

# Amended Sales Factor Regulations Adopted

## Overview

On August 21, 2017, the Illinois Department of Revenue (“Department”) published final amendments to its sales factor regulations<sup>1</sup> to reflect apportionment factor amendments to the Illinois Income Tax Act enacted since 1999, notably the 2008 adoption of market-based sourcing principles.<sup>2</sup> The amended sales factor regulations primarily seek to clarify the existing statutory framework with the following notable elements:

- Inclusion of an investment management example
- Characterization of the sale of subsidiary stock as an occasional sale
- Elimination of the double-throwback rule effective for taxable years ending on or after December 31, 2008.

This Tax Alert summarizes the amended sales factor regulations which apply for corporate, partnership, individual, trust, and estate tax purposes.

## Sourcing of Sale of Services

For taxable years ending on or after December 31, 2008, the Illinois statute requires receipts from the sale of services to be sourced to Illinois if the services are received in Illinois.<sup>3</sup>

The amended regulations provide that a contract with a provision for services and the use of property is a sale of service “unless [the] contract is properly treated as a lease of property under 26 USC 7701(e)(1).”<sup>4</sup> Receipts from the sale of services which include an item of tangible personal property are sourced to Illinois if the item of property is delivered to the customer in Illinois under the sourcing rules for tangible personal property.<sup>5</sup> If the service includes an item of real property, the sale is sourced based on the location of the real property.<sup>6</sup> Where services are performed on an individual, the sale is sourced to the location where the individual received the service.<sup>7</sup> Significantly, “services performed by a taxpayer that are directly connected to or in support of services received in the state are services received in the state.”<sup>8</sup>

The statute provides that if the state where the services are received is not readily determinable, the services are deemed to be received at the location of the office of the customer from which the services were ordered in the regular course of business.<sup>9</sup> If the ordering office cannot be determined, the sale of services will be sourced to the office of the customer to which the services were billed.<sup>10</sup> Finally, if the taxpayer is not taxable in the state in which the services are received, the gross receipts attributed to those services must be excluded from both the numerator and denominator of the sales factor (this is often referred to as a “throwout” rule).<sup>11</sup>

## Fixed place of business rule – Services provided to a corporation, partnership, or trust

Pursuant to statute, “gross receipts from the performance of services provided to a corporation, partnership, or trust may only be attributed to a state where that corporation, partnership, or trust has a *fixed place of business*.”<sup>12</sup> The amended regulations refer to 86 Ill. Admin. Code 100.3405(b)(1) to define “fixed place of business.” Under this

<sup>1</sup> 86 Ill. Admin. Code 100.3370, a copy of the regulation is accessible [here](#); 86 Ill. Admin. Code 100.3380, a copy of the regulation is accessible [here](#); 86 Ill. Admin. Code 100.3390, a copy of the regulation is accessible [here](#).

<sup>2</sup> Public Act 095-0233, effective August 16, 2007, amended 35 ILCS § 5/304.

<sup>3</sup> 35 ILCS § 5/304(a)(3)(c-5)(iv).

<sup>4</sup> 86 Ill. Admin. Code 100.3370(c)(6)(D)(ii).

<sup>5</sup> 86 Ill. Admin. Code 100.3370(c)(6)(D)(iii).

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.*

<sup>9</sup> 35 ILCS § 5/304(a)(3)(c-5)(iv).

<sup>10</sup> 86 Ill. Admin. Code 100.3370(c)(6)(D)(iv).

<sup>11</sup> *Id.*

<sup>12</sup> 35 ILCS § 5/304(a)(3)(c-5)(iv). [Emphasis added]

definition, “fixed place of business” has the same meaning as that term is given in Section 864 of the Internal Revenue Code and the related Treasury regulations.<sup>13</sup>

In the case of an entity without a fixed place of business in Illinois, the services are “deemed to be received at the location of the office of the customer from which the services were ordered in the regular course of customer’s trade or business.”<sup>14</sup> If the location of the customer’s ordering office is indeterminable, the “services shall be deemed to be received at the office of the customer to which the services are billed.”<sup>15</sup>

### Sourcing Rules for Investment Services

As detailed in an investment management-specific example provided in the amended regulations, “services performed by an investment fund on behalf of an investor are received in the State if the investor resides in the State (in the case of an individual) or has its ordering or billing address in this state (for other investors).”<sup>16</sup> The investment management example reflects a provision commonly known as the “look through” rule whereby the taxpayer’s receipts are sourced to the location of the investors rather than the location of the investment fund. This applies to services “directly connected with services provided to the investors, such as preparation of communications and statements to investors, and allocations of earnings and distributions to investors.”<sup>17</sup> The investor’s residence is determined by investor’s mailing address as indicated by the investment funds records.<sup>18</sup>

It should be noted that the regulations do not apply a look through rule for “services provided to an investment fund that are *not* directly connected to or in support of services provided separately to investors, such as brokerage services or investment advising.”<sup>19</sup> In such a case, the service would be sourced to the office of the investment fund.<sup>20</sup>

It should be noted that application of a “look through” rule may not be entirely consistent with the fixed place of business sourcing provision provided in 35 ILCS § 5/304(a)(3)(c-5)(iv) noted above, because investment funds frequently do not have “fixed places of business” locations that equate to where the fund investors may be located.

In the amended regulations, however, the Department appears to be suggesting that the focus of the fixed place of business rules is on the *customers of the fund*, and not the fund itself (as the customer of the investment manager). The Department expounds on the fixed place of business rule in the regulations, as follows -

[I]n the case of services performed by the taxpayer as a subcontractor or as an agent acting on behalf of a principal, if either the contractor or principal has a fixed place of business in the state in which the services are received or the customer of the contractor or principal is either an individual or has a fixed place of business in the state which the services are received, the service will be treated as received in a state in which the customer of the taxpayer has a fixed place of business.<sup>21</sup>

In attempting to reconcile the look through rule with the fixed place of business provision, the Department is suggesting that the investment manager is acting as a subcontractor of the fund, and the fund’s customers are the investors. If the investors are individual residents in Illinois or have a fixed place of business in Illinois, the fixed place of business requirement is satisfied since, in the subcontractor relationship, the investor is the customer.

### Sourcing Rules for Patents, Copyrights, Trademarks, or Similar Items

For taxable years ending on or after December 31, 1999, the statute provides that receipts from patents, copyrights, trademarks, and similar items of intangible property are only included in the sales factor if such items comprise more than 50% of the taxpayer’s total gross receipts in the current and two preceding tax years.<sup>22</sup> The amended regulations provide that gross receipts from patents, copyrights, trademarks, and similar items of intangible property include amounts received as damages or settlements from claims of infringement.<sup>23</sup> The amended regulations also provide that gross receipts from patents are only the receipts received from a person using the patent in manufacturing, production, fabrication, or some

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<sup>13</sup> 86 Ill. Admin. Code 100.3405(b)(1).

<sup>14</sup> 35 ILCS § 5/304(a)(3)(c-5)(iv).

<sup>15</sup> *Id.*

<sup>16</sup> See, 86 Ill. Admin. Code 100.3370(c)(6)(D)(iii) Example 5.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.* [Emphasis added.]

<sup>19</sup> *Id.* [Emphasis added.]

<sup>20</sup> *Id.*

<sup>21</sup> 86 Ill. Admin. Code 100.3370(c)(6)(D)(iv).

<sup>22</sup> 35 ILCS § 5/304(a)(3)(B-2). In practice, application of this provision limits the scope of taxpayers that would include such receipts in their sales factor.

<sup>23</sup> 86 Ill. Admin. Code 100.3370(a)(2)(F)(i).

other form of processing.<sup>24</sup> Similarly, gross receipts received from a copyright are only included if the buyer uses the copyright for printing or publication. The regulations define "similar items" as items "of intellectual property that [are] registered or otherwise enforced under a law equivalent to 35 USC 151, 17 USC 408, or 15 USC 1051 or that [are] otherwise recognized in the country under whose law the sale or license agreement would be enforced, or under which an infringement claim would be brought."<sup>25</sup>

For taxpayers whose receipts meet the greater than 50% gross receipts test, under 35 ILCS § 5/304(a)(3)(B-1), receipts from patents, copyrights, trademarks, and similar items are sourced based on the intangible's "place of utilization" for taxable years ending on or after December 31, 1999.<sup>26</sup> The amended regulations clarify that copyrights are utilized in Illinois to the extent the publication or printing originates in Illinois.<sup>27</sup> Printing or publication originates "at the place at which the licensee of the copyright incorporates the copyrighted material into the physical medium by which it will be delivered to the purchaser of the material."<sup>28</sup> For copyrighted materials delivered to a purchaser without the use of a physical medium, the publication originates in the location "at which delivery of the copyrighted material to the person purchasing the material from the licensee originates."<sup>29</sup>

### **Sourcing Rules for Other Items of Intangible Personal Property**

For taxable years ending on or after December 31, 2008, if the taxpayer is a dealer of intangible personal property (other than patents, copyrights, trademarks, or similar items), the regulations source the interest or net gain from the sale of the property to Illinois based on the customer's location.<sup>30</sup> The customer is the person with whom the dealer transacts business.<sup>31</sup> If the customer is an individual, trust or estate, the customer's location is based on the customer's residence. The location of all other customers is based on the customer's commercial domicile. The dealer taxpayer must have actual knowledge of the customer's residence or commercial domicile, otherwise the sale is sourced based on the customer's billing address.

For taxable years ending on or after December 31, 2008, if the taxpayer is not a dealer, the sale is sourced to Illinois if the income-producing activity is wholly in Illinois or if a greater proportion of the income-producing activity of the taxpayer is performed within Illinois than in any other state.<sup>32</sup> These sourcing rules apply to intangible personal property that can "ordinarily be resold or otherwise reconveyed by the person acquiring... and does not include any obligation of the taxpayer to make a payment or perform any act."<sup>33</sup>

### **Incidental or Occasional Sales of Assets**

The amended regulations make various modification to the rules regarding the exclusion of incidental or occasional sale of assets from the Illinois sales factor.<sup>34</sup> The regulations previously provided an example where a sale of a plant was characterized as an incidental or occasional sale, thus excluded from the sales factor. The amended regulations add another example where the gross receipts from the sale of stock in a subsidiary is also characterized as an incidental or occasional sale and excluded from the Illinois sales factor.<sup>35</sup> In addition, the regulations add a list of factors that may result in a transaction, others than the two noted above, being characterized as an incidental or occasional sale. These factor include the following: sales not made in the market for the taxpayer's goods or services; gains realized on the sale of assets are comprised of recapture of depreciation deductions which caused prior year economic income to be understated and

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<sup>24</sup> 35 ILCS § 5/304(a)(3)(B-2); 86 Ill. Admin. Code 100.3370(a)(2)(F)(ii).

<sup>25</sup> 86 Ill. Admin. Code 100.3370(a)(2)(F)(iii).

<sup>26</sup> 35 ILCS § 5/304(a)(3)(B-1)(ii).

<sup>27</sup> 86 Ill. Admin. Code 100.3370(a)(2)(F)(iv).

<sup>28</sup> 86 Ill. Admin. Code 100.3370(c)(3)(B).

<sup>29</sup> *Id.*

<sup>30</sup> 86 Ill. Admin. Code 100.3370(c)(6)(C)(i).

<sup>31</sup> *Id.*

<sup>32</sup> 35 ILCS § 5/304(a)(3)(c-5)(iii)(b).

<sup>33</sup> See, 86 Ill. Admin. Code 100.3370(c)(6)(C)(iii) Example 1 (stating admission tickets in the hands of the owner of the stadium are not "intangible personal property" for the purposes of this section but an admission ticket in the hands of the original purchaser or any subsequent purchaser is considered "intangible personal property.") The regulations also provide examples in the context of canned software and rewards program. 86 Ill. Admin. Code 100.3370(c)(6)(C)(iii) Example 2, Example 3.

<sup>34</sup> 86 Ill. Admin. Code 100.3380(c)(2).

<sup>35</sup> *Id.*

allocation is appropriate; gain on the sale is attributable to goodwill or similar intangibles; and assets sold in connection with a partial or complete withdrawal from the market in the state in which the assets are located.<sup>36</sup>

### Double-Throwback Repealed Effective Tax Year Ending On or After December 31, 2008

The amended regulations also retroactively repeal the “double-throwback rule” for taxable years ending on or after December 31, 2008.<sup>37</sup> The double throwback rule required taxpayers selling tangible personal property and that were taxable in neither the state of origin nor the state of destination to throwback sales to Illinois if the taxpayer’s activities in Illinois exceeded Public Law 86-272.<sup>38</sup> Prior to this amendment, it was not clear if Illinois applied a double-throwback rule for more recent tax years. The regulations have been modified to explicitly limit the existence of the double throwback rule to taxable years ending on or before December 31, 2008.<sup>39</sup> The amended regulations states that the double-throwback rule does not apply to subsequent years because “attributing the sale to this State is not required by IITA Section 304(a)(3) and does not fairly represent the market for the person’s goods, services, or other sources of business income in this State.”<sup>40</sup>

### Alternative Apportionment

The alternative apportionment regulations have been updated to take into account the existence of the Illinois Independent Tax Tribunal and account for the market-based sourcing regulations.<sup>41</sup> The regulations has been amended to state that the petitions for alternative allocation or apportionment may be appropriate for taxable years ending on or after December 31, 2008, when the general allocation and apportionment provisions “do not... fairly represent the market for the person’s goods, services, or other sources of business income.”<sup>42</sup>

### Electricity Sourcing

The amended regulations also clarify the sourcing of electricity.<sup>43</sup> The regulations states that, for taxable years ending prior to December 31, 2008, sales of electricity *are sales other than sales of tangible personal property* sourced under IITA Section 304(a)(3)(C).<sup>44</sup> For taxable years ending on or after December 31, 2008 and prior to July 16, 2009, sales of electricity are *sales of services* sourced under IITA Section 304(a)(3)(C-5)(iv).<sup>45</sup> For taxable years ending after July 15, 2009, sales of electricity are *sales of tangible personal property* sourced under IITA Section 304(a)(3)(B).<sup>46</sup>

### Lottery Sourcing

The amended regulations also state that for taxable years ending on or after December 31, 2013, gross receipts from winnings and from the assignment of a prize under the Illinois Lottery Law are sourced to Illinois.<sup>47</sup>

### Considerations

Based on the modifications to the sourcing of services provided in the amended regulations and the various retroactive effective dates, taxpayers should consult with their tax advisers to analyze the implications for their Illinois income tax obligations.

## Contacts:

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<sup>36</sup> 86 Ill. Admin. Code 100.3380(c)(2)(A)-(D).

<sup>37</sup> 86 Ill. Admin. Code 100.3380(c)(1).

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> 86 Ill. Admin. Code 100.3390.

<sup>42</sup> 86 Ill. Admin. Code 100.3390(a).

<sup>43</sup> 86 Ill. Admin. Code 100.3370(a)(4).

<sup>44</sup> *Id.* [Emphasis added.]

<sup>45</sup> *Id.* [Emphasis added.]

<sup>46</sup> *Id.* [Emphasis added.] See, *Exelon Corp. v. Department of Revenue*, 234 Ill. 2d 266 (2009) for additional background relative to the variance in the characterization of electricity.

<sup>47</sup> 86 Ill. Admin. Code 100.3370(c)(4).

## External Multistate Tax Alert

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