

General Information Letter: Alternative apportionment not allowed unless taxpayer demonstrates sales factor does not fairly reflect market for goods or services.

March 22, 2023

NAME
ADDRESS
E-MAIL

Re: Petition for Alternative Apportionment
CORPORATION
FEIN: ##-#####
Tax Year Ended: YEAR

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 1200.120(b) and (c).

For the reasons discussed below, your petition cannot be granted at this time.

Your petition states as follows:

We are the accountants for the captioned taxpayer and we are herein submitting this request on behalf of the taxpayer. The taxpayer is a STATE S-Corp. which will begin filing Illinois Form IL-1120-ST for the calendar year YEAR. Should you have any questions please contact NAME at the ADDRESS office address/phone number noted above. NAME email address is E-MAIL.

Background:

The taxpayer is an S corporation incorporated in the State of STATE on DATE. For all of its existence, from DATE until DATE this S corporation has owned rental real estate located solely in the State of STATE and conducted rental activities solely in the State of STATE. On DATE this entity sold its only property (located in STATE) and utilizing the services of a qualified intermediary, elected under Internal Revenue Code section 1031 to qualify

for like kind exchange treatment by acquiring interests in various rental real estate properties located in various U.S. states other than the State of STATE. One (1) of these like kind replacement investments consisted of a multifamily residential rental property located in Illinois. This investment was acquired on DATE.

Alternate Method of Accounting Requested:

Pursuant to the instructions to Form IL-1120-ST, "... if the apportionment methods prescribed by IITA, Sections 304(a) through (d), and (h) do not fairly and accurately represent the market for your goods, services, or other sources of business income, or lead to a grossly distorted result, you may want to use a more accurate alternative method ...". We do believe the apportionment method as prescribed by the aforementioned rules and regulations would result in an unfair and distorted result.

The use of the prescribed apportionment method (based on a ratio of income within the state of Illinois as a percentage of income from other states) is not equitable since the company's sales from other states will include a large capital gain from the sale of the company's STATE property on DATE. Prior to DATE the taxpayer operated solely within the State of STATE. It should be noted that although an IRC sec. 1031 election was made in connection with the sale of the STATE property, the sale transaction still generated a significant taxable gain which will be reportable on the company's YEAR Federal S Corp. return. The reason a taxable gain was generated is because the taxpayer only reinvested a portion of the sales proceeds in replacement properties. The non-reinvested proceeds subjected the taxpayer to a large recognized capital gain. This gain was generated on DATE which was prior to the acquisition of the Illinois property on DATE.

Furthermore, some of the other states in which the taxpayer purchased properties, provide that rental real estate income is not subject to apportionment but instead is allocated directly to the state in which the property is physically located. As such, in order to be consistent with those other states and also for the appropriate amount of income to be recorded and taxed by the State of Illinois, we request that the State grant permission for the taxpayer to allocate to the State of Illinois, the rental income and all related expenses that are earned/incurred directly from the property physically located in Illinois. The taxpayer's accounting system specifically tracks the rental activities for each and every property it owns on a state-by-state basis. Accordingly, the taxpayer has the ability to separately account for each rental property's income and expenses and report such accounting results specifically to the State of Illinois. Reporting the actual rental income and expenses to the individual state where each property is located reflects the most accurate and appropriate representation of net

income earned in that state and reflects the true economic reality of that investment.

Use of the apportionment method would result in a distortion of income being allocated to the State of Illinois, especially in YEAR since a significant portion of sales that would be allocated to Illinois using the apportionment method would include income from a very large capital gain that was recognized from the sale of the original STATE property. This sale occurred prior to the taxpayer's acquisition of the property located in Illinois and other states and prior to the commencement of any activities in the State of Illinois or other states.

Conclusion:

Therefore, it is the taxpayer's position that the aforementioned facts are sufficient for the State of Illinois to grant permission for the taxpayer to use a separate or direct method of accounting, wherein the taxpayer reports only the rental income and expenses to the State of Illinois that pertain to the property located in Illinois as opposed to using the apportionment prescribed IITA, Sections 304(a) through (d), and (h). Using a direct accounting method would result in reporting the true economic substance of the net rental income earned from the Illinois rental property.

Please note that the taxpayer is submitting similar requests to all states, other than STATE, in which it owns and operates rental real estate and which states allow for such submission to elect a separate or direct method of accounting rather than the use of an apportionment factors method. Furthermore, we want to inform you that the taxpayer intends to elect to be subject to the Illinois PTE tax of 4.95% for the tax year YEAR.

RULING

"Taxable income" is defined by Section 203(e)(1) of the Illinois Income Tax Act ("IITA" 35 ILCS 5/203(e)(1)) as "income properly reportable for federal income tax purposes for the taxable year under the provisions of the Internal Revenue Code."

IITA Section 304(a) 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 sales 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.

IITA Section 1501(a)(21) defines the term “sales” as all gross receipts of the taxpayer not characterized as business income. Further, for the purposes of the sales factor of the apportionment formula, Section 100.3370(a)(1) of the Illinois Administrative Code (“Ill. Adm. Code”) (86 Ill. Adm. Code Section 100.3370(a)(1)) provides the term “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. 86 Ill. Adm. Code Section 100.3370 provides for the rules in determining “sales” in various situations, except in instances in which an alternative method of determining the sales factor is prescribed in 86 Ill. Adm. Code Section 100.3380. IITA Section 304(a)(3)(C-5)(i) provides sales from the sale or lease of real property are in this state if the property is located in Illinois.

IITA Section 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.

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.

Taxpayers who wish to use an alternative method of apportionment under these provisions are required to file a petition complying with the requirements of 86 Ill. Adm. Code Section 100.3390. Subsection (c) of that regulation provides:

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).

In order to make a determination under IITA Section 304(h) as to whether or not the apportionment provisions of subsections (a) through (e) and of subsection (h) reflect the market for the person's goods, services, or other sources of business income, it is necessary that the taxpayer first determine its apportionment under such sections. If the apportionment under such sections does not fairly reflect the taxpayer's market, then an alternative apportionment method may be permitted. Your request does not indicate whether the taxpayer has determined its apportionment under IITA Section 304. Your request contains no information relative to the market for the taxpayer's goods, nor does it contain information by which a determination can be made as to whether the apportionment resulting under IITA Section 304 fails to fairly reflect that market. Your

request contains no evidence that the statutory apportionment formula does not fairly represent the extent of the taxpayer's business activities in Illinois or that the proposed alternative method of separate accounting does produce a reasonable result.

Furthermore, the statutory apportionment formula is not rendered distortive based on the timing of when income is recognized for federal income tax purposes. The general rule pursuant to Internal Revenue Code § 451(a) is that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period. IITA Section 304(f) relief was unavailable to a taxpayer questioning whether any portion of the distributive share of expenses allocated against apportionable business income could be carried forward to another tax year from an alleged distortion in income apparently the result of partnership loss that was deductible for federal purposes but not for Illinois purposes. See *Rockwood Holding Co. v. Department of Revenue*, 312 Ill. App. 3d 1120 (1st Dist. 2000). The Court declined to read Section 304(f) broadly so as to correct "glitches" that were not foreseen at the time of enactment. The Court stated "the plain language of section 304(f) seeks to achieve a fair representation of 'the extent of a person's business activity' in Illinois" and "does not address the calculation of the taxpayer's tax liability." *Id.* at 1126. In this matter, it is the income for the taxpayer's YEAR taxable year that is being apportioned and taxed. As indicated above, "taxable income" is defined by IITA Section 203(e)(1) as "income properly reportable for federal income tax purposes for the taxable year" under provisions of the IRC (*emphasis added*). The statutory apportionment formula is not distortive simply based on the timing of the recognition of capital gain income.

The facts stated in your petition are not sufficient to satisfy the burden set forth in 86 Ill. Adm. Code Section 100.3390(c). Because your request merely states that separate accounting for the taxpayer's Illinois income more accurately reflects its Illinois activity, this petition does not meet this regulatory requirement and cannot be granted at this time.

Accordingly, your petition for alternative apportionment for tax year ended DATE cannot be granted. However, if you have additional information related to this request that was not previously submitted, you may supplement your petition and the Department will reconsider your request. Please note that 86 Ill. Adm. Code Section 100.3390(e)(1) requires a petition to be filed at least 120 days prior to the due date (including extensions) for the first return for which permission is sought to use the alternative apportionment method. In addition, each PLR request submitted to the Department for consideration must include certain information outlined in 2 Ill. Adm. Code Section 1200.110.

As stated above, this is a GIL. A GIL does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department.

Sincerely,

CPA /NAME
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Jennifer Uhles
Associate Counsel (Income Tax)