a)(27) prohibits its inclusion in the Illinois combined return.
>
> <u>What is COMPANY5 and what does it do</u>?

The COMPANY2 companies purchase insurance against various risks, including workers' compensation, auto liability, general liability and property from COMPANY5. In order to balance overall premium costs with the coverage of major or catastrophic losses, COMPANY5 provides the COMPANY2 group with an option to insure losses that would otherwise fall within the deductible layer of policies guarding against major or catastrophic loss. The current structure coverage is depicted below.

Risk	Abbreviation
Auto Liability	AL
General Liability	GL
Employers' Liability	EL
Workers' Compensation	WC
Earthquake	EQ
Property	PR

The table below summarizes major coverages by company, risk, and carrier.

[TABLE OMITTED]

As you can see from this table, COMPANY2 entities essentially pool their risks and purchase coverage from COMPANY5 for the deductibles under the outside policies. COMPANY5 underwrites / sets the rates for these policies based on actual historical experience.

COMPANY5 results for 2007 and Year-to-Date November 2008 are as follows:

[TABLE OMITTED]

Like any true insurance company, COMPANY5 can either earn income or incur losses in any given year, based on actual historical experience.

<u>Insurance premium and loss payments are valid business expenses</u>.

While insurance costs are of concern to every business enterprise, transportation companies may be uniquely vulnerable to a tax policy such as the new Illinois law.

Trucking is a high-volume, low-margin, physically demanding activity. COMANY1 drivers alone moved 8.8 million tons – 16.6 billion pounds – over 760 million miles in 2007. COMPANY2 invests millions of dollars each year in safety programs and has earned several local and national awards, including most recently the STATE Motor Carriers Association award for safety. COMPANY2's record is one of the best in a dangerous business.

Despite COMPANY2's investments and its driver's extraordinary care, the fact remains that in an environment often marked by traffic and weather extremes, accidents unfortunately happen. These accidents result in sometimes significant losses. Payment of these losses by our related insurer is a necessary and valid business expense, not an exploitation of a "corporate loophole."

The Illinois law change, combined with the prohibition against combining insurance companies with transportation companies, distorts Illinois taxable income.

As noted above, trucking is a high-volume, low-margin, dangerous operation. Losses comprise a significant portion of operating expenses, as shown in the table below.

[TABLE OMITTED]

2007 losses exceeded many other deductible expenses, including office supplies, utilities, and communications. Excluding valid deductions for insurance, merely because COMPANY2 pays the premiums to an affiliated entity, far exceeds closing a "corporate loophole." Singling out insurance premiums among other valid, third-party expenses for discriminatory tax treatment creates distortion in a unitary group; it does nothing to resolve it.

The COMPANY2 enterprise is a major Illinois employer and taxpayer

The rationale for the insurance premium disallowance, in the words of Illinois governor Rod Blagojevich, was to close a loophole by which "12,500 businesses, representing some of the largest corporations in Illinois, with billions in annual revenue paid an average of $151 in corporate income tax."

While COMPANY2 cannot speak for other large corporations, this statement grossly misrepresents COMPANY2's history as an Illinois corporate citizen to strike at a company that provided over 1500 family wage jobs, including health insurance, to Illinois residents in 2007.

[TABLE OMITTED]

COMPANY5 is a unitary member of the COMPANY1 transportation group.

Illinois Section 1501(a)(27) defines a "unitary business group" as "a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other." COMPANY5 and the COMPANY2 operating companies meet each of these requirements.

A. Common ownership. COMPANY2 Inc. owns 100% of each subsidiary.
B. Integrated, dependent, contributing business activities. COMPANY1 and its affiliated transportation companies purchase nearly all of their insurance, excluding coverage for catastrophic losses, from COMPANY5. COMPANY5's low-priced risk pooling offers a real advantage to the COMPANY2 group and is an integral part of the business. COMPANY5's absence would force COMPANY2 to purchase higher-priced coverage elsewhere. COMPANY2's insurance group advises that purchasing COMPANY5 insurance from a nonaffiliated insurance company would increase COMPANY2's insurance costs by 25%. Ironically, this would reduce Illinois taxable income rather than increase it.

Relief Sought

Section 1501(a)(27) excludes from a unitary business group "members which are ordinarily required to apportion business income under different subsections of Section 304." As 304(d) mandates transportation-specific apportionment methods, no nontransportation company, including an insurance company, may join any transportation unitary return, regardless of the extent of the underlying business relationships. Section 304(d), by excluding a unitary insurance company such as COMPANY5, distorts taxable income by effectively disallowing any deduction for valid losses paid to third parties.

Section 304(f)(4) allows the Director to cure this distortion by "the employment of any other method to effectuate an equitable allocation and apportionment of the person's business income." In this case, including COMPANY5 in the COMPANY2 and Affiliates unitary group would achieve the proper unitary result. Any net underwriting/investment income, all generated through the unitary business, would be subject to Illinois income.

We believe this is the true aim of the legislation – not to disallow valid and necessary business deductions, but to report true unitary taxable income to the State. A "pro forma" Calendar Year 2007 return including COMPANY5 in the unitary group is attached, as well as a copy of the return as originally filed on October 15, 2008.

Mechanically, if the insurance company is a member of the unitary transportation group, intercompany premiums would be effectively eliminated. The unitary group would then deduct expenses for third-party insurance claims, and report taxable income for any third-party revenues such as interest and other investment income. You can see that Illinois tax increases from $476,553 on the return as originally filed to $553,968 when the insurance company is included. This is due to the inclusion of the insurance company's net interest and investment income in Illinois taxable income – a reasonable and logical result, given the insurance company's status as a unitary company.

The taxpayer requests permission from the Department of Revenue to include COMPANY5 in the unitary transportation group Illinois income tax returns for years ending on or after December 31, 2008.

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) [of Section 304] do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Department 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 304(f) does not provide a basis for the relief sought in your Petition. Section 304(f) allows the Department to depart from the statutorily prescribed formulas for apportioning business income under Section 304(a) through (e) in cases where the application of those formulas does not result in an apportionment of business income that reflects the relative amount of business activity conducted in Illinois. The section does not allow the Department to depart from the definition of unitary business group under IITA Section 1501(a)(27) by including in the group a company that the statute excludes.

IITA Section 203(b)(2)(E-14) disallows a deduction for certain insurance premium expenses by requiring an addition modification to taxable income. The section states in part:

> For taxable years ending on or after December 31, 2008, an amount equal to the amount of insurance premium expenses and costs otherwise allowed as a deduction in computing base income, and that were paid, accrued, or incurred, directly or indirectly, to a person who would be a member of the same unitary business group but for the fact that the person is prohibited under Section 1501(a)(27) from being included in the unitary business group because he or she is ordinarily required to apportion business income under different subsections of Section 304.

IITA Section 1501(a)(27) defines the term "unitary business group" as a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other. However, the section includes the following language:

> In no event, however, will any unitary business group include members which are ordinarily required to apportion business income under different subsections of Section 304 except that for tax years ending on or after December 31, 1987 this prohibition shall not apply to a unitary business group composed of one or more taxpayers all of which apportion business income pursuant to subsection (b) of Section 304, or all of which apportion business income pursuant to subsection (d) of Section 304, and a holding company of such single-factor taxpayers (see definition of "financial organization" for rule regarding holding companies of financial organizations). If a unitary business group would, but for the preceding sentence, include members that are ordinarily required to apportion business income under different subsections of Section 304, then for each subsection of Section 304 for which there are two or more members, there shall be a separate unitary business group composed of such members. For purposes of the preceding two sentences, a member is "ordinarily required to apportion business income" under a particular subsection of Section 304 if it would be required to use the apportionment method prescribed by such subsection except for the fact that it derives business income solely from Illinois.

This aspect of the unitary business group definition, commonly referred to as the noncombination rule, means that, except in the case of certain holding companies, persons required on a separate company basis to apportion business income using different subsections of Section 304 cannot be members of the same unitary business group.

Your Petition asserts that taken together IITA Section 203(b)(2)(E-14) and the noncombination rule result in distortion of the COMPANY2 group's taxable income. To the contrary, these provisions do not distort taxable income, but are specifically intended by the IITA to apply in calculating Illinois net income as defined in IITA Section 202. Illinois net income is defined in Section 202 as base income (i.e. federal taxable income plus or minus addition and subtraction modifications) allocated or apportioned to Illinois. The Illinois Legislature clearly intended that no deduction be allowed for insurance premiums paid by a combined group to its captive insurance company. By virtue of the addition modification in Section 203(b)(2)(E-14), the IITA defines taxable income so that insurance premiums paid to a captive insurance company are not allowable expenses. Such disallowance is specifically intended in calculating the amount of income that will be allocated and apportioned under the provisions Article 3 of the IITA. Similarly, the statutory definition of unitary business group states that such group does not include any company required to use a different subsection of Section 304 to apportion business income. It follows that a transportation company and insurance company may not be part of the same unitary business group, may not be part of the same combined group under IITA Section 502(e), and must apply the combined apportionment method under IITA Section 304(e) either separately or as part of different unitary business groups. Consequently, transactions between a transportation company and insurance company are not accorded intercompany transaction treatment, and in the case of insurance premiums are not allowed as a deduction to the transportation company. These results are clearly intended by the Legislature, and do not result from application of the apportionment methods prescribed under IITA Sections 304(a) though (e).

Finally, if IITA Section 304(f) were to apply as your Petition suggests, to include in a unitary business group a corporation otherwise excluded under the noncombination rule in order to “achieve the proper unitary result,” the noncombination rule would be effectively read out of the statute. Under this view, the noncombination rule would be considered distortive of the “proper unitary result” in every case.

For the above-stated reasons, your Petition must be denied.

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. If you wish to obtain a PLR which will bind the Department, please submit a request conforming to the requirements of 2 Ill. Adm. Code 100.1200 and 86 Ill. Adm. Code 100.3390.

Sincerely,

Brian L. Stocker
Associate Counsel (Income Tax)