The Illinois Conversion to Market-Sourcing for Income Apportionment Begins to Take Shape

The Illinois Department of Revenue (“IDOR”) plans to begin promulgating new corporate tax regulations on a one-a-week basis, beginning after Labor Day. These regulations will implement ground-breaking legislation enacted last year that converts most of the Illinois Income Tax Act (“IITA”) single-sales factor sourcing to a market-based approach, effective for tax years ending on or after December 31, 2008. Internal drafts of the regulations were recently provided to members of the Director of Revenue’s Advisory Group, a hand-picked group of individuals from industry and the tax practitioner community. (Reed Smith partner Michael Wynne, a former General Counsel for the IDOR, is a member of this group.)

The General Approach of the Market-Based Sourcing Proposals

Nearly every market-based sourcing provision proposed by the IDOR follows a hierarchy for determining where a service is received or an intangible is used, starting with the location of actual receipt or use (presumed to be at a “fixed place of business” within Illinois where the order was placed for a corporation, partnership or trust), and then defaulting to the location to which the services are billed. It is of concern, though, that a “throw-out” approach—excluding the subject receipts from both the sales factor numerator and the denominator—is used whenever the actual or default methods cannot be applied. Whatever the merits of a throw-out approach may be, it is troubling that the IDOR is proposing throw-out treatment as part of its interpretation of the statutory formula, rather than as a form of special apportionment under the Illinois version of UDITPA’s Section 18 that is somehow necessary to more clearly reflect activities in Illinois. The IDOR has said the throw-out approach reflects the State policy against “nowhere” income, which suggests that it serves the Director’s interest in assuring a clear reflection of income in individual cases, rather than a proper interpretation of the general apportionment provisions.

Specific draft regulations were circulated for:

- **Services.** Sales other than tangible personal property are most drastically affected by the change to market-based sourcing. Instead of the cost-of-performance approach applied to income-producing activities under the prior law, sales of services are now apportioned to Illinois if “the services are received in this State.” Services are received in Illinois, by a corporation, partnership or trust, if such entities have a fixed place of business in Illinois (using a federal ‘permanent establishment’ approach), or, lacking information on such a fixed place of business, if the office of the customer from which services were ordered is in Illinois, or, lacking such information, if the billing address for the services is in Illinois. If the taxpayer is not taxable in the state where the services are received, then a throw-back rule is applied.
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- Income From Intangibles. The IDOR draft makes a distinction between a taxpayer that is a “dealer” in intangible personal property, and a non-dealer. For a dealer, interest, net gains, and other income from intangible personal property are sourced to Illinois if the dealer receives the income from a “customer in this State.” Absent actual knowledge of the residence or commercial domicile of a customer, the billing address of the customer controls the sourcing. For non-dealers, interest, net gain and other income from intangible personal property is sourced based on where the cost-of-performance associated with the income-producing activity test is incurred.

- Leasing. Under the IDOR draft, receipts from leasing property are sourced to the location of the property during the rental period.

- Telecommunication Services. The draft regulation for receipts from telecommunications services also takes a market-based approach and mostly does away with the previous cost-of-performance regime. The draft regulation applies to all receipts from telecommunications services— not just those received by corporations whose primary business is providing such services. (Unlike financial organizations, transportation companies, and insurance companies, which have a separate apportionment formula designated by the statute, there is no special apportionment formula for telecommunications companies, and no prohibition against unitary combination of a telecommunications company with another company that uses a different apportionment formula. Consequently, there are non-telecommunication services income categories that may be apportioned using the general market-based approach for services used by all other taxpayers, or, in some cases, the cost-of-performance approach that is retained for certain activities.)

- Other Services. The legislation adopted last year gave the IDOR the discretion to “adopt rules prescribing where specific types of services are received, including but not limited to broadcast, cable, advertising, publishing, and utility service.” IITA Section 304(a)(3)(C-5)(iv). These are services for which no separate statutory apportionment formula is prescribed (taxpayers using such formulas are also subject to statutory prohibitions on unitary combined reporting).

- Broadcasting. In response to a question during the Advisory Group meeting, the IDOR clarified that where the medium at issue is the Internet, the broadcasting and telecommunication regulations are not applicable and, instead, the newly proposed publishing regulation will apply. The broadcasting regulation concerns advertising revenues and other receipts from broadcasting of film or radio programming by any means of communication, including public airwaves, cable, satellite, through a network, or through independent television or radio broadcasting. Advertising revenues will be sourced as determined by an “audience factor” that is the ratio of the audience in Illinois to the total audience, based on the books and records of the taxpayer or on published rating statistics. Where a fee is charged to the recipients of broadcasting, the number of recipients in Illinois to total recipients shall determine the sourcing ratio. Where a fee is charged to the person providing the programming, or a fee is charged to a broadcaster by the person providing the programming, the audience factor method is applied to the total revenue. Here too the IDOR uses its hierarchy of sourcing on sales to corporations, partnerships or trusts, relying on a fixed place of business in Illinois for such entities, or on the billing address from which the service is ordered, or applying a throw-out rule in the absence of such other information.

- Publishing. A “circulation factor” for purchasers or subscribers is used to apportion income from publishing services. The definition of “printed material” includes any “form of printed matter” that “may be contained on any property or medium (including any electronic medium, other than a broadcasting medium...).” Thus “printed material” includes material disseminated through the Internet. “Printed material” includes “the physical embodiment or printed version of any thought or expression,” which may be published by “selling, licensing (other than...for purposes of
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printing or other publication), or distributing newspapers, magazines, periodicals, trade journals, or other printed material.” Here too the IDOR uses its hierarchy of sourcing on sales to corporations, partnerships or trusts, relying on a fixed place of business in Illinois for such entities, or on the billing address from which the service is ordered, or applying a throw-out rule in the absence of such other information.

- **Utility Services.** Notwithstanding the invitation to regulate that the General Assembly extended to the IDOR, no draft regulation on utility service income was provided to the Department’s Advisory Group. A draft is under development and expected shortly.

- **Apportionment for Specific Industries.** Taxpayers required to use a special statutory apportionment formula, and subject to limitations on unitary combined reporting, are also addressed by the draft regulations.

  - **Insurance Companies.** Under Illinois law, an insurance company generally apportions its income to Illinois by multiplying its income by a fraction, the numerator of which is the sum of the “direct premiums written” for insurance upon property or risk in Illinois and the denominator of which is “direct premiums written” everywhere. The draft regulations explain what amounts are included in “direct premiums written.” The amount of premiums written for reinsurance in respect of property or risk in Illinois must be determined in consideration of each premium written, eliminating the up-to-now available option of using a ratio of such premiums from Illinois domiciled companies to total premiums written for reinsurance accepted from all sources, or a ratio of such premiums by each ceding company to total premiums by such ceding company.

  - **Transportation Companies.** The IDOR is also proposing that the “special apportionment” regulation implementing the Illinois UDITPA Section 18 provision be amended, specifically for air carriers, to provide that “flyover miles” (revenue miles flown over a state in a flight that neither takes off or lands in the state) are thrown out of the numerator and denominator of the revenue-miles formula for transportation companies. This treatment also excludes miles flown over international waters and other areas not subject to a government’s jurisdiction. Instead of a 50/50 apportionment based on take-offs and landings, application of the rule would leave a numerator composed of miles flown in Illinois when it is the take-off or landing state, and a denominator composed of all miles flown in take-off and landing states.

A separate, new regulation for apportionment of business income of transportation companies parrots the statutory apportionment language, and then adds a definition of a “transportation company” that is based on whether “more than 80 percent of the entity’s gross income…is derived from business activities characteristic of a transportation company.” This percentage of characteristic-activity-income approach mirrors that adopted some years ago by the IDOR in defining a “financial organization;” an approach that appears to have worked reasonably well. The “entity” to which the test is applied must be one that actually engaged in providing transportation services, and such services must not be “incidental to the sale of goods or other services” by the entity, and no entity is a transportation company unless it charges a fee for transportation services, apart from any charges for goods or services.

Separate apportionment factors are computed for each mode of transportation, e.g., rail, pipeline, ground, or air, and then computing an average of the separate fractions weighted as provided by the IITA for freight and passenger services.

- **Financial Organizations.** The draft regulation mostly parrots the statutory changes implementing a market-based approach, doing away with the well-known lock-box receipt rule for sourcing interest. Gross receipts of financial organizations generally are sourced to Illinois under the draft
regulation if received from a person deemed a resident or commercially domiciled in Illinois. The draft regulations determine the state of residence or commercial domicile of payers, based on a number of concepts, including the location of “fixed place of business,” and substantive contacts (e.g., research or approval) for the income with such a fixed place. The draft regulation also provides a that the gross receipts of financial organizations are sourced, by default, to the billing address of the payer, and includes a throw-out rule applicable to situations when information is lacking to apply other sourcing provisions. Although there are a great many issues to analyze in connection with the sourcing of receipts of financial organizations, these issues emanate mostly from the statute, rather than the regulation, so for the sake of brevity we will not further detail these here.

Curiously, the draft regulation for financial organizations adds examples to: (i) source to Illinois sales of certain tangible personal property that would, in the case of other taxpayers, be excluded from the apportionment factor as incidental or occasional sales (e.g., the sale of a factory or plant) but that will be included in the apportionment factor for a financial organization; and (ii) source gross receipts from the licensing, sale or other disposition of patents to the extent utilized in Illinois (without applying the 50 percent of gross receipts test used by other non-financial organization taxpayers).

The draft regulation also provides a rule for sourcing service income of financial organizations, following the new general rule for market-based sourcing of such income (see “Services,” above).

- **Other Proposals.** Although the focus of this client alert is the IDOR’s apportionment proposals, the IDOR also circulated draft regulations on: (a) list-keeping requirements for reportable transactions; (b) registration of tax shelters; (c) composite returns and estimated payments, overpayments and underpayments; (d) pass-through entity withholding requirements; (e) adjustments to Illinois net operating losses for discharge of indebtedness income; and (f) add-backs for 80/20 companies and non-combination companies. Draft sales tax regulations were also circulated for changes to the rolling stock exemption, and to the special order items.

**The Illinois Rulemaking Process**

The draft regulations described above are merely proposals and there will be ample opportunity to comment on these proposals during the formal rulemaking process. This process will commence when the IDOR begins publishing the proposals in the *Illinois Register*, which is not expected to occur before Labor Day.

Once the IDOR promulgates a regulation by publishing a notice in the Illinois Register, a minimum First Notice period of 45 days for comment begins. During the First Notice Period, interested persons can submit their views on the proposed rulemaking to the IDOR. The IDOR must report to Joint Committee on Administrative Rules (“JCAR”) on the comments received, and it can modify the rulemaking during First Notice by submitting a First Notice Changes document to JCAR when it gives Second Notice.

During the Second Notice period, which lasts a maximum of 45 days, JCAR staff conducts the legislative review of the proposed rules and JCAR then reviews the rules for statutory authority, propriety, standards for exercise of discretion, economic effects, clarity, procedural requirements, and other aspects of the rules. The public is allowed to contact JCAR, typically where the agency has refused to modify its rulemaking in response to their comment, or where they discovered the existence of a proposed rulemaking too late for the First Notice public comment period.

Reed Smith would be pleased to discuss any of the draft regulations described in this client alert and to assist any interested person in submitting comments to the IDOR before or during the rulemaking process.
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