

Alternative apportionment not appropriate where including all of the gross receipts attributable to the sale of goodwill in the sales factor denominator does not reflect the market for the taxpayer's goods, services or other ordinary sources of business income because such sourcing differs from the sales factor computed without regard to that sale. (This is a GIL.)

May 11, 2021

Re: Petition for Alternative Apportionment
COMPANY1
Tax Year Ended: 12/31/YYYY

Dear NAME:

This is in response to your petition 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 issued the 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). For the reasons discussed below, your petition cannot be granted based on the information provided.

Your petition states as follows:

We are writing regarding COMPANY1 (FEIN: XX-XXXXXXX, "Taxpayer") to claim a refund of \$\$\$\$\$\$ for taxable year ended 12/31/YYYY of Illinois Income and Replacement Tax. Enclosed is Taxpayer's Amended Corporation Income and Replacement Tax Return (Form IL-1120-X).

Taxpayer is a media company providing award-winning CONTENT. Headquartered in CITY, STATE1, Taxpayer owns local media businesses in eight markets with NAMES include the OUTLETA, OUTLETB, OUTLETC, OUTLETD, OUTLETE, STATE2's OUTLETF and OUTLETG, OUTLETH and OUTLETI. In June 18, YYYY, Taxpayer completed the sale of the OUTLETJ, OUTLETK, and various other NAMES of the Taxpayer's COMPANY3 ("Transaction") resulting in a federal net gain of \$\$\$\$\$\$.

Taxpayer is amending its return to adjust its sales factor for purposes of computing Illinois business income. On the originally filed return, Taxpayer did not include receipts related to the Transaction in the Illinois sales factor.

Taxpayer asserts that Ill. Adm. Code Sec. 100.3380(c)(2), which excludes gross receipts that arise from an incidental or occasional sale of assets used in the regular course of business, should not be applicable where those gross receipts give rise to the Taxpayer's only item of taxable income. In the alternative, and pursuant to 35 ILCS 5/304(f), COMPANY1 respectfully petitions for a method to effectuate an equitable allocation and apportionment of business income because the allocation and apportionment provisions of subsections (a) through (e) and of subsection (h) of 35 ILCS 5/304 do not fairly represent the market for COMPANY1'S sources of business income.

The amended return also includes a petition for alternative apportionment that should be referred to the Legal Services Bureau/Income Tax Division. Our position to claim alternative apportionment is supported by Ill. Admin. Code tit. 86, §100.3390 which states:

If the allocation and apportionment provisions of IITA Section 304(a) through (e) do not, for taxable years ending before December 31, 2008, fairly represent the extent of the person's business activity in this State, or do not, for taxable years ending on or after December 31, 2008, fairly represent the market for the person's goods, services or other sources of business income, 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 of the factors
- 3) the inclusion of one or more additional factors which will fairly represent the person's business activity in this State; or
- 4) the employment of any other method to effectuate an equitable allocation and apportionment of the person's income.

Included with the amended return is a petition for alternative apportionment which includes further explanation. As a result of this amended return, Taxpayer respectfully requests a refund in the amount of \$\$\$\$\$\$ for taxable year ended 12/31/YYYY, plus applicable interest.

Your submission includes the following additional information pertinent to your petition for alternative apportionment:

II. Facts

COMPANY1 is a media company rooted in award-winning CONTENT. COMPANY1 operates newsrooms in ten of the nation's largest markets with OUTLET NAMES including the OUTLETA, OUTLETB, OUTLETC, OUTLETD, OUTLETE, STATE2's OUTLETF and OUTLETG, OUTLETH and OUTLETI.

COMPANY1 operates each OUTLET as a separate business unit with stand-alone financial statements. A substantial majority of subscribers for each OUTLET are located within the state in which the OUTLET operates. Based on this consumer demographic and COMPANY1'S general operating structure, each OUTLET operates independently from each other. Integral functions of each OUTLET are operated autonomously such as the creation and selection of editorial content, subscriber marketing, acquisition and maintenance of advertiser relationships, and circulation services such as printing and distribution.

COMPANY1'S OUTLETS, and the MEDIA industry as a whole, are experiencing reduced consumer demand for print circulation and decreased circulation revenue. These declines are the result of several factors including: increased competition from other media, particularly the Internet; changing MEDIA readership demographics; and shifting preferences among some consumers toward receiving all, or a portion of, their news from sources other than MEDIA.

COMPANY1 Acquisitions and Dispositions

In YYYY, the COMPANY1 came out of bankruptcy. In YYYY, COMPANY1 announced that it would split into two companies, spinning off its publishing division into the COMPANY1 with its remaining media assets remaining in the former parent company renamed COMPANY2. The spin off was executed in YYYY. Following the spin off, COMPANY1 acquired six suburban daily and 32 weekly MEDIA in the CITY1 Metropolitan Area in October YYYY. In YYYY, COMPANY1 announced that it had reached a deal to acquire the OUTLETK and its associated properties for \$\$\$ million. Following the completion of the acquisition, the OUTLETK and OUTLETJ became

part of a new operating entity known as the COMPANY3. In YYYY, COMPANY1 announced that it had acquired the OUTLETB.

On June 18, YYYY, COMPANY1 completed the sale of the OUTLETJ, the OUTLETK, and various other of the COMPANY3 for approximately \$\$\$\$ million in gross proceeds (the "Transaction"). The transaction was structured as a sale of assets. Due to the nature of COMPANY1'S industry, the assets sold to COMPANY4 are specific to the STATE3 media market. Approximately 99% of subscribers to the OUTLETJ and OUTLETK reside in, or in a state adjacent to, STATE3. Included in the Transaction were various types of tangible and intangible assets as detailed in the table below [Tabular material omitted].

As a result of the bankruptcy proceedings in YYYY, the federal tax basis of COMPANY1 properties was reduced to zero. Due to COMPANY1'S business trends and the overall trends in the OUTLET industry, it follows that the taxable gain related to the Transaction was largely due to a lack of federal tax basis and not to the appreciation in value of COMPANY1'S STATE3 OUTLET NAMES.

COMPANY1'S Originally Filed Return

For the tax year ended December 31, YYYY, COMPANY1 reported federal taxable income of \$\$\$\$\$\$. Included in COMPANY1'S computation of federal taxable income was a federal gain of \$\$\$\$\$\$ which included capital losses of \$\$\$\$\$\$ related to other transactions. The gain related to the transaction was \$\$\$\$\$\$. On its originally filed Illinois return, COMPANY1 elected to treat all income as business income pursuant to the election provided in 35 ILCS 5/1501(a)(1) and 86 Ill. Admin. Code Sec. 100.3015. In the computation of its Illinois sales factor, COMPANY1 did not include gross proceeds or net gains related to the sale of assets included in the Transaction.

Illinois imposes a tax on the "net income" of corporations for the privilege of earning or receiving income in the State. To determine net income, a corporate taxpayer begins with its "taxable income properly reportable for federal income tax purposes for the taxable year under the provisions of the Internal Revenue Code," applies certain specifically enumerated adjustments, and then allocates or apports such income to the state. Business income is defined to mean "all income that may be treated as apportionable business income under the Constitution of the United States." For tax years ending on or after December 31, 2000, corporations that derive business income in Illinois and one or more other states shall apportion business income to Illinois by use of a single sales factor. The sales factor is a fraction, the numerator of which is the total sales of the corporation in Illinois during the taxable year, and the denominator of which is the total sales of the corporation everywhere during the taxable year. The term "sales" is defined to mean "all gross receipts not allocated" under the provisions of the Illinois Income Tax Act.

A taxpayer may treat all income, other than compensation, as business income, by making an irrevocable election pursuant to 35 ILCS 5/1501(a)(1). For the tax year ended December 31, YYYY, COMPANY1 elected to treat all its income as business income. Therefore, COMPANY1'S income, including the federal gain of \$\$\$\$\$\$ million from the Transaction, is apportioned to Illinois by use of a single sales factor.

For purposes of determining the numerator of the sales factor, the Illinois Department of Revenue has adopted specific rules prescribing where the sales from publishing activities are received. Gross receipts derived from the sale of published materials in the form of tangible personal property are sourced based on the location where the property is delivered or shipped to a purchaser. The portion of gross receipts derived from sales of published materials in a form other than tangible personal property, from advertising and from the sale, rental or other use of

the taxpayer's customer lists for a particular publication or any portion thereof is attributed to the State using the taxpayer's circulation factor for that publication. Therefore, COMPANY1'S primary sources of income from the normal operation of each MEDIA – subscription revenue and advertising revenue – are sourced based on the circulation of that MEDIA. As previously noted, the substantial majority of the subscribers for each of COMPANY1'S MEDIA reside in the same state as that MEDIA base of operations.

Under both the Due Process and the Commerce Clauses of the U.S. Constitution, a State may not, when imposing an income-based tax, "tax value earned outside its borders." In the case of an integrated business enterprise operating in more than one state, arriving at a territorial allocation of "value" through formulary apportionment has generated constitutional litigation. While a state may apply an apportionment formula to tax an appropriate share of the interstate income of a unitary business operating in more than one state, both the Due Process and Commerce Clauses of the U.S. Constitution also prevent a State from taxing income arising out of extraterritorial activities, "even on a proportional basis," unless there is a "minimum connection" or "nexus" between the interstate activities and the taxing State, and a "rational relationship between the income attributed to the State and the intrastate values of the enterprise.

It is furthermore a "limiting principle" that no State may tax the interstate income of a multistate corporation's unitary business by means of a formula apportionment "which cannot in fairness be attributed to the taxpayer's activities within the State." Thus, a formula-based tax on income may be struck down if "the income attributed to the State is in fact "out of all appropriate proportions to the business transacted [by the taxpayer] in that State," or if application of the apportionment formula has "lead to a grossly distorted result." As discussed below, it is inherently inequitable, and grossly distortive, for Illinois to apportion income from the sale of the STATE3 OUTLETS using an apportionment factor which overattributes income to Illinois.

Illinois' apportionment statute, 35 Ill. Comp. Laws § 5/304(a)(3) defines the sales factor as "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." Those sales are defined as "all gross receipts derived by the taxpayer from transactions and activity in the regular course of such trade or business." Nothing in the statute limits the inclusion of receipts from the sale of assets.

35 Ill. Comp. Laws § 5/304(f) states that "if the allocation and apportionment provisions of [35 Ill. Comp. Laws §5/304(a)] do not ... fairly represent the extent of a person's business activity in this State, or ... fairly represent the market for the person's goods, services, or other sources of business income, the person may petition for, or the Director 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 or market in this State; or
- (4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

Pursuant to the statute, the Director promulgated a regulation, Illinois Administrative Code §100.3380, which provides a number of instances where the Department of Revenue has determined "Section 304(a) through (e) and (h) do not fairly represent the extent of a person's business activity or market within Illinois." One of those instances is Ill. Admin. Code Sec.

100.3380(c)(2), which excludes gross receipts that arise from an incidental or occasional sale of assets used in the regular course of business (“Occasional Sale Rule”).

Specifically, the Occasional Sale Rule provides that:

[w]hen 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 shall be excluded.

The sale of assets at issue is neither the sale of a factory or plant, nor the stock of a subsidiary. The regulation explains that “[e]xclusion of these gross receipts from the sales factor is appropriate for several reasons, more than one of which may apply to a particular sale, including...” and goes on to articulate several specific scenarios where this rule would be appropriate. However, none of the reasonings included in the regulation are applicable to COMPANY1’S Transaction nor do they appropriately illustrate why the rule’s application would result in an accurate measurement of the market for COMPANY1’S business income.

The first reason given by the regulation in subsection (c)(2)(A) is that “incidental or occasional sales are not made in the market for the person’s goods, services or ordinary sources of business income.” This reasoning makes sense in the context of a business with operating profits that makes a one-time sale of a business asset. However, it is utterly distortive in the case of a taxpayer like COMPANY1 where that one-time sale makes up all of its taxable income for the year. For the tax year ended December 31, YYYY, COMPANY1’S sources of business income were those derived from its regular course of business (e.g. subscription and advertisement revenue), and those derived from the gain on the Transaction (i.e. the sale of the STATE1 OUTLETS). COMPANY1 reported federal taxable income of \$\$\$\$ million, which included the \$\$\$\$ million net gain from the Transaction. Without the federal taxable gain from the Transaction, COMPANY1 would have reported a federal taxable loss. The only business income being effectively apportioned to Illinois is from the sale of the STATE3 MEDIA.

Second, the reasoning articulated by subsection (c)(2)(B) states:

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 there 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.

However, in the case of the COMPANY1 Transaction the gain on the sale was not due to the recapture of depreciation deductions. The vast majority of the gain was related to the sale of goodwill which is not subject to depreciation.

Third, subsection (c) states:

To the extent the gain on a 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 shall 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.

The rationale behind (c)(2)(C) is generally the same as the rationale behind (c)(2)(A), i.e. that it would be distortive to apportion taxable income related to regular business operations using a factor that includes the sale of other assets. However, as discussed above, in this case all of the net apportionable income, after netting against operational losses, is due to the sale of goodwill. Accordingly, the concern outlined by (c)(2)(C) is effectively flipped on its head. Instead of ordinary income being apportioned using extraordinary factors, the reverse is true.

Finally, under subsection (c)(2)(D) the regulatory reasoning provides, “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.

COMPANY1’S sale of the *OUTLETJ* and *OUTLETK* was a partial or complete withdrawal of COMPANY1’S business from the state of STATE3. But although COMPANY1’S market in STATE3 decreased, COMPANY1’S business income for the tax year ended December 31, YYYY was specifically related to the sale of its STATE3 OUTLETS. The only source of business income that requires a measurement of market value is the gain from the Transaction which can properly be represented by inclusion of receipts from the Transaction.

Therefore, COMPANY1 asserts that the occasional sale rule under Ill. Admin. Code Sec. 100.3380(c)(2), which excludes gross receipts that arise from an incidental or occasional sale of assets used in the regular course of business, is both arbitrary and overbroad as applied to these facts. The stated purpose of the allocation and apportionment provisions of 35 Ill. Comp Laws §5/304 are to “fairly represent the extent of a person’s business activity or market within Illinois.” However, the application of such a rule in the case of COMPANY1, where a one-time sale makes up all of the taxpayer’s taxable income for the year, is itself utterly distortive of the taxpayer’s activity or market within Illinois. At the very least, COMPANY1 asserts that the occasional sale rule is not applicable because the regulation specifically provides that “[e]xclusion of these gross receipts from the sales factor is appropriate for several reasons, more than one of which may apply to a particular sale, including...” and goes on to articulate several specific reasons why this rule be applied. However, none of the reasonings included in the regulation are applicable to COMPANY1’S Transaction nor do they appropriately illustrate why the rule’s application would result in an accurate measurement of the market for COMPANY’S business income.

Original Statutory Apportionment Formula Should be Applied to Include Gains Where Occasional Sale Rule is Distortive

Illinois regulations interpret the language in 35 Ill. Comp. Laws § 5/304(f) to mean, “[a]n 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. It is only where “the application of the statutory formula will lead to a grossly distorted result in a particular case, [that] a fair and accurate alternative method is appropriate.” In this case, it is the application of the Director’s alternative to the statutory formula that leads to the grossly distorted result.

In order to vary from the prescribed apportionment formula, the party seeking alternative apportionment “bears the burden of showing by clear and cogent evidence that the income attributed to Illinois is out of all proportion to the business transacted in Illinois. For example, in *Miami Corp. v. Dept. of Revenue*, the Illinois Appeals Court found that that imposition of the

state's statutory apportionment formula did lead to a gross distortion of the taxpayer's income-producing activities in Illinois because the formula failed to take into account the intangible value of oil and gas leases derived from its Louisiana land and, consequently, did not reflect that 80% of the taxpayer's income was generated by those intangible assets.

In that case, the taxpayer, the Miami Corporation ("Miami"), headquartered in Chicago, derived income through investments in real estate, stocks, and other securities. Years prior, Miami had separated its oil and gas and real estate investments from its securities portfolio. Miami owned real estate in Louisiana where oil was discovered. It did not engage in developing these oil and gas reserves but, rather, contracted with independent oil and gas companies which explored, drilled and produced oil and gas from the reserves. The corporation only retained a passive royalty interest in the reserves.

Miami's oil and gas reserves in Louisiana generated in excess of 80% of Miami's income but due to factual circumstances, these reserves were not fully reflected in the state's apportionment formula. Miami argued that the application of the standard three factor apportionment formula used during the tax years at issue was grossly distortive. The Appellate Court examined each of the three standard apportionment factors used during the tax year at issue, as they applied to Miami. Due to the relative low original cost of the oil reserve versus the Chicago headquarters lease, the Court found that "[t]he singular structure and operation of the taxpayer negatives the application of the property factor," as, "it produces a distortive effect because of the individual characteristics of the taxpayer's operations and its tangible property." The Appellate Court further affirmed the trial court's finding that "the application of the payroll factor was inappropriate due to [Miami's] unusual corporate structure" where the costs related to the oil and gas reserves were borne by independent contractors. As a result, the Appellate Court found that Miami had met its burden by producing clear and cogent evidence that the income attributed to Illinois was out of appropriate proportion to the business transacted in the state, that therefore an alternative method of apportionment was appropriate. In Miami's case, that meant using separate accounting to determine the portion of its business conducted in Illinois, versus formulary apportionment.

COMPANY1'S factorial circumstances are analogous to those of the *Miami Corp* decision. Similarly, for the tax year ended December 31, YYYY COMPANY1'S federal taxable income is effectively represented by the net gain from the sale of COMPANY1'S STATE3 MEDIA. COMPANY1'S MEDIA operate autonomously, and they are specific to large local markets like CITY1, CITY2, or CITY3. COMPANY1's primary sources of income from each MEDIA are subscription revenue and advertising revenue which are measured by the circulation factor of its MEDIA, as required by Ill. Admin. Code Sec. 100.3373(c)(2). Therefore, the value of the sale of the OUTLETJ and OUTLETK COMPANY1 is also related to COMPANY1'S OUTLET circulation which is inside, not outside, of STATE3. Under Illinois' standard apportionment provisions, the net gain from the transaction would be entirely apportioned using COMPANY1'S receipts from its primary sources of income from each MEDIA, i.e. receipts from outside STATE3. As in *Miami*, this results in inequitable apportionment, as the business income from the sale of the OUTLETJ and OUTLETK would be apportioned by the circulation of other OUTLETS (e.g. OUTLETA, OUTLETD, etc.). The market for the business income from the sale of the OUTLETJ and OUTLETK is the state of STATE3. The circulation of the OUTLETJ and the OUTLETK is therefore appropriate to measure the market for the business income generated by the Transaction. Thus, the provisions of 35 ILCS 5/304 do not represent the market for COMPANY1'S business income.

Based on the *Miami* decision, it would be appropriate under COMPANY1'S facts to use the separate accounting method to determine their proper income tax liability. Section 304 continues

to specifically include separate accounting as an appropriate alternative to the standard apportionment formula. This would result in no tax on the gain from the Transaction being allocated to Illinois. However, COMPANY1 is not proposing such a calculation. An equitable measurement of the market for COMPANY1'S sources of business income would be to include gross proceeds from the sale of fixed assets of \$\$\$\$\$\$, gross receipts from the sale of other assets of \$\$\$\$\$\$, and net gain from the sale of intangible assets of \$\$\$\$\$\$ in the denominator of the sales factor along with the sales from COMPANY1'S regular course of business. In that way receipts from the Transaction are represented in the sales factor, and the circulation of OUTLETS outside of STATE3 is still utilized to apportion COMPANY1'S business income, as provided in the operation of 35 Ill. Comp. Laws §5/304.

Illinois' Occasional Sale Rule is similar to the one used in California pursuant to Cal. Code Regs., tit 18, §25137(c) ("California Occasional Sale Rule) which excludes capital gains from the sales factor where inclusion in the sale would cause the factor to change by more than 5%. As outlined in *Appeal of Fluor Corporation*, California follows the same analysis as followed by the Court in *Miami Corp*, requiring that any party seeking to deviate from the California occasional sale rule must first establish by clear and convincing evidence that the regulation does not fairly represent the extent of the taxpayer's activities in this state.

In *Appeal of Emmis Communications*, the taxpayer, Emmis Communications, was a diversified media company based in Indiana. The company decided to begin divesting of its television business and during the tax year at issue, it sold 13 of its 16 television stations, resulting in a large gain. Similar to COMPANY1, the gross receipts from the sale of the stations were a majority of Emmis' gross receipts for the tax year in issue and constituted 100 percent of its income. Emmis Communications also had a history of selling business assets, having completed 41 acquisitions and 28 dispositions in the ten years leading up to the tax year at issue. Pursuant to an audit, the California Franchise Tax Board excluded the receipts from the sale of the television stations from the sale factor.

The taxpayer argued that its receipts from the sale of the television stations should be included for two major reasons. First, the taxpayer contended that due to the fact that the sales were part of a history of acquisitions and dispositions and therefore should not be considered to be "occasional." Second, the taxpayer argued that because the gains constituted all of the company's taxable income, it would be grossly distortive for California to tax the gain without any reflection of that income in the apportionment factor. California argued that the sales should be considered to be occasional because they were outside of the taxpayer's normal course of business of running a media company. The state further argued that regardless of the fact that all of the income was related to the sale, it should be apportioned using the regular apportionment formula based on the company's activity in California. The Board of Equalization sided with Emmis Communications, holding in a 4-1 decision that the receipts from the sale should be included in the sales factor.

COMPANY1, like Emmis Communications, had a history of mergers and acquisitions when they sold a large part of their core business. Since its spin-off was executed in YYYY, COMPANY1 had engaged in a series of strategic business purchases. In October YYYY, COMPANY1 acquired six suburban daily and 32 weekly OUTLETS in the CITY Metropolitan Area. In YYYY, COMPANY1 announced that it acquired the OUTLETK and its associated properties. In YYYY, COMPANY1 announced that it had acquired the OUTLETB. This sale, like Emmis Communications, resulted in a gain that constituted all of the taxable income the company had for the year. Accordingly, as the Board of Equalization found, these facts constitute clear and cogent evidence that excluding the gains at issue would be grossly distortive.

In the alternative, COMPANY1 argues that if the occasional sale rule is applicable under the circumstances, for the tax year ended December 31, YYYY, the standard allocation and apportionment provisions 35 ILCS 5/304 do not fairly represent the market for COMPANY1'S business income for the following reasons:

The circulation factor for all of COMPANY1'S MEDIA is being used to apportion business income from the sale of COMPANY1'S STATE3 MEDIA; and
A complete year of COMPANY1'S STATE3 circulation is not being utilized to apportion business income from the sale of COMPANY1'S STATE3 MEDIA.

As explained below, COMPANY1'S business income is generally apportioned by a measure of its MEDIA circulation. However, for the tax year ended December 31, YYYY, COMPANY1'S business income was generated by the net gain from the sale of OUTLETJ and OUTLETK. The assets sold in the Transaction included fixed assets located in STATE3, deferred revenue from the STATE3 MEDIA and intangible assets of the STATE3 MEDIA such as goodwill, trademarks and the masthead.

The sale of the OUTLETJ and OUTLETK was completed on June 18, YYYY. As a result, COMPANY1'S sales factor includes regular sales (subscriptions and advertising) from its STATE3 MEDIA from January 1, YYYY to June 18, YYYY. However, regular sales from COMPANY1'S MEDIA outside of STATE3 are included in COMPANY1'S Illinois sales factor for the entire tax year (January 1, YYYY to December 31, YYYY). COMPANY1'S MEDIA operate autonomously, and the MEDIA are specific to large local markets like CITY1, CITY2, or CITY3. The value of the OUTLETJ and OUTLETK is not related to COMPANY1'S MEDIA circulation outside of STATE3. The circulation of the OUTLETJ and OUTLETK is therefore appropriate to measure the market for the business income generated by the Transaction. However, the application of 35 ILCS 5/304 and Ill. Admin. Code Sec. 100.3373(c)(2) functions to apportion the net gain from the sale of the OUTLETJ and OUTLETK based on the circulation of all of COMPANY1'S MEDIA (e.g. OUTLETA, OUTLETD, etc.). This includes using only a partial year of sales from the market for the OUTLETJ and OUTLETK, which places greater weighting on the circulation of COMPANY1'S MEDIA outside of STATE3 in the apportionment of net gain from the Transaction.

To further illustrate the existence of distortion when applying 35 ILCS 5/304 and Ill. Admin. Code Sec. 100.3370(c)(2), one can apply an alternative closing date of the Transaction. Absent alternative apportionment, if the sale of OUTLETJ and OUTLETK was completed on January 1, YYYY, this would have effectively apportioned the entire net gain from the Transaction solely based on the circulation of COMPANY1'S MEDIA outside of STATE3. Although STATE3 is clearly the market for COMPANY1'S sale of the OUTLETJ and OUTLETK, there would be no representation of the STATE3 market. It follows that the closing date of the Transaction is arbitrary when determining the apportionment of COMPANY1'S business income.

A cure for the apportionment distortion of the partial-year STATE3 circulation is to include the annualized gross receipts derived from January 1, YYYY to June 18, YYYY of the OUTLETJ and OUTLETK in the Illinois sales factor. The STATE3 gross receipts reported during the pre-Transaction period is \$\$\$\$\$\$ which annualized equals \$\$\$\$\$\$. Therefore, COMPANY1 proposes to include an additional \$\$\$\$\$\$ in its Illinois sales factor in order to equally weight the revenue and circulation of both STATE3 MEDIA and those located outside of STATE3.

Illinois law provides for alternative apportionment relief when subsections (a) through (e) and of subsection (h) of 35 ILCS 5/304 do not fairly represent the market for COMPANY1'S source of

business income. Based on COMPANY1'S petition for alternative apportionment pursuant to 35 ILCS 5/304(f), an adjustment of \$\$\$\$\$\$ is reported to total sales of COMPANY1'S Illinois sales factor. This amended return adjustment better represents the market for COMPANY1'S source of business income.

As a result of the amended apportionment computation and application of 35 ILCS 5/304(f), COMPANY1 is apportioning % of its business income to Illinois. This computation provides that the circulation of COMPANY1'S Illinois MEDIA (OUTLETA) is still used to apportion the net gain derived from the sale of the OUTLETJ and OUTLETK. As discussed throughout, the adjustment results in a more equitable and fair apportionment to represent the market for COMPANY1'S business income.

RULING

Section 304(a) of the Illinois Income Tax Act ("IITA" 35 ILCS 5/304) provides that when a nonresident derives business income from Illinois and one or more other states, such income shall be apportioned to Illinois by multiplying the income by the taxpayer's apportionment factor. For taxable years ending on and after December 31, 1998, except in the case of an insurance company, financial organization, transportation company, or federally regulated exchange, the apportionment factor is equal to the sales factor. IITA Section 304(a)(3) defines the sale factor as a fraction, the numerator of which is the total sales of the person in Illinois during the taxable year, and the denominator of which is the total sales of the person everywhere during the taxable year. Section 304(a)(3)(C-5)(iv) provides that the Department shall adopt rules prescribing where specific types of services are received, including, but not limited to, publishing, and utility service.

Department Regulations Section 100.3373(c)(1) provides:

c) Sales within this State from publishing include:

- 1) Gross receipts derived from the sale of published materials in the form of tangible personal property, as provided in Sections 100.3370(c) and 100.3380(c).
- 2) The portion of gross receipts derived from sales of published materials in a form other than tangible personal property, from advertising and from the sale, rental or other use of the taxpayer's customer lists for a particular publication or any portion thereof attributed to this State using the taxpayer's circulation factor for that publication during the applicable tax period.

Section 304(f) of the IITA states:

If the allocation and apportionment provisions of subsections (a) through (e) and of subsection (h) do not, for taxable years ending before December 31, 2008, fairly represent the extent of a person's business activity in this State, or, for taxable years ending on or after December 31, 2008, fairly represent the market for the person's goods, services, or other sources of business income, the person may petition for, or the Director 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 or market in this State; or

(4) The employment of any other method to effectuate an equitable allocation and apportionment of the person's business income.

Department Regulations Section 100.3380(a)(2) states:

The Director has determined that, in the instances described in this Section, the apportionment provisions provided in ILTA Section 304(a) through (e) and (h) do not fairly represent the extent of a person's business activity or market within Illinois. For tax years beginning on or after the effective date of a rulemaking amending this Section to prescribe a specific method of apportioning business income, all nonresident taxpayers shall apportion their business income employing that method in order to properly apportion their business income to Illinois. Taxpayers whose business activity or market within Illinois is not fairly represented by a method prescribed in this Section and who want to use another method for a tax year beginning after the effective date of the rulemaking adopting that method may obtain permission to use that other method by filing a petition under Section 100.3390. For tax years beginning prior to the effective date of the rulemaking adopting a method of apportioning business income, the Department will not require a taxpayer to adopt that method; provided, however, if any taxpayer has used that method for any of those tax years, the taxpayer must continue to use that method for that tax year. Moreover, a taxpayer may file a petition under Section 100.3390 to use a method of apportionment prescribed in this Section for any open tax year beginning prior to the effective date of the rulemaking adopting that method, and that petition shall be granted in the absence of facts showing that that method will not fairly represent the extent of a person's business activity or market in Illinois.

Department Regulations Section 100.3380(c)(2) states:

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 shall be excluded. Gross receipts from an incidental or occasional sale of stock in a subsidiary shall also be excluded. Exclusion of these gross receipts from the sales 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 shall 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.

Your petition indicates that in June of YYYY Taxpayer completed the sale of its STATE3 properties, which included certain fixed assets, intangible assets such as goodwill, trade names, subscribers, mastheads, and advertiser relationships, and other assets. You indicate that the gain from such sale “was largely due to a lack of federal tax basis” as required under section 108 of the Internal Revenue Code (IRC) “and not to the appreciation in value of [Taxpayer’s] STATE3 OUTLET NAMES.” You indicate that gross receipts from the sale of these assets is excluded from the sales factor under Department Regulations §100.3380(c)(2) as an incidental or occasional sale of assets used in the regular course of Taxpayer’s trade or business. Your petition asserts that the failure to include such receipts in the denominator of the Taxpayer’s sales factor results in an amount of income apportioned to Illinois that does not fairly represent the market for Taxpayer’s goods, services, or other sources of business income. The primary basis for this assertion is that none of the rationales provided in Section 100.3380(c)(2) applies to the YYYY sale transaction, so that failure to include receipts from such sale is distortive of the market for the Taxpayer’s sources of business income.

Department Regulations §100.3380(c)(2) properly applies in this case. Including gross receipts from the June YYYY Transaction in the Taxpayer’s sales factor does not “fairly represent the extent of a person's business activity or market within Illinois.” Including such gross receipts in the sales factor results in distortion for the very reasons set forth in §100.3380(c)(2).

Your petition indicates that as a result of bankruptcy proceedings in YYYY, the basis of Taxpayer’s assets was reduced to zero. You next indicate that the taxable gain related to the June YYYY Transaction was “largely due to a lack of federal tax basis and not to the appreciation in value of COMPANY1’S STATE3 OUTLET NAMES.” Under IRC section 108, income from discharge of indebtedness is excluded from gross income where the discharge occurs in a title 11 case. However, under IRC section 108(b) certain tax attributes, including the basis of the property of the taxpayer, must be reduced by the amount of the excluded income. The effect of IRC section 108, then, is generally to defer taxation of debt discharge income rather than to forgive tax on such income entirely. In this case, Taxpayer’s gain derived from the June YYYY Transaction constitutes recapture of previously excluded discharge of indebtedness income. As a result, including the gross receipts from the June YYYY Transaction in the sales factor is plainly distortive of an apportionment reflecting the relative market for the Taxpayer’s sources of business income. Presumably, the debt which Taxpayer incurred, and which was subsequently discharged, benefited the Taxpayer’s unitary business and markets as a whole, not merely its STATE3 business and STATE3 market. Moreover, if the discharge of indebtedness income had been included in gross income when realized in YYYY, the income would have been properly apportioned based on the taxpayer’s Illinois apportionment in that year. In any case, the proper apportionment of the Taxpayer’s income for the year in which the discharge occurred would have been determined without inclusion of the discharge income in the sales factor. Gross receipts from discharge of indebtedness income is not provided for in IITA Section 304, and is not reflective of the market for the Taxpayer’s ordinary sources of business income. Therefore, including the gross receipts from the occasional sale of Taxpayer’s STATE3 assets would distort the apportionment formula, as that gain reflects discharge of debt income that is properly apportioned according to the respective markets of the unitary business as a whole. As discharge of indebtedness income is properly apportioned according to the respective markets of the unitary business as a whole, including the gross receipts from the June YYYY Transaction in the sales factor does not fairly represent the extent of the Taxpayer’s market within Illinois.

Department Regulations §100.3380(c)(2)(A) provides that gross receipts from an incidental or occasional sale are excluded from the sales factor because such sales are not made in the market for the taxpayer's goods, services or other ordinary sources of business income. Exclusion of such receipts from the sales factor thereby prevents distortion of the sales factor that would otherwise occur where assets which are generally used to conduct a unitary business are removed from the business by sale to a third-party purchaser. The gross receipts from such a sale do not reflect the market for the taxpayer's ordinary sources of business income, which is the income generated by the use of those assets in generating sales to customers, as opposed to a sale of those assets to a non-customer. In this case, the June YYYY Transaction is an occasional sale of assets used in the Taxpayer's trade or business, and therefore is not made in the market for the Taxpayer's goods, services, or other ordinary sources of business income.

Department Regulations §100.3380(c)(2)(B) states that to the extent that gains realized on the incidental or occasional 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. In addition, Department Regulations §100.3380(c)(2)(C) states that to the extent gain from an incidental or occasional 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 shall 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. Your petition indicates that the "vast majority of the gain was related to the sale of goodwill which is not subject to depreciation." Your petition does not specifically indicate whether any portion of the Taxpayer's goodwill was subject to basis reduction under IRC section 108, whether any portion of Taxpayer's goodwill was an amortizable intangible under IRC section 197, or whether any portion of the Taxpayer's goodwill is self-created. In any case, however, subparagraphs (B) and (C) support exclusion of the gross receipts from the June YYYY Transaction from the sales factor. To the extent that the Taxpayer's basis in goodwill was reduced either under IRC section 108, or as amortization deductions were claimed under IRC section 197, the rationale of subparagraph (B) applies to exclude receipts attributable to goodwill from the sales factor. To the extent that gain from the YYYY Transaction is attributed to self-created goodwill, the rationale of subparagraph (C) applies. In particular, goodwill is an asset that appreciates in value over many taxable years. Presumably, any goodwill inherent in the Taxpayer's STATE3 business was generated over multiple years as the Taxpayer operated its unitary business. The increase in value of the Taxpayer's goodwill was not realized for tax purposes until the goodwill was sold, but the value was generated in the conduct of the unitary business over the years in which the unitary business was conducted. Furthermore, the costs incurred in generating the asset goodwill, including advertising expenses and other ordinary business expenses, were likewise deducted over the years the unitary business was conducted. As such, the tax deductions attributable to the costs of generating the goodwill were apportioned to Illinois using the apportionment factor for Taxpayer's unitary business in the years the costs were incurred. Therefore, including all of the gross receipts attributable to the sale of goodwill in the sales factor denominator does not reflect the market for the taxpayer's goods, services or other ordinary sources of business income because such sourcing differs from the sales factor computed without regard to that sale..

Finally, Department Regulations §100.3380(c)(2)(D) provides that where sales of assets are made in connection with a 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. In this case, Taxpayer is liquidating its STATE3 assets and thereby withdrawing from the STATE3 market. Including the gross receipts from the June YYYY Transaction in the sales factor increases the amount of income apportioned to a market the Taxpayer is exiting.

For the reasons stated above, Department Regulations §100.3380(c)(2) properly applies in this case to exclude from the sales factor the gross receipts from the June YYYY Transaction. Accordingly, your petition for alternative apportionment cannot be granted.

Sincerely,

Brian Stocker
Associate Counsel (Income Tax)