

Petition to include property and payroll apportionment factors in sales factor calculation cannot be granted unless taxpayer demonstrates sales factor does not fairly reflect market for goods or services. (This is a GIL.)

June 25, 2026

NAME
COMPANY1
ADDRESS1
EMAIL

Re: Petition for Alternative Apportionment
 COMPANY2
 FEIN: NUMBER1
 Tax Years Ended: YEAR1 – YEAR4

Dear NAME:

This letter is in response to your petition dated February 13, 2026, on behalf of COMPANY2 to use an alternative method of allocation or apportionment effective for tax years ended YEAR1, YEAR2, YEAR3, and YEAR4. The Department issues two types of letter rulings. Private Letter Rulings (“PLRs”) are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department’s regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter (“GIL”) is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at <https://tax.illinois.gov/> to review regulations, letter rulings and other types of information relevant to your inquiry.

The nature of your inquiry and the information you have provided require that we respond with a GIL.

INQUIRY:

Executive Summary

In this petition, COMPANY2 (“COMPANY2” or “Taxpayer”) requests alternative apportionment relief from Illinois’s distortive single sales factor

formula under 35 ILCS 5/304(f). The petition begins with a brief introduction to the underlying issues and request for relief. It then proceeds to provide relevant factual background for Taxpayer's business. Following the factual background, the petition lays out its primary argument that Illinois's single sales factor formula is distortive as applied to Taxpayer's facts. This distortion is present for both the corporate income tax and Illinois's Personal Property Replacement Tax ("PPRT"). To explain this distortion, the argument first explains the historical case law foundation for modern distortion statutes. Then, the petition demonstrates how based on the case law's logic, the single sales factor is distortive because it ignores business-essential contributions of labor and capital in the manufacture of automobiles. To conclude the primary argument, the petition provides hard economic evidence of distortion in the form of a transfer pricing analysis. This analysis uses transfer pricing metrics to demonstrate that most of Taxpayer's profit comes from its unrepresented manufacturing and R&D activities.

Next, the petition introduces its supplemental argument which relates only to the PPRT. The PPRT's historical background as a replacement to local ad valorem personal property taxes presents unique distortive effects. Specifically, the PPRT funds services provided by local taxing districts who previously collected revenue based on personal property present in their respective jurisdictions. However, under the PPRT the income base used for taxation is based on a statewide sales factor untied to activity in the local taxing jurisdiction. This creates a disconnect between the income taxed and the services provided by local taxing jurisdictions. As such, there is not a fair relation between the activity taxed and the benefits provided by the taxing jurisdictions. Finally, the petition concludes with Taxpayer's request for corporate income tax apportionment based on a three-factor formula with a modified tangible property factor and a single personal property factor to apportion income for PPRT purposes.

Introduction

Pursuant to 35 ILCS 5/304(f), COMPANY2 petitions for relief from the standard apportionment provisions on the basis that they do not fairly represent the extent of the taxpayer's business activities in Illinois, in large part due to underrepresenting significant out-of-State activities involved in the production of goods.

35 ILCS 5/304(f) provides that when the standard provisions do not fairly represent the taxpayer's business, the taxpayer may petition to use other reasonable methods including but not limited to including or excluding certain

items of income. The Illinois Supreme Court affirmed the use of alternative apportionment under 35 ILCS 5/304(f) in circumstances wherein departing from the statutory formula is necessary to obtain fair or equitable results.¹

Taxpayer believes that it is entitled to relief from the standard formulary apportionment and allocations rules and, as such, petitions for relief pursuant to 35 ILCS 5/304(f) using any other similar or different method calculated to “fairly represent the market for the person’s goods, services, or other sources of business income.”²

This petition is based on Taxpayer’s position that:

1. Taxpayer’s business consists of the design, development, and manufacture as well as the wholesale distribution of automobiles. But for the design-to-manufacture of automobiles, there would be no wholesale distribution activity. Accordingly, to reflect the by-state activity of the Taxpayer’s business by sales alone reflects a disconnect of the apportionment methodology and the underlying business model. The degrees of separation between the apportionment methodology adopted by Illinois and the Taxpayer’s business activities have led to a distortion of the amount of income that Illinois business income tax statutes associated with the Taxpayer’s in-state activities. The development and production of automobiles are, in fact, the most significant aspect of the Taxpayer’s business model and for which representative apportionment inputs are absent from Illinois’ apportionment formula. This lack of representation results in distortion of the income associated with the taxpayer’s in-state activities. Taxpayer can demonstrate this distortion through a transfer pricing analysis which shows the profit that was generated by activities other than retail sales.
2. Additionally, the Illinois Personal Property Replacement Tax (“PPRT”) is distortive as applied to Taxpayer. This law creates an egregious burden on interstate commerce by shifting the personal property tax burden to out-of-state manufacturing. Furthermore, because it uses the same statutory formula it inherits all the same distortion problems as the corporate income tax. This hostile treatment is constitutionally impermissible but may be alleviated by granting alternative apportionment under 35 ILCS 5/304(f).

¹ See *AT&T Teleholdings, Inc. v. Dep’t of Revenue*, 978 N.E.2d 371, 385 (2012).

² 35 ILCS 5/304(f)

Factual Background

Summary of Company Operations

COMPANY3 is wholly-owned by COMPANY4 and is incorporated in STATE1, with principal offices at ADDRESS2. COMPANY3 is a functionally integrated automotive business in all material aspects, including management, performance objectives, U.S. manufacturing, and product line-up. It conducts business activities in all U.S. states.

COMPANY3 manufactures PRODUCT1 and PRODUCT2 cars, SUVs, and trucks and related components in the United States at facilities located in ADDRESS3; ADDRESS4; and ADDRESS5. COMPANY3 manufactures finished vehicles using raw materials and component parts purchased from COMPANY4, COMPANY5 and other related and unrelated suppliers. Additionally, it licenses technology, know-how and intangibles from COMPANY4. COMPANY3 also purchases PRODUCT1 and PRODUCT2 completely built units (“CBUs”) from COMPANY4 and COMPANY5.

COMPANY4

COMPANY4 is a publicly-held COUNTRY1 company with its headquarters in CITY. COMPANY4 manufactures automobiles, trucks and other motor vehicles in COUNTRY1 and other countries through its affiliates. With respect to the U.S. market, COMPANY4 manufactures and sells finished vehicles, spare parts and component parts used to manufacture passenger cars, sport utility vehicles, and trucks in the United States (“U.S. vehicles”). It also engages in research, development and design (“RD&D”) activities and performs related functions.

COMPANY3

COMPANY3 is a wholly-owned U.S. subsidiary of COMPANY4. COMPANY3 and its consolidated subsidiaries perform research, design, manufacturing, sales, marketing, financing and related functions with respect to PRODUCT1-brand and PRODUCT2-brand CBUs and parts in the United States. COMPANY3 is a functionally integrated automotive business in all material aspects, including management, performance objectives, U.S. manufacturing, and product line-up. COMPANY3 engages in intercompany cross-border tangible, intangible, and services transactions with COMPANY4, COMPANY5, COMPANY6, and other affiliates.

COMPANY7

COMPANY7 is a wholly owned U.S. subsidiary of COMPANY3 and a member of its U.S. consolidated return group. It is the captive automotive financing arm of COMPANY3 in the U.S., and virtually all of its revenue is derived from providing consumer and dealer financing to support COMPANY3's distribution of PRODUCT1 and PRODUCT2 branded vehicles. COMPANY7 provides the following types of financing to support COMPANY2's efforts to market vehicles in the United States: lease financing for customers, retail loans for customers, and wholesale and other loans for dealers. COMPANY7 also provides a guarantee to one of its COUNTRY2 affiliates, COMPANY8.

The primary focus of these financing activities is to support the sale and lease of COMPANY2 automobiles. Additionally, with its vast lease customer network and dealer networks developed as part of its financing, COMPANY7 provides an ongoing feed of renewed leases and sales of PRODUCT1 and PRODUCT2 branded vehicles through customer loyalty programs as well as other co-marketing campaigns in collaboration with COMPANY3's sales and marketing functions and its dealer network. As such, COMPANY7 is an integral component of COMPANY3's automobile operations. COMPANY3 (via its dealer network) is COMPANY7's primary source of revenue; a majority of the COMPANY2 vehicles sold are financed by COMPANY7, and 100 percent of COMPANY2 leased vehicles are leased by COMPANY7. On DATE, COMPANY7 merged into COMPANY3.

COMPANY6

COMPANY6, a COUNTRY3 company, is NUMBER21 percent owned by COMPANY4 and NUMBER22 percent owned by COMPANY9, and has its headquarters in ADDRESS6. It purchases CBUs, vehicles and spare parts from COMPANY4, COMPANY3 and COMPANY5 for resale in the COUNTRY3 market, provides financing in connection with its distribution functions, and purchases ancillary information technology and other services from COMPANY3. COMPANY6 does not conduct any manufacturing activities, nor does it engage in any significant activities unrelated to its distribution functions.

COMPANY5

COMPANY5 is a COUNTRY2 subsidiary of COMPANY10, a COUNTRY4 holding company, which in turn is owned by COMPANY4. COMPANY5 manufactures and distributes PRODUCT1-brand CBUs in COUNTRY2. With respect to the North American market, COMPANY5 manufactures PRODUCT3, PRODUCT4, and PRODUCT5 CBUs, component parts and spare parts for sale to

COMPANY3 and purchases COMPANY3 manufactured vehicles and parts as well as procurement and other services from COMPANY3.

Illinois's Single Factor Formula is Distortive as Applied to Taxpayer's Facts Because It Ignores the Business-Essential Contributions of Labor and Capital in the Manufacture of Automobiles

Legal Background

Illinois Distortion Statute

Illinois substantially follows Section 18 of the Uniform Division of Income for Tax Purposes Act (UDITPA) which provides a mechanism permitting a variation from the statutory apportionment formula. Section 18 grants these variances if the taxpayer or the state can demonstrate that the statutory formula does not fairly reflect the extent of the taxpayer's business activity within the state. Illinois's analogue for Section 18, codified in 35 ILCS 5/304(f) differs from Section 18 in that for tax years ending on or after December 31, 2008, the formula must "fairly represent the market for the person's goods, services, or other sources of business income."³ This change from business activity to market creates a new standard lower than that required by the Constitution as will discussed below. Nonetheless, the Illinois statute still provides several remedies:

- (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.

These remedies and the background of Section 18 illustrate its origin as a pressure release valve for constitutional strain on the statutory apportionment formula. When the National Commission on Uniform Laws was developing UDITPA in the mid-1950s, apportionment and unitary theory were in their adolescence. The critical question was how to devise a standard apportionment formula that would pass constitutional muster under the due process and dormant commerce clauses. However, for every devised formula there could exist cases where that formula as applied would produce an unconstitutional result.⁴

³ 35 ILCS 5/304(f)

⁴ See *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 276-79 (1978).

This propensity for unconstitutional results was in some sense a natural, foreseeable result. Unlike other areas of law, like criminal or tort, which arise from the natural world and reflect our basic moral intuition, apportionment is entirely borne out of the industrial revolution and 20th century America. The concepts underlying its genesis; such as, accounting, economies of scale, and the legal fiction of the corporation are all artificial. Being thus detached from the natural experience and made to reflect such complex underlying concepts and relationships, any apportionment formula could be inherently arbitrary and imprecise.⁵

Anticipating this possible negative result depending on facts and circumstances, the drafters of UDITPA knew they had to include a mechanism for the inevitable cases when the formula would yield unfair and inequitable results threatening constitutionality. Thus, they created Section 18 and provided for different remedies that would cure any potential distortive effect. The inclusion in UDITPA allowed taxpayers and the state to address these issues on a case-by-case basis without the need for litigation. Similarly, the Multistate Tax Compact had a three-factor formula election without the need for proving distortion. While this election has been contested and litigated, it is still on the books in at least nine states.⁶ Both the MTC election and Section 18 provided avenues for taxpayers and the state to save time and resources. Ultimately these provisions prevented the risk that the entire system would be declared unconstitutional by a court. Such a result would erode confidence in the tax system and create unpredictability both for the public fisc and taxpayers.

Therefore, to best understand 35 ILCS 5/304(f)'s application we need to understand the constitutional framework animating its operation. By looking to the constitutional standard, we can then examine a taxpayer's particular facts to see if the formula fairly reflects their business activity in the state. If not, then we can compare different remedies to find which best reflects the taxpayer's in-state business activity.

Apportionment – Constitutional Standard

The manner in which states tax individuals & businesses is constrained by constitutional provisions. In *Complete Auto Transit, Inc. v. Brady*, the Supreme Court outlined a four-part test for determining whether a tax is constitutional.⁷ This four-part test requires that the taxpayer have substantial

⁵ See *id.* at p. 280; see also *General Motors Corp. v. District of Columbia*, 380 U.S. 553, 561 (1965).

⁶ Alaska Stat. § 43.19.010; Code of Ala. § 40-27-1; K.S.A. § 79-4301; HRS § 255-1; Idaho Code § 63-3701; Rev. Code. Wash. § 82.56.010; Section 32.200 R.S. Mo.; Tex. Tax Code § 141.001; M.C.A. § 15-1-601.

⁷ *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

nexus with the state; that the tax has a relationship to the service provided in the state; that the tax not discriminate against interstate commerce; and that the tax be fairly apportioned. These tests have been further explained in subsequent case law.

With regard to the Taxpayer, the last three prongs are the most relevant. The second prong looks at the relationship between the tax and the benefits provided by the state. The Due Process Clause of the U.S. Constitution requires that the tax be “rationally related to ‘the values connected with the taxing State’”.⁸ The third prong of the test requires that the tax not discriminate against interstate commerce. The Constitution gives the federal government the power to regulate commerce between the states. This has been interpreted by the courts to mean that states are not permitted to burden interstate commerce. Finally, under the fourth prong, the tax must be fairly apportioned.

The courts have focused heavily on the meaning of fairly apportioned since long before *Complete Auto*’s inclusion of the phrase in its test of constitutionality. The first broad judicial discussions of a fair apportionment began in 1920 with the tacit acknowledgement that a fair, if imperfect, methodology was required for states “faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders.”⁹

Fair Apportionment

The results of an apportionment formula were overturned for not meeting this final prong in *Hans Rees’ Sons, Inc. v. North Carolina*.¹⁰ That case established that for the statute to be unconstitutional in the taxpayer’s case, the formula must be “out of all appropriate proportion to the business transacted by the appellant in that State.”¹¹

The Court noted that providing sufficient evidence was of key importance when it stated:

Evidence which was found to be lacking in the *Underwood* and *Bass* cases is present here. These decisions are not authority for the conclusion that where a corporation manufactures in one State and sells in another, the net profits of the entire

⁸ See *Moorman, supra*, at p. 273 (quoting *Norfolk & Western R. Co. v. State Tax Comm’n*, 390 U.S. 317, 325).

⁹ *Underwood Typewriter Co. v. Chamberlain*, (1920) 254 U.S. 113, 120-121.

¹⁰ *Hans Rees’ Sons, Inc. v. State of North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931).

¹¹ *Id.* at 135.

transaction, as a unitary enterprise, may be attributed, regardless of evidence, to either State.¹²

In that case, the taxpayer had made painstaking efforts to demonstrate that the profit that was being taxed resulted from activities and equipment in another state. “The petitioner also offered evidence to the effect that the income from the business was derived from three sources, to-wit: (1) buying profit; (2) manufacturing profit; (3) selling profit.”¹³ This demonstration of value and profit analysis seems to be persuasive evidence to show by clear and cogent evidence that the statutory factor results in apportionment of income out of all proportion to the income earned in a state.

Single Sales Factor – Fair apportionment

The U.S. Supreme Court addressed whether use of the single sales factor formula was on its face unconstitutional in the 1978 case *Moorman Manufacturing Co. v. Blair*.¹⁴ In that decision, the Court determined that a single-sales factor formula was not a per se violation of due process, but primarily focused on the fact that the taxpayer had not met the necessary factual standard to prevail. The court ruled against the taxpayer noting that:

The Iowa statute afforded appellant an opportunity to demonstrate that the single-factor formula produced an arbitrary result in its case. But this record contains no such showing and therefore the Director’s assessment is not subject to challenge under the Due Process Clause.¹⁵

The Court reiterated the need for an economic analysis of the business to establish that the manufacturing was profitable such that the sales activities were not the true generator of income:

Appellant does not suggest that it has shown that a significant portion of the income attributed to Iowa in fact was generated by its Illinois operations; the record does not contain any separate accounting analysis showing what portion of appellant’s profits was attributable to sales, to manufacturing, or to any other phase of the company’s operations.¹⁶

¹² *Id.* at 133.

¹³ *Id.* at 894.

¹⁴ See *Moorman, supra*, at p. 281.

¹⁵ *Id.* at 275

¹⁶ *Id.* at 272

While this decision is broadly cited to support that a single sales-factor formula is not a per se violation of due process, *Moorman* leaves the door open to a Due Process Clause challenge as applied based on the facts of a specific case. A taxpayer can demonstrate this by showing with clear and cogent evidence that the manufacturing activities' income contribution is not fairly reflected in the apportionment factor.¹⁷ The U.S. Supreme Court in *Container Corp.*, another case with a manufacturer decided only a few years after *Moorman*, reaffirmed that the three-factor formula is the benchmark for apportionment.¹⁸

History Going Full Circle from Hans Rees to Moorman

Hans Rees was a cautionary tale about how the use of formulary apportionment can lead to disastrously distorted levels of in-state income in the face of reliable transfer-pricing based income computations. Of course, in hindsight, it seems obvious that the use of a single factor – property – skewed the amount of North Carolina taxable income given that all manufacturing occurred in Asheville, North Carolina. That case was decided nearly a hundred years ago and yet *Hans Rees* is still regarded by the U.S. Supreme Court as good law and the Court pointed that out in *Moorman*.¹⁹ In the aftermath of *Hans Rees*, there was near universal acceptance by states to utilize equally-weighted property, payroll, and sales factors to apportion income.²⁰

This was spurred in part by the congressional Willis Report which recommended congressional action.²¹ Specifically, the Willis Report recommended a two-factor formula based on property and payroll.²² In the era's manufacturing-dominant economy these factors closely reflected income and could typically be tied to business locations.²³ This would have created uniformity and meant that apportionment would have similar contours to physical presence jurisdictional standards under due process.²⁴ In response, states almost universally accepted the three-factor formula via UDITPA to forestall congressional action. This was acceptable as the

¹⁷ See *Moorman, supra*, at 274 (“In individual cases, it is true, the Court has found that the *application* of a single-factor formula to a particular taxpayer violated due process.”).

¹⁸ *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 170 (1983).

¹⁹ *Moorman, supra*, at p. 274.

²⁰ *Id.* at p. 282 (Blackmun, J., dissenting) (“With their almost universal adoption by the States, the Iowa system’s adverse and parochial impact on commerce comes vividly into focus.”); see also *id.* at p. 283 (Powell, J., dissenting) (“44 of the 45 other states (including the District of Columbia) which impose corporate income taxes use a three-factor formula involving property, payroll, and sales....”).

²¹ Rep of Comm on Judiciary at pp.1143-64, HR No. 952, 89th Cong, 1st Sess, Sept. 2, 1965.

²² *Id.* at p. 1145.

²³ *Id.* at pp. 1146-49.

²⁴ *Id.* at p. 1156.

formulary factors were relevant representations of the three main value drivers for manufacturing concerns; capital, labor, and sales efforts.²⁵ Variations of the use of these three factors prevailed through the remainder of the 20th century.

The shift away from three factors to instead rely on a lone sales factor to apportion income is relatively recent. It coincides with the emergence of the service economy, which replaced manufacturing's dominant role in contributing to the economy. The use of apportionment to approximate in-state income rather than to rely on geographic accounting should be viewed with caution.²⁶ For that reason, state legislatures wisely adopted statutes allowing for taxpayers and state tax directors alike to challenge whether the in-state income arrived at through apportionment is fair.²⁷ It is axiomatic that using more, rather than fewer, factors to represent multi-state business activities will correlate better with specific geographic accounting. Thus, having abandoned reliance on three factors in favor of a lone sales factor will less often correlate positively with geographic accounting.²⁸ "The factor or factors used in the apportionment formula must reflect a reasonable sense of how income is generated."²⁹ This is particularly acute with regard to manufacturers. Capital and labor are significant contributing factors to the success of the manufacturing business model. Ignoring these factors inevitably leads to distortion.

Furthermore, use of a single sales factor to apportion, instead of multiple factors, is by design intended to shift the overall corporate income burden away in favor of corporations with in-state property and payroll.³⁰ When a particular group's business model requires significant concentrations of human and tangible capital, ignoring the property and payroll factors creates a distortion of income associated with in-state activities. It is even more insidious when this distortion occurs against the backdrop of a designed shift of the taxation burden out of state. Obviously, alternative apportionment is mandatory in circumstances where distortion exceeds constitutional tolerance. Nevertheless, alternative apportionment statutes

²⁵ See *id* at p. 295 (Powell, J., dissenting) ("three-factor formula which gives equal weight to the geographical distribution of plant, payroll, and sales").

²⁶ See *General Motors, supra*, at p. 558 n. 8 (1965) ("All that is required is that the formula adopted for general application take account of the *geographical spread* of the major dimensions of a business.") (emphasis added).

²⁷ See 35 ILCS 5/304(f).

²⁸ See *General Motors, supra*, at p. 561 ("The standard three-factor formula can be justified as a rough, practical approximation of the distribution of either a corporation's sources of income or the social costs which it generates. By contrast, the geographic distribution of a corporation's sales is, by itself, of dubious significance in indicating the locus of either factor.").

²⁹ See *Container, supra*, at p. 169.

³⁰ *Moorman, supra*, at p. 282-83 (Blackmun, J. dissenting); see also *id.* (Powell, J., dissenting).

must also be used to resolve inequities that are palpable and calculable yet below an unconstitutional level of distortion. The intent of the legislature was to ensure that both the state and the taxpayer remit tax on the appropriate amount of income associated with in-state activities.

It is telling that one of the UDITPA drafters, William J. Pierce, said the following about Section 18:

[A] general section which permits the tax administrator to require, or the taxpayer to petition, for some other method of allocating and apportioning the income where unreasonable results ensue from the operation of the other provisions of the act. This section necessarily must be used where the statute reaches arbitrary or unreasonable results so that its application could be attacked successfully on constitutional grounds. Furthermore, it gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative method must be available to handle the constitutional problem *as well as* the unusual cases because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics.³¹

As intended by the drafters of the model provision, alternative apportionment statutes are broad intentionally to reflect the reality that any apportionment formula cannot fairly reflect every possible business's income due to in-state activity. The need for a broader standard is brought further into focus with the questions surrounding how accurately the single sales factor reflects in-state activities.³² Because Illinois' statute is modeled after Section 18, William Pierce's commentary is applicable in interpreting 35 ILCS 5/304(f). Therefore, to successfully claim distortion under 35 ILCS 5/304(f) a taxpayer need only show unreasonableness in the application of that statutory formula to their facts.

Illinois Distortion Case Law

³¹ William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 781 (1957)(emphasis added).

³² See *General Motors, supra*, at p. 561

Over the years, Illinois has fleshed out the application of section 304(f). First, taxpayers must show by clear and cogent evidence that the standard allocation and apportionment provisions do not fairly represent the business's market [previously activity] within the state. An unfair representation would be one that leads "to a grossly distorted result in [the taxpayer's] particular case."³³ Stated differently the burden is to prove "by clear and cogent evidence that the statutory formula results in the taxation of extraterritorial values and operates unreasonably and arbitrarily in attributing to Illinois a percentage of income which is out of proportion to the business transacted in this State."³⁴ But, a mere difference in apportionment percentage is not sufficient to trigger an alternative apportionment method.

The Appellate Court of Illinois developed the contours of a successful distortion claim by comparing two cases in *AT&T Teleholdings, Inc. v. Department of Revenue*:

For instance, in *Lakehead Pipe Line Co.*, this court held that there was no gross distortion so as to justify an alternative apportionment method where the method used did not take into account the company's Illinois capital assets or employee activity, both of which were important to determine the extent of the company's Illinois business. In that case, the court found that such gross distortion was not present where the difference between the income apportioned to Illinois under the statutory formula and the income that would be apportioned taking those factors into account was between 30% and 140%, depending on the year. In contrast, the type of evidence that justifies an alternative apportionment under section 304(f) is illustrated in *Miami Corp.* In that case, the statutory apportionment formula led to a gross distortion of the taxpayer's income-producing activities in Illinois, where that formula failed to take into account the intangible value of oil and gas leases derived from its Louisiana land and, consequently, did not reflect that 80% of the taxpayer's income was generated by those intangible assets. The court noted, however, that the fact that the statutory formula caused an increase in the taxpayer's Illinois tax liability from \$719,000 to \$2.4 million was not, in itself, indicative of

³³ 86 Ill. Adm. Code 100.3390(c).

³⁴ 86 Ill. Adm. Code 100.3390(c).

malapportionment merely because of the size of the increase.³⁵

The *AT&T Teleholdings* court looked at two cases in which the apportioned income changed materially between methods. However, only in one case was the statutory formula found to be distortive. From this comparison, we can take two points. First, a material change in apportioned income is a necessary but not sufficient condition for determining whether alternative apportionment is appropriate. If the change in apportioned income is not material enough then the matter is not worth further inquiry. Second what separates successful 304(f) claims is a demonstration that the statutory formula by the mechanics of its operation fails to fairly reflect the taxpayer's business activity.³⁶ In *Miami Corp.*, the taxpayer proved this because the formula did not include the intangible value of the oil and gas leases in the property factor.³⁷ In other words, the part of the business actually generating the income was not represented in the formula itself hence causing distortion. Thus, a successful distortion claim will show by clear and cogent evidence both a material change in apportioned income and how the statutory formula by its operation fails to reflect the taxpayer's business activity.

Discussion

Taxpayer's Petition Picks Up Where *Moorman* Left Off

Taxpayer's facts merit alternative apportionment because Taxpayer can demonstrate by clear and cogent evidence using transfer pricing analysis that Illinois's statutory apportionment formula results in distortion. As discussed above, under 35 ILCS 5/304(f), Taxpayer must show by clear and cogent evidence that the single sales factor formula is distortive as applied. Here, the formula is distortive because Taxpayer's business generates significant profit from capital-intensive manufacturing and R&D activities. For the automotive industry, these activities are of paramount importance for the level of success necessary to sustain the business enterprise. Furthermore, Taxpayer's transfer pricing analysis uses a comparable profits method ("CPM") to demonstrate that this is true not only in theory but in reality. Unlike *Moorman*, Taxpayer here provides the underlying economic evidence which shows how the single sales factor formula is distortive for

³⁵ *AT&T Teleholdings, Inc. v. Dep't of Revenue*, 978 N.E.2d 371, 385 (2012).

³⁶ *AT&T Teleholdings, supra*, at p. 385. It should be noted that the current version of 304(f) looks to market rather than business activity. This will be discussed in greater detail below as it is a lower standard than that required by the Constitution.

³⁷ *Miami Corp. v. Dep't of Revenue*, 212 Ill. App. 3d, 708-09(1991).

COMPANY2.³⁸ As such, the Taxpayer meets the burden to prove distortion by clear and cogent evidence.³⁹

A background on the legal and economic context is necessary to give meaning and significance to the transfer pricing analysis. As mentioned in the law section, *Moorman* is the seminal case on the constitutionality of the single sales factor apportionment formula. *Moorman* held that single sales factor formulas are not per se violations of the Constitution.⁴⁰ Note that the narrow question before the *Moorman* court was whether the single sales factor formula was on its face unconstitutional.⁴¹ With the advent of the three-factor formula under UDITPA, a majority of states had moved away from single factor formulas.⁴² Additionally, at the time there were multiple cases in which single factor formulas were found to be unconstitutional on their face or distortive.⁴³ Within this context, the taxpayer in *Moorman* sought judicial intervention to once and for all bar single factor formulas under the Constitution.⁴⁴ Thus, *Moorman* was at heart a decision about the extent to which the Court would dictate to states how to fashion their apportionment formulas.⁴⁵ In the end, the *Moorman* court declined this mandate indicating that such uniform rules should be legislated by Congress under its commerce power.⁴⁶

It is important to remember that Congress had considered utilizing its commerce power to impose formulary apportionment and allocation rules upon states.⁴⁷ In 1965, the House Committee on the Judiciary had released the Willis Report.⁴⁸ This report not only recommended a two-factor formula but criticized the sales factor for being difficult to administer.⁴⁹ If the states had not stepped up and passed three-factor formulas based on UDITPA, then Congress would likely have followed through with its threat by the time *Moorman* was decided. While operating in the background, the *Moorman* court did not address the Willis Report and the linkage to Congressional intent which led to the widespread adoption of UDITPA's three factor formula.

³⁸ See *Moorman, supra*, at pp. 276-78.

³⁹ See *AT&T Teleholdings, supra*, at p. 385.

⁴⁰ See *Moorman, supra*, at p. 281.

⁴¹ *Id.* at p. 269.

⁴² *Id.* at p. 276.

⁴³ *Id.* at pp. 282-83 (Blackmun, J., dissenting).

⁴⁴ See *id.* at pp. 276-77.

⁴⁵ See *id.* at pp. 280-81.

⁴⁶ *Id.* at p. 280.

⁴⁷ HR No. 952, *supra*, at pp. 1143-45.

⁴⁸ *Ibid.*

⁴⁹ *Id.* at pp. 1149-50.

The *Moorman* Court’s silence on the Willis Report may led to the mistaken impression that Congress was not concerned with state taxation. In fact, Congress’s actions with respect to state taxation were precisely what spurred the creation of the Multistate Tax Compact (“MTC”) and passage of UDITPA. As the MTC notes on their website:

On January 13 and 14, 1966, the National Association of Tax Administrators...held an unprecedented special meeting in Chicago to discuss and adopt a resolution opposing H.R. 11798, the Interstate Taxation Act. You know it as the famous Willis bill. The resolution called the Willis bill “an unwarranted, unnecessary, and undesirable intrusion into the tax and fiscal jurisdiction of the states...[that] would be destructive of the principles of federalism enunciated by our founding fathers.” NATA offered workable alternatives to eliminate the need for such extreme federal preemption. This was the first meeting where the idea of a multistate compact was envisioned.⁵⁰

On the same page, the MTC even references the Willis Committee: “The [Willis] committee’s activities and recommendations spurred the states into cooperative action to address the compliance burdens on interstate business and led to the eventual formation of the MTC.”⁵¹

This is to say that the threat of Congressional action via the Willis Bill influenced the widespread adoption of UDITPA’s three factor formula. Congress was not silent. Instead, Congress formed a committee, released a report, and brought forth a bill that prompted collective state action.⁵² Congress simply did not pass the bill because it found UDITPA’s three factor formula satisfactory. Because policy favors allowing states autonomy and the states provided an adequate solution, Congress opted not to preempt state power despite its commerce clause authority. Therefore, when considering Congressional intent, one must consider how impactful Congress’s actions were despite not passing any legislation.⁵³

⁵⁰ MTC History. <https://www.mtc.gov/the-commission/mtc-history/> (December 2, 2025).

⁵¹ *Ibid.*

⁵² HR No. 952, *supra*, at pp. 1143-45; MTC History, <https://www.mtc.gov/the-commission/mtc-history/> (December 2, 2025).

⁵³ While the *Moorman* Court did not raise the Willis Report in its opinion, it neither endorsed the sales single factor formula. Rather six years later, the Court in *Container Corp.* explicitly endorsed the three-factor apportionment formula as the “benchmark” while still giving states latitude to implement their own tax laws. See *Container Corp.*, *supra*, at p. 170. In fact, the Court preceded to cite Justice Blackmun’s dissent in *Moorman* and *General Motors Corp.* to support its assertion that the three-factor formula as the standard. *Ibid.* This demonstrates that the Court was aware that it had allowed single sales factor in *Moorman* to avoid legislating from the bench but did not consider it to be the benchmark or gold standard formula.

Looking to the broader historical context, *Moorman* was decided in 1978 towards the end of the Burger Court. This time marked a shift in the Court's attitudes towards state power. Beginning in the New Deal era and climaxing with the Warren Court in the 1950s and 1960s, the Court had been steadily expanding federal power at the expense of the states. We see this in cases like *Northwestern Cement* which led to the passage of P.L. 86-272. This expansion of federal power into state taxation motivated things like UDITPA and the widespread adoption of three-factor apportionment. However, by the late 1970s, the Court was beginning to swing back culminating in the Rehnquist Court's conservative revolution.

Thus, *Moorman* sits at the crossroads of history in 1978. The Court had before it a question about a single factor formula which historically were found to be distortive. The question was whether the Court, like it had done in so many prior cases across so many areas of law, would create a uniform federal rule. Instead, the Court in rhythm with the current of history kicked the question back to the states and declined to expand federal judicial power.⁵⁴ Nonetheless, it was clear that the formula had high potential to cause distortive results. As Justice Blackmun, who had extensive experience in tax as a lawyer and judge, wrote in his dissent:

Today's decision is bound to be regressive. Single-factor formulas are relics of the early days of state income taxation. The three-factor formulas were inevitable improvements and, while not perfect, reflect more accurately the realities of the business and tax world. With their almost universal adoption by the States, the Iowa system's adverse and parochial impact on commerce comes vividly into focus. But with its single-factor formula now upheld by the Court, there is little reason why other States, perceiving or imagining a similar advantage to local interests, may not go back to the old ways. The end result, in any event, is to exacerbate what the Commerce Clause, absent governing congressional action, was devised to avoid.⁵⁵

⁵⁴ *Moorman, supra*, at p. 281.

⁵⁵ *Id.* at pp. 282-83 (Blackmun, J., dissenting). In addition to Justice Blackmun's perspective, others have considered such discriminatory taxation to be akin to an impermissible tariff. For example, Justice Powell in his *Moorman* dissent opined that "Iowa's use of single-factor sales-apportionment formula – though facially neutral – operates as a tariff on goods manufactured in other States and as a subsidy to Iowa manufacturers selling their goods outside of Iowa." *Id.* at p. 283 (Powell, J., dissenting); see also *Camp Newfounds/Owatonna v. Town of Harrison* 520 U.S. 564, 621-637 (1997) (Thomas, J., dissenting)(providing historical background on interstate tariffs within the context of whether state taxation is regulated by the Constitution under the Import-Export Clause). This perspective is

In order to avoid this issue directly, the *Moorman* majority did not consider the question of whether single sales factor formula could be distortive.⁵⁶ Instead, they ruled very tightly that Iowa was not prohibited from requiring taxpayers to show distortion first before using a different formula.⁵⁷ Particularly, the *Moorman* court noted that the taxpayer had not *proven* distortion with sufficient evidence.⁵⁸ Furthermore, the *Moorman* court noted that by giving states latitude to draft their own formulas there were bound to be imperfections and even duplicative taxation.⁵⁹ Hence, the *Moorman* court's focus was whether the danger of distortion and double taxation was great enough to justify legislating an apportionment formula from the bench.⁶⁰ The *Moorman* court declined to legislate but left the door open to distortion challenges.⁶¹ In other words, *Moorman* contours the limits of federal intervention in state taxation and not how to determine distortion.⁶² As such, *Moorman* should be read as holding that the single sales factor is not distortive. Instead, taxpayers must show that distortion does exist under the formula using the appropriate framework.

The Constitution Requires a Distortion Analysis to Consider More than the Taxpayer's Market

When Illinois changed “business activity” “market” in 35 ILCS 5/304(f), the state did so to align 304(f)'s language with market-based sourcing for sales of services. While this change was helpful particularly in the broader economic context of the shift away from manufacturing towards services, it did not alter the underlying constitutional standard. As such, a court would likely interpret “market” in 304(f) as equivalent to “business activity” to avoid any constitutional conflict.

If “market” meant something narrower than “business activity” this could result in conflict. Based on *Container Corp.* and *Moorman*, it is evident that narrowing “business activities” with “market” misses the constitutional mark. The *Container Corp.* court noted that under both the Due Process and

particularly on the nose in the case of multistate manufacturers as they deal in tangible goods moving across stateliness.

⁵⁶ See *id.* at pp. 280-81.

⁵⁷ See *id.* at p. 281.

⁵⁸ See *id.* at pp. 276-78.

⁵⁹ See *id.* at pp. 278-80.

⁶⁰ See *id.* at p. 280 (“It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions.”)

⁶¹ See *id.* at p. 281 (“[T]axpayers to prove that application of the single sales factor formula has produced arbitrary results in a particular case.”).

⁶² See *id.* at pp. 279-80.

the Commerce Clauses an apportionment formula must possess external consistency. This meant “the apportionment formula must actually reflect a reasonable sense of how income is generated.”⁶³ The court proceeded to expound on this point in its discussion of different approaches:

Both geographical accounting and formula apportionment are imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory. Some methods of formula apportionment are particularly problematic because they focus on only a small part of the spectrum of activities by which value is generated. Although we have generally upheld the use of such formulas,...we have on occasion found the distortive effect of focusing on only one factor so outrageous in a particular case as to require reversal....

The three-factor formula used by California has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated. It is therefore able to avoid the sorts of distortions that were present in *Hans Rees’ Sons, Inc.*⁶⁴

This excerpt from *Container Corp.* demonstrates what the Court considers when determining fair reflection. Unlike the current 304(f) which looks only at market and hence sales contributions, the *Container Corp.* court considers the full spectrum of activities when analyzing distortion.⁶⁵ Note that formulas which rely on one factor are seen to “focus on only a small part of the spectrum of activities by which value is generated.” Furthermore, the three-factor formula is seen as mostly avoiding distortion because it “reflect[s] a very large share of the activities by which value is generated.” This circumspection in determining apportionment and by extension distortion is what protects taxpayers from unconstitutional taxation. An interpretation of “market” which narrows “business activities,” 304(f) deprives taxpayers of the comprehensive analysis afforded them by external consistency.⁶⁶

Likewise, *Moorman* upheld the single sales formula precisely because the Iowa statute allowed taxpayers an opportunity to prove distortion in light of the taxpayer’s activities. The opinion’s penultimate sentence encapsulates the holding as follows: “[a]ccordingly, until Congress prescribes a different

⁶³ See *Container, supra*, at 169.

⁶⁴ See *Container, supra*, at 182-83.

⁶⁵ See *Container, supra*, at 182-83; see also 35 ILCS 5/304(f).

⁶⁶ See *Container, supra*, at 182-83; see also 35 ILCS 5/304(f).

rule, Iowa is not constitutionally prohibited from requiring taxpayers to prove that application of the single-factor formula has produced arbitrary results in a particular case.”⁶⁷ It should be noted that the Iowa statute at issue allowed taxpayers to seek alternative apportionment based on reasonable attribution to “business within the State.”⁶⁸ This is further supported by the Court’s description of Iowa’s formula as “reasonably related to the activities conducted within the taxing State.”⁶⁹ Thus, when considering whether single sales formula is distortive in a particular case the Court expected an examination of a taxpayer’s activities more broadly than the sales market.

To narrow the criterion to solely focus on the states market is to force an outcome by ignoring the very activities which the sales factor fails to represent. As a result, such a criterion would be at immense risk of missing distortion from the single sales factor formula as had troubled the *Container Corp.* court.⁷⁰ Even worse this definition denies taxpayers the protection afforded by external consistency under the Due Process and Commerce Clauses. This type of constitutional conflict is the kind of interpretation which a court would reject. Therefore, Taxpayer will consider distortion in light of all its activities so as to interpret 304(f) in a way which does not offend the Constitution.

Application of Illinois Case Law

In the instant matter, Illinois law provides a blueprint for finding distortion under 35 ILCS 5/304(f). *AT&T Teleholdings* instructs that the key to proving distortion by clear and cogent evidence is the disconnect between the statutory formula and the income producing activities.⁷¹ Here, Taxpayer will provide that evidence first as a discussion of the industry’s economics and second through proving that theory by a transfer pricing analysis.

Understanding the economics of the automotive industry will elucidate the transfer pricing analysis’s findings. This is because car manufacturing is a capital-intensive industry. For example, the cost to design and develop a new model is approximately \$1 billion. This is before getting into distribution costs which are significant considering it is the transportation of automobiles. All these costs take place at design centers and corporate headquarters. Importantly, these activities are highly risky. If a particular car model does not sell, then all these out-of-state capital expenditures are for

⁶⁷ See *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 281 (1978).

⁶⁸ *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 270 (1978).

⁶⁹ *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 270 (1978).

⁷⁰ See *Container, supra*, at 182-83.

⁷¹ See *AT&T Teleholdings, supra*, at p. 385.

naught. Nevertheless, this risky investment is essential for COMPANY2 to have vehicles to sell to Illinois customers. COMPANY2 is not a reseller of vehicles manufactured by other companies. The Illinois single sales apportionment factor represents COMPANY2's market in Illinois fairly. That the apportion factor used to determine Illinois income omits representation for the significant amounts labor and capital essential to the production of vehicles means that single sales apportionment does not result in a fair reflection of COMPANY2's Illinois income.

This is similar to the evidence sought by the *AT&T Teleholdings* court. In that case, the court opined that a taxpayer must demonstrate how the statutory formula fails to represent the taxpayer's activities.⁷² The *Miami Corp.* court, cited in *AT&T Teleholdings*, found that such distortion did exist when the property factor failed to include the intangible value of Louisiana oil and gas leases which accounted for 80% of income.⁷³ This disconnect was sufficient for the taxpayer to demonstrate distortion out of all proportion to their activities within Illinois.⁷⁴

Here, the majority of taxpayer's activities can be tied directly outside Illinois. Taxpayer invests millions in payroll and property into these out of state facilities. The substantial part of this capital's risk is placed out of Illinois. Their material effect on profit is given exactly zero weight due to the lack of representative property and payroll factors. The success of taxpayer's activity in the Illinois market represented by the sales factor is contingent on the work of taxpayer's out-of-state activity. If a car is not well-designed or well-built, it will not sell well no matter how robust the market is. Thus, the success of Illinois sales is tied directly through contingency on this out-of-state activity. Like *Miami Corp.*, these value-adding activities are not fairly represented if at all in the statutory formula.⁷⁵ Because the formula contains no property or payroll factors these activities do not enter the formula calculation. They are excluded in much the same way as the oil and gas leases were in *Miami Corp.*⁷⁶

Taxpayer's case is also similar to *Lakehead Pipe Line Co. v. Dep't of Revenue*.⁷⁷ In *Lakehead*, the taxpayer operated an oil pipeline that traversed Illinois.⁷⁸ The taxpayer sought alternative apportionment from its statutory

⁷² See *AT&T Teleholdings*, *supra*, at p. 385.

⁷³ See *Miami*, *supra*, at pp. 708-09, 711.

⁷⁴ See *Miami*, *supra*, at p. 711.

⁷⁵ See *Miami*, *supra*, at pp. 708-09.

⁷⁶ See *Miami*, *supra*, at pp. 708-09.

⁷⁷ 192 Ill. App. 3d 756 (1989).

⁷⁸ *Lakehead*, *supra*, at p. 760.

formula which was a one-factor barrel mile formula.⁷⁹ Ultimately, the court rejected the taxpayer's bid to use three-factor formula which was the standard formula for most taxpayers at the time.⁸⁰ While not given much discussion in the *Lakehead* opinion, it is important to remember why Illinois had elected a different apportionment formula for companies like Lakehead. The vast majority of Lakehead's activity in Illinois was the pipeline itself which derived value by transferring oil through the state.⁸¹ Had Illinois used a single sales factor there would have been little to no income apportioned to Illinois because the line only had two delivery points in the state.⁸² As such, the barrel mile formula more fairly reflected the economic value of Lakehead's capital asset, the pipeline, in Illinois.⁸³ Similarly, Taxpayer's business model relies on the concentration of labor and capital in limited areas to utilize economies of scale in the manufacture of automobiles. By using a single sales factor, the state ignores the capital assets functionally reversing the court's logic in *Lakehead*.⁸⁴ Thus, applying *Lakehead*'s logic here, a three-factor formula which accounts for Taxpayer's substantial capital and labor more fairly reflects Taxpayer's activity in Illinois.⁸⁵ Therefore, Taxpayer has met their burden of demonstrating that the formula does not fairly reflect their highly significant manufacturing, design, and R&D activities. Not only is this evident in a descriptive sense, but it can be shown through actual economic evidence.

Taxpayer's transfer pricing analysis provides economic evidence of these facts. The economic analysis shows that these out-of-state activities themselves were material elements of income productions.⁸⁶ The analysis utilizes the transfer pricing concepts and methods set forth under the regulations published pursuant to Section 482 of the United States Internal Revenue Code (hereafter, "the Section 482 Regulations") highlighting how the sales and distribution activities conducted by Taxpayer during fiscal year ended YEAR3 produced results which were significantly above an acceptable 5-year average range of profitability indicators for a sample of firms which perform similar functions and bear similar business risks. The results support the conclusion that use of Illinois' standard formulary apportionment method – single sales factor – resulted in an unfair amount of income associated with Taxpayer's in-state activities. **Economic Analysis**

⁷⁹ *Lakehead*, *supra*, at p. 759.

⁸⁰ *Lakehead*, *supra*, at pp. 765-66.

⁸¹ *Lakehead*, *supra*, at p. 764.

⁸² See *Lakehead*, *supra*, at p. 760.

⁸³ *Lakehead*, *supra*, at p. 764.

⁸⁴ See *Lakehead*, *supra*, at pp. 764-66.

⁸⁵ See *Lakehead*, *supra*, at pp. 764-66.

⁸⁶ See *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978).

Value Chain Analysis

In addition to the sales, marketing and distribution of vehicles to customers, COMPANY2's Unitary Group consists of high-quality and innovative vehicle designs, rigorous high-quality manufacturing processes and standards, and means to facilitate the monetization of vehicle sales (e.g., automotive financing). Demand for consumer vehicles is driven by a number of macroeconomic factors, and chiefly among them, the ability to access affordable means of financing vehicle purchases (as availed by COMPANY2's financing and leasing operations).

Notwithstanding the above, it would be reasonable to assume that the profitability COMPANY2's Unitary Group sales operations should fall within the general range of profitability results exhibited by a sample of comparable sales and distribution firms. As discussed further below, an examination of COMPANY2's year ended YEAR3 results indicates that this indeed was not the case.

Methodology

One of the most commonly used economic analysis techniques for tax purposes set forth under the Section 482 transfer pricing regulations is the Comparable Profits Method, or "CPM."

Under the CPM, the net profitability of an entity known as the "tested party," which generally represents the entity party to a controlled transaction which represents the most simple set of functions, assets, and risks (e.g., most tested parties function as routine distributors, contract manufacturers, service providers, etc., and do not typically bear material business risks nor do they own or develop valuable intangible property), is compared to the net profitability results of a sample of firms that is broadly comparable to the tested party in terms of functions, assets and risks.

The CPM allows the use of the multiple profit level indicators, or "PLIs." Certain PLIs may be more appropriate for certain functions than others. For instance, distributor profitability is often measured by the Operating Margin ("OM"), which measures the ratio of operating profits to net revenues. In this case, operating profit are just that, the profits related the company or entity's core operations These exclude extraordinary items such as restructuring expenses, asset impairments, gains/losses on the divestiture of assets, income taxes, interest expense, and other items. The goal of the OM is to measure the net profitability of the core function being studied (in this example, distribution). For service providers, a markup on cost is often used

as the basis for comparison, as service providers typically markup their labor and overhead in determining hourly rates of other fee structures. For comparison purposes, the OM of the unitary business as a whole, consistent with state principles to treat the unitary group as a single business enterprise, was utilized for comparative transfer pricing purposes.

Profitability Comparison

For the year ended YEAR3, COMPANY2's Unitary Group reported taxable income (defined consistently with the description above) of approximately USD AMOUNT1. This, when expressed over its net sales of USD AMOUNT2, reflects an OM of NUMBER2 percent.

COMPANY2's OM can be compared to the arm's-length interquartile range (a provision set forth in the Section 482 Regulations which relies upon the statistical range of results spanning the 25th to 75th percentiles of OM results exhibited by a broad sample of publicly traded comparable distribution firms). The sample identified, which is comprised of 18 unique firms, produced a 5-year arm's-length range of OM results panning from NUMBER3 percent to NUMBER4 percent, with a median of NUMBER5 percent, for the most recent five-year period closely aligned to COMPANY3's year ended YEAR3. This comparison is illustrated below in the following table.

CPM Profitability Comparison (COMPANY3 vs. Comparable Firms):

COMPANY2 OM (year ended YEAR3)	NUMBER2%
OM Results for Comparable Firms (5-Yr Wtd. Avg.)	
Upper Quartile (75 th Percentile)	NUMBER4%
Median (50 th Percentile)	NUMBER5%
Lower Quartile (25 th Percentile)	NUMBER3%

Transfer Pricing Analysis Findings

Under the CPM, a tested party (in this case, COMPANY2) PLI result which falls within the arm's-length range produced by a properly screened sample of comparables, suggests that the pricing of the transactions to which said

tested party is party to is what the Section 482 regulations refer to as arm's-length. In this case, COMPANY2's OM result falls significantly above the determined arm's-length range. Should the tested party achieve an OM result above the arm's-length range, the profits above this range are typically attributed to a "residual" factor such as manufacturing assets, intangible asset ownership or other synergies which may lead to such premium profits above those expected given the functions the tested party performs. This "residual" factor demonstrates that a significant non-sales contribution to Taxpayer's income is not properly reflected in the single sales factor formula. Hence, as applied to Taxpayer's facts the statutory formula is distortive.

This distortion is further evident in the apportionment factor and business income base comparison. For years ended YEAR5-YEAR7, application of the statutory single sales factor resulted in Illinois taxable income of \$NUMBER6 for the year ended YEAR5, \$NUMBER7 for the year ended YEAR6, and \$NUMBER8 for the year ended YEAR7. Using the medium comparable operating margin for mere wholesale distribution from the table above – NUMBER5% - suggests that a fairer amount of income associated with COMPANY2's Illinois sales would have averaged only \$NUMBER23 over those same periods. This distorted overstatement of Illinois sales results from there being no representation of critical business elements to automobile manufacturing; labor and capital. This is similar to levels of distortion found unconstitutional in other cases. As such, single sales factor is distortive as applied to Taxpayer. Therefore, Taxpayer respectfully requests alternative apportionment by means of an equally weighted three-factor formula. Under this formula, the revised apportion factor would be NUMBER9%, NUMBER10%, and NUMBER11% for the years ended YEAR1 through YEAR3 respectively compared to NUMBER12%, NUMBER13%, and NUMBER14% as filed. Likewise, apportioned income would change to \$NUMBER15; \$NUMBER16; and \$NUMBER17 from \$NUMBER18; \$NUMBER19; and \$NUMBER20 in the respective years. While these numbers are slightly larger than the economic analysis supports, this would be more in line with a fair representation of the activities in Illinois and avoid the necessity/burden of separate accounting.

Using Single Sales Factor to Apportion Income for the Purpose of the Personal Property Replacement Tax Raises Additional Distortive Effects Based on the Lack of Fair Relation Between Taxpayer's Activity and the Benefit Received from the Local Taxing Jurisdictions

Legal Background

In addition to corporate income tax, Illinois has a Personal Property Replacement Income Tax (“PPRT”) meant to replace revenue from an abolished ad valorem tax. In 1970, the Illinois constitution was amended to abolish ad valorem personal property taxes.⁸⁷ At the time, these taxes were used to fund local governments and school districts. To replace this lost local revenue, the 1970 Illinois Constitution required the General Assembly to pass a replacement tax.⁸⁸ Eventually in 1979, Illinois passed the PPRT.⁸⁹

Like the corporate income tax, the PPRT is a tax on Illinois net income using the statutory apportionment formula. Originally, this was the three-factor formula but has since been displaced with a formula consisting only of a single sales factor.⁹⁰ However, the revenue from the PPRT is placed in a trust fund to be allocated by the Illinois Department of Revenue in a manner that mimicked and, in effect, replaced the former personal property tax.⁹¹ The Illinois Department of Revenue then splits the funds between Cook County and the downstate counties.⁹² These then in turn allocate the funds between taxing districts based on their percentage of the personal property tax revenue in the base year (1976 for Cook County, 1977 for the downstate counties).⁹³

As will be discussed below, the disconnect between the purpose and allocation of the PPRT funds and the single sales factor formula raises serious constitutional concerns.⁹⁴ In effect, the sales factor allows out-of-state income to be pulled in and taxed as a disguised ad valorem tax.⁹⁵ Within the context of distortion, such constitutional strain can only further the need for alternative apportionment.

Discussion

Relying on the same apportionment formula, the PPRT inherits the same distortion problems as the corporate income tax. Additionally, the replacement tax regime has discrimination problems unique to itself. First, the tax replaces a previous ad valorem personal property tax which taxed personal property within the state.⁹⁶ By utilizing an apportionment formula,

⁸⁷ Ill. Const., Art. IX, Sec. 5(c).

⁸⁸ Ill. Const., Art. IX, Sec. 5(c).

⁸⁹ *Continental Ill. Nat’l Bank & Trust Co. v. Zagel*, 78 Ill. 2d 387, 395 (1979).

⁹⁰ 35 ILCS 5/304(h); see also 35 ILCS 5/304(a).

⁹¹ See *Continental*, *supra*, at pp. 412-14.

⁹² See *Continental*, *supra*, at pp. 412-14.

⁹³ See *Continental*, *supra*, at pp. 412-14.

⁹⁴ See *Complete Auto*, *supra*, at p. 287.

⁹⁵ See *Continental*, *supra*, at pp. 402-05.

⁹⁶ Ill. Const., Art. IX, Sec. 5(c).

the replacement tax went from a tax directly on activity in the state to one that pulled in out of state income. The shift to single sales factor exacerbated this discrepancy by replacing a tax based on personal property with one based on sales. This disconnection is more apparent when considering that although the tax is based on sales, allocation to local taxing units is based on the historical personal property tax basis.

In the litigation coinciding with the PPRT's adoption, the Illinois Supreme Court addressed the Illinois Constitution's language mandating the creation of the PPRT. Illinois Constitution, Art. IX, Section 5(c) states:

Such revenue shall be replaced by imposing statewide taxes, other than ad valorem taxes on real estate, solely on those classes relieved of the burden of paying ad valorem personal property taxes because of the abolition of such taxes subsequent to January 2, 1971.

At the time, different taxpayers brought claims that the PPRT violated Section 5(c) because the taxpayers under the income-based PPRT were not sufficiently the same as those who had paid the Personal Property Tax. In *Continental Illinois National Bank and Trust Co. v. Zagel*, the Illinois Supreme Court rejected this argument by saying that "it is clear that the replacement tax was intended to be imposed broadly on those classes rather than on those particular persons relieved of paying the personal property tax."⁹⁷ In other words, the analysis under Section 5(c) is about classes rather than particular persons subject to tax.⁹⁸ Nevertheless, the court did say that Section 5(c) had not been violated because there was sufficient correlation between the classes subject to replacement tax and those subject to personal property tax.⁹⁹ To drive the point home that class referred to classes of taxpayers not particular persons or their income, the *Continental* court directly addressed the question of foreign source income:

While petitioners argue that the replacement corporate income tax includes foreign-source income of the corporation in violation of section 5(c) of article IX, it seems clear that since corporations were subject to personal property tax, they are a class within the scope of a replacement income tax and *the*

⁹⁷ 78 Ill. 2d 387, 403-04 (1979).

⁹⁸ *Continental, supra*, at pp. 403-04.

⁹⁹ *Continental, supra*, at p. 404.

*source of that income is irrelevant unless excluded by the legislature.*¹⁰⁰

In *Continental*, none of the petitioners argued that the replacement tax taxed a new class of taxpayers by apportioning income using the UDITPA formula rather than a personal property factor.¹⁰¹ Had the PPRT used a personal property factor to apportion income, then it would more closely mirror those taxpayers who had paid personal property tax. By stating that “the source of that income is irrelevant,” the Illinois Supreme Court implicitly rejected this argument.¹⁰² However, by writing off the source of income as irrelevant the Court creates tension within its own logic.¹⁰³ Essentially, the court is saying that the PPRT is a new tax which is not a personal property tax because it is not based on who in fact historically paid personal property tax.¹⁰⁴ This cuts against the court’s earlier analysis that the PPRT does not violate Section 5(c).¹⁰⁵ There the court says the classes must be sufficiently correlated, suggesting that the PPRT must have enough overlap with the personal property tax to permissibly replace it.¹⁰⁶ Thus, the court gives two ways to view the PPRT: either the PPRT should be treated as an income tax separate from the personal property tax or as a new personal property tax based on income rather than value.¹⁰⁷ Under either interpretation, the tax is impermissible under the *Complete Auto* analysis.¹⁰⁸ That being said, Taxpayer takes the position that the PPRT is in essence a personal property tax like its predecessor but one based on income rather than valuation.¹⁰⁹

¹⁰⁰ *Continental, supra*, at p. 405.

¹⁰¹ See *Continental, supra*, at pp. 387-415.

¹⁰² *Continental, supra*, at p. 405; see also *id.* at p. 404 (“Certainly a tax imposed on the basis of income would not be expected to exempt those who had little or no personal property.”).

¹⁰³ See *Continental, supra*, at pp. 404-05.

¹⁰⁴ See *Continental, supra*, at pp. 403-04 (“[W]e do find that section 5(c) of article IX does not require in the replacement tax an exact correlation of persons and property taxed with those formerly subject to personal property tax.”).

¹⁰⁵ See *Continental, supra*, at pp. 403-04.

¹⁰⁶ *Continental, supra*, at p. 404.

¹⁰⁷ See *Continental, supra*, at pp. 402-05.

¹⁰⁸ See *Complete Auto, supra*, at p. 287.

¹⁰⁹ If the PPRT is treated as an income tax then it suffers all the problems previously discussed. The *Continental* opinion does the state no favors with regards to intent. In its analysis, the court noted that “a tax imposed on the basis of income would not be expected to exempt those who had little or no personal property.” See *Continental, supra*, at p. 404. This is a clear acknowledgement that the PPRT would have an expanded tax base subjecting previously exempt out-of-state taxpayers to taxation. See *Continental, supra*, at pp. 403-04. This means that court understood the PPRT to shift the taxation burden out of state. See *Continental, supra*, at pp. 403-04. The court even further doubled down by saying that “the source of income was irrelevant.” *Continental, supra*, at p. 405. Given that PPRT was meant to produce a similar revenue amount as the personal property tax, the introduction to the tax base of previously untaxed out of state business could only come at the reduction of in-state taxpayers’ liabilities. See *Continental, supra*, at pp. 398-99; see also Ill. Const., Art. IX, Sec. 5(c). Thus, but the court’s own admission, the PPRT burdens interstate commerce to the detriment of out-of-state business. See *Continental, supra*, at pp. 403-04.

It should also be noted that the PPRT had at one time an investment credit which allowed manufacturers to claim a credit for certain personal property used in the state. Ironically, this was property which would have been subject to the personal property tax. This creates a relationship between the investment credit and property previously taxed under ad valorem personal property tax demonstrating the successive connection between the PPRT and the prior tax scheme. As such, it is proof that the PPRT should be treated a personal property tax based on income. Furthermore, the credit's end result was that the PPRT tax burden to be shifted almost exclusively out of state. This further suggests that Illinois's choice in the apportioning income based first on UDITPA, and then single sales factor, was motivated by a desire to shift the tax burden out of state. Thus, the PPRT is a personal property tax based on income which uses an apportionment formula and previously a credit regime which shift the taxation burden out of state.

As a personal property tax like its predecessor, the PPRT offends not only the discrimination prong but another *Complete Auto* prong – fair relation to the benefits provided by the taxing jurisdiction.¹¹⁰ This second prong has roots both in the Due Process Clause and the Dormant Commerce Clause. Under Due Process, it is important for jurisdictional purposes that tax be related to taxable activity actually occurring within the taxing jurisdiction.¹¹¹ While under Dormant Commerce Clause, the amount of tax must be in fair relation or proportion to the benefits provided by the taxing jurisdiction.¹¹² The PPRT's resemblance to its predecessor tax while using a sales factor apportionment scheme dooms it under both lines of the second prong.

Here, the PPRT replaces the revenue lost by local taxing units from the abolishment of the ad valorem personal property tax.¹¹³ Under the previous regime, local taxing units taxed the personal property within their

Therefore, if treated as an income tax, the PPRT offends the dormant commerce clause by shifting the taxation burden to out of state businesses like Taxpayer.

¹¹⁰ *Complete Auto*, *supra*, at p. 287.

¹¹¹ Outside of Illinois, California has interpreted the due process concerns underlying the second prong of *Complete Auto* in the context of municipal taxes. The California Supreme Court ruled that “no measure of apportionment can satisfy the constitutional standard if the measure of tax is made to depend upon a factor which bears no fair relationship to the proportion of the taxed activity actually taking place within the taxing jurisdiction.” *Los Angeles v. Shell Oil Co.*, 4 Cal. 3d 108, 124 (1971), cited by *City of Los Angeles v. London Towne Livery Service Ltd*, 97 Cal. App. 3d 814, 817 (1979). It is taxpayer's position that the *Complete Auto*'s second prong as applied to political subdivisions requires the geographic (in-state or out) basis of the relationship between taxed activity and benefits to be the extent of the subdivision's jurisdiction, not the state's. Any attempt to avoid this constitutional requirement by having the state government collect tax on behalf the local taxing jurisdictions is unsatisfactory. To allow this would be to elevate form over substance. Thus, the PPRT violates *Complete Auto*'s second prong. See *Complete Auto*, *supra*, at p. 287.

¹¹² See *Complete Auto*, *supra*, at p. 287.

¹¹³ Ill. Const., Art. IX, Sec. 5(c).

jurisdictions to raise revenue to fund the services provided in those jurisdictions.¹¹⁴ This demonstrated a clear relation between the tax and benefits provided. However, under the PPRT, this relationship breaks down as tax is calculated based on income apportioned by a sole statewide sales factor.¹¹⁵ This means that many taxpayers with no personal property in a particular local taxing unit will be paying taxes to that unit through the PPRT allocation regime. Even worse, there are taxpayers with no taxable events in the jurisdiction of certain local taxing units nonetheless paying taxes to them. This clearly violates *Complete Auto*'s Due Process considerations which requires a relationship between the tax and actual taxable activity occurring in the taxing jurisdiction.¹¹⁶

Arguably, Illinois simply increased the state income tax rate to replace revenue lost by the abolition of personal property tax. Each action, whether independent of each other or otherwise, is permissible. Illinois has instead fashioned an increase to income tax collections to fund the revenue shortfall created through the elimination of the personal property tax. The PPRT is separately administered and distributed in a non-transparent manner to (1) eliminate tax on personal property located in Illinois and (2) shift that burden to corporations based solely on the ratio in-state sales over sales everywhere. As discussed above, the PPRT collection and distribution is administered precisely in the manner of a personal property tax based on income. In addition, to the prior investment credit regime, the 2.5% rate added on top of the 7% corporate income tax rate allows approximately 36% more of the statewide base income to be taxed. This allows even more income outside of the local taxing jurisdictions to be taxed by disguising the personal property tax in the PPRT scheme. The U.S. Supreme Court addressed a similar issue in *Aloha Airlines, Inc. v. Director of Taxation of Hawaii*; *Hawaiian Airlines, Inc. v. Director of Taxation of Hawaii*.¹¹⁷ That case involved a federal law prohibiting gross receipts taxes on air fare. Hawaii adopted a property tax based on airline gross receipts. The Supreme Court had no difficulty finding that a property tax measured by gross receipts is, in fact, a tax on gross receipts. Through the "Personal Property Replacement Tax," Illinois has simply shifted the pre-existing personal property tax burden on corporations without regard for the extent of in-state personal property holdings. Rather, it was the intent and the result of the Illinois legislatures' actions to shift the personal property tax burden over to corporations irrespective of those companies' Illinois personal property holdings.

¹¹⁴ See *Continental, supra*, at pp. 398-99.

¹¹⁵ 35 ILCS 5/304(h)(3).

¹¹⁶ See *Complete Auto, supra*, at p. 287.

¹¹⁷ 464 U.S. 7 (1983).

Similarly, dressing the PPRT as an income tax does not mask the underlying illegitimate reality behind the Illinois PPRT regime.

Another possible defense is that the taxing jurisdiction is the state not the local taxing units as the state collects the PPRT. This defense fails because in practice the revenue goes to the local taxing units as it had under the previous personal property tax regime.¹¹⁸ The PPRT regime requires the state to place the revenue in a separate trust fund and allocate it based on historical property basis.¹¹⁹ This significantly restricts the state's control over the funds. Additionally, the Illinois Constitution required the PPRT to collect at least the same amount of revenue as the previous tax regime.¹²⁰ Thus, even though the state collects the tax, the tax itself is still substantively at the local level as the state merely functions as a collection agent passing through the collected amounts.¹²¹ Functionally, this attempts to create a transactional structure that would allow local jurisdictions to tax income they would not otherwise have jurisdiction to tax under *Complete Auto*. Ultimately, it boils down to the elevation of form over substance. As a result, this transactional structure does not shield the PPRT from violating *Complete Auto*'s relationship prong.¹²²

Finally, the PPRT's allocation regime itself highlights the disconnect between the tax and the benefits provided. The PPRT's allocation regime's reliance on historical property tax bases ties the PPRT revenue to where property was historically located.¹²³ This means that the allocation regime reflects benefits as related to services that would have been provided to said local property.¹²⁴ Whereas on the collection side, the PPRT is apportioned based on a statewide sales factor.¹²⁵ Such an apportionment formula best reflects the statewide market for goods and services not the location of property within local jurisdictions. As a result, *how* much tax Taxpayer pays is based on their sales activity in the state of Illinois, but *who* Taxpayer pays that same tax to is based on an unrelated historical local property tax base.

It is important to remember that the allocation regime uses the entire property tax base of the local taxing unit as of 1979 (or 1978 for Cook County).¹²⁶ Such a system utilizes absolutely zero reference to Taxpayer's

¹¹⁸ See *Continental, supra*, at pp. 413-14; see also Ill. Const., Art. IX, Sec. 5(c).

¹¹⁹ Ill. Const., Art. IX, Sec. 5(c).

¹²⁰ See *Continental, supra*, at pp. 398-99; see also Ill. Const., Art. IX, Sec. 5(c).

¹²¹ See *Continental, supra*, at pp. 413-14; see also Ill. Const., Art. IX, Sec. 5(c).

¹²² See *Complete Auto, supra*, at p. 287.

¹²³ See *Continental, supra*, at pp. 412-14; see also Ill. Const., Art. IX, Sec. 5(c).

¹²⁴ See *Continental, supra*, at pp. 412-14; see also Ill. Const., Art. IX, Sec. 5(c).

¹²⁵ 35 ILCS 5/304(h)(3).

¹²⁶ See *Continental, supra*, at pp. 412-14; see also Ill. Const., Art. IX, Sec. 5(c).

actual activity during a given year. This means that *who* Taxpayer pays tax to has no basis in Taxpayer's actual activity during the taxable year in any specific local taxing jurisdiction. Worse under this regime, taxpayer pays tax to local taxing units based on the historical personal property of other taxpayers – most of whom were in-state businesses. This is a clear case of discrimination where an out of state business pays taxes to local jurisdictions based on the benefits received not by Taxpayer but mostly by local businesses. Inevitably, Taxpayer pays taxes under the PPRT regime to local taxing units out of all proportion to Taxpayer's actual activity in those jurisdictions. This is the exact kind of unfair relationship, violative of the Dormant Commerce Clause, which concerned the *Complete Auto* court.¹²⁷ Because of this discriminatory disconnect between the collection and allocation regimes, the *how much* and the *to whom*, the PPRT violates *Complete Auto*'s second prong.¹²⁸ Additionally, this disconnect fails under *Complete Auto*'s internal consistency prong as a result of double taxation.¹²⁹ Taxpayer pays considerable personal property tax to STATE2 as a result of COMPANY3 manufacturing being headquartered in the state. Because PPRT is apportioned based on sales rather than property this means that income attributable to STATE2 personal property will invariably be taxed by Illinois. As a result, Taxpayer faces double taxation on the same personal property further violating *Complete Auto*'s constitutional standard.¹³⁰

In conclusion, the PPRT excretes significant constitutional strain in Taxpayer's case. The PPRT's use of single sales factor impermissibly shifts the tax burden out of state, especially for manufacturers.¹³¹ Furthermore, the PPRT's unique history and structure raise additional concerns under *Complete Auto*.¹³² Specifically, the disconnect between the PPRT's apportionment and allocation methods demonstrates that the tax does not bear relation to the benefits provided by the taxing jurisdictions.¹³³ The clear solution to this constitutional pressure is alternative apportionment under 35 ILCS 5/304(f) by apportioning PPRT taxable income based on a sole personal property factor.

Conclusion

¹²⁷ See *Complete Auto*, *supra*, at p. 287.

¹²⁸ See *Complete Auto*, *supra*, at p. 287.

¹²⁹ See *Complete Auto*, *supra*, at p. 287.

¹³⁰ See *Complete Auto*, *supra*, at p. 287.

¹³¹ *Moorman*, *supra*, at pp. 282-83 (Blackmun, J., dissenting).

¹³² See *Complete Auto*, *supra*, at p. 287.

¹³³ See Ill. Const., Art. IX, Sec. 5(c); 35 ILCS 5/304(h)(3); see also *Complete Auto*, *supra*, at p. 287.

Illinois law permits taxpayers to petition for the use of an alternative apportionment when the statutory apportionment calculation does not fairly reflect the income earned within the state. As illustrated by the transfer pricing metrics included in the appendix and discussed throughout, the single sales factor apportionment formula as applied to Taxpayer does not fairly reflect the income earned as a result of their Illinois operations. 35 ILCS 5/304(f) provides several possible remedies when reasonable, specifically:

- (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.

Under subsection (3), we are requesting a return to the provisions of UDITPA, with the inclusion of the additional factors that would fairly represent the business as a whole for the Illinois Corporate Income Tax.¹³⁴ This apportionment formula more fairly reflects the income attributable to activities in the state of Illinois. Using a three-factor formula consisting of property used to manufacture automobiles, payroll and sales results in an apportionment factor that more closely approximates the income that should be apportioned to Illinois. As previously discussed, under this formula, the revised apportion factor would be NUMBER9%, NUMBER10%, and NUMBER11% for the years ended YEAR1 through YEAR3 respectively compared to NUMBER12%, NUMBER13%, and NUMBER14% as filed. Likewise, apportioned income would change to \$NUMBER15; \$NUMBER16; and \$NUMBER17 from \$NUMBER18; \$NUMBER19; and \$NUMBER20 in the respective years. To the extent of tax years open under the statute of limitation, we request a refund of tax determined to be overpaid with the requested remedy applied.

Taxpayer reserves the right to supplement this petition with any and all necessary information to support this claim. If additional information is needed to perfect this filing, please contact me by phone at PHONE, or by email at EMAIL.

DEPARTMENT'S RULING:

¹³⁴ We are not limited to this remedy. In the alternative, we would request that the manufacturing and distribution segments be bifurcated and that the three-factor formula be applied only to the manufacturing segment.

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 sales factor as a fraction, the numerator of which is the total sales of the person in Illinois during the taxable year, and the denominator of which is the total sales of the person everywhere during the taxable year.

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.

Taxpayers who wish to use an alternative method of apportionment under IITA Section 304(f) are required to file a petition complying with the requirements of 86 Ill. Adm. Code Section 100.3390.

86 Ill. Adm. Code Section 100.3390(c) outlines the burden of proof for a taxpayer petitioning for an alternative method of apportionment:

Burden of Proof. 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 indicates that the statutory single-sales factor apportionment formula as applied to COMPANY2 does not fairly reflect the market activities as a result of their Illinois operations. You indicate that property and payroll apportionment factors must be included to reflect the essential contributions of labor and capital in the manufacture of automobiles and in producing sales in Illinois. In addition, you indicate it is reasonable to request those factors to be considered in the determination of the share of income attributable to Illinois as failing to do so would result in a significant gross distortion of COMPANY2'S true economic activity and market within Illinois for both corporate income tax and personal property tax replacement income tax.

The facts stated in your petition are not sufficient to satisfy the burden set forth in 86 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) and of subsection (h) 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 petition merely states that due to the statutory exclusion of the property and payroll apportionment factors, an evenly weighted three-factor formula consisting of property, payroll, and sales reaches a different apportionment percentage than the required statutory formula and an alternative apportionment formula would more accurately represent COMPANY2'S market in Illinois. The petition indicates that using an evenly weighted three-factor formula is expected to result in a smaller Illinois apportionment factor. 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. Additionally, an assertion that the single sales factor apportionment method might not be the most accurate, or might not be as accurate as some other method, does not by itself demonstrate that the statutory apportionment method does not fairly represent the extent of taxpayer's market in this State.

In addition, the NUMBER2% operating margin for tax year ended YEAR3, when compared to the other firms in the transfer pricing analysis, is not a grossly distorted result in which to warrant the application of an alternative method of apportionment. A slightly higher operating margin in comparison to other firms in a sample does not support a showing that the statutory apportionment formula operates unreasonably and arbitrarily in attributing to this State a percentage of the taxpayer's 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. A higher operating margin does not, in itself, constitute evidence of a grossly distortive result or unfair representation of the taxpayer's market in this State.

The Department declines to issue a Private Letter Ruling on taxpayer's alternative apportionment request to calculate the personal property tax replacement income tax using a single sales factor but applying only personal property factors. Your petition fails to show that the statutory formula leads to a grossly distorted result and the proposed alternative method fairly and accurately apportions income to Illinois and would be more appropriate. While the specific ruling requested is not expressly stated, implicit in your petition is the contention that taxing the income in question with the same single sales factor as applied to corporate income tax would be unconstitutional. The Department cannot make such a finding. The Department must apply the law as prescribed by the General Assembly.

Accordingly, your petition for alternative apportionment for tax years ended YEAR1, YEAR2, YEAR3, and YEAR4 cannot be granted.

As stated above, this is a General Information Letter. A General Information Letter 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

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