IT 24-0006-GIL 06/24/2024 ALTERNATIVE APPORTIONMENT

Alternative apportionment not appropriate where royalties earned from licensing the use of intangible personal property did not comprise more than 50% of taxpayer's total gross receipts included in gross income and are excluded from sales factor pursuant to IITA Section 304(a)(3)(B-2). (This is a GIL.)

June 24, 2024

NAME
TITLE, BUSINESS
COMPANY1
ADDRESS

Re: Petition for Alternative Apportionment
COMPANY1
FEIN: ##-#######
Tax Years Ended: MM/DD/YEAR1, MM/DD/YEAR2

Dear NAME:

This is in response to your April 22, 2024, petition to use an alternative method of allocation or apportionment. The nature of your request and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy, and is not binding on the Department. *See* 2 Ill. Adm. Code Section 1200.120(b) and (c), which may be found on the Department's website at https://tax.illinois.gov/. For the reasons discussed below, your petition cannot be granted based on the information provided.

Your petition for the YEAR1 tax year ended states as follows:

> COMPANY1 ("COMPANY1" or "Taxpayer") timely filed an original YEAR3 Illinois Corporate Income and Replacement Tax Return ("Return"). The Taxpayer is now amending its YEAR3 Return to revise the Taxpayer's apportionment. Taxpayer respectfully requests that the Illinois Department of Revenue ("Department") approve the utilization of alternative apportionment and accept the Amended Return as filed and for prospective tax years ending on or after YEAR4.
>
> Background Information
> COMPANY1 is a wholly owned subsidiary of COMPANY2 ("COMPANY2"). COMPANY2 was formed in YEAR5 when the firm made its initial public offering, and was later incorporated in STATE in YEAR6. COMPANY2 operates solely outside of Illinois in southwest STATE. COMPANY2, along with its subsidiaries, is a global leader in the consumer goods industry providing branded products of superior quality and value.

The COMPANY2 business revolves around five major segments: Beauty; Grooming; Health Care; Fabric and Home Care; and Baby, Feminine, and Family Care.[1] COMPANY2's products are instantly recognizable when browsing the aisles of most stores. Brands available around the globe include: NAME, among many others. These products are sold in more than ### countries and territories, primarily through mass merchandisers, e-commerce, grocery stores, membership club stores, drug stores, department stores, distributors and pharmacies.[2] The United States ("U.S.") accounts for roughly %%% of the company's worldwide net sales.[3] Europe is responsible for %%% of sales, Asia contributes %%% and Latin America %%%.[4] To facilitate such activities, the company has on-the-ground manufacturing and commercial operations in approximately ### countries.[5]

COMPANY2, along with other U.S. subsidiaries that are included in the Illinois combined filing group, own many valuable intangibles used in the U.S. and globally. COMPANY2 and its U.S. subsidiaries are responsible for all corporate governance and administrative duties, advertising, and research and development for its global brands. As a result, in addition to sales of consumer goods, COMPANY2 and certain U.S. subsidiaries receive royalties from foreign affiliates through licensing arrangements for the intangibles owned by COMPANY2 and its U.S. subsidiaries. These foreign royalties are earned as a percentage of sales from foreign affiliates and represent the primary source of royalties reported on the Federal 1120. The income producing activities related to the royalty income, including research and development, monitoring, and supervision of the intangible personal property, take place entirely outside of Illinois. These royalties represent a significant amount of income and have a relative profit margin much higher than other apportionable income as further discussed below.

Pursuant to 35 ILCS 5/304(h) of the Illinois Income Tax Act ("IITA", "35 ILCS 5/", "the Act", "ILCS Chapter 35 Section 5/"), Taxpayer filed its original return following the standard apportionment method using a single sale factor formula. Taxpayer's sales factor consisted primarily of sales of tangible personal property representing consumer goods sold by members of the Illinois combined group. However, COMPANY2 and certain U.S. subsidiaries were unable to include in the Taxpayer's sales factor the royalties earned from licensing the use of intangible personal property because such income did not comprise more than 50% of Taxpayer's total gross receipts included in gross income as required under IITA 35 ILCS 5/304(a)(3)(B-2).

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[1] COMPANY2, Annual Report (Form 10-K) (June 30, 2018).
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.*

Alternative Apportionment

Law

ILCS Chapter 35 Section 5/304(f) provides that if the normal allocation and apportionment methods do not fairly represent the market for the person's goods, services, or other sources of business income in Illinois, the person can petition the Director of Revenue to permit separate accounting or the use of any other method to create an equitable allocation and apportionment of the taxpayer's business income.

Ill. Admin. Code §100.3390(a)(c) (IITA Section 304(f)) reads as follows:

> 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 or 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).

The Appellate Court of Illinois held in *Miami Corp v. Dept. Rev.*, 571 N.E.2nd 800 that use of the statutory method was inappropriate. It was determined that the taxpayer was entitled to utilize separate accounting. The statutory apportionment formula (the three-factor method) did not fairly represent activities in Illinois with respect to Louisiana oil and gas reserves which generated in excess of 80% of the

taxpayer's total income. The court found that the distortion created by the use of the statutory formula amounted to an unfair representation of the taxpayer's activities within Illinois. Part of the court's reasoning was based on the fact that intangibles (sourced to Louisiana) were not included in the property factor and substantial out-of-state independent contractors were not considered in the payroll factor.

The Department has granted alternative apportionment requests when the statutory apportioned income attributable to business activity in Illinois does not fairly reflect the activities of the taxpayer in Illinois. In Private Letter Ruling IT 05-0002-PLR (3/29/2005), the Department granted the use of separate accounting when the taxpayer demonstrated that the statutory apportionment method attributed more income to Illinois than was earned by the individual unitary group members who were conducting business in Illinois. The Department further approved a separate accounting method for the same taxpayer in Private Letter ruling IT 05-0007-PLR (10/17/2005).

The Illinois Administrative Code sets forth the rules and requirements for alternative apportionment petitions.[6] Subsection (e) of the Regulation prescribes three options for requesting alternative apportionment. In relevant part, the Regulation provides that a petition for alternative apportionment may be filed as an attachment to a return amending an original return which was filed using the statutory allocation and apportionment rules.[7]

Subsection (a) of the Regulation identifies the types of alternative apportionment that may be requested. If reasonable, a taxpayer may petition for the following: (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 the state; or (4) the employment of any other method to effectuate an equitable allocation and apportionment of the person's income.[8]

Discussion

In Taxpayer's case, the standard apportionment formula does not fairly represent the market for its business income, which includes royalties earned from the licensing of intangible personal property. Taxpayer is petitioning for an equitable allocation and apportionment of its income under 86 Ill. Admin. Code §100.3390(a)(4).

[6] *See* 86 Ill. Admin. Code §100.3390 (the "Regulation").
[7] 86 Ill. Admin. Code §100.3390(e)(2).
[8] 86 Ill. Admin. Code §100.3390(a)(1)-(4).

As stated above, Taxpayer was unable to include in its sales factor royalties earned from licensing the use of intangible personal property primarily consisting of royalties paid by foreign affiliates through licensing arrangements for the intangibles owned by COMPANY2 and its U.S. subsidiaries included in the Illinois combined group. Taxpayer asserts that the application of the standard single sales factor which excludes the royalties from the sales factor is distortive and does not fairly represent the market for the taxpayer's business income.

For the fiscal years ending DATE - DATE, the royalties earned by COMPANY2 and its subsidiaries included in the Illinois combined filing group represents %%% of total gross income, while the net royalty income represents %%% of Illinois combined unitary income. The royalties earned by the Taxpayer are included in business income subject to formula apportionment in Illinois. However, there is no representation of the royalties in the sales factor because the royalties are excluded pursuant to IITA 35 ILCS 5/304(a)(3)(B-2).

IITA 35 ILCS 5/304(a)(3)(B-2) provides as follows:

> Gross receipts from the license, sale, or other disposition of patents, copyrights, trademarks, and similar items of intangible personal property, other than gross receipts governed by paragraph (B-7) of this item (3), may be included in the numerator or denominator of the sales factor only if gross receipts from licenses, sales, or other disposition of such items comprise more than 50% of the taxpayer's total gross receipts included in gross income during the tax year and during each of the 2 immediately preceding tax years; provided that, when a taxpayer is a member of a unitary business group, such determination shall be made on the basis of the gross receipts of the entire unitary business group.

The standard apportionment formula allows gross receipts from the licensing of intangible property (e.g., royalties) to be included in the sales factor only if gross receipts from licensing of such items comprise more than 50% of the taxpayer's total gross receipts included in gross income during the tax year and during each of the 2 immediately preceding tax years. Because Taxpayer's royalty income consists of only %%% of total gross income, the royalty income is excluded from the sales factor. Note, if Taxpayer's royalty income was included in the sales factor, the gross receipts would be sourced to Illinois if the income producing activity of such income is performed in the state based on costs of performance.

Effective for tax years ending on or after December 31, 2008, gross receipts from transactions involving intangible personal property when the taxpayer is not a dealer with respect to the intangible personal property, are attributed to Illinois if

the income producing activity is performed in the state, based on costs of performance.[9] Such gross receipts are sourced in Illinois when the income producing activities are performed both in and outside the state and, based on costs of performance, a greater proportion of the income producing activity is performed in Illinois than in any other state.[10]

However, the standard apportionment formula was not created with Taxpayer's facts in mind. It does not consider the significant impact the earned royalties represent of total business income. The net royalty income represents %%% of the total combined business income for the tax years ended DATE - DATE. Yet there is no connection between Illinois and the foreign royalties, including from where they were paid and received, as well as the income producing activity which takes place outside of Illinois. Furthermore, including the foreign royalties in the sales factor results in relief from the disparate taxation of extraterritorial income (i.e., the foreign royalties) earned from the Taxpayer's unitary business and paid by unitary foreign affiliates. Without such relief, the statutory formula operates unreasonably and arbitrarily in attributing income to Illinois when the royalties have no representation in the sales factor as further discussed below.

Moreover, the profit margin on the royalty income, representing branded consumer product sales outside of the United States, is significantly higher than the profit margin earned on the other sales earned by the Taxpayer. In aggregate for fiscal years ending DATE – DATE, the average profit margin for royalty income was %%%. In contrast, the average profit margin earned by the Taxpayer's other income was %%% for fiscal years ending DATE – DATE. This further supports that there is a grossly distorted result when the royalties have no representation in the sales factor, while the profit margin for the royalties is approximately %%% to %%% higher than the profit margin earned by the Taxpayer's other income.

In *Colgate-Palmolive Company, Inc*. ("*Colgate-Palmolive*") *v. Bower*, No. 01 L 50195 (10/15/2002) ("*Colgate*"), the Cook County Judicial Circuit Court held that a Delaware corporation that had business operations in Illinois was not allowed to modify the standard apportionment formula (the three-factor formula method). Colgate-Palmolive filed for alternative apportionment to add a fourth intangible property factor to the Illinois three-factor formula to fairly represent foreign royalties and dividends from foreign subsidiaries. The Administrative Law Judge ruled that Colgate-Palmolive failed to meet its burden of establishing that the standard formula failed to "fairly represent the extent" of Colgate-Palmolive's business in Illinois.[11] The court found that " … each part of Illinois' statutory three factor

[9] 86 Ill. Admin. Code §100.3370(c)(6).
[10] 86 Ill. Admin. Code §100.3370(c)(6)(C)(ii).
[11] *Colgate*.

formula takes into account the ordinary income producing activities and expenses related to Colgate-Palmolive's production of the income at issue, as well as the fact the income producing activities related to the particular income at issue were not performed within Illinois."[12]

In reaching the decision that Colgate-Palmolive failed to meet its burden, the court reasoned that all three factors had representation of the activities associated with the foreign royalties and dividends from foreign subsidiaries. Specifically, the sales factor included the dividends from foreign corporations and royalty income earned from licensing intangible personal property to foreign subsidiaries. Regarding the royalty income in particular, the sales factor was specifically designed to take into account where the costs of performance related to a taxpayer's licensing or other disposition of business intangibles occurred, in order to apportion the receipts realized by such activities in the ordinary course of the taxpayer business. 35 ILCS 5/304(a)(3), 5/1501(21); 86 Ill. Admin. Code §100.3370(a), (b).[13]

It should be noted that the foreign royalties and dividends from foreign subsidiaries earned by Colgate-Palmolive were included in the sales factor despite the fact that they did not comprise more than 50% of the total gross receipts of the taxpayer.[14]

The court's reasoning in Colgate can be applied in the Taxpayer's case. In contrast to Colgate, the standard apportionment formula today fails to represent the market for the royalty income in the Taxpayer's case because the royalties earned from licensing of intangible property are excluded from the sales factor (i.e., the royalties do not comprise more than 50% of Taxpayer's gross income). The lack of inclusion in the factor fails to take into account the ordinary income producing activities and expenses related to Taxpayer's royalty income (i.e., no factor representation), as well as the fact the income producing activities related to the particular income at issue were not performed in Illinois. Further, Illinois administrative code specifies that income shall be included in the denominator (and numerator) of the sales factor when the income producing activity relative to the sourcing of business income from intangible personal property can be readily identified, such as in the Taxpayer's case.[15]

<u>Other State Alternative Apportionment Decisions</u>

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[12] *Id*.
[13] *Id*.
[14] The facts of the *Colgate* decision detail that Colgate-Palmolive reported net sales of $2,085,271,427 on Line 1 of its 1990 Federal return, while Colgate-Palmolive received $247,818,837 in royalty and dividend income. Accordingly, the royalty and dividend income represented approximately 10.62% of the summation of Line 1 of its 1990 Federal return and the royalty and dividend income earned in 1990.
[15] 86 Ill. Admin. Code §100.3380(c)(3).

In *Crocker Equipment Leasing, Inc. ("Crocker") v. Department of Revenue,* No. 2973, 12 OTR 16 (1992), the Court found that the taxpayer's alternative formula was a reasonable method of attributing income to the state. The three-factor apportionment formula used by the Department of Revenue to apportion the Oregon business income of the subsidiary of a U.S. chartered national bank for corporate excise tax purposes did not fairly represent the extent of the corporation's business activity in Oregon, because the calculation did not include intangible property in the property factor. Crocker maintained that 98 percent of its earning assets were intangible, so the property must be included in the factor to avoid distortion. The court found that the taxpayer's methodology was reasonable, as it established a "realistic relationship to how the income is earned."

The court's reasons can be applied to the Taxpayer's case. Including royalties in the sales factor realistically represents the relationship between licensing of intangible property and the income earned from sale of those consumer goods. By not including the royalties, the apportionment formula does not reasonably represent the Taxpayer's activities in Illinois. Stated differently, similar to Crocker, the inclusion of the royalties in the sales factor establishes a realistic relationship to how the Taxpayer earns its income, because the royalties represent the income earned from branded consumer product sales worldwide by unitary foreign affiliates as a result of the use of the same intangible property for the sale of branded consumer goods in the United States.

In *Twentieth Century-Fox Film Corp. ("Twentieth Century Fox") v. Department of Revenue,* 299 Or. 220, 700 P.2d 1035 (1985), Twentieth Century Fox used the statutory three-factor formula for apportionment of income to Oregon. The taxpayer included in the numerator of the property factor only the cost of the positive prints of its films, which were the only tangible personal property distributed in Oregon. Film negatives, which were not included in the numerator, are valued at the cost of producing the film, making them quite valuable. The court determined that it was unfair to merely include the value of the positive prints and ignore the negatives, because it ignored the economic reality of the film industry. The Oregon Department of Revenue modified the property factor by including the value of the film negatives in the value of the positive prints.

The court's reasoning can also be applied to the Taxpayer's case. In order to convey the economic reality of the Taxpayer's business, the sales factor needs to include activity from both the sales of tangible personal property and royalties received from licensing of intangible property. The income generated by the licensing of intangible property is effectively a portion of the sales of consumer goods, because the royalty income is based on a percentage of the sales of branded consumer goods by certain unitary foreign affiliates. It is unreasonable to exclude the royalties

related to the sale of branded consumer goods by the unitary foreign affiliates that is earned as a percentage royalty, just as it was unreasonable to exclude the negative prints from apportionment for Twentieth Century Fox.

While the Twentieth Century Fox case may be an industry related issue, the Taxpayer has an economic reality that differs from most other companies within its industry. The Taxpayer generates a significant amount of revenue from foreign royalties as a result of their brand strategy and recognition and generates substantial revenue from royalties which have no representation in the sales factor. By subjecting the Taxpayer to an apportionment formula excluding one of their major revenue producing activities, there is gross distortion in the amount of income apportioned to Illinois and it is not representative of the Illinois market.

In *Atlantic Richfield Co. ("Atlantic Richfield") v. Alaska*, 705 P.2d 418 (Alaska 1985) (*"Atlantic Richfield"*), as addressed in the GIL, the Alaska supreme court wrote that:

> A unique characteristic of unitary oil and gas businesses is that the major income-producing element is the value of the oil and gas reserves in the ground. While this element can be readily identified, it is not recognized under traditional formula apportionment methods. *** [S]eparate accounting, not formula apportionment, is the prevailing method throughout the United States for reporting income for oil production.[16]

The case of *Atlantic Richfield* shows that failure to reflect income that is prevalent and a major income producing element to a company is distortive. Atlantic Richfield's major income producing element was their gas and oil reserves, which was not recognized using traditional apportionment methods. In the instant case, Taxpayer's major income-producing element is the use of the intangible property related to the business's branded consumer product sales. The intangible property is used by the Taxpayer to earn revenue from the selling of branded consumer goods inside and outside of the United States. The character of the gross receipt from the consumer goods sold inside the United States represents the sale of tangible personal property, while the character of the gross receipts from the consumer goods sold outside the United States is royalty income. Both gross receipt characters must be included in the sales factor in order for the sales factor to fairly and accurately reflect the Taxpayer's major income-producing element (i.e., the sale of consumer goods). Again, without their intangibles, COMPANY2 would not have the ability to produce and sell its consumer branded products. The intangible property related to their brands is a central part of their business model, which relies on the success of existing brands as well as creation of new products

[16] Atlantic Richfield Co., 705 P.2d at 418, 426.

and brands. COMPANY2 attributes their financial success directly with the success of their brands.[17]

In *Appeal of Crisa Corporation, 2002-SBE-004 (6/20/02)*, California State Board of Equalization ("SBE") found the taxpayer's numerical comparisons standing alone are not sufficient to prove distortion and the taxpayer's request was ultimately denied. The SBE ruled that the central question related to alternative apportionment is not whether there is a large enough numerical distortive change, but rather whether there are unusual facts that lead to unfair representation under the standard apportionment factor. They provided five examples of "unusual transactions" that could trigger application of alternative apportionment, one of which reading as follows:

> A particular factor does not have material representation in either the numerator or denominator, rendering that factor useless as a means of reflecting business activity. For example, because a company does not own or rent any tangible or real personal property, the numerator and denominator of the property factor are zero. (See Appeal of Oscar Enterprises, LTD, 87-SBE-069, Oct. 6, 1987.)

This example of an "unusual transaction" can be applied to Taxpayer's activity in Illinois. The royalty revenues represent a significant portion of the profitability of the Taxpayer, but are not represented in the sales factor numerator or denominator. When looking at profit margin, the margin earned on royalty revenues is approximately %%% to %%% higher than the profit margin earned on other gross income of the Taxpayer for fiscal years ending DATE - DATE. However, only the other gross income earned by the Taxpayer is represented in the statutory sales formula resulting in a material misrepresentation. Furthermore, the exclusion of the royalties from the sales factor leads to unfair representation under the standard apportionment factor because the sales factor is not representing all of the income earned from the Taxpayer's intangible property in connection with the sale of branded consumer products as described above.

In *Microsoft Corp. ("Microsoft") v. Franchise Tax Board*, 39 Ca. 4th 750, 771 (2006) (*"Microsoft Corp."*), the court found that treasury receipts were distortive where the receipts generated less than 2 percent of Microsoft's income but 73 percent of its gross receipts.[18] However, the court also noted that the FTB's approach of removing large receipts can result in an exaggeration of California tax when the receipts

[17] COMPANY2., Annual Report (Form 10-K) (June 30, 2021).
[18] Microsoft Corp., 39 Cal. 4th at 771.

account for a substantial portion of the taxpayer's income.[19] Specifically, the court stated:

> We caution, however, that in other cases the Board's approach may go too far in the opposite direction and fail the test of reasonableness. By mixing net receipts for a particular set of out-of-state transactions with gross receipts for all other transactions, it minimizes the contribution of those out-of-state transactions to the taxpayer's income and exaggerates the resulting California tax. If, unlike here, treasury operations provide a substantial portion of a taxpayer's income, this exaggeration may result in an apportionment that does not fairly represent California business activity.[20]

The situation that *Microsoft Corp.* warned of is present in this case. The royalty income at issue "provide[s] a substantial portion of a taxpayer's income." As discussed above, Taxpayer's net royalty income represents %%% of the Taxpayer's combined business income for the tax years ended DATE – DATE. Further, as stated above, the royalties have a much higher profit margin than other gross income earned by the Taxpayer. The royalty income gets no factor representation but contributes an aggregate average %%% profit margin towards apportionable income. The aggregate average profit margin for other gross income earned by the Taxpayer is only %%%.

This is not a situation where including the royalty income defeats the purpose of the sales factor to reflect the market for Taxpayer's activities, which is the intended purpose of the special apportionment rule to exclude certain revenues earned from licensing of intangible property as required under IITA 35 ILCS 5/304(a)(3)(B-2). In this case, including the royalty income in the sales factor properly represents the "market" for Illinois. Otherwise, the exclusion of the royalty income from the sales factor exaggerates Illinois tax and does not fairly represent Taxpayer's unitary business income in Illinois.

<u>Conclusion</u>
Based on the above, Taxpayer requests a deviation from the Illinois' statutory apportionment method as it relates to the royalty earned from licensing of intangible personal property because the application of Illinois's tax apportionment formula produces a tax that fails to represent the activities or market in Illinois. As a result of this distortion, Taxpayer requests the use of an alternative method to fairly represent the market for Taxpayer's business income by including its royalty income on Schedule UB Step 4, Line 2 "net sales everywhere" in the amount of $$$$$$.

[19] Id.
[20] Id.

Alternative Position
In the event that the Department challenges or denies the Taxpayer's alternative apportionment position and refund request, the Taxpayer also requests the Department consider and apply another method to effectuate an equitable allocation and apportionment of Taxpayer's royalties.

Another method is the use of separate accounting to apportion the Taxpayer's royalties separate and apart from all other activity. Using separate accounting, Taxpayer's apportionment will fairly represent Taxpayer's activity in Illinois, as it will no longer be skewed by the inclusion of the royalties which are not fairly reflected in the apportionment formula.

Finally, yet another method to use is to include as members of the Illinois combined group all of the 80/20 companies that are excluded from the combined group under IITA 35 ILCS 5/1501(a)(27)(A) that are paying the royalties to the Taxpayer. The inclusion of the 80/20 companies would serve to include the business income of the foreign corporations, as well as include the sales of such corporations into the apportionment formula. This method will also fairly represent Taxpayer's activity in Illinois as it would have matching representation between business income and sales in the sales factor.

Your petition for the YEAR2 tax year ended states as follows:

COMPANY1 ("COMPANY1" or "Taxpayer") timely filed an original YEAR1 Illinois Corporate Income and Replacement Tax Return ("Return"). The Taxpayer is now amending its YEAR1 Return to revise the Taxpayer's apportionment. Taxpayer respectfully requests that the Illinois Department of Revenue ("Department") approve the utilization of alternative apportionment and accept the Amended Return as filed and for prospective tax years ending on or after YEAR4.

Background Information
COMPANY1 is a wholly owned subsidiary of COMPANY2 ("COMPANY2"). COMPANY2 was formed in YEAR5, when the firm made its initial public offering, and was later incorporated in STATE in YEAR6. COMPANY2 operates solely outside of Illinois in southwest STATE. COMPANY2, along with its subsidiaries, is a global leader in the consumer goods industry providing branded products of superior quality and value.

The COMPANY2 business revolves around five major segments: Beauty; Grooming; Health Care; Fabric and Home Care; and Baby, Feminine, and Family Care.[21] COMPANY2 products are instantly recognizable when browsing the aisles of most

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stores. Brands available around the globe include: NAME, among many others. These products are sold in more than ### countries and territories, primarily through mass merchandisers, e-commerce, grocery stores, membership club stores, drug stores, department stores, distributors and pharmacies.[22] The United States ("U.S.") accounts for roughly %%% of the company's worldwide net sales.[23] Europe is responsible for %%% of sales, Asia contributes %%% and Latin America %%.[24] To facilitate such activities, the company has on-the-ground manufacturing and commercial operations in approximately ## countries.[25]

COMPANY2 along with other U.S. subsidiaries that are included in the Illinois combined filing group, own many valuable intangibles used in the U.S. and globally. COMPANY2 and its U.S. subsidiaries are responsible for all corporate governance and administrative duties, advertising, and research and development for its global brands. As a result, in addition to sales of consumer goods, COMPANY2 and certain U.S. subsidiaries receive royalties from foreign affiliates through licensing arrangements for the intangibles owned by COMPANY2 and its U.S. subsidiaries. These foreign royalties are earned as a percentage of sales from foreign affiliates and represent the primary source of royalties reported on the Federal 1120. The income producing activities related to the royalty income, including research and development, monitoring, and supervision of the intangible personal property, take place entirely outside of Illinois. These royalties represent a significant amount of income and have a relative profit margin much higher than other apportionable income as further discussed below.

Pursuant to 35 ILCS 5/304(h) of the Illinois Income Tax Act ("IITA", "35 ILCS 5/", "the Act", "ILCS Chapter 35 Section 5/"), Taxpayer filed its original return following the standard apportionment method using a single sale factor formula. Taxpayer's sales factor consisted primarily of sales of tangible personal property representing consumer goods sold by members of the Illinois combined group. However, COMPANY2 and certain U.S. subsidiaries were unable to include in the Taxpayer's sales factor the royalties earned from licensing the use of intangible personal property because such income did not comprise more than 50% of Taxpayer's total gross receipts included in gross income as required under IITA 35 ILCS 5/304(a)(3)(B-2).

Alternative Apportionment

Law

[22] *Id.*
[23] *Id.*
[24] *Id.*
[25] *Id.*

ILCS Chapter 35 Section 5/304(f) provides that if the normal allocation and apportionment methods do not fairly represent the market for the person's goods, services, or other sources of business income in Illinois, the person can petition the Director of Revenue to permit separate accounting or the use of any other method to create an equitable allocation and apportionment of the taxpayer's business income.

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> 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 or 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).

The Appellate Court of Illinois held in *Miami Corp v. Dept. Rev.*, 571 N.E.2nd 800 that use of the statutory method was inappropriate. It was determined that the taxpayer was entitled to utilize separate accounting. The statutory apportionment formula (the three-factor method) did not fairly represent activities in Illinois with respect to Louisiana oil and gas reserves which generated in excess of 80% of the taxpayer's total income. The court found that the distortion created by the use of the statutory formula amounted to an unfair representation of the taxpayer's activities within Illinois. Part of the court's reasoning was based on the fact that intangibles (sourced to Louisiana) were not included in the property factor and

substantial out-of-state independent contractors were not considered in the payroll factor.

The Department has granted alternative apportionment requests when the statutory apportioned income attributable to business activity in Illinois does not fairly reflect the activities of the taxpayer in Illinois. In Private Letter Ruling IT 05-0002-PLR (3/29/2005), the Department granted the use of separate accounting when the taxpayer demonstrated that the statutory apportionment method attributed more income to Illinois than was earned by the individual unitary group members who were conducting business in Illinois. The Department further approved a separate accounting method for the same taxpayer in Private Letter ruling IT 05-0007-PLR (10/17/2005).

The Illinois Administrative Code sets forth the rules and requirements for alternative apportionment petitions.[26] Subsection (e) of the Regulation prescribes three options for requesting alternative apportionment. In relevant part, the Regulation provides that a petition for alternative apportionment may be filed as an attachment to a return amending an original return which was filed using the statutory allocation and apportionment rules.[27]

Subsection (a) of the Regulation identifies the types of alternative apportionment that may be requested. If reasonable, a taxpayer may petition for the following: (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 the state; or (4) the employment of any other method to effectuate an equitable allocation and apportionment of the person's income.[28]

Discussion

In Taxpayer's case, the standard apportionment formula does not fairly represent the market for its business income, which includes royalties earned from the licensing of intangible personal property. Taxpayer is petitioning for an equitable allocation and apportionment of its income under 86 Ill. Admin. Code §100.3390(a)(4).

As stated above, Taxpayer was unable to include in its sales factor royalties earned from licensing the use of intangible personal property primarily consisting of royalties paid by foreign affiliates through licensing arrangements for the intangibles owned by COMPANY2 and its U.S. subsidiaries included in the Illinois combined group. Taxpayer asserts that the application of the standard single sales factor

[26] *See* 86 Ill. Admin. Code §100.3390 (the "Regulation").
[27] 86 Ill. Admin. Code §100.3390(e)(2).
[28] 86 Ill. Admin. Code §100.3390(a)(1)-(4).

which excludes the royalties from the sales factor is distortive and does not fairly represent the market for the taxpayer's business income.

For the fiscal years ending DATE - DATE, the royalties earned by COMPANY2 and its subsidiaries included in the Illinois combined filing group represents %%% of total gross income, while the net royalty income represents %%% of Illinois combined unitary income. The royalties earned by the Taxpayer are included in business income subject to formula apportionment in Illinois. However, there is no representation of the royalties in the sales factor because the royalties are excluded pursuant to IITA 35 ILCS 5/304(a)(3)(B-2).

IITA 35 ILCS 5/304(a)(3)(B-2) provides as follows:

> Gross receipts from the license, sale, or other disposition of patents, copyrights, trademarks, and similar items of intangible personal property, other than gross receipts governed by paragraph (B-7) of this item (3), may be included in the numerator or denominator of the sales factor only if gross receipts from licenses, sales, or other disposition of such items comprise more than 50% of the taxpayer's total gross receipts included in gross income during the tax year and during each of the 2 immediately preceding tax years; provided that, when a taxpayer is a member of a unitary business group, such determination shall be made on the basis of the gross receipts of the entire unitary business group.

The standard apportionment formula allows gross receipts from the licensing of intangible property (e.g., royalties) to be included in the sales factor only if gross receipts from licensing of such items comprise more than 50% of the taxpayer's total gross receipts included in gross income during the tax year and during each of the 2 immediately preceding tax years. Because Taxpayer's royalty income consists of only %%% of total gross income, the royalty income is excluded from the sales factor. Note, if Taxpayer's royalty income was included in the sales factor, the gross receipts would be sourced to Illinois if the income producing activity of such income is performed in the state based on costs of performance.

Effective for tax years ending on or after December 31, 2008, gross receipts from transactions involving intangible personal property when the taxpayer is not a dealer with respect to the intangible personal property, are attributed to Illinois if the income producing activity is performed in the state, based on costs of performance.[29] Such gross receipts are sourced in Illinois when the income producing activities are performed both in and outside the state and, based on

[29] 86 Ill. Admin. Code §100.3370(c)(6).

costs of performance, a greater proportion of the income producing activity is performed in Illinois than in any other state.[30]

However, the standard apportionment formula was not created with Taxpayer's facts in mind. It does not consider the significant impact the earned royalties represent of total business income. The net royalty income represents %%% of the total combined business income for the tax years ended DATE - DATE. Yet there is no connection between Illinois and the foreign royalties, including from where they were paid and received, as well as the income producing activity which takes place outside of Illinois. Furthermore, including the foreign royalties in the sales factor results in relief from the disparate taxation of extraterritorial income (i.e., the foreign royalties) earned from the Taxpayer's unitary business and paid by unitary foreign affiliates. Without such relief, the statutory formula operates unreasonably and arbitrarily in attributing income to Illinois when the royalties have no representation in the sales factor as further discussed below.

Moreover, the profit margin on the royalty income, representing branded consumer product sales outside of the United States, is significantly higher than the profit margin earned on the other sales earned by the Taxpayer. In aggregate for fiscal years ending DATE – DATE, the average profit margin for royalty income was %%%. In contrast, the average profit margin earned by the Taxpayer's other income was %%% for fiscal years ending DATE – DATE. This further supports that there is a grossly distorted result when the royalties have no representation in the sales factor, while the profit margin for the royalties is approximately %%% to %%% higher than the profit margin earned by the Taxpayer's other income.

In *Colgate-Palmolive Company, Inc*. ("*Colgate-Palmolive*") *v. Bower*, No. 01 L 50195 (10/15/2002) ("*Colgate*"), the Cook County Judicial Circuit Court held that a Delaware corporation that had business operations in Illinois was not allowed to modify the standard apportionment formula (the three-factor formula method). Colgate-Palmolive filed for alternative apportionment to add a fourth intangible property factor to the Illinois three-factor formula to fairly represent foreign royalties and dividends from foreign subsidiaries. The Administrative Law Judge ruled that Colgate-Palmolive failed to meet its burden of establishing that the standard formula failed to "fairly represent the extent" of Colgate-Palmolive's business in Illinois.[31] The court found that " ... each part of Illinois' statutory three factor formula takes into account the ordinary income producing activities and expenses related to Colgate-Palmolive's production of the income at issue, as well as the fact

[30] 86 Ill. Admin. Code §100.3370(c)(6)(C)(ii).
[31] *Colgate*.

the income producing activities related to the particular income at issue were not performed within Illinois."[32]

In reaching the decision that Colgate-Palmolive failed to meet its burden, the court reasoned that all three factors had representation of the activities associated with the foreign royalties and dividends from foreign subsidiaries. Specifically, the sales factor included the dividends from foreign corporations and royalty income earned from licensing intangible personal property to foreign subsidiaries. Regarding the royalty income in particular, the sales factor was specifically designed to take into account where the costs of performance related to a taxpayer's licensing or other disposition of business intangibles occurred, in order to apportion the receipts realized by such activities in the ordinary course of the taxpayer business. 35 ILCS 5/304(a)(3), 5/1501(21); 86 Ill. Admin. Code §100.3370(a), (b).[33]

It should be noted that the foreign royalties and dividends from foreign subsidiaries earned by Colgate-Palmolive were included in the sales factor despite the fact that they did not comprise more than 50% of the total gross receipts of the taxpayer.[34]

The court's reasoning in Colgate can be applied in the Taxpayer's case. In contrast to Colgate, the standard apportionment formula today fails to represent the market for the royalty income in the Taxpayer's case because the royalties earned from licensing of intangible property are excluded from the sales factor (i.e., the royalties do not comprise more than 50% of Taxpayer's gross income). The lack of inclusion in the factor fails to take into account the ordinary income producing activities and expenses related to Taxpayer's royalty income (i.e., no factor representation), as well as the fact the income producing activities related to the particular income at issue were not performed in Illinois. Further, Illinois administrative code specifies that income shall be included in the denominator (and numerator) of the sales factor when the income producing activity relative to the sourcing of business income from intangible personal property can be readily identified, such as in the Taxpayer's case.[35]

Other State Alternative Apportionment Decisions

In *Crocker Equipment Leasing, Inc. ("Crocker") v. Department of Revenue,* No. 2973, 12 OTR 16 (1992), the Court found that the taxpayer's alternative formula was a reasonable method of attributing income to the state. The three-factor

[32] *Id*.
[33] *Id*.
[34] The facts of the *Colgate* decision detail that Colgate-Palmolive reported net sales of $2,085,271,427 on Line 1 of its 1990 Federal return, while Colgate-Palmolive received $247,818,837 in royalty and dividend income. Accordingly, the royalty and dividend income represented approximately 10.62% of the summation of Line 1 of its 1990 Federal return and the royalty and dividend income earned in 1990.
[35] 86 Ill. Admin. Code §100.3380(c)(3).

apportionment formula used by the Department of Revenue to apportion the Oregon business income of the subsidiary of a U.S. chartered national bank for corporate excise tax purposes did not fairly represent the extent of the corporation's business activity in Oregon, because the calculation did not include intangible property in the property factor. Crocker maintained that 98 percent of its earning assets were intangible, so the property must be included in the factor to avoid distortion. The court found that the taxpayer's methodology was reasonable, as it established a "realistic relationship to how the income is earned."

The court's reasons can be applied to the Taxpayer's case. Including royalties in the sales factor realistically represents the relationship between licensing of intangible property and the income earned from sale of those consumer goods. By not including the royalties, the apportionment formula does not reasonably represent the Taxpayer's activities in Illinois. Stated differently, similar to Crocker, the inclusion of the royalties in the sales factor establishes a realistic relationship to how the Taxpayer earns its income, because the royalties represent the income earned from branded consumer product sales worldwide by unitary foreign affiliates as a result of the use of the same intangible property for the sale of branded consumer goods in the United States.

In *Twentieth Century-Fox Film Corp. ("Twentieth Century Fox") v. Department of Revenue,* 299 Or. 220, 700 P.2d 1035 (1985), Twentieth Century Fox used the statutory three-factor formula for apportionment of income to Oregon. The taxpayer included in the numerator of the property factor only the cost of the positive prints of its films, which were the only tangible personal property distributed in Oregon. Film negatives, which were not included in the numerator, are valued at the cost of producing the film, making them quite valuable. The court determined that it was unfair to merely include the value of the positive prints and ignore the negatives, because it ignored the economic reality of the film industry. The Oregon Department of Revenue modified the property factor by including the value of the film negatives in the value of the positive prints.

The court's reasoning can also be applied to the Taxpayer's case. In order to convey the economic reality of the Taxpayer's business, the sales factor needs to include activity from both the sales of tangible personal property and royalties received from licensing of intangible property. The income generated by the licensing of intangible property is effectively a portion of the sales of consumer goods, because the royalty income is based on a percentage of the sales of branded consumer goods by certain unitary foreign affiliates. It is unreasonable to exclude the royalties related to the sale of branded consumer goods by the unitary foreign affiliates that is earned as a percentage royalty, just as it was unreasonable to exclude the negative prints from apportionment for Twentieth Century Fox.

While the Twentieth Century Fox case may be an industry related issue, the Taxpayer has an economic reality that differs from most other companies within its industry. The Taxpayer generates a significant amount of revenue from foreign royalties as a result of their brand strategy and recognition and generates substantial revenue from royalties which have no representation in the sales factor. By subjecting the Taxpayer to an apportionment formula excluding one of their major revenue producing activities, there is gross distortion in the amount of income apportioned to Illinois and it is not representative of the Illinois market.

In *Atlantic Richfield Co. ("Atlantic Richfield") v. Alaska*, 705 P.2d 418 (Alaska 1985) (*"Atlantic Richfield"*), as addressed in the GIL, the Alaska supreme court wrote that:

> A unique characteristic of unitary oil and gas businesses is that the major income-producing element is the value of the oil and gas reserves in the ground. While this element can be readily identified, it is not recognized under traditional formula apportionment methods. *** [S]eparate accounting, not formula apportionment, is the prevailing method throughout the United States for reporting income for oil production.[36]

The case of *Atlantic Richfield* shows that failure to reflect income that is prevalent and a major income producing element to a company is distortive. Atlantic Richfield's major income producing element was their gas and oil reserves, which was not recognized using traditional apportionment methods. In the instant case, Taxpayer's major income-producing element is the use of the intangible property related to the business's branded consumer product sales. The intangible property is used by the Taxpayer to earn revenue from the selling of branded consumer goods inside and outside of the United States. The character of the gross receipt from the consumer goods sold inside the United States represents the sale of tangible personal property, while the character of the gross receipts from the consumer goods sold outside the United States is royalty income. Both gross receipt characters must be included in the sales factor in order for the sales factor to fairly and accurately reflect the Taxpayer's major income-producing element (i.e., the sale of consumer goods). Again, without their intangibles, COMPANY2 would not have the ability to produce and sell its consumer branded products. The intangible property related to their brands is a central part of their business model, which relies on the success of existing brands as well as creation of new products and brands. COMPANY2 attributes their financial success directly with the success of their brands.[37]

[36] Atlantic Richfield Co., 705 P.2d at 418, 426.
[37] COMPANY2., Annual Report (Form 10-K) (June 30, 2021).

In *Appeal of Crisa Corporation, 2002-SBE-004 (6/20/02)*, California State Board of Equalization ("SBE") found the taxpayer's numerical comparisons standing alone are not sufficient to prove distortion and the taxpayer's request was ultimately denied. The SBE ruled that the central question related to alternative apportionment is not whether there is a large enough numerical distortive change, but rather whether there are unusual facts that lead to unfair representation under the standard apportionment factor. They provided five examples of "unusual transactions" that could trigger application of alternative apportionment, one of which reading as follows:

> A particular factor does not have material representation in either the numerator or denominator, rendering that factor useless as a means of reflecting business activity. For example, because a company does not own or rent any tangible or real personal property, the numerator and denominator of the property factor are zero. (See Appeal of Oscar Enterprises, LTD, 87-SBE-069, Oct. 6, 1987.)

This example of an "unusual transaction" can be applied to Taxpayer's activity in Illinois. The royalty revenues represent a significant portion of the profitability of the Taxpayer, but are not represented in the sales factor numerator or denominator. When looking at profit margin, the margin earned on royalty revenues is approximately %%% to %%% higher than the profit margin earned on other gross income of the Taxpayer for fiscal years ending DATE - DATE. However, only the other gross income earned by the Taxpayer is represented in the statutory sales formula resulting in a material misrepresentation. Furthermore, the exclusion of the royalties from the sales factor leads to unfair representation under the standard apportionment factor because the sales factor is not representing all of the income earned from the Taxpayer's intangible property in connection with the sale of branded consumer products as described above.

In *Microsoft Corp. ("Microsoft") v. Franchise Tax Board*, 39 Ca. 4th 750, 771 (2006) (*"Microsoft Corp."*), the court found that treasury receipts were distortive where the receipts generated less than 2 percent of Microsoft's income but 73 percent of its gross receipts.[38] However, the court also noted that the FTB's approach of removing large receipts can result in an exaggeration of California tax when the receipts account for a substantial portion of the taxpayer's income.[39] Specifically, the court stated:

> We caution, however, that in other cases the Board's approach may go too far in the opposite direction and fail the test of reasonableness. By mixing

[38] Microsoft Corp., 39 Cal. 4th at 771.
[39] Id.

> net receipts for a particular set of out-of-state transactions with gross receipts for all other transactions, it minimizes the contribution of those out-of-state transactions to the taxpayer's income and exaggerates the resulting California tax. If, unlike here, treasury operations provide a substantial portion of a taxpayer's income, this exaggeration may result in an apportionment that does not fairly represent California business activity.[40]

The situation that *Microsoft Corp.* warned of is present in this case. The royalty income at issue "provide[s] a substantial portion of a taxpayer's income." As discussed above, Taxpayer's net royalty income represents %%% of the Taxpayer's combined business income for the tax years ended DATE – DATE. Further, as stated above, the royalties have a much higher profit margin than other gross income earned by the Taxpayer. The royalty income gets no factor representation but contributes an aggregate average %%% profit margin towards apportionable income. The aggregate average profit margin for other gross income earned by the Taxpayer is only %%%.

This is not a situation where including the royalty income defeats the purpose of the sales factor to reflect the market for Taxpayer's activities, which is the intended purpose of the special apportionment rule to exclude certain revenues earned from licensing of intangible property as required under IITA 35 ILCS 5/304(a)(3)(B-2). In this case, including the royalty income in the sales factor properly represents the "market" for Illinois. Otherwise, the exclusion of the royalty income from the sales factor exaggerates Illinois tax and does not fairly represent Taxpayer's unitary business income in Illinois.

Conclusion

Based on the above, Taxpayer requests a deviation from the Illinois' statutory apportionment method as it relates to the royalty earned from licensing of intangible personal property because the application of Illinois's tax apportionment formula produces a tax that fails to represent the activities or market in Illinois. As a result of this distortion, Taxpayer requests the use of an alternative method to fairly represent the market for Taxpayer's business income by including its royalty income on Schedule UB Step 4, Line 2 "net sales everywhere" in the amount of $$$$$$.

Alternative Position

In the event that the Department challenges or denies the Taxpayer's alternative apportionment position and refund request, the Taxpayer also requests the Department consider and apply another method to effectuate an equitable allocation and apportionment of Taxpayer's royalties.

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[40] Id.

> Another method is the use of separate accounting to apportion the Taxpayer's royalties separate and apart from all other activity. Using separate accounting, Taxpayer's apportionment will fairly represent Taxpayer's activity in Illinois, as it will no longer be skewed by the inclusion of the royalties which are not fairly reflected in the apportionment formula.
>
> Finally, yet another method to use is to include as members of the Illinois combined group all of the 80/20 companies that are excluded from the combined group under IITA 35 ILCS 5/1501(a)(27)(A) that are paying the royalties to the Taxpayer. The inclusion of the 80/20 companies would serve to include the business income of the foreign corporations, as well as include the sales of such corporations into the apportionment formula. This method will also fairly represent Taxpayer's activity in Illinois as it would have matching representation between business income and sales in the sales factor.

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.

For taxable years ending on or after December 31, 1999, IITA Section 304(a)(3)(B-2) provides that gross receipts from the license, sale, or other disposition of patents, copyrights, trademarks, and similar items of intangible personal property may be included in the sales factor only if gross receipts from the license, sale, or other disposition of such items comprise more than 50% of the taxpayer's total gross receipts included in gross income during the tax year and during each of the two immediately preceding tax years, and provided that when a taxpayer is a member of a unitary business group, such determination shall be made on the basis of the gross receipts of the entire unitary business group. If not excluded from the sales factor under the 50% B-2 test, these receipts are sourced to Illinois according to IITA Section 304(a)(3)(B-1).

Section 304(f) of the IITA 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).

Your petition for alternative apportionment indicates that gross receipts from the foreign royalties are not more than 50% of COMPANY1's total gross receipts for the tax years ended YEAR1 and YEAR2, and are therefore excluded from the sales factor under IITA Section 304(a)(3)(B-2). Your petition asserts that the royalties earned by COMPANY1 are included in business income subject to formula apportionment in Illinois but the failure to include such receipts in the sales factor results in an Illinois tax liability that is distortive and does not fairly represent the market for COMPANY1's business income in the State. The primary basis for this assertion is that for fiscal years ending DATE – DATE, the statutory apportionment formula fails to take into account that the gross receipts from the foreign royalties earned by COMPANY1 represents %%% of total gross income, while the net royalty income represents %%% of Illinois combined unitary income. In addition, you state there is a grossly distorted result when the royalties have no representation in the sales factor but the profit margin for the royalties is approximately %%% - %%% higher than the profit margin earned by the Taxpayer's other income.

The facts stated in your petition are not sufficient to satisfy the burden set forth in Ill. Adm. Code Section 100.3390(c). As indicated above, for taxable years ending on or after December 31, 2008, alternative apportionment under IITA Section 304(f) is appropriate in cases where the allocation and apportionment provisions under IITA Sections 304(a)

through (e) do not fairly represent the market for the taxpayer's goods, services, or other sources of business income. In this case, your petition does not meet the regulatory requirement and cannot be granted at this time. Your request merely states that due to the statutory exclusion of foreign royalty from the sales factor pursuant to IITA Section 304(a)(3)(B-2), an alternative apportionment formula would more accurately represent COMPANY1's market in Illinois. An alternative apportionment method may not be invoked, either by the Department or by a taxpayer, merely because it reaches a different apportionment percentage than the required statutory formula.

In this case, IITA Section 304(a)(3)(B-2) and 86 Ill. Adm. Code Section 100.3370(a)(2)(F) provide that for taxable years ending on or after December 31, 1999, gross receipts from the licensing, sale, or other disposition of a patent, copyright, trademark, or similar item of intangible personal property may be included in the sales factor only if gross receipts from licenses, sales, or other dispositions of these items comprise more than 50% of the taxpayer's total gross receipts included in gross income during the tax year and during each of the two immediately preceding tax years. Exclusion of such receipts from the sales factor thereby prevents distortion of the sales factor that would otherwise occur.

Section 304(f) relief is proper where the income allocated to the State by the otherwise applicable statutory formula is unfairly disproportionate to the business activity conducted in the State. There is nothing inherently distortive or unfair in excluding from the sales factor those royalties that do not comprise more than 50% of gross receipts from royalties earned from the licensing of intangible property based on the activities of the taxpayer. See also *Vectren Infrastructure Services Corp., successor in interest to Minnesota Limited, Inc., v. Department of Treasury*, 512 Mich. 594. In that case, the Michigan Supreme Court held that the inclusion of income from an asset sale in the tax base apportionment under the Michigan Business Tax Act did not violate the Due Process Clause nor the Commerce Clause, and that the taxpayer failed to prove the statutory apportionment formula, excluding the sale of assets from the sales factor, created a grossly disproportionate result when applied to this one-time asset sale.

> "ML and Justice Zahra's dissent further argue that removing the value of the asset sale from the denominator of the sales factor leads to gross distortion because, without it, the sales factor fails to adequately consider how the income was generated. This is nothing more than a gripe about which factors are or are not included in the formula, and it is unpersuasive. Whether a one- or three-factor test is used (or any other number of factors), litigants have consistently unsuccessfully argued exactly what ML argues here—that a different combination is required. Just as the courts in *Moorman, Kraft, Container Corp,*and *Trinova II* rejected these endless propositions of different proportionality factor combinations, so too do we. Michigan chose a single-factor modifier based upon sales generated within the state. Courts have routinely upheld the use of both a sales-factor modifier and

> other single-factor modifiers. The same courts have also upheld the end result even when the difference using an alternative modifier would have resulted in a much lower tax bill."

Vectren, 512 Mich. 594 at 648.

In addition, your proposed alternative methods fail to demonstrate that the statutory method would lead to a distorted result 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. See *Lakehead Pipe Line Co. v. Dep't of Rev.*, 192 Ill. App. 3d 756 (1st Dist. 1989); *Miami Corp. v. Dep't of Rev.*, 212 Ill. App. 3d 702 (1st Dist. 1991); *AT&T Teleholdings, Inc. v. Dep't of Rev.*, 978 N.E.2d 371 (Ill. App. Ct. 2012). Merely indicating separate accounting would effectuate equitable allocation and apportionment of COMPANY1's royalties, without any explanation of why these methods are more accurate than formulary apportionment, is insufficient to meet the burden of proof imposed by 86 Ill. Adm. Code Section 100.3390(c) on taxpayers requesting permission to use an alternative method of apportionment. As a unitary business enterprise, there are intercompany transactions that are not reflected in your calculations. Separating companies from their unitary group often creates more distortions due to intercompany pricing issues.

This conclusion is also warranted by a review of Illinois cases involving a taxpayer's request to invoke an alternative apportionment method pursuant to IITA Section 304(f). For example, in *Miami Corp. v. Dep't of Rev.*, which you cite as an authority in support of your petition to use an alternative formula, the Illinois appellate court affirmed the circuit court's decision that the Illinois three-factor formula, as applied by the Department in that case, grossly distorted the amount of income to be apportioned to Illinois. The facts of that case, however, are distinguishable from the facts presented in your petition, and distinguishable in a way that warrants a different result. The primary difference is the fact that the intangible income at issue in *Miami Corp.* arose from the taxpayer's ownership of real estate situated in other states, and the fact that Miami Corp. had no such intangible property rights regarding land owned in Illinois. Both the appellate and the trial court in *Miami Corp.* relied to a great degree on the reasoning of the Alaska supreme court in *Atlantic Richfield Co. v. Alaska*, 705 P.2d 418 (Alaska 1985) *app. dism'd*, 474 U.S. 1043, 106 S.Ct. 74, 88 L.ed.2d 754 (1985). Specifically, the Alaska supreme court wrote that:

> A unique characteristic of unitary oil and gas businesses is that the major income-producing element is the value of the oil and gas reserves in the ground. While this element can be readily identified, it is not recognized under traditional formula apportionment methods. *** [S]eparate accounting, not formula apportionment, is the prevailing method throughout the United States for reporting income for oil production.

Atlantic Richfield Co., 705 P.2d 418 at 418, 426.

Furthermore, the statutory apportionment formula has since changed from three-factor apportionment formula (property, payroll, and sales) to a one factor formula (sales). The intangibles at issue here are not like the intangible rights that ran with the land in *Miami Corp*.

Accordingly, your petition for alternative apportionment for tax years ended YEAR1, and YEAR2, and for prospective tax years ending on or after YEAR4, cannot be granted. However, if you have additional information related to this request that was not previously submitted, you may supplement your petition and we 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.

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

Sincerely,

Jennifer Uhles
Associate Counsel (Income Tax)