

Private Letter Ruling: Under facts represented in the request, regulation Section 100.3380(c)(2) would require elimination of gain from sales factor and lack of income-producing activities in Illinois would prevent interest income from being included in the Illinois numerator of the sales factor.

September 15, 2001

Dear:

This is in response to your letter dated September 10, 2001 in which you request a Private Letter Ruling on behalf of xxxxxxxxxxxxxx (“xxxxxxxxxxx”) and xxxxxxxxxxxxxx (“xxxxxxxxxxx”). Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of 86 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 xxxxxxxxxxxx and xx xxxxxxxxxxxx for the issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that xxxxxxxxxxxx, xxxxxxxxxxxx and/or any related taxpayer(s) is not 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:

Pursuant to 2 Ill. Admin. Code Sec. 1200.110, our client, xxxxxxxxxxxxxxxxxxxxxxxx., a Delaware corporation (“xxxx”), on behalf of its proposed subsidiaries, xxxxxxxxxxxxxxxx, which would be a Delaware limited liability company (“xxxxxxxxxxx”), and xxxxxxxxxxxxxxxx, which would also be a Delaware limited liability company (“xxxxxxxxxxx”), requests the Department of Revenue (the “Department”) issue a Private Letter Ruling (the “PLR”) interpreting the application to xxxxxxxxxxxx and xxxxxxxxxxxx of the Illinois income and replacement tax laws and the Department’s regulations administering the same in the proposed international restructuring transaction engaged in by xxxxxxxxxxxx, xxxxxxxxxxxx and other members of xxxxx affiliated group.

I. Administrative Matters

- 1) An original Form IL-2848, Power of Attorney, authorizing the undersigned to represent xxx in this matter is enclosed.
- 2) This request regards the application of the Illinois income and replacement tax laws.
- 3) The PLR is not requested with regard to a hypothetical or alternative proposed transaction. The PLR is requested with regard to actual transactions formerly taking place and future transactions that will or will not occur based on the Department’s response to this PLR.
- 4) xxx is not currently under audit by the Department on these transactions; however, xxx and certain of its affiliates have been audited or are currently undergoing audit by the Department on transactions unrelated to those discussed herein.
- 5) At this time, we are not enclosing any documents pertinent to this request other than an organizational chart identifying the subject business entities.
- 6) To the best of the knowledge of employees and representatives of xxx and its affiliates, and to the best of my own knowledge, the Department has not previously ruled on the application of the Illinois income and replacement tax laws to xxx under the facts as presented,

and the issues raised herein have not previously been formally submitted to the Department by xxx or members of its affiliated group.

7) xxx respectfully requests that all business names, addresses, business locations, country names, and representative names be deleted from the PLR prior to public dissemination.

I. Statement of Authority

There are no direct cases or Illinois Private Letter Rulings addressing the specific facts described herein.

II. Issues Presented

1. Whether the proposed activities of xxxxxxxxxx or its affiliates, as set forth below, will cause any portion of the subject gain to be characterized as an Illinois receipt for apportionment purposes.
2. Whether the proposed activities of xxxxxxxxxx or its affiliates, as set forth below, will cause any portion of the subject interest income to be characterized as an Illinois receipt for apportionment purposes.
3. Whether the proposed activities of xxxxxxxxxxxxxx or its affiliates, as set forth below, will cause any portion of the subject interest income to be characterized as an Illinois receipt for apportionment purposes.

III. Statement of Facts

A. Background

As proposed, xxxxxxxxxx would be an indirect, wholly-owned subsidiary of xxx, which is an engineered components and specialty systems company with headquarter offices located in xxxxxxxx, Illinois. xxxxxxxxxx would be a direct, wholly-owned subsidiary of xxxx xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx, a Delaware corporation (“xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx”) (another indirect, wholly-owned subsidiary of xxx).

In November 1999, xxx acquired the stock of xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx, a Delaware corporation (“xxx”). In connection with that merger, xxx acquired numerous businesses located both within and outside of the United States. xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx was created to serve as an intermediate holding company for the various xxx and xxx business entities located outside of the United States.

xxxxxxx would maintain its principal office at xxxxxxxxxxxxxxxxxxxx, xxxxxxxx, xxxxxxxx, Delaware. For federal and Illinois tax purposes, xxxxxxxx would be classified as corporation. For Delaware and Illinois legal purposes, xxxxxxxx would be classified as a limited liability company (“LLC”) with a single member.

Pursuant to Title 6, section 18-201 of the Delaware Code, an LLC is created when one or more authorized persons executes a certificate of formation which is filed in the office of the Delaware Secretary of State. The document governing the internal structure, rights, and functions of a Delaware LLC is the “Limited Liability Company Agreement,” which is comparable to corporate by-laws. The Limited Liability Company Agreement is a contract

between members detailing the management structure, limitations on continuation of the business and transferability of membership interests.¹

The owners of an LLC who have all rights incident to ownership, not merely economic rights, are called "members."² Unless otherwise provided in its Limited Liability Company Agreement, the management of a Delaware LLC is vested in its members.³ And unless otherwise provided in the LLC's Limited Liability Company Agreement, a member of the LLC has the power and authority to delegate the member's rights and powers to manage and control the LLC's business and affairs including delegation by a management agreement.⁴

In the instant matter, xxxxxxxxxx would be organized as a single member, member-managed LLC. Acting pursuant to Section 18-407 of the Delaware LLC Act, the member (xxxxxxxxxxxx xxxxxxxxxx) will enter into a management services contract with xxx pursuant to which xxx will provide management services relating to the business and affairs of xxxxxxxxxx. xxx will perform such services using its own officers and employees at xxxxx office in xxxxxxxx, Illinois and from xxxxxxxxxx office in xxxxxxxxxx, Delaware.⁵ xxxxxxxxxx would also have a permanent employee who would conduct its day-to-day business activities from xxxxxxxxxx xxxxxxxxxx, Delaware office.

B. Relevant Legal Entities

Initially, xxxxxxxxxx would be an intermediate holding company that would own the share or member interests in two legal entities:

1. xxxxxxxxxxxxxxxxxxxxxxxxxx, a xxxxxxxxxx company ("xxxxxxxxxxxxxxx"); and,
2. xxxxxxxxxx.

xxxxxxxxxxxxxxx is a xxxxxxxxxx-based operating company. As of May 31, 2001, (the date of its latest balance sheet) xxxxxxxxxx had total assets valued at U.S. \$24,551,890. Of that amount, net property, plant and equipment totaled U.S. \$5,318,948 (gross cost was U.S. \$11,790,762), and inventory totaled U.S. \$6,536,163. Also as of May 31, 2001, xxxxxxxxxx had 349 full-time employees and 9 part-time employees.

Two of xxxxxxxxxxxxxxxxxx directors are domiciled in xxxxxxxxxx, one director is domiciled in xxxxxxxxxx, and two directors are domiciled in Illinois. As of the date hereof, xxxxxxxxxx is classified as a disregarded entity for U.S. federal tax purposes. Accordingly, xxx xxxxxxxxxx would be treated as a branch of xxxxxxxxxx for U.S. federal tax purposes.

xxxxxxxxxxxxxxx would maintain its principal office at xxxxxxxxxxxxxxxxxx, xxxxxxxxxx, xxxxxxxxxx, Delaware. For federal and Illinois tax purposes, xxxxxxxxxx would be classified as corporation. For Delaware and Illinois legal purposes, xxxxxxxxxx would be classified as an LLC with a single member.

In addition, xxxxxxxxxx would be organized as a single member, member-managed LLC. Acting pursuant to Section 18-407 of the Delaware LLC Act, the member (xxxxxxxxxxx) will enter into a management services contract with xxx pursuant to which xxx will provide management services relating to the business and affairs of xxxxxxxxxx. xxx will perform such services using its own employees at xxxxx office in xxxxxxxx, Illinois and from xx xxxxxxxxxx office in xxxxxxxxxx, Delaware. xxxxxxxxxx would also have a permanent employee who would conduct its day-to-day business activities from xxxxxxxxxxxxxxxxxx xxxxxxxxxx, Delaware office.

Generally, xxxxxxxxxxxx would be engaged in various domestic and foreign intercompany financing activities. In particular, xxxxxxxxxxxx would own the share or member interests in the following entities:

1. xx (xxxxxxxx) xxx xxxxxx, a registered company under the Corporation Law of xxxxxxxx, xxxxxxxx (“xxx”);
2. xxxxxxxxxxxxxxxxxxxx, a registered company under the Corporation Laws of xxxxxxxx, xxxxxxxx (“xxx”) (indirectly through the ownership of xxx); and,
3. xxxxxxxxxxxx a Delaware corporation (“xxxx”).

xxx is limited by shares and is classified as a proprietary company under xxxxxxxx law. Its registered office is at xxxxxxxxxxxx, xxxxxxxx, xxxxxxxx xxx. As of the date hereof, xxx is classified as a disregarded entity for U.S. federal tax purposes. Accordingly, xxx would be classified as a branch of xxxxxxxxxxxx for U.S. federal income tax purposes.

xxx is limited by shares and is classified as a proprietary company under xxxxxxxx law. It was formed to serve as a full service financial and leasing company for the xxx group of companies organized and resident in xxxxxxxx. Among other things, xxx serves to centralize xxxxx borrowing, lending and licensing activities in xxxxxxxx. xxxxx primary source of revenue consists of interest and royalty income derived from financing activities with related xxxxxxxxxxxx companies. Two of xxxxx directors are domiciled in xxxxxxxx, and two of its directors are domiciled in Illinois. As of the date hereof, xxx is classified as a disregarded entity for U.S. federal tax purposes. Accordingly, xxx would be classified as a branch of xxxxxxxxxxxx for U.S. federal income tax purposes.

xxxx maintains its principal office in xxxxxxxx, Illinois, and serves as a finance and leasing company for the xxx affiliated group. It would own, in addition to the shares of various subsidiaries, the member interest in xxxxxxxxxxxxxxxxxxxx, a Delaware limited liability company (“xxxxxxxxxxxxxxxx”), which is engaged in the business of leasing real property to members of the xxx affiliated group from its principal office in xxxxxxxx, Illinois. xxxxxxxxxxxxxxxxxxxx operates in the capacity of a centralized property owner to assist corporate and operating unit management in measuring the true cost of occupancy. The role of the centralized property owner is to assume the burdens of property ownership and earn a commensurate reward. In this way, the returns for the operating businesses will be a clearer indication of the operating units deployment of their operating assets and not their real estate.

The rights and powers exercised by xxxxxxxxxxxxxxxxxxxx include the power to execute leases, as well as the power to make economic decisions regarding the use of the owned property. At present, xxxxxxxxxxxxxxxxxxxx is responsible for leasing real property located throughout the U.S (approximately 100 properties in 21 states with approximate value of \$300 million). For purposes hereof, xxxxxxxxxxxxxxxxxxxx would be classified as a division of xxxx for federal tax purposes. As a result, xxxx would have nexus in each state where xxxxxxxxxxxxxxxxxxxx engages in leasing activities.

A chart illustrating the foregoing organization structure is attached as Exhibit A.

C. The Transactions Completed Through June 18, 2001

The organization structure set forth above would be adopted as part of an overall change to the manner in which xxx conducts business operations in xxxxxxxx. Among other things, xxx

For U.S. federal tax purposes, the transaction would be ignored as a transaction between a corporation and its branch.

4. xxx would then contribute Demand Note 2 to the capital of xxx.

For U.S. federal tax purposes, the transaction would be ignored as a transaction between a branch of a corporation and another branch of the same corporation.

5. xxx would then use Demand Note 2 and its own purchase money note ("Purchase Money Note 1") to acquire the Purchase Agreements from xxxxxxxxxxxx. The value of Purchase Money Note 1 would be U.S. \$3 billion.

For U.S. federal tax purposes, the transaction would be ignored as a transaction between a corporation and its branch. Moreover, Demand Note 2 would be extinguished upon its return to its issuer, xxxxxxxxxxxx.

6. xxx would then contribute the Purchase Agreements and its obligation under Purchase Money Note 1 to xxxx in exchange for an issuance of two classes of stock. The first class of stock would be voting common stock. All of the common shares would be issued to xxx. The second class of stock would be voting preferred stock. All of the voting preferred stock would be issued to xxx.

For U.S. federal tax purposes, the contribution would be subject to the non-recognition provisions of IRC section 351. In addition, due to the terms of the voting preferred stock issued to xxx by xxxx, this instrument would be characterized as debt for federal income tax purposes. Moreover, since xxxxx basis in the Purchase Agreements would exceed the value of the liabilities assumed by xxxx (Purchase Money Note 1 and the preferred stock), there should not be a federal tax consequence associated with the subject transfer.

E. The Relevant Illinois Unitary Business Groups

For purposes of this PLR request, it should be assumed that xxx, xxxxxx, xxxxxxxxxxxxxx xxxxxxxxxxxxxx, and xxxx (including xxxxxxxxxxxxxx) would file as members of a common unitary business group along with certain other xxx affiliates. As a result, the royalty expenses reported by xxx and xxxxxx in connection with royalty payments made to xxxx in accordance with the Purchase Agreements should be offset in combination.

For purposes of this PLR request, it should also be assumed that xxxxxxxxxxxx would not be permitted to join in the filing of a combined Illinois return with the members of the xxx unitary business group. Based on the amount of xxx xxxxxxxxxxxxxx property and payroll located outside of the U.S., xxxxxxxxxxxx would be classified as an "80/20 company" that would be precluded from joining in the filing of a combined Illinois tax return with any other member of the xxx affiliated group. As a result, the gain deferred for federal tax purposes pursuant to the federal consolidated return regulations would be fully reported on a *pro forma* return filed by xxxxxxxxxxxx for Illinois tax purposes. In addition, xxxxxxxxxxxx would receive principal and interest payments from xxxxxxxxxxxx in connection with Demand Note 1.

Finally, for purposes of this PLR request, it should be assumed that xxxxxxxxxxxx would not be permitted to join in the filing of a combined Illinois return with the members of the xxx unitary business group or with xxxxxxxxxxxx. Based on the amount of xxxxx property and payroll located outside of the U.S., xxxxxxxxxxxx would also be classified as an "80/20 company" that

would be precluded from joining in the filing of a combined Illinois tax return with any other member of the xxx affiliated group or with xxxxxxxxxx. As a result, xxxxxxxxxx would receive principal and interest payments from xxxx in connection with Purchase Money Note 1 as well as interest payments from the preferred stock.⁶ Likewise, xxxx would report its interest payments to xxxxxxxxxx as a deductible expense for Illinois tax purposes without offset in combination.

V. Applicable Illinois Law

Section 304 of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *et. seq.*) provides a general framework for apportioning a taxpayer's business income to Illinois by formula. The applicable formula to be applied in the instant matter provides that, for calendar years ending on or after December 31, 2000, business income shall be apportioned to Illinois using an apportionment formula comprised solely of the sales factor.

In computing the sales factor, IITA section 304(a)(3)(C) provides:

Sales, other than sales of tangible personal property, are in this State if:

- (i) The income-producing activity is performed in this State; or
- (ii) The income-producing activity is performed both within and without this State and a greater proportion of the income-producing activity is performed within this State than without this State, based on costs of performance.

86 Ill. Admin. Code Section 100.3370(c)(3)(A) provides:

Income producing activity defined. The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by a person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a person, such as those conducted by an independent contractor.

86 Ill. Admin. Code Section 100.3370(c)(3)(B) provides:

Cost of performance defined. The term "cost of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the person.

86 Ill. Admin. Code Section 100.3370(a)(2)(D)(ii) provides:

Gross receipts from intercompany transactions between two corporate members of a federal consolidated group, the taxable income on which is deferred under Treas. Reg. Section 1.1502-13, will be included in the sales factor of the recipient unless subtracted under a provision of IITA Section 203 or eliminated in combination of the two corporations as members of a unitary business group.

86 Ill. Admin. Code Section 100.3380(c)(2) provides:

Where substantial amounts of 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.

IITA section 1501(a)(27) provides, in relevant part, that an Illinois unitary business group “will not include those members whose business activity outside of the United States is 80% or more of any such member’s total business activity....” IITA section 1501(a)(27) further provides that, in the case of persons required to apportion business income under IITA section 304(a), the foregoing test is measured using the property and payroll factors with the resulting amount divided by 2.

VI. Illinois Treatment of xxxxxxxxxxxx Gain and Interest Income

As indicated, xxxxxxxxxxxx would be a member-managed LLC. The business and affairs of xx xxxxxxxx would be managed by xxx acting as an independent contractor under a management services contract between xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx (the LLC’s member) and xxx. xxx would perform these management services using its own officers and employees who would manage the activities of xxxxxxxxxxxx from xxxxx facilities located in Illinois and xxxxxxxxxxxx office located in Delaware.

As also indicated, xxxxxxxxxxxxxxxx is classified as a branch of xxxxxxxxxxxx for federal income tax purposes. xxxxxxxxxxxxxxxx has significant property and payroll located outside of the United States. xxxxxxxxxxxx as a separate legal entity would have a single employee and leased office space both of which would be located in Delaware. Based on our calculations, at the time the subject gain is realized by xxxxxxxxxxxx, it would be deemed to have more than 80 percent of its average payroll and property located outside of the U.S.

Pursuant to IITA section 1501(a)(27), xxxxxxxxxxxx would not be permitted to file on a combined basis with xxxxxxxxxxxx for Illinois tax purposes. xxxxxxxxxxxx also would not be permitted to apply the U.S. federal consolidated return regulations in computing its Illinois taxable income for the year in which the subject gain is realized.

In view of the foregoing, xxxxxxxxxxxx would be required to file an Illinois return separate and apart from the other members of its federal affiliated group, including xxxxxxxxxxxx. As a result, xxxxxxxxxxxx would be required to prepare an Illinois return reporting U.S. federal taxable income of \$4 billion on a *pro forma* basis.

The receipts from the subject transaction would arise from an incidental or occasional sale of assets used in the regular course of xxxxxxxxxxxx business. 86 Ill. Admin. Code Section 100.3380(c)(2) provides that receipts from an incidental or occasional sale of assets used in the regular course of business should be excluded from the sales factor. As such, the subject receipts should be excluded from both the numerator and denominator of xxxxxxxxxxxx Illinois sales factor.

In addition, no portion of the interest income paid to xxxxxxxxxxxx by xxxxxxxxxxxx pursuant to Demand Note 1 should be included in the numerator of xxxxxxxxxxxx Illinois sales factor. Pursuant to 86 Ill. Admin. Code Section 100.3370(c)(3)(A), the term “income producing activity” applies to each separate item of income and means the transactions and activity directly engaged in by a person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a person, such as those conducted by an independent contractor.

In the instant matter, the usual and ordinary business activities of xxxxxxxxxxxx would be performed by xxxxxxxxxxxx Delaware-based employee and by xxx utilizing its own Illinois-

based officers and employees. xxx would be acting as an independent contractor pursuant to the management services contract. The Illinois-based officers and employees of xxx would not be officers or employees of xxxxxxxxxx. They would remain employees of xxx and, although xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx may compensate xxx for providing services under the management services contract, neither xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx nor xxxxxxxxxx would compensate any of xxxxx officers or employees, all of whom would be compensated by xxx and would at all times remain under the supervision and control of xxx. Consequently, xx xxxxxxxx should not have any Illinois income producing activities since such activities do not include those activities performed on behalf of a person.

Pursuant to the applicable regulations, it seems clear that an xxx that has no property or employees in Illinois at any time would not be conducting any income-producing activity in the State and no costs of performance associated with any income-producing activity of that taxpayer would be incurred in Illinois. Accordingly, xxxxxxxxxx would not have Illinois income producing activities in connection with its receipt of interest income from Demand Note 1. As such, although xxxxxxxxxx would be required to include the subject gain and interest income in its Illinois tax base, it would not have to report receipts from either the gain or the interest income in the numerator of its Illinois sales factor.

VII. Illinois Treatment of xxxxxxxxxxxxxxxx Interest Income

As indicated, xxxxxxxxxxxxxxxx would be a member-managed LLC. The business and affairs of xxxxxxxxxxxxxxxx would be managed by xxx acting as an independent contractor under a management services contract between xxxxxxxxxxxxxxxx (the LLC's member) and xxx. xxx would perform these management services using its own officers and employees who would manage the activities of xxxxxxxxxxxxxxxx from xxxxx facilities located in Illinois and xxxxxxxxxxxxxxxx office located in Delaware.

As also indicated, xxx would be classified as a branch of xxxxxxxxxxxxxxxx for federal income tax purposes. xxx is engaged in business as a full service financial and leasing company for the xxx group of companies organized and resident in xxxxxxxxxx, and maintains both leased employees and leased business offices in xxxxxxxxxx. Based on our calculations, at the time xx xxxxxxxxxx accrues the subject interest income, it would be deemed to have more than 80 percent of its average payroll and property located outside of the U.S. For purposes of this PLR, we are assuming that xxxxxxxxxxxxxxxx would be classified as an 80/20 company.

Pursuant to IITA section 1501(a)(27), xxxxxxxxxxxxxxxx would not be permitted to file on a combined basis with the xxx unitary business group. As a result, xxxxxxxxxxxxxxxx would not be permitted to file on a combined basis with xxxxx, the payor of the subject interest income.

In view of the foregoing, xxxxxxxxxxxxxxxx would be required to file an Illinois return separate and apart from the other members of its federal affiliated group, including xxxxx. As a result, xx xxxxxxxxxx would be required to prepare an Illinois return reporting U.S. federal taxable income arising from the xxxxx interest payments (as well as the xxxxxxxxxx income of its xxx branch).

No portion of the interest income paid to xxxxxxxxxxxxxxxx by xxxxx pursuant to Purchase Money Note 1 or the preferred stock should be included in the numerator of xxxxxxxxxxxxxxxx Illinois sales factor. Pursuant to 86 Ill. Admin. Code Section 100.3370(c)(3)(A), the term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by a person in the regular course of its trade or business for the

ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a person, such as those conducted by an independent contractor.

In the instant matter, the usual and ordinary business activities of xxxxxxxxxxxx would be performed by xxxxxxxxxxxx Delaware-based employee and by xxx utilizing its own Illinois-based officers and employees. The Illinois-based officers and employees of xxx would not be officers or employees of xxxxxxxxxxxx. They would remain employees of xxx and, although xx xxxxxxxx may compensate xxx for providing services under the management services contract, neither xxxxxxxxxxxx nor xxxxxxxxxxxx would compensate any of xxxxx officers or employees, all of whom would be compensated by xxx and would at all times remain under the supervision and control of xxx. Consequently, xxxxxxxxxxxx should not have any Illinois income producing activities since such activities do not include those activities performed on behalf of a person.

Pursuant to the applicable regulations, it seems clear that an LLC that has no property or employees in Illinois at any time would not be conducting any income-producing activity in the State and no costs of performance associated with any income-producing activity of that taxpayer would be incurred in Illinois. Accordingly, xxxxxxxxxxxx would not have Illinois income producing activities in connection with its receipt of interest income from Purchase Money Note 1 or the preferred stock. As such, although xxxxxxxxxxxx would be required to include the subject interest income in its Illinois tax base, it would not have to report the interest income in the numerator of its Illinois sales factor.

VIII. Request for Ruling

We respectfully request a ruling that, although xxxxxxxxxxxx and xxxxxxxxxxxx may be required to file Illinois returns on a separate basis from each other and from the other members of their U.S. federal consolidated group, and although they may have to include the subject income in their respective pre-apportionment income base, neither xxxxxxxxxxxx nor xxxxxxxxxxxx would be required to apportion any income to Illinois. Specifically, we request a ruling that:

- (i) the subject gain should be excluded from xxxxxxxxxxxx Illinois apportionment factor as proceeds arising from an isolated or occasional sale pursuant to 86 Ill. Admin. Code Section 100.3380(c)(2);
- (ii) the interest paid to xxxxxxxxxxxx by xxxxxxxxxxxx pursuant to Demand Note 1 should not be included in the numerator of xxxxxxxxxxxx Illinois apportionment factor because xxxxxxxxxxxx would not have Illinois income producing activities in connection with its receipt of the subject income; and,
- (iii) the interest paid to xxxxxxxxxxxx by xxxxx pursuant to Purchase Money Note 1 or the preferred stock should not be included in the numerator of xxxxxxxxxxxx Illinois apportionment factor because xxxxxxxxxxxx would not have Illinois income producing activities in connection with its receipt of the subject income.

We represent that sufficient reason has been presented for the Department to issue a PLR confirming the tax consequences discussed above. However, if the Department intends to rule that the transactions described herein give rise to an obligation under the Illinois income tax and the personal property replacement tax, we respectfully request that advance notice of such intent be provided to us so that we may provide needed clarification, information or argument that may yet persuade the Department to issue a PLR as requested. Such notice may be given to the undersigned.

RULING

I. Applicable Law

Section 201(a) of the Illinois Income Tax Act (“the IITA”; 35 ILCS 5/101 *et seq.*) imposes a tax measured by “net income” upon every corporation on the privilege of earning or receiving income in Illinois. Similarly, section 201(c) imposes the Personal Property Tax Replacement Income Tax upon the privilege of earning or receiving income in Illinois. Section 502(a) requires that a corporation file an Illinois income tax return for each taxable year for which the corporation is liable for tax, and for each year it is qualified to do business in Illinois and required to file a federal return, even if not liable for Illinois tax. Section 1501(a)(4) of the IITA defines the term “corporation” to include a limited liability company treated as a corporation for federal income tax purposes.

Section 202 of the IITA defines “net income” to mean the portion of the taxpayer’s “base income” allocable to Illinois, less a standard exemption (IITA §204) and the deduction for net operating losses (IITA §207). In general, a corporation’s “base income” means its federal “taxable income” adjusted by certain statutory addition and subtraction modifications. (IITA §203(b)) However, in the case of a corporation that is a member of an affiliated group of corporations that elect to file a consolidated federal income tax return, the corporation’s “taxable income” is its taxable income determined “as if” it had filed instead a separate federal income tax return. (IITA §203(e)(2)(E))

IITA section 502(e) provides in part:

For taxable years ending on or after December 31, 1993, taxpayers that are corporations (other than Subchapter S corporations) and that are members of the same unitary business group shall be treated as one taxpayer for purposes of any original return, amended return which includes the same taxpayers of the unitary group which joined in filing the original return, extension, claim for refund, assessment, collection and payment and determination of the group’s tax liability under this Act.

IITA section 1501(a)(27) defines the term “unitary business group” to mean a group of commonly owned persons whose business activities are integrated, interdependent, and contribute to each other. However, the statute provides that a unitary business group does not include “80/20 companies.” Specifically,

[t]he group will not include those members whose business activity outside the United States is 80% or more of any such member’s total business activity. [B]usiness activity within the United States shall be measured by means of the factors ordinarily applicable under [subsection (a)] ... of Section 304 except that ... such members shall not use the sales factor in the

computation and the results of the property and payroll factor computations shall be divided by 2 (by one if either the property or payroll factor has a denominator of zero).

Pursuant to section 301(c) of the IITA, that portion of a corporation's base income that constitutes business income is allocated to Illinois under section 304. Section 304(a) sets forth the manner by which a corporation other than an insurance company, financial organization, or transportation company allocates its business income to Illinois, as follows:

The business income of a person other than a resident shall be allocated to this State if such person's business income is derived solely from this State. 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 in 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 weighing their property, payroll, and sales factors as provided in subsection (h) of this Section.

For taxable years ending on or after December 31, 2000, under section 304(h) the apportionment factor under section 304(a) equals the sales factor.

The sales factor is defined at IITA section 304(a)(3)(A) as a fraction, the numerator of which is Illinois sales during the taxable year and the denominator of which is the total sales of the taxpayer. Illinois Department of Revenue Regulations ("Regulations") section 100.3370(a)(1) provides that the term "sales" for purposes of the sales factor means all gross receipts from transactions and activity in the regular course of the taxpayer's trade or business. In addition, Regulations section 100.3370(a)(2)(D)(ii) provides that gross receipts with respect to intercompany transactions the taxation of which is deferred pursuant to the federal consolidated return rules will be included in the sales factor unless subtracted from base income or eliminated in the computation of unitary business income. However, Regulations section 100.3380(c)(1) states:

Where substantial amounts of 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.

IITA section 304(a)(3)(C) provides the sourcing rule for sales factor purposes for gross receipts from sales other than sales of tangible personal property. The section states:

Sales, other than sales of tangible personal property, are in this State if:

- (i) The income-producing activity is performed in this State; or

(ii) The income-producing activity is performed both within and without this State and a greater proportion of the income-producing activity is performed within this State than without this State, based on performance costs.

Regulations section 100.3370(c)(3)(A) explains this rule in more detail:

Income producing activity defined. The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a person, such as those conducted on its behalf by an independent contractor.

Pursuant to these provisions, only the activities of the taxpayer and the taxpayer's employees may be considered income-producing activity of the taxpayer. Activities of other third parties may not be considered income-producing activity of the taxpayer. Thus, a taxpayer without property or employees in Illinois at any time would not be conducting income-producing activity within Illinois. (See General Information Letter, IT-99-0040)

II. Analysis

A. xxxxxxxxxx

1. Base income

As indicated above, a corporation's Illinois net income equals that portion of its base income allocable to Illinois, less a standard exemption and the deduction for net operating losses. Base income means taxable income, adjusted by certain statutory addition and subtraction modifications. Your letter indicates that xxxxxxxxxx will be organized as a Delaware LLC. For federal income tax purposes, xx xxxxxx will be treated as a corporation and as a member of an affiliated group of corporations filing a consolidated federal income tax return. In addition, you indicate that xxxxxxxxxx will own the share or member interests in xxxxxxxxxxxxxxxx. xxxxxxxxxxxxxxxx will be treated as a branch of xxxxxxxxxx for federal income tax purposes, so that its tax items and attributes will be attributable to xxxxxxxxxx. Taking account of xxxxxxxxxxxxxxxx property and payroll located outside the United States, you indicate that xxxxxxxxxx would be classified as an "80/20 company" under IITA §1501(a)(27).

Based upon your representations, the Department rules as follows. xxxxxxxxxx will be treated as a corporation for Illinois income tax purposes pursuant to section 1501(a)(4) of the IITA. xxxxxxxxxx may not be a member of a unitary business group under IITA section 1501(a)(27) treated as one taxpayer for Illinois income tax purposes since 80% or more of its business activity is located outside the United States. Accordingly, pursuant to IITA section 203(e)(2)(E) xxxxxxxxxx must compute its base income as if it had filed a separate income tax return for the taxable year for federal income tax purposes. xxxxxxxxxx must satisfy any liability for Illinois income tax under IITA section 201, as well as meet any requirement to file an Illinois income tax return under IITA section 502(a).

Your letter states that xxxxxxxxxx will transfer to xxxxxxxxxxxxxxxx certain "Purchase Agreements" in exchange for a Demand Note 1. Demand Note 1 has a FMV of U.S. \$4 billion.⁷ Your letter implies

that xxxxxxxxxxxx adjusted basis in the Purchase Agreements for federal income tax purposes will be zero.

Based upon your representations, the Department rules that xxxxxxxxxxxx must realize gain of U.S. \$4 billion under Internal Revenue Code (IRC) section 1001(a). Pursuant to IRC section 1001(c), the entire amount of that gain must be recognized.⁸ Thus, xxxxxxxxxxxx must include in Illinois base income the \$4 billion realized gain. In addition, xxxxxxxxxxxx must include in base income any interest income with respect to Demand Note 1 properly recognized in its federal taxable income.

2. Illinois Apportionment Factor

As indicated above, that portion of a corporation's base income that constitutes business income is allocated to Illinois under IITA section 304. Section 304(a) requires corporations (other than insurance companies, financial organizations, and transportation companies) to allocate business income to Illinois based upon its apportionment factor. For taxable years ending on or after December 31, 2000, the apportionment factor under section 304(a) equals the sales factor. Section 304(a)(3)(A) defines the sales factor is a fraction equal to the taxpayer's Illinois sales for the taxable year over its total sales everywhere.

a. Receipts on Sale of Purchase Agreements

As indicated above, the sales factor generally includes all gross receipts from transactions and activity in the regular course of the taxpayer's trade or business. However, under Regulations section 100.3380(c)(2) the sales factor does not include substantial amounts of gross receipts that arise from an incidental or occasional sale of assets used in the regular course of the taxpayer's trade or business. Your letter represents that gross receipts with respect to xxxxxxxxxxxx sale of Purchase Agreements to xxxxxxxxxxxx would arise from an incidental or occasional sale of assets used in the regular course of xxxxxxxxxxxx business. Based upon your representation, the Department rules that such gross receipts will be entirely excluded from the sales factor.

b. Interest

As indicated above, gross receipts from sales other than sales of tangible personal property are in Illinois if the income-producing activity is performed in Illinois, or if such activity is performed both within and without Illinois and the greater proportion of such activity is performed within Illinois than outside Illinois, based on costs of performance. Under Regulations section 100.3370(c)(3)(A), the term "income-producing activity" applies with respect to each item of income and is defined as the transactions and activity directly engaged in by the person in the regular course of its trade or business. However, such activity does not include activity performed on behalf of the taxpayer, such as activity conducted by an independent contractor. As indicated above, only activities of the taxpayer and its employees may be considered income-producing activity of the taxpayer. Therefore, a taxpayer without property or employees in Illinois at any time does not conduct income-producing activity in Illinois.

Your letter represents that xxxxxxxxxxxx will not own or use any property in Illinois, and that its daily operations will be performed by its employee in Delaware. Further, you represent that xxxxxxxxxxxx will

be a member-managed LLC under Delaware law, and that pursuant to that law its sole member, xxxxxxxxxxxxxxxxxxxxxxxxxxxx, will enter into a management services contract with xxxx Pursuant to that contract, xxx will provide management services to xxxxxxxxxxxx as an independent contractor. Such services will be performed by xxxxx officers and employees in Illinois solely in their capacity as officers and employees of xxx. Lastly, it does not appear from your letter that xxxxxxxxxxxxxxxxxxxx owns or uses any property in Illinois, or has employees in Illinois. Although two xxxxxxxxxxxxxxxxxxxx directors are domiciled in Illinois, directors of a corporation are considered independent contractors. (Rev. Rul. 57-246, 1957-1 C.B. 338)

Based upon your representations, the Department rules that xxxxxxxxxxxx will not be required to include interest with respect to Demand Note 1 in the numerator of its Illinois sales factor. Because the only activities in Illinois related to the conduct of xxxxxxxxxxxx business are performed on its behalf by independent contractors, xxxxxxxxxxxx does not engage in Illinois in any income-producing activity.

B. xxxxxxxxxxxxxx

1. Base Income

Your letter indicates that xxxxxxxxxxxx will be organized as a Delaware LLC. For federal income tax purposes, xxxxxxxxxxxx will be treated as a corporation and as a member of an affiliated group of corporations filing a consolidated federal income tax return. In addition, you indicate that xxxxxxxxxxxx will own the share or member interests in xxx (indirectly through its ownership of xxx). xxx will be treated as a branch of xxxxxxxxxxxx for federal income tax purposes, so that its tax items and attributes will be attributable to xxxxxxxxxxxx. Taking account of xxxxx property and payroll located outside the United States, you indicate that xxxxxxxxxxxx would be classified as an "80/20 company" under IITA section 1501(a)(27).

Based on your representations, the Department rules as follows. xxxxxxxxxxxx will be treated as a corporation for Illinois income tax purposes pursuant to section 1501(a)(4) of the IITA. xxxxxxxxxxxx may not be a member of a unitary business group under IITA section 1501(a)(27) treated as one taxpayer for Illinois income tax purposes since 80% or more of its business activity is located outside the United States. Accordingly, pursuant to IITA section 203(e)(2)(E) xxxxxxxxxxxx must compute its base income as if it had filed a separate income tax return for the taxable year for federal income tax purposes. xxxxxxxxxxxx must satisfy any liability for Illinois income tax under IITA section 201, as well as meet any requirement to file an Illinois income tax return under IITA section 502(a).

Your letter states that xxxxxxxxxxxx will transfer to xxxx the Purchase Agreements acquired from xx xxxxxxxx in exchange for common and preferred stock of xxxx. In addition, xxxx will assume Purchase Money Note 1 payable to xxxxxxxxxxxx.⁹ Also, your letter indicates that the preferred stock of xxxx will be treated as debt for federal income tax purposes.

You have represented that xxxxxxxxxxxx does not realize gain on the transfer of Purchase Agreements to xxxx. Since the aggregate value of the xxxx stock and Purchase Money Note 1 equals xxxxxxxxxxxx adjusted basis in the Purchase Agreements, no gain is realized. Accordingly, gain is not recognized under IRC section 351(b). IRC section 357(c) is not applicable. Therefore, xx

xxxxxxx must include in base income any interest income with respect to the preferred stock and Purchase Money Note 1 properly recognized in its federal taxable income.

2. Apportionment Factor

Your letter represents that xxxxxxxxxxxx will not own or use any property in Illinois, and that its daily operations will be performed by its employee in Delaware. Further, you represent that xxxxxxxxxxxx will be a member-managed LLC under Delaware law, and that pursuant to that law its sole member, xxxxxxxxxxxx, will enter into a management services contract with xxx. Pursuant to that contract, xxx will provide management services to xxxxxxxxxxxx as an independent contractor. Such services will be performed by xxxxx officers and employees in Illinois solely in their capacity as officers and employees of xxx. Lastly, it does not appear from your letter that xxx owns or uses any property in Illinois, or has employees in Illinois. Although two xxx directors are domiciled in Illinois, directors of a corporation are considered independent contractors. (Rev. Rul. 57-246, 1957-1 C.B. 338)

Based upon your representations, the Department rules that xxxxxxxxxxxx will not be required to include interest with respect to the xxx preferred stock or Purchase Money Note 1 in the numerator of its Illinois sales factor. Because the only activities in Illinois related to the conduct of xx xxxxxxxxxxxx business are performed on its behalf by independent contractors, xxxxxxxxxxxx does not engage in Illinois in any income-producing activity.

III. Summary

As set out above, the Department rules as follows:

1. xxxxxxxxxxxx gross receipts from the sale of Purchase Agreements should be excluded from its sales factor pursuant to Regulations section 100.3380(c)(2). In addition, interest income of xxxxxxxxxxxx with respect to Demand Note I should not be included in the numerator of its sales factor since xxxxxxxxxxxx does not conduct income-producing activity in Illinois.
2. Interest income of xxxxxxxxxxxx with respect to Purchase Money Note 1 and xxx preferred stock should not be included in the numerator of its sales factor since xxxxxxxxxxxx does not conduct income-producing activity in Illinois.

The facts upon which this ruling is 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.

Very Truly Yours,

Brian L. Stocker
Staff Attorney (Income Tax)

¹ Delaware Code, Title 6, section 18-101(7).

² Delaware Code, Title 6, section 18-301.

³ Delaware Code, Title 6, section 18-402.

⁴ Delaware Code, Title 6, section 18-407.

⁵ It is possible that a person who is an officer of both xxxxxxxxxxxxxxxxxxxxxxxxxxxx and xxx may be asked by xxx to provide management services to xxxxxxxxxx. Such services would be performed solely under the terms of the management contract. The services in question would not be performed in the person's capacity as an officer of xxxxxxxxxxxxxxxxxxxxxxxxxxxx.

⁶ Under the described facts, interest paid by xxxx in connection with the preferred stock would be paid to xxx. As noted, xxx would be classified as a branch of xxxxxxxxxxxxxx for U.S. tax purposes. Therefore, for U.S. tax purposes, the subject income would be deemed to have been earned by xx xxxxxxxxxx through one of its divisions. Solely for purposes of this PLR request, such interest income will generally be discussed as if it were paid directly by xxxx to xxxxxxxxxxxxxx.

⁷ It is assumed for purposes of this PLR that the demand note is properly treated as debt for federal income tax purposes, and that the FMV of the Purchase Agreements is U.S. \$4 billion.

⁸ It is assumed for purposes of this ruling that the entire \$4 billion realized gain must be recognized for federal income tax purposes in the taxable year of sale. Your letter does not indicate whether such gain is properly reportable under the installment method of IRC §453, or whether xxxxxxxxxx intends to elect out of installment reporting. See IRC §453(d); Treas. Reg. §15A.453-1(d)(3).

⁹ It is assumed for purposes of this PLR that the purchase money note is properly treated as debt for federal income tax purposes, and that the value of the stock and purchase money note total U.S. \$4 billion.