

Alternative apportionment not appropriate when gross receipts arising from an incidental or occasional sale of assets used in the regular course of trade or business generate a gain in goodwill are excluded from the sales factor pursuant to 86 Ill. Adm. Code Section 100.3380(c)(2). (This is a GIL.)

September 13, 2022

NAME/TAXPAYER REPRESENTATIVE/

Re: Petition for Alternative Apportionment
COMPANY 1
FEIN: ##-#####
Tax Year Ended: 12/31/20##

Dear XXX:

This is in response to your letter dated June 15, 2022, in which you request a Private Letter Ruling on behalf of COMPANY1 to use an alternative method of 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 on 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 on the Department. See 2 Ill. Adm. Code Section 1200.100(b) and (c). For the reasons discussed below, your request to use an alternative method of apportionment cannot be granted based on the information provided.

Your letter states as follows:

On behalf of our client, COMPANY1 ("COMPANY1" and/or "Company" and/or "Taxpayer"), we respectfully request a letter ruling pursuant to 2 Ill. Admin. Code § 1200.110 confirming our understanding of how Illinois standard statutory apportionment provisions apply to receipts from gain on the sale of goodwill.

If the Illinois Department of Revenue ("Department") does not agree with our understanding, we request permission to use an alternative apportionment formula pursuant to 35 Ill. Comp. Stat. § 5/304(f) and 86 Ill. Admin. Code § 100.3390 in connection with its taxable year ended December 31, 20##.

Based on the information below, and any and all evidence required by the Department, the statutory formula under 35 Ill. Comp. Stat. § 5/304(a) through (e) does not fairly represent the extent of Taxpayer's market, business activities, or income in Illinois and alternative apportionment, as proposed by the Taxpayer, is justified under Illinois law and the U.S. Constitution.

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

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I. Relevant Facts

A. Company History

COMPANY1 has over ### years of history in the PRODUCT1 and PRODUCT2 industry, and is the largest independent PRODUCT3 INDUSTRY1, INDUSTRY2, and INDUSTRY3 in the United States. COMPANY1 operates the nation's largest INDUSTRY1 system with approximately AMOUNT1 per day of PRODUCT1 INDUSTRY1 capacity. COMPANY1 is also positioned as one of the largest wholesale suppliers of PRODUCT2 and ITEM1 to resellers in the United States. COMPANY1 distributes its INDUSTRY1 products through one of the largest terminal operations in the United States and one of the largest private domestic

fleets of inland PRODUCT3 barges. In addition, COMPANY1's integrated INDUSTRY3 energy asset network links producers of PRODUCT4 and PRODUCT4 liquids from some of the largest supply basins in the United States to domestic and international markets.

Historically, COMPANY1's operations consisted of three operating segments: (1) INDUSTRY1 & INDUSTRY2; (2) INDUSTRY3; and (3) Retail. Each of these segments is organized and managed based upon the nature of the products and services it offers.

- INDUSTRY1 & INDUSTRY2. This segment PRODUCES PRODUCT1 and other PRODUCT5 at FACILITIES in the Gulf Coast, Mid-Continent, and West Coast regions of the United States. It also purchases INVENTORY and PRODUCT6 for resale and distributes INVENTORY through transportation, storage, distribution, and marketing services provided largely by the INDUSTRY3 segment. This segment sells INVENTORY to wholesale marketing customers domestically and internationally, to buyers on the spot market, to independent entrepreneurs who operate primarily COMPANY1's branded outlets, through long-term supply contracts with independently owned PRODUCT2 and CUSTOMER1, including locations under the PRODUCT7 brand.
- INDUSTRY3. This segment transports, stores, distributes, and markets PRODUCT1 and INVENTORY principally for the INDUSTRY1 & INDUSTRY2 segment via INDUSTRY1 logistics assets, pipelines, terminals, towboats, and barges; gathers, processes, and transports PRODUCT4; and gathers, transports, fractionates, stores, and markets PRODUCT4 liquids.
- Retail. This segment sells transportation PRODUCT8s and convenience products in the retail market across the United States through company-owned and operated CUSTOMERS1, primarily under the COMPANY2 brand, and long-term PRODUCT8 supply contracts with independently owned and operated PRODUCT8 locations mainly under the PRODUCT7 brand.

B. Retail Operations and the COMPANY2 Brand

Vital to this petition are COMPANY2's company-owned and operated retail PRODUCT2 and PRODUCT8 locations (collectively referred to herein as "COMPANY2"). COMPANY2 commenced operations in 19## as COMPANY2 ## and was acquired by COMPANY1 in 19##. COMPANY2 rebranded to what is the current COMPANY2 in 19##. From inception, COMPANY1 quickly expanded the COMPANY2 retail store concept;

growth occurred through a series of acquisitions of smaller regional PRODUCT2 FRANCHISES. Once acquired, these regional chains would be converted and operated under the COMPANY2 brand under a unified retail strategy.

At the time of its sale, COMPANY2 grew to become the second largest chain of company-owned and operated retail PRODUCT2 and PRODUCT8 in the United States, with approximately AMOUNT2 PRODUCT8. Taken as a whole, this growth and COMPANY2's execution of its strategy resulted in the value realized at the time of its sale.

COMPANY2's strategic focus over the years included: (1) integrating acquisitions, (2) building new store locations, (3) remodeling and rebuilding existing locations in core markets, (4) building out its network of commercial PRODUCT10 PRODUCT9ing lane locations, and (5) significant marketing and customer loyalty programs, including major marketing sponsorships such as COMPANY3, Official PRODUCT9 Supplier for COMPANY4, and COMPANY5. COMPANY2's commercial domicile is STATE1; its headquarters is located in CITY1, STATE1, and limited organizational support is provided from COMPANY1 from its commercial domicile in CITY2, STATE1. Additionally, all strategic decisions, management, and value creation of the COMPANY2 brand, specifically the goodwill of the company sold in the sale, was generated and managed in STATE1.

C. COMPANY2 Customer Loyalty Program

In 20##, COMPANY2 founded PRODUCT11, a loyalty program that has been highly successful. By 20##, PRODUCT11 averaged AMOUNT3 active members. This program is a key driver of the value of the COMPANY2 brand. Historically, the rewards program provided COMPANY1 with a unique competitive advantage and opportunity to increase its customer base at existing and new COMPANY2 locations. COMPANY2's ability to capture and analyze member-specific transactional data enables the Company to offer PRODUCT11 members discounts and promotions specific to their buying behavior. COMPANY1 considers the PRODUCT11 program as a key reason why customers choose COMPANY2 over competitors and is a significant driver of the value of the COMPANY2 brand. PRODUCT11 membership growth is illustrated in the following Table.

TABLE REDACTED

The PRODUCT11 Program was created, developed, and managed in CITY1, STATE1.

D. COMPANY2 Sale

On DATE1, COMPANY1 entered into a definitive agreement to sell COMPANY2 to COMPANY6¹ for approximately AMOUNT4. The sale closed on DATE2. The assets sold represent all of COMPANY1's retail store operations which include COMPANY2. In total, COMPANY1 disposed of approximately AMOUNT2 retail locations in Illinois and throughout the country. The sale to COMPANY6 reflects the disposition of COMPANY1's entire company-owned and operated retail store business segment.

As currently estimated by the Taxpayer, the gain on the sale is projected to be AMOUNT5; of this gain, approximately AMOUNT6 is associated with the sale of goodwill.²

E. COMPANY1's Illinois Operations

COMPANY1 has filed an Illinois Corporation Income and Replacement Tax Return (an "IL Return") for over ## years. Historically, COMPANY1's business activities in Illinois have included:

- Operation of an PRODUCT1 FACILITY within Illinois;
- Operation of INDUSTRY3 property located in Illinois by COMPANY8, a publicly traded partnership of which COMPANY1 and its subsidiaries are material unitholders earning Illinois receipts from operation of the INDUSTRY3 operations;
- Operation of INDUSTRY1 and INDUSTRY2 segment in Illinois, resulting in Illinois receipts;
- Operation of retail property located in Illinois, owned and operated by COMPANY2, resulting in Illinois receipts;
- Receipts from its retail operations, through COMPANY2 stores.

Following the Sale, COMPANY1's retail operations, including COMPANY2 and the other retail entities sold will no longer contribute to COMPANY1's Illinois apportionment factor. The sale completely divested COMPANY1 of its retail operations.

¹ COMPANY2 was sold to COMPANY7, which is a wholly owned subsidiary of COMPANY6, Inc.

² Information based on the purchase price allocation of the sale. Details available on request.

II. Law and Analysis

In Part A, below, we request a letter ruling confirming how Illinois standard apportionment provisions apply to include receipts from the gain on the sale of COMPANY2 goodwill in the Illinois sales factor and to source those receipts largely outside of Illinois. If the Department does not agree, then in Part B, below, we request alternative apportionment. As detailed in Part B, failure to adopt the proposed reasonable alternative formula would result in taxation of the gain in a manner that does not fairly reflect the market for COMPANY1's goods, services, or other sources of income in Illinois under the Illinois statute and is inconsistent with the fair apportionment requirement of the Commerce Clause.³ Additionally, in Part B, we propose a reasonable alternative formula to rectify the statutory and constitutional distortion.

A. Application of Illinois Standard Apportionment Formula

Illinois statutes state the business income of a non-resident taxpayer is apportioned to Illinois, for a taxpayer that derives income from Illinois and other states, using an apportionment formula.⁴ For tax years ending on or after December 31, 2000, the apportionment formula is composed of a single sales factor.⁵ Illinois defines the sales factor as follows: the numerator is the total sales of the taxpayer in Illinois during the taxable year and the denominator is the total sales of the taxpayer everywhere during the taxable year.⁶ Illinois regulations define the term "sales" for apportionment purposes as "all gross receipts derived by the person from transactions and activity in the regular course of his or her trade or business."⁷

If a taxpayer's sales are not specifically governed by paragraphs (B), (B-1), (B-2), (B-5), or (B-7) of 35 Ill. Comp. Stat. § 5/304(a)(3), a taxpayer sources income from intangible property based on 35 Ill. Comp. Stat. § 5/304(a)(3)(C-5)(iii). 35 Ill. Comp. Stat. § 5/304(a)(3)(C-5)(iii)(a) and (b) source interest, net gains, and other items of income from intangible personal property by customer location or income producing activity, depending on whether the taxpayer is a dealer in the item of intangible personal property.⁸ If the taxpayer is classified as a dealer under I.R.C. § 475, the income or gain received from a customer is sourced to Illinois if

³ Article I, Section 8, Clause 3 of the United States Constitution

⁴ 35 Ill. Comp. Stat. § 5/304(a); 35 Ill. Comp. Stat. § 5/304(h)(3).

⁵ 35 Ill. Comp. Stat. § 5/304(h)(3).

⁶ 35 Ill. Comp. Stat. § 5/304(a)(3)(A).

⁷ 86 Ill. Admin. Code § 100.3370(a)(1). Pursuant to 86 Ill. Admin. Code § 100.3380(c)(5), in COMPANY1's case, the receipts would be included at net rather than gross.

⁸ 35 Ill. Comp. Stat. § 5/304(a)(3)(C-5)(iii).

the customer is commercially domiciled in the state.⁹ In all other cases, other items of income from intangible personal property are sourced to Illinois if “the income-producing activity of the taxpayer is performed in this State or, if the income-producing activity of the taxpayer is performed both within and without this State, if a greater proportion of the income-producing activity of the taxpayer is performed within this State than in any other state, based on performance costs.”¹⁰

The Department provided additional guidance in General Information Letter IT 08-0028-GIL which states, “The purpose of the Section is not to create a customer-based sourcing rule only for dealers in securities ... Taxpayers in the business of selling a certain intangible item assign gross receipts based on the location of their customers, while taxpayer’s not in the business of selling such item assign gross receipts based on the income-producing activity.”¹¹

COMPANY1’s sale of goodwill is considered an “other item of income from intangible property.” COMPANY1 regularly buys or sells interests in a business, which can include goodwill. Over the last # years, COMPANY1 has acquired or sold many businesses, including but not limited to: COMPANY9 in 20## (AMOUNT7), COMPANY10 in 20## (AMOUNT8), COMPANY11 in 20## (AMOUNT9), and COMPANY2 in 2021 (AMOUNT4). While COMPANY1 does not separately charge as part of its franchising agreements, COMPANY1 also continuously licenses trademarks and tradenames, which reflect goodwill. To the extent this activity classifies COMPANY1 as a dealer, the sale of COMPANY2 goodwill is sourced to the commercial domicile of the customer for that sale, COMPANY6. The customer’s, COMPANY6’s, commercial domicile is outside of Illinois; specifically STATE2.¹²

If the state determines COMPANY1 is not a dealer, other items of income from intangible personal property are sourced to the state based on the income-producing activity.¹³ In this instance, the activity giving rise to the intangible gain was the sale of an intangible asset--goodwill. The income-producing activity was performed outside of Illinois, where the sale took place.¹⁴ When looking at the transaction at issue, the negotiations, discussions, the signing of documents, the transfer of ownership, all that could be considered the income-producing activity associated with the sale of COMPANY2 goodwill occurred outside of Illinois. This income-

⁹ 35 Ill. Comp. Stat. § 5/304(a)(3)(C-5)(iii)(a).

¹⁰ 35 Ill. Comp. Stat. § 5/304(a)(3)(C-5)(iii)(b).

¹¹ IL General Information Letter IT 08-0028-GIL.

¹² *COMPANY6 Corporate, About*, available at ADDRESS (last accessed on June 14, 2022).

¹³ 35 Ill. Comp. Stat. § 5/304(a)(3)(C-5)(iii)(b).

¹⁴ IL General Information Letter IT 08-0028-GIL.

producing activity is readily identifiable and should be included in the factor.¹⁵ Furthermore, even if COMPANY1's buying and selling activity is not sufficient to make COMPANY1 a dealer, given the nature of the transactions (the sale of an entire business or line of business) COMPANY1's activities are sufficient so that this should not be considered an occasional sale.¹⁶ This is especially true if one were to take into account that COMPANY1 regularly receives receipts from goodwill through its trademarks and tradenames, making it an ordinary source of business income. In accordance with Illinois statute, a greater portion of the income-producing activity was performed outside of Illinois. Therefore, the sale of goodwill is not sourced to the Illinois numerator.

COMPANY1 requests the Department confirm that the sale of COMPANY2 goodwill should be sourced based on customer location or income-producing activity, and under either of those sourcing rules, would be sourced outside of Illinois for purposes of the Illinois numerator, but included in the everywhere sales for purposes of the denominator. If the Department disagrees with our conclusion, we request alternative apportionment for the reasons laid out below.

B. Alternatively, Request for Alternative Apportionment

If the Department does not agree with COMPANY1's conclusion regarding application of the standard apportionment formula to COMPANY2 goodwill and would instead exclude the receipts from the sale of the goodwill, then COMPANY1 petitions for alternative apportionment.

1. Illinois Statutory Criteria for Alternative Apportionment is Met

86 Ill. Admin. Code § 100.3380(c)(2) states that if the determination of sales does not "clearly reflect the market for the taxpayer's goods, services, or other sources of income in Illinois (for taxable years ending on or after December 31, 2008), the taxpayer may request the use of an alternative method of apportionment."¹⁷

35 Ill. Comp. Stat. § 5/304(f) provides the alternative apportionment methodologies.

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

¹⁵ 86 Ill. Admin. Code § 100.3380(c)(3).

¹⁶ 86 Ill. Admin. Code § 100.3380(c)(2).

¹⁷ 86 Ill. Admin. Code § 100.3380(a)(1).

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.

86 Ill. Admin. Code § 100.3390 provides, for tax years starting on January 1, 2009 and later:

A departure from the required apportionment method is allowed only when those methods do not accurately and fairly reflect [the taxpayer's] market 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 convincing evidence that the statutory formula results in the taxation of extraterritorial values or operates unreasonably and arbitrarily in attributing to Illinois a percentage of income that is out of all proportion to the market for the taxpayer's goods, services or other sources of business income 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 the market for the taxpayer's goods, services or other sources of business income in this State.¹⁸

a. The Standard Formula Does Not Fairly Represent the Market for COMPANY1's Sale of Goodwill

If the receipts from COMPANY1's sale of COMPANY2 goodwill asset are not included in the sales factor and sourced significantly outside of Illinois,

¹⁸ 86 Ill. Admin. Code § 100.3390.

the state statutory apportionment formula will not “fairly represent the market” for the goodwill asset.¹⁹ The market for the goodwill asset is where the customer for that asset, COMPANY6, is located. COMPANY6 has retail locations within Illinois but is domiciled outside of Illinois; specifically, in STATE2. The application of the standard formula does not reflect that market if the goodwill receipts are excluded from the sales factor. The exclusion of goodwill from the sales factor would lead to distortion. In the sale of assets other than goodwill, the standard apportionment formula sources the income from the sale of these assets to the location of the market. For example, the sale of retail items in a convenience store located in Illinois would be sourced to Illinois because that is where the market is. In this instance, the sale of the goodwill asset is unfairly entirely excluded from the sales factor resulting in COMPANY1’s apportionment factor overstating its market in Illinois. The exclusion of goodwill from the factor entirely does not fairly represent COMPANY1’s market for that goodwill.

86 Ill. Admin. Code § 100.3380(c)(2)(C) states that “goodwill ... represent[s] the value of customer relationships.”²⁰ The “value of customer relationships” exists at the location of the business activities that developed and maintained those relationships. This location, for COMPANY1’s sale of its goodwill asset, is in STATE1. Almost all business activities associated with the development and maintenance of the goodwill were conducted in STATE1. Below is an activity map created based on the information gathered during the economic valuation. Based on this information, the most significant portion of the high value activities were performed in STATE1.

TABLE REDACTED

Thus, the location of the goodwill asset, like the location of the market for the goodwill asset, is outside of Illinois. While the location of the asset is not the same thing as the location of the market for the asset, in COMPANY1’s case, these locations are both outside of Illinois. Therefore, either excluding the goodwill entirely or sourcing a portion of the goodwill to Illinois does not “fairly represent the market” for the sale and COMPANY1 is entitled to alternative apportionment.

b. Standard Formula Does Not Fairly Represent Illinois Business Activity

The Illinois statute, in prong (3) of the alternative apportionment section, also references the need to “fairly represent the person’s business activities ... in this state” as a rationale for “inclusion of one or more

¹⁹ Pursuant to 86 Ill. Admin. Code § 100.3380(c)(5), includable receipts are at net.

²⁰ 86 Ill. Admin. Code § 100.3380(c)(2)(C).

additional factors.”²¹ In this case, the standard formula also overstates the extent to which business activity that gave rise to the income being apportioned took place in Illinois.

As a result of the sale, COMPANY1 has undertaken an economic valuation analysis in order to identify the locations where goodwill should be attributed. COMPANY1 engaged TAXPAYER REPRESENTATIVE to perform this study. TAXPAYER REPRESENTATIVE prepared a state activity map for the COMPANY2 business based on a review of supporting documentation and background information including transfer pricing studies, financial data, and notes from functional interviews with COMPANY2. The analysis identifies the states in which business activity occurred which created and maintained the value of the COMPANY2 goodwill, and thus gave rise to the income associated with the sale of the goodwill. The preliminary results show that up to %%% of the value of goodwill is attributable to a single state—STATE1, using the comparable transaction analysis. This method analyzes the economic profits attributable to STATE1 based on market royalties for entities performing similar functions. Based on this analysis, a portion of the goodwill should be separately accounted for and sourced to STATE1. The remaining value of the goodwill may then be sourced to Illinois using standard apportionment. Without removing the amounts that are attributable to STATE1, the standard formula application would overstate the value of the goodwill sourced to Illinois and would not fairly represent COMPANY1’s business activities in Illinois. An Illinois apportionment formula that reflects all other business activity, without including the activity that created and maintained the goodwill, results in over attribution of the goodwill income to Illinois business activity.²²

As noted above, COMPANY1 currently expects the sale to result in approximately AMOUNT6 in gain on the goodwill. COMPANY1’s expected total gain is AMOUNT5.²³ With the goodwill representing roughly %%% of the taxpayer’s entire gain, and the sale of COMPANY2 representing the cessation of the company’s complete retail operations, consideration of how the sale should be apportioned, in relation to the Taxpayer’s overall business activities is required. The Retail business is built upon creating intangible value through key strategies and business decisions; all of which were made outside of Illinois. Key corporate marketing and retail strategies such as the PRODUCT11 drove a large amount of the intangible value created. Therefore, alternative apportionment is the acceptable remedy to address this distortion.

²¹ 35 Ill. Comp. Stat. § 5/304(f)(3).

²² This concept was accepted by the California Supreme Court in *Microsoft Corp. v. Franchise Tax Bd.*, 39 Cal. 4th 750, 139 P.3d 1169 (2006).

²³ Information based on the purchase price allocation of the sale. Details available on request.

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While the sale of tangible stores in Illinois and the value attributable to those locations should be sourced to and included in the Illinois tax base and apportionment factor, the bulk of the gain on goodwill and intangibles is directly traceable to STATE1 and the efforts taken there to grow COMPANY1's Retail business segment. Given the significance of the transaction and the gain, alternate apportionment is required.

c. Standard Formula Does Not Result in Equitable Apportionment

Illinois statute under prong (4) of the alternative apportionment section, also references the need for “equitable allocation and apportionment of the person’s business income” as a basis for applying “any other method” of apportionment.²⁴ As noted above, the standard formula overstates the business income attributable to Illinois due to a failure to reflect either the market or the other business activity that gave rise to the income. COMPANY1 has undertaken an economic valuation analysis that shows the portion of goodwill that can be attributable to the various states, including Illinois. Based on this analysis, the standard formula application would inequitably overstate this value and does not fairly represent COMPANY1’s business activities in Illinois. Therefore, COMPANY1 is entitled to alternative apportionment.

2. U.S. Constitutional Criteria for Alternative Apportionment is Met

In addressing unconstitutional taxation necessitating alternate apportionment, the U.S. Supreme Court has stated that:

The facts of life do not neatly lend themselves to the niceties of constitutionalism; but neither does the Constitution tolerate any result, however distorted, just because it is the product of a convenient mathematical formula which, in most situations, may produce a tolerable product.²⁵

The Constitution requires that an apportionment formula be “fair,” and the U.S. Supreme Court has said that for a formula to be “fair,” it must be internally and externally consistent.²⁶ External consistency requires “that the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated.”²⁷ The external consistency test looks “to the economic justification for the State’s claim upon the value taxed, to discover whether a State’s tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State.”²⁸ The economic valuation analysis indicates that the value associated with the goodwill was predominately generated by business activities performed in STATE1. That business activity must be included to actually reflect a reasonable sense of how COMPANY1’s income associated with the goodwill was generated. By eliminating the gain from the sales factor and sourcing only based on COMPANY1’s other factors,

²⁴ 35 Ill. Comp. Stat. 5/304(f)(4).

²⁵ *Norfolk & W. Ry. Co. v. Missouri State Tax Comm.*, 390 U.S. 317, 327 (1968).

²⁶ *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).

²⁷ *Id.*

²⁸ *Oklahoma Tax Comm. v. Jefferson Lines, Inc.*, 514 U.S. 175, 175 (1995).

the Illinois statutory formula would not reflect a reasonable sense of how the income associated with the goodwill gain is generated.²⁹

If the statutory formula fails the external consistency test, the taxpayer is entitled to challenge the application of the standard formula, as applied, and seek application of an alternative apportionment that more fairly reflects the extent of the taxpayer's activities within the taxing state. Evidence may always be received and reviewed to determine whether the state has applied a method of apportionment which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction.³⁰

While the U.S. Supreme Court has held that an increase in the tax base of 250% or greater is sufficient to establish distortion of a constitutional magnitude, it has not set a bright-line rule as to what threshold level of distortion is unconstitutional and requires alternate apportionment.³¹

As noted above, the sale resulted in approximately AMOUNT5 in net gain, AMOUNT6 of which is attributable to net gain on the goodwill. COMPANY1's economic valuation analysis indicates that up to approximately AMOUNT10 of the net goodwill gain is attributable to STATE1. For the apportionment to be fairly reflective of the amount that should be apportioned to Illinois, Illinois would apportion its share of the remaining AMOUNT11 net goodwill gain. Failing to subtract the value resulting from activities in STATE1, would result in distortion due to an increase to the apportionable goodwill gain of over %%. Even if this may not reach the level of distortion present in *Hans Rees' Sons*, it nonetheless is grossly distortive and would not be considered a "fair reflection" of the income which is the standard adopted by Illinois.

3. Proposed Alternative Apportionment: Separate Accounting

As the intangible value attributable to COMPANY2 was created, managed, maintained, and operated from COMPANY2 and COMPANY1's headquarters in STATE1, a portion of the gain attributable to goodwill and intangibles should be allocated to STATE1 via separate accounting. From its STATE1 headquarters, COMPANY2 built its COMPANY2 brand, and the resulting market for its goods and services through: (1) integrating acquisitions under the COMPANY2 brand strategy on external signage and internal layout; (2) building new store locations with a regional focus; (3) remodeling and rebuilding existing locations in core markets; (4)

²⁹ See, e.g., *Miller Brothers Co. v. State of Maryland*, 347 U.S. 340, 344-345 (1954); see also *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978).

³⁰ *Hans Rees' Sons Inc. v. North Carolina*, 283 U.S. 123 (1931).

³¹ *Id.*

building out its network of commercial PRODUCT10 PRODUCT9ing lane locations to take advantage of demand; and (5) significant marketing and COMPANY2 customer loyalty programs (e.g., PRODUCT11). Specifically with respect to (5) above, a key value driver in the value of COMPANY2, and the related entities sold in the sale, was the PRODUCT11 program. This program was created, developed, and managed completely outside of the state of Illinois. The decisions and logic built into the rewards program to incentivize further purchases at COMPANY2 was all done from locations outside of Illinois. These activities were key in developing the market for COMPANY2's goods and services within Illinois. As a result, the value created through the program, specifically the goodwill sold as part of the sale, should be attributed to the location where the program was created, developed, and managed.

COMPANY1 conducted an economic valuation analysis related to the value of the goodwill created in STATE1. The economic valuation analysis shows that as much as %%% of the goodwill value is attributable to STATE1. The value of the goodwill that the study shows is attributed to STATE1 should be carved out of the tax base. The remaining goodwill will be included in the apportionable tax base and divided among the remaining states based on the standard apportionment factor. COMPANY1 will provide a specific calculation with the apportionment data is available, closer to the Illinois filing deadline.

If Illinois does not accept the above alternative formula, COMPANY1 proposes that Illinois simply allow the gain from the sale of goodwill to be added back to the factor and the numerator sourced appropriately to STATE1.

III. Conclusion

In sum, COMPANY1 respectfully requests a letter ruling pursuant to 2 Ill. Admin. Code § 1200.110 confirming our understanding of how Illinois standard statutory apportionment provisions apply to receipts from gain on the sale of goodwill. If Department does not agree with our understanding, we request permission to use an alternative apportionment formula pursuant to 35 Ill. Comp. Stat. § 5/304(f) and 86 Ill. Admin. Code § 100.3390 in connection with its taxable year ended December 31, 20##. Based on the information above, and any and all evidence required by the Department, the statutory formula under 35 Ill. Comp. Stat. § 5/304(a) through (e) does not fairly represent the extent of Taxpayer's market, business activities, or income in Illinois and alternative apportionment, as proposed by the Taxpayer, is justified under Illinois law and the U.S. Constitution. To the extent that additional information is needed or can be provided, please contact TAXPAYER REPRESENTATIVE.

RULING

Section 304(f) of the Illinois Income Tax Act ("IITA", 35 ILCS 5/304(f)) provides:

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.

In addition, 86 Ill. Adm. Code Section 100.3380(a)(2) provides:

The Director has determined that, in the instances described in this Section, the apportionment provisions provided in IITA 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.

86 Ill. Adm. Code Section 100.3390 outlines the procedures in which a taxpayer may petition the Department for an alternative allocation or apportionment formula. The burden of proof for alternative allocation or apportionment petitions is explained in Section 100.3390(c):

A departure from the required apportionment method is allowed only when those methods do not accurately and fairly reflect business activity in Illinois (for taxable years ending before December 31, 2008) or market in Illinois (for taxable years ending on or after December 31, 2008). 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 convincing evidence that the statutory formula results in the taxation of extraterritorial values or operates unreasonably and arbitrarily in attributing to Illinois a percentage of income that is out of all proportion to the business transacted in this State (for taxable years ending before December 31, 2008) or the market for the taxpayer's goods, services or other sources of business income in this State (for taxable years ending on or after December 31, 2008). 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 (for taxable years ending before December 31, 2008) or the market for the taxpayer's goods, services or other sources of business income in this State (for taxable years ending on or after December 31, 2008).

Section 304(a) of the IITA 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. Section 304(h) of the IITA provides for taxable years ending on and after December 31, 2000, the apportionment factor for taxpayers apportioning business income under Section 304(a) is equal to the sales factor. Section 304(a)(3)(A) of the IITA defines the sales factor as follows:

The sales factor is 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.

The term “sales” is defined under Section 1501(a)(21) of the IITA to mean all gross receipts of the taxpayer not allocated under Sections 301, 302, and 303. For purposes of the sales factor of the apportionment formula for each trade or business of the person, 86 Ill. Adm. Code Section 100.3370(a)(1) defines “sales” to mean “all gross receipts derived by the person from transactions and activity in the regular course of his or her trade or business.”

In applying IITA Section 304(a), 86 Ill. Adm. Code Section 100.3380(c)(2) provides the following special rule:

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 DATE2, COMPANY1 completed the sale of COMPANY2, which reflects the disposition of COMPANY1's entire company-owned and operated retail store business segment. You indicate that "the sale completely divested COMPANY1 of its retail operations." You indicate that the gain from such sale is AMOUNT5 and the gain on goodwill is approximately AMOUNT6, "representing roughly %%% of the taxpayer's entire gain." Your petition asserts that the failure to include in COMPANY1's sales factor the goodwill receipts from this sale results in an amount of income apportioned to Illinois that does not fairly represent the market for COMPANY1's goods, services, or other sources of business income. Your primary basis for this assertion is the exclusion is unfair and would lead to distortion in overstating its market in Illinois as the gain on goodwill is traceable to STATE1. However, your petition does not indicate the potential quantitative difference in apportionment percentage assuming the sale receipts were to be excluded from the standard apportionment formula, or alternatively, were to be sourced outside of Illinois for purposes of the numerator but included in the everywhere sales of the denominator, and whether the Department were to grant an alternative apportionment method.

Your petition also indicates that the nature of the transaction – "the sale of an entire business or line of business" – should not be considered an occasional sale because "COMPANY1 regularly receives receipts from goodwill through trademarks and tradenames, making it an ordinary source of business income." The purpose of 86 Ill. Adm. Code Section 100.3380(c)(2)(A) 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. 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 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. As indicated above, incidental or occasional sales are not made in the market for the taxpayer's ordinary sources of business income.

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Based on the facts you represent, 86 Ill. Adm. Code Section 100.3380(c)(2) properly applies in this case. Your request for alternative apportionment cannot be granted.

Your letter indicates COMPANY1's business operating segments consist of INDUSTRY1 and INDUSTRY2, INDUSTRY3, and retailing. Prior to the DATE2 sale, COMPANY1's Illinois business operations included operation of an PRODUCT1 FACILITY in Illinois, operation of INDUSTRY3 property in Illinois, operation of INDUSTRY1 and INDUSTRY2 in Illinois, operation of retail property in Illinois, and receipts from the retail operations. Following the sale, COMPANY1's retail operations will no longer contribute to COMPANY1's Illinois apportionment factor as the sale completely divested COMPANY1 from retail operations. Therefore, COMPANY1's DATE2 sale of COMPANY2 to a third-party purchaser is an incidental or occasional sale of assets used in the trade or business and not a sale made in the market for COMPANY1's goods, services, or other ordinary sources of business income made in the regular course of business conducted by COMPANY1. The sale of COMPANY2 is a cessation of the company's complete retail operations – one of COMPANY1's three business operating segments. Including gross receipts from the DATE2 sale in the 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 86 Ill. Adm. Code Section 100.3380(c)(2). Accordingly, gross receipts from the sale (including goodwill) must be excluded from COMPANY1's sales factor.

86 Ill. Adm. Code Section 100.3380(c)(2)(C) provides "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." Your letter indicates goodwill represents "roughly %%% of the taxpayer's entire gain" on the sale. As goodwill is an asset that appreciates in value over many taxable years, it is presumed that any goodwill inherent in COMPANY1's business in Illinois was generated over multiple years as the taxpayer operated its retail business. The increase in value of COMPANY1's goodwill was not realized for tax purposes until the goodwill was sold, but the value was generated in the behavior of the business over the years in which the 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 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 COMPANY1's 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

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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. See *also* IT 21-0002-GIL.

86 Ill. Adm. Code Section 100.3380(c)(2)(D) provides that where "sales of assets 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." In this case, COMPANY1 sold all its retail operations in Illinois and is withdrawing from the Illinois retail market. Including the gross receipts from the DATE2 sale in the sales factor increases the amount of income apportioned to a market COMPANY1 is exiting. See *also* IT 18-0003-GIL; IT 13-0001-PLR.

As stated above, this is a GIL. A GIL does not constitute a statement of Department policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. In addition, this GIL makes no determination on COMPANY1's request to be classified as a dealer in goodwill under Internal Revenue Code Section 475, IITA 5/304(a)(3)(C-5)(iii), and 86 Ill. Adm. Code Section 100.3370.

Sincerely,

Jennifer Uhles
Associate Counsel (Income Tax)