

General Information Letter: Petition for alternative apportionment does not contain sufficient information to allow a ruling.

May 15, 2012

Dear:

This is in response to your letter dated March 16, 2012, in which you request permission to exclude from apportionment certain gain realized on the sale of a significant portion of its business, rather than apportioning the gain using the statutorily-mandated apportionment formula for insurance companies, pursuant to Section 304(f) of the Illinois Income Tax Act (the "IITA"; 35 ILCS 101 *et seq.*). The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at [www.revenue.state.il.us](http://www.revenue.state.il.us). For the reasons discussed below, your petition cannot be granted at this time.

In your letter you have stated the following:

COMPANY1 formerly known as COMPANY2 ("Company") respectfully requests the issuance of a Private Letter Ruling (PLR) by the Illinois Department of Revenue pursuant to 2 Ill. Adm. Code 1200.100. The Company wishes to know the effect a sale of premium renewal rights will have on its 2011 income tax liability in Illinois. The precise questions are: (1) whether the gain from the sale of premium renewal rights described below constitutes "business income" or "non-business income" and (2) whether the gain should be subject to apportionment under Illinois Income Tax Act ("IITA") Section 304(b).

This PLR is not requested for hypothetical or alternatively proposed transactions, but rather to determine the income tax consequences of an actual transaction conducted by the Company, as described below. The Company is not currently engaged in litigation with the Department with regard to this or any other tax matter. The Department has not previously ruled regarding this matter for the Company and the Company has not submitted the same or similar issue to the Department previously. The Company is not aware of any authority contrary to the authorities referred to and cited below.

#### Statement of Facts

The Company is a mutual property and casualty insurer domiciled in STATE1. The Company is licensed for direct business in X states. After many unprofitable years, in 20XX, the Company changed its business model. As part of that change the Company found it necessary to sell a very significant portion (approximately X%) of its book of business, notably expirations and renewal rights, to COMPANY3, a STATE2 domiciled mutual property and casualty insurance company. This transaction closed in MONTH, 2011, with a net gain to the Company of \$X. As a result of this transaction the Company is actively writing business in only X offices. Illinois is one of these states.

#### Pertinent Law and Regulations

Section 1501(a)(1) of the IITA defines "business income" as all income that may be treated as apportionable business income under the Constitution of the United States. Business income is net of 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.

Section 1501(a)(13) provides “the term ‘nonbusiness income’ means all income other than business income or compensation.”

IITA Section 303 sets forth the manner in which the nonbusiness income of any person other than a resident is allocated. Section 303(b)(3) states that “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 such sale or exchange.”

Section 304 sets forth the manner in which business income of a corporation is apportioned between Illinois and one or more other states. Section 304(b)(1) states that “business income of an insurance company for a taxable year shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is the direct premiums written for insurance upon property or risk in this State, and the denominator of which is the direct premiums written for insurance upon property and risk everywhere.”

Section 304(f) of the IITA provides: If the allocation and apportionment provisions of subsections (a) through (e) and of subsection (h) do not fairly represent the extent of a person’s business activity in this State, the person may petition for, or the Director may 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.

#### Ruling Requested

Prior to the disposition of a portion of its book of business, the Company was subject to the IITA as a foreign property and casualty insurance company. The election of “treating all income other than compensation as business income” was not elected.

The transaction in MONTH 2011 did not impact its tax status because the Company continued to operate as an insurance company in X states including Illinois. According to IITA Section 1501(a)(1), it appears that the gain resulted from the sale of premium renewal rights could be admitted as “business income”, and therefore, subject to apportionment under IITA Section 304(b). However, the Company believes such treatment would lead to a significant income apportionment distortion among states and does not fairly represent its business activity in Illinois.

First, the right to write and renew an insurance policy is the primary income generating resource for an insurance company and it is jurisdictional specific. An insurance company can not procure premium income from a state without authorization. It seems only logical to allocate the gain from selling such rights back to the states where the

business sold was written.

Second, the occurrence of the transaction impacted the apportionment factor under Section 304(b) dramatically. Specifically, the factor changed from Illinois direct written premiums divided by X states direct written premiums to Illinois direct written premiums divided by X states direct written premiums. The difference in the denominator is the loss of renewal premiums in X states. In other words, the \$X gain to the Company is thrown out of the apportionment factor. The Company does not believe that Illinois should benefit from the sale of business originated from other states while other states claim zero share of the gain due to zero direct written premiums, thus zero apportionment factors. Also if Illinois were one of the X states, knowing that Illinois business were sold, would the Department agree zero gain for Illinois apportion?

Therefore, a private letter ruling is respectfully requested to address following questions:

- (1) Should the \$X gain be treated as "business income"? If not, can it be characterized as "non-business income" under IITA Section 303(b)(3)?
- (2) If it were "business income", can the Director of the Department grant a Section 304(f) relief to exclude the gain from apportionment since such apportionment would result in an unfair attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this State?

## **Response**

As you note in your request, Section 1501(a)(1) of the IITA provides that:

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.

Pursuant to the decision of the United States Supreme Court in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), the gain derived from the sale of expirations and renewal rights would be apportionable because the expirations and renewal rights serve an operational function in the business of COMPANY1. Accordingly, the gain is business income.

As an insurance company, COMPANY1 would apportion the business income from the sale to Illinois under Section 304(d) of the IITA, which apportions income using direct premiums written on risks located in the State compared to total direct premiums written.

Section 304(f) of the IITA provides for use of alternative apportionment methods in certain instances:

If the allocation and apportionment provisions of subsections (a) through (e) and of subsection (h) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may 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.

Taxpayers who wish to use an alternative method of apportionment under this provision are required to file a petition complying with the requirements of 86 Ill. Adm. Code Section 100.3390, which may be found on the Department's web site at [www. tax.illinois.gov](http://www.tax.illinois.gov). Section 100.3390(c) provides:

A departure from the required apportionment method is allowed only where such methods do not accurately and fairly reflect business activity in Illinois. 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 of going forward with the evidence and proving by clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of all proportion to the business transacted in this State. 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.

The petition contains no description of what activities the taxpayer conducted in connection with the creation, management, and eventual sale of the expirations and renewal rights that were sold, or of any other aspect of its business, or where those activities were conducted. Without such an analysis, it is impossible to determine if the apportionment fraction computed under Section 304(d) of the IITA fairly reflects the scope of the business activity of COMPANY1 within Illinois. Moreover, the petition contains no explanation of why simply excluding the gain on the sales of expirations and renewal rights from apportionable business income, as requested in the petition, would result in an amount of income apportioned to Illinois that does fairly reflect the business activity of COMPANY1 within this State. Accordingly, the petition cannot be granted at this time.

Please note that 86 Ill. Adm. Code Section 100.3390(e)(1) requires a petition to be filed at least 120 days prior to the due date (including extensions) for the first return for which permission is sought to use the alternative apportionment method. A petition filed March 16, 2012 will allow a taxpayer to use the requested method on original returns due on or after July 14, 2012, if granted.

As stated above, this is a general information letter which does not constitute a statement of policy

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that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you still believe that your petition should be granted, please supplement the petition in accordance with the provisions of 86 Ill. Adm. Code Section 100.3390. If you have any questions, you may contact me at (217) 524-3951.

Sincerely,

Paul S. Caselton

Deputy General Counsel -- Income Tax