Insights: Publications

Illinois Corporate Income Tax Basics: Apportionment

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In a previous post, we addressed the basics for calculating Illinois base income. Once a taxpayer has calculated its Illinois base income, a corporate taxpayer should use Form IL-1120, Step 4, lines 24 through 34 to calculate its Illinois sourced income. As the instructions show, Illinois has different apportionment formulae for general businesses, insurance companies, financial organizations, federally regulated exchanges, and transportation companies. *See also* 35 ILCS 5/304(a), (b), (c), (c-1), and (d). We will discuss Illinois' combined reporting rules and the specific treatment of insurance companies and financial organizations in more depth in later posts. This post will focus on Illinois' general apportionment rules.

Illinois generally apportions income using a single sales factor formula and adheres to a market-based sourcing approach. In apportioning receipts to Illinois under the sales factor, the IITA describes a number of different income streams and sets forth the manner in which each type of revenue should be apportioned. These different streams include sales of: tangible personal property, "patents, copyrights, trademarks, and similar items of intangible personal property," telecommunications services or mobile telecommunications services, and broadcasting services. The most important category of revenue, however, is a catch-all category which refers to all sales other than the specific categories described above. This category includes: sales from the sale or lease of real property, sales from the lease or rental of tangible personal property, "interest, net gains and other items of income from intangible personal property," and sales of services. 35 ILCS 5/304(a)(3)(C-5)(i)-(iv).

SALES OF SERVICES

In Illinois, sales of services are sourced to the state if the services are "received" in Illinois. 35 ILCS 5/304(a)(3)(C-5)(iv). Illinois, like many other states, conforms to a sourcing hierarchy to determine where the services are received. If the state where the services are received is not readily determinable, or the corporation receiving the service does not have a fixed place of business in that state, the services shall be deemed to be received at the location of the office of the customer from which the services were ordered in the regular course of the customer's trade or business. If the ordering office cannot be determined, the services shall be deemed to be received at the office of the customer to which the services are billed. *Id.* Importantly, if the taxpayer is not taxable in the state in which the services are received, Illinois has adopted a "throwout" rule, wherein the sale must be excluded from both the numerator and denominator of the sales factor.

SALES OR LICENSES OF INTANGIBLES

It is extremely important for taxpayers to understand the different categories of revenue streams, as the different categories are not always intuitive. For instance, in the context of income from the license or sale of intangibles,

Illinois has created two primary categories: (1) "patents, copyrights, trademarks, and similar items of intangible personal property," and "interest, net gains and other items of income from intangible personal property." 35 ILCS 5/304(a)(3)(C-5)(i)-(iv). (And separate broadcasting rules leave open the possibility that the income is not derived from intangibles at all, but is in fact "broadcasting revenue" subject to entirely different sourcing rules.) In the context of patents, copyrights, trademarks and similar items of intangible personal property, receipts should be apportioned according to the "place of utilization," which is defined differently for different types of intangibles. The receipts should only be included in the numerator or denominator of the sales factor if gross receipts from these items of income comprise more than 50% of the taxpayer's total gross receipts during each of the preceding tax years; this determination is to be made on the basis of the gross receipts of the entire unitary business group. 35 ILCS 5/304(a)(3)(B-2).

Income from interest, net gains and other items of income may be apportioned in one of two ways. First, in the case of a taxpayer who is a "dealer" of intangible personal property, the income or gain is sourced to the location where received by the customer. Generally speaking, the customer will receive the intangible at its commercial domicile. 35 ILCS 5/304(a)(3)(C-5)(iii)(a). If the taxpayer is not a "dealer" as defined by the statute, its receipts should be apportioned according to the income-producing activity test based on costs of performance. 35 ILCS 5/304(a)(3)(C-5)(iii)(b). There is no "throwout" rule for this type of income, so the receipts should always be included in the apportionment factor, even where the taxpayer is not subject to tax in a jurisdiction where the receipts should be sourced, and even if its receipts do not constitute more than 50% of its gross receipts.

A number of questions arise when apportioning receipts from intangibles in Illinois. For instance, both categories of intangibles include a catch-all category. One category includes "similar items of intangible personal property" to patents, copyrights, and trademarks. The other category includes "other items of intangible personal property." Reference to IRC 197(d), which defines a number of intangibles, does not necessarily help. In IRC 197, goodwill, going concern value, patents, copyrights, or trade processes, and similar items are all situated in one category. Illinois does not conform to this definition, however, and even if it did, is goodwill similar to trademarks, patents, and copyrights, or is it simply some type of "other" intangible? The same question may be asked of trade secrets, proprietary information, and a number of other types of receipts. The classification of a particular intangible revenue stream will result in very different methods of apportionment.

SALES OR LICENSES OF SOFTWARE

In light of the ambiguity regarding sales of intangible personal property, a taxpayer is likely to confront ambiguity when apportioning receipts of software. The Department of Revenue has explained that a "taxpayer selling canned computer software is selling intangible personal property? If the taxpayer sells software to customers in the ordinary course of its business, it is a dealer with respect to those sales. In contrast, a taxpayer providing programming or maintenance services to its customers is selling services rather than intangible personal property." 86 Ill. Admin. Code 100.3370(c)(6)(C). Additionally, a "taxpayer selling access to an online database or applications software, and who is required to perform regular update services to the database or software, retains control over the contents of the database or software, and provides access to the same database or software to multiple customers is not selling or licensing an item of intangible personal property to its customers, but rather is providing a service." 86 Ill. Admin. Code 100.3370(d)(ii). The complexity regarding characterization of receipts from the sale or license of software is

best summarized by a 2014 Department of Revenue General Information Letter:

> If either taxpayer is transferring a copyright in software to its customers, gross receipts from such transactions are sourced according to the rule at IITA Section 304(a)(3)(B-1). On the other hand, if either taxpayer is licensing software to its customers (other than a copyright right), gross receipts from such transactions are sourced according to the rules at IITA Section 304(a)(3)(C-5)(iii). Finally, if either taxpayer is providing a service to its customers, gross receipts from such transactions are sourced under IITA Section 304(a)(3)(C-5)(iv).

Illinois Dept. of Rev. IT 14-0003-GIL (4/2/2014).

Whether a sale of software is similar to a copyright, a license of some "other" intangible, or a service will, once again, have a substantial impact on the manner in which such income should be apportioned. If similar to a copyright, the receipts will be sourced to the place of utilization and will be excluded from the factor if such receipts constitute less than 50% of the taxpayer's gross receipts. If a license of an intangible, and the taxpayer is a "dealer" of such software, a market based sourcing approach without any throwout will apply. If the taxpayer is not a dealer of such intangibles, the income-producing activity test will apply. And finally, if the taxpayer is providing a service, market based sourcing will apply, but the receipts will be thrown out of the apportionment factor if the taxpayer is not taxable in the destination state.

THE "JOYCE" RULE

Although probably better situated in the context of discussing combined reporting or nexus, it is also important to note that Illinois has adopted the "Joyce" approach. 86 Ill. Admin. Code 100.9270(f). Under this rule, if a taxpayer is a member of the Illinois combined group, its receipts should be included in the denominator of the Illinois apportionment factor. However, if that specific entity does not have nexus with Illinois, its receipts will be excluded from the numerator of the apportionment factor. Although Illinois' recent assertion of being an "economic nexus" state would appear in conflict with the Joyce Rule, it is important for taxpayers to recognize that entities with no nexus with Illinois should exclude their receipts form the numerator of the Illinois apportionment factor.

ONE FINAL THOUGHT ON THROWBACK AND THROWOUT

Generally speaking, sourcing sales of tangible personal property is straightforward. Such sales should be sourced to Illinois if the property is delivered or shipped to a purchaser, other than the United States government, within Illinois regardless of the f.o.b. point or other conditions of sale. 35 ILCS 5/304(a)(3)(B)(i). However, Illinois has adopted a "throwback" rule, which states that if the property is shipped from a location in Illinois and the taxpayer is not subject to tax in the destination state, the sale should be included in the numerator of the Illinois apportionment factor. The validity of this rule has been addressed by a number of Illinois courts. *Beatrice Companies, Inc. v. Whitley*, 292 Ill App 3d 532 (1997); *Hartmarx Corporation v. Bower*, 243 Ill Dec 517 (1999). In most cases, the reason a taxpayer will not be subject to tax in the foreign jurisdiction when it makes sales of tangible personal property is because the taxpayer is protected from taxation by P.L. 86-272, which prevents states from imposing a net income tax where the only activity of a taxpayer is soliciting sales of tangible personal property in the state.

P.L. 86-272, however, does not apply to sales of services. Nonetheless, as discussed above, Illinois imposes a throwout rule for sales of services where the taxpayer does not pay tax in the destination state. Illinois purports to require that the taxpayer actually show that it paid tax in the foreign jurisdiction in order to avoid excluding the receipts from the denominator of its Illinois apportionment factor. This is particularly problematic today because Illinois purports to conform to an economic nexus and market based sourcing paradigm. As such although Illinois requires taxpayers receiving income from intangibles or with substantial receipts in the state to pay income tax irrespective of whether those companies have a physical presence in Illinois, it requires that a taxpayer show that it actually paid tax to avoid throwout.

Illinois courts have yet to address this concern. However, in *Lorillard Licensing Company v. Director*, A-2033-13T1 (Superior Ct. NJ 2015), the superior court of New Jersey addressed an identical problem. In that case, the taxpayer had nexus with the state because it licensed intangible property to customers in the state. It licensed intangible property across the country, but a number of states took the position that such activities did not subject the taxpayer to tax in those states. New Jersey attempted to exclude those receipts from the taxpayer's apportionment factor. The New Jersey court, however, held that New Jersey must use a consistent test for determining whether the taxpayer was “subject to tax” in those foreign states. If such activities would create nexus with New Jersey, then for purposes of throwout, such activities made the taxpayer “subject to tax” in those foreign states notwithstanding the fact that the taxpayer did not actually file returns in those states. Applying *Lorillard* to Illinois law, Illinois should only throwout receipts when the Illinois taxpayer would not be subject to tax under Illinois law. As such, Illinois should not be able to throwout receipts of Illinois taxpayers who is is not subject to tax in a foreign jurisdiction because the state either (1) does not impose a net income tax or (2) has not adopted an economic nexus framework.

CONCLUSION

This analysis provides an introduction to the manner in which Illinois apportions most business income. Illinois' adoption of a single sales factor and market based sourcing occurred just about ten years ago, so many questions regarding characterization of income, the ongoing validity of throwout, and the applicability of the Joyce Rule persist. In subsequent posts, we will dive deeper into industry-specific apportionment rules and their interplay with combined reporting.

Related People



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