IT 18-0002-PLR 05/03/2018 ALTERNATIVE APPORTIONMENT

Occasional Sale Rule not applicable to sale in the regular course of business.

May 3, 2018

Re: Request for Private Letter Ruling
COMPANY.

Dear Xxxxx:

This is in response to your letter dated December 18, 2017 in which you request a Private Letter Ruling on behalf of TAXPAYER. Review of your request for a Private Letter Ruling indicates that all information described in paragraphs 1 through 8 of subsection (b) of 2 Ill. Adm. Code 1200.110 is contained in your request. This Private Letter Ruling will bind the Department only with respect to TAXPAYER. Issuance of this ruling is conditioned upon the understanding that TAXPAYER 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 states as follows:

The purpose of this letter is to request a private letter ruling from the Illinois Department of Revenue ("Department"), pursuant to Section 1200.100 of Title 2 of the Illinois Administrative Code, confirming how TAXPAYER should treat the gross proceeds from the sale of a building from a unitary partnership.

Disclosure

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 with respect to this or any other tax matter.
3. The Taxpayer is not currently under audit by the Department with respect to this matter for the year in question, March 31, 2017.
4. The Taxpayer requests that certain information be redacted from the PLR prior to dissemination to others. The Taxpayer requests that its name, all contractual parties' names, its exhibits, and the name of its representative be redacted.
5. The Taxpayer knows of no authority contrary to the authorities referred to and cited below.
6. To the best of the knowledge of both Taxpayer and Taxpayer's representative, the Department has neither previously ruled on the same or a similar issue for the taxpayer or a predecessor, nor has any representative previously submitted the same or a similar issue to the Department but withdrew it before a letter ruling was issued.

Facts

Corporate Structure and General Purpose

Taxpayer is a C corporation headquartered in Chicago, Illinois. Taxpayer is in the business of purchasing real property and immediately leasing the property back to the seller of such property under a sale-leaseback arrangement. Under this historic business model, Taxpayer collects rental income and fees from the seller (lessee), with the ultimate goal of selling the property within a relatively short period of time for a gain. For federal income tax purposes, Taxpayer is a dealer in real properties. Taxpayer is ultimately wholly owned by ABC, a C corporation headquartered in Chicago, Illinois.

Recently, Taxpayer has expanded the scope of its portfolio to include larger transactions with outside investors. Due to the size of these transactions, Taxpayer has required each outside investor to serve as a formal joint venture (JV) partner with Taxpayer. The transaction that is the subject of this ruling request (the "JV" transaction) was one of the first of these larger transactions. However, the JV transaction is not unusual in nature as compared to Taxpayer's core business, and is not the only transaction undertaken by Taxpayer during the year.

The JV Transaction

The JV Transaction originated when Taxpayer entered into a contract of sale with a third party to purchase a property located in CITY 1, New Jersey on May 11, 2015 (the "JV Real Property"). To facilitate the JV Transaction, Taxpayer formed a JV, DEF, a Delaware limited liability company, on the date on which the JV Real Property was purchased. In contemplation of the JV Transaction, Taxpayer also formed GHI, a solely-owned Delaware limited liability company, disregarded for federal and Illinois income tax purposes, owned by TAXPAYER to directly hold a 40% membership interest in DEF. Taxpayer's unrelated JV partner ("Partner") held the remaining 60% membership interest in DEF. For purposes of this Private Letter Ruling request, since TAXPAYER is a disregarded entity, we will reference its member, Taxpayer, as the recipient of the flow of income and apportionment from DEF.

TAXPAYER and Partner executed a limited liability company operating agreement governing the operation of DEF. TAXPAYER Member and Partner confirmed that DEF was specifically formed for the purpose of acquiring, leasing, holding, and selling the JV Real Property. Under the agreement, Taxpayer served as the manager and tax matters partner of DEF. As manager and as discussed in the operating agreement, Taxpayer has the sole authority to sell the property. On February 18, 2016, JV sold the JV Real Property for a gain that was reported by JV for federal and Illinois income tax purposes under the installment method described in Section 453. Under the terms of the sale, payments will be received on a seller-financed note in tax periods beyond 2016. DEF will recognize the gain realized on the sale using a gross profit percentage calculated at the time of the sale as proceeds from the note are received.

Federal and Illinois Corporate Income Tax Posture

Taxpayer files as part of a federal consolidated income tax return and Illinois combined unitary corporation income return with ABC. Its year end is March 31, 2017. DEF files partnership information returns to report its income and activity, which is included on Taxpayer's federal and Illinois returns. DEF is a calendar-year taxpayer. The sale generated by the JV transaction occurred during the DEF's tax year ended December 31, 2016, but would be included in the March 31, 2017 year end tax return, in accordance with Treas. Reg. §1.706-1(a)(1).

For federal income tax purposes, DEF is treated as an investor of real property on its informational returns. As an investor, the sale of the property is accounted for using the installment method. Gain is recognized over several years as funds from a seller-financed note are received. The treatment as an investor stands in contrast to how a dealer is required to report income. Under a dealer characterization, the sale would not qualify for installment treatment and instead be accounted for as the sale of inventory in the ordinary course of a trade or business, with all of the resulting gain recognized in the year of sale. So while the sale itself occurs whether investor or dealer characterization is appropriate, the federal income tax treatment of such sale may be substantially different under either scenario.

For purposes of this Private Letter Ruling request, we have assumed that Taxpayer, TAXPAYER Member and DEF are part of the same “unitary business group,” under the definition of such term as “a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other.” See 35 Ill. Comp. Stat. 5/1501(a)(27)(A).

Questions

1. Will the sale arising from the JV Transaction includible in Taxpayer’s sales factor for purposes of Illinois corporation income tax apportionment, or excludible from Taxpayer’s sales factor as an incidental or occasional sale?

2. If includible in Taxpayer’s sales factor, then is the sale arising from the JV Transaction includible on a gross proceeds or net gain basis?

3. If includible in Taxpayer’s sales factor on a gross proceeds basis, then how are the gross receipts from the JV Transaction sourced?

4. If DEF is treated as a dealer of real property instead of an investor, would Taxpayer’s sales factor treatment of the sale from the JV Transaction be different?

Analysis

Treatment of DEF’s Income/Sales Factor to Taxpayer as Unitary Business

DEF, as a JV, is a limited liability company filing Federal Tax Form 1065, U.S. Return of Partnership Income. IITA Section 1501(a)(16) defines the term “partnership” to include a joint venture, including a limited liability company formed under the Illinois Limited Liability Company Act, classified as a partnership for federal income tax purposes. As such, the JV is addressed as a partnership in the context of this Private Letter Ruling.

If DEF is treated as an investor in real property, it will include a capital gain from the sale of the building on a Form K-1 it issues to TAXPAYER Member. The partner/member then must determine how it should treat the Form K-1 that it receives. In general, most states will look at the relationship between the member and the partnership. If a unitary relationship exists, income is generally apportioned at the partner level. This means the income and apportionment received from the partnership are combined with those of the partner/member in determining the partner/member’s state-sourced income. Conversely, if a unitary relationship does not exist, the income from the partnership is generally apportioned at the partnership level and then distributed to the

partner/member. The partner/member will then include this post-apportioned income and combine that income with its own apportioned income. Ill. Admin. Code tit. 86 100.3380(d) discusses inclusion of shares of partnership unitary business income and factors in combined unitary business income and factors of partners. Specifically, Ill. Admin. Code tit. 86 § 100.3380(d)(1) states:

"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."

Adding, Ill. Admin. Code tit. 86 § 100.3380(d)(2)(A) states the partner's distributive share of the business income and apportionment factors of the partnership shall be included in that partner's business income and apportionment factors.

Inclusion of Proceeds from JV Transaction in Taxpayer's Sales Factor

Since we have assumed that a unitary relationship exists between DEF and Taxpayer, and the income and apportionment factor received from DEF should be combined with Taxpayer's own income and apportionment factor, the next issue to be considered is whether the sale arising from the JV transaction is includible in Taxpayer's sales factor for purposes of Illinois corporation income tax apportionment, or excludible from Taxpayer's sales factor as in incidental or occasional sale. Ill. Admin. Code tit. 86 § 100.3380(c)(2) states that, "when gross receipts arise from an incidental or occasional sale of assets used in the regular course of the person's trade or business, those gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded. Gross receipts from an incidental or occasional sale of stock in a subsidiary will also be excluded." The recently amended Illinois regulation provides several reasons when it is appropriate to exclude the gross receipts from the sales factor including:
● when sales are not made in the market for the person's goods, services or other ordinary sources of business income.
● to the extent that gains realized on the sale of assets in a taxpayer's business are the recapture of depreciation deductions, the taxpayer's economic income was understated in the years when those deductions were taken. In this situation, the recapture gains should be allocated using a method approximating the factor used in apportioning the deductions.
● to the extent the gain on the sale is from goodwill or similar intangibles, including the gross receipts will not reflect the market for the taxpayer's ordinary sources of business income.
● for sales of assets that are made in connection with a partial or complete withdrawal from the market in the state where the assets are located, including the gross receipts from these sales would increase the business income apportioned to that state when the taxpayer's market in that state has decreased.

We do not believe the sale of the property at the DEF level would be considered an incidental or occasional sale of assets described above, as the sole purpose of the JV was to purchase and lease back the property, and ultimately sell the property, in accordance with its business plan. The JV Transaction is markedly different from the sale of a factory or plant, as those types of assets are generally not the primary product a company sells or the reason it started a business. Additionally, the sale of a subsidiary can occur if a business is trying to exit a particular product line

or market. The actual sale of the subsidiary is generally not what the company is in the business to do.

While DEF will exit the market in New Jersey by selling the JV Real Property, this is emblematic of how Taxpayer's specific industry works. (It should be noted that Taxpayer still has nexus in New Jersey independent of DEF). At any given time, Taxpayer holds property in numerous states, and could purchase a property in a particular state (including Illinois, or even New Jersey again), by setting up a limited liability company structure to hold the property. This is very different than a company selling off an unprofitable subsidiary or product line and determining that it wants to exit a particular market. The sale of the JV Real Property is the sole revenue-generating asset of DEF, and ownership of this asset was the sole reason that DEF was formed. Once this asset is sold, DEF no longer owns any revenue-generating assets. Accordingly, Taxpayer's share of the sale arising from the JV Transaction would be includible in Taxpayer's sales factor, and would not be excludible from Taxpayer's sales factor as an incidental or occasional sale.

Inclusion of Gross Proceeds in Sales Factor

The second issue to consider is whether the sale arising from the JV Transaction is includible in Taxpayer's sales factor on a gross proceeds or net gain basis. 35 Ill. Comp. Stat. §5/1501(a)(21) defines "sales" to mean all gross receipts of the taxpayer not allocated under Sections 301, 302 and 303. 35 Ill. Comp. Stat. § 5/304(a)(3) defines the sales factor to be "a fraction, the numerator of which is the total sales of the person in this State during the taxable year, and the denominator of which is the total sales of the person everywhere during the taxable year. Ill. Admin. Code tit 86 § 100.3380(c)(5) requires the net gain to be used for sales of intangibles. However, Ill Admin Code tit 86 § 100.3370(a)(1)(F) requires the inclusion of gross receipts from sales of equipment, and gives the example of a trucking express company selling its trucks under a regular replacement program. Since the JV Real Property is not an intangible asset and instead constitutes real property, Taxpayer's share of the gross proceeds from the sale arising from the JV Transaction would be includible in Taxpayer's sales factor.

Sourcing of Gross Proceeds in Sales Factor

The third issue to consider is how the gross receipts from the JV Transaction are sourced for purposes of Taxpayer's sales factor. 35 Ill. Comp. Stat. 5/304(a)(3)(C-5)(i) requires that sales from the sale or lease of real property are sourced to Illinois if the underlying property is located in Illinois. Since the property sold under the JV Transaction is located in New Jersey, Taxpayer's share of the gross proceeds from such sale would be included in Taxpayer's sales factor denominator, and excluded from Taxpayer's sales factor numerator.

Effect of Dealer Versus Investor Characterization

Finally, if DEF is treated as a dealer of real property instead of an investor, Taxpayer would not change its sales factor apportionment treatment of the sale arising from the JV Transaction, and would still be able to include the gross receipts from the sale of the JV Real Property in its gross receipts. For federal income tax purposes, the receipts would be reported on line 1 of the federal form 1065. The income and receipts received from Taxpayer's interest in DEF, a member of Taxpayer's unitary business group as previously described, would be apportioned at the partner level to Taxpayer as described in Ill. Admin. Code tit. 86 § 100.3380(d)(2)(A).

RULING

Department Regulations Section 100.3380 provides special rules for purposes of computing the apportionment factor under Section 304 of the Illinois Income Tax Act ("IITA"; 35 ILCS 5/304). Department Regulations Section 100.3380(d)(2) provides the following special rule where a partnership is engaged in a unitary business with one or more of its partners:

[E]xcept in a case in which substantially all of the interests in the partnership (other than a publicly-traded partnership under 26 USC 7704) are owned or controlled by members of the same unitary business group, when the activities of a partnership and any of its partners' business activities constitute a unitary business … [t]he partner's distributive share of the business income and apportionment factors of the partnership shall be included in that partner's business income and apportionment factors.

In addition, Department Regulations Section 100.3380(c)(2) provides:

When gross receipts arise from an incidental or occasional sale of assets used in the regular course of the person's trade or business, those gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded. Gross receipts from an incidental or occasional sale of stock in a subsidiary will also be excluded. Exclusion of these gross receipts from the sale factor is appropriate for several reasons, more than one of which may apply to a particular sale, including:

(A) incidental or occasional sales are not made in the market for the person's goods, services or other ordinary sources of business income;

(B) to the extent that gains realized on the sale of assets used in a taxpayer's business are comprised of recapture of depreciation deductions, the economic income of the taxpayer was understated in the years in which those deductions were taken. The recapture gains that reflect a correction of that understatement should be allocated using a method approximating the factors that were used in apportioning the deductions. If the business otherwise remains unchanged, including the gross receipts from the sale in the sales factor numerator of the state in which the assets were located would allocate a disproportionate amount of the recapture gains to that state compared to how the deductions being recaptured were allocated;

(C) to the extent the gain on the sale is attributable to goodwill or similar intangibles representing the value of customer relationships, including the gross receipts from the sale in the sales factor will not reflect the market for the taxpayer's goods, services or other ordinary sources of business income to the extent the sourcing of the receipts from that sale differs from the sales factor computed without regard to that sale; and

(D) in the case of sales of assets that are made in connection with a partial or complete withdrawal from the market in the state in which the assets are located, including the gross receipts from those sales in the sales factor would increase the business income apportioned to that state when the taxpayer's market in that state has decreased.

The purpose of Department Regulations Section 100.3380(c)(2) is to exclude from both the numerator and denominator of the sales factor gross receipts from transactions that, while generating business income, do not arise from transactions and activity that may be regarded as the taxpayer's regular or ordinary course of business. As indicated above, incidental or occasional sales are not made in the market for the taxpayer's ordinary sources of business income. You represent that the sole purpose of DEF was to purchase and lease back the JV Real Property, and to ultimately sell the property within a short period of time. You indicate that the JV Real Property is DEF's sole income producing asset, and that the transactions related to the property are the only transactions in which DEF engaged. In addition, you represent that the activities of DEF are part of the same unitary business in which the Taxpayer engages. You represent that Taxpayer's regular unitary business activities involve the purchase and leaseback of real property with the ultimate goal of selling the property within a short period of time. You represent that, for federal income tax purposes, these business activities qualify Taxpayer as a dealer in real properties.[1]

When assets are used in the conduct of a unitary business, whether or not gross receipts from the sale of such assets arise from an incidental or occasional sale is determined by reference to the activities of the unitary business in which the assets are employed. Based on the facts you represent, DEF's sale of the JV Real Property is not an incidental or occasional sale. Rather, the sale occurred in the regular course of the unitary business conducted by DEF and Taxpayer. Accordingly, gross receipts from the sale of the JV Real Property should not be excluded from the DEF's sales factor under Department Regulations Section 100.3380(c)(2), and Taxpayer must take into account its distributive share of such gross receipts in accordance with Department Regulations Section 100.3380(d)(2).

Department Regulations Section 100.3370(b) states that the denominator of the sales factor shall include the total gross receipts derived by the taxpayer from transactions and activity in the regular course of its trade or business, except receipts excluded under Section 100.3380(c). Department Regulations Section 100.3370(c) states:

The numerator of the sales factor shall include the gross receipts attributable to this State and derived by the person from transactions and activity in the regular course of its trade or business.
…

(6) For taxable years ending on or after December 31, 2008, gross receipts from transactions not governed by the provisions of subsection (c)(1), (2), (3) or (4) *are in this State if any of the following criteria are met*:

> A) *Sales from the sale or lease of real property are in this State if the property is located in this State.* (IITA Section 304(a)(3)(C-5)(i))

Under these provisions, DEF should include gross receipts (not net gain) from the sale of the JV Real Property in its sales factor denominator. Because the JV Real Property is located in New Jersey, the gross receipts are not included in DEF's sales factor numerator. DEF's status as a dealer in real property for federal income tax purposes does not alter the sales factor apportionment treatment as set forth in this ruling.[2]

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[1] Under Internal Revenue Code § 1221(a)(1), the term capital asset does not include "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

[2] While not dispositive, DEF's asserted federal position as a dealer in real property would be evidence that the sale of the JV Real Property occurred in the ordinary course of the taxpayer's trade or business.

This ruling shall bind the Department as provided herein. 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 and incorporated in this ruling are correct and complete. This ruling shall bind the Department for all taxable years, except as limited pursuant to 2 Ill. Adm. Code 1200.110(d) and (e).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.

Sincerely,

Brian L. Stocker
Chairman, PLR Committee (Income Tax)