

Investment management example included in proposed Illinois sales factor regulation

Overview

On December 30, 2016, the Illinois Department of Revenue ("Department") published proposed changes to its sales factor regulation.¹ The proposed changes were drafted to reflect changes in the Illinois Income Tax Act,² in particular, market-based sourcing for services which became effective for tax years ending on or after December 31, 2008. The first public notice period for commenting on these proposed changes ended on February 13, 2017.³

This tax alert summarizes the proposed changes to the sourcing rules that are relevant for investment managers.⁴ (Note - additional proposed changes to the sales factor regulation not associated with investment activity are outside the scope of this alert.)

Services provided to an investor

The proposed regulation defines services received in Illinois to include "services performed by a taxpayer that are directly connected to or in support of services received" in the State.⁵ An investment management-specific example provided in the proposed regulation further explains that "services performed by an investment fund on behalf of an investor are received in the State if the investor resides in the State."⁶ The investment management example also contains 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."⁷

Services not directly connected to an investor

The proposed regulation does 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."⁸

Fixed place of business

As is outlined below, this proposed "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), because investment funds typically do not have "fixed places of business" locations that equate to where the fund investors may be located.

The fixed place of business provision states that "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."⁹ The proposed regulation refers to Title 86 Illinois Administrative Code 100.3405(b)(1) to define "fixed place of business". Under this definition, "'fixed place of business' has the same meaning as that term is given in Sections 864 of the Internal Revenue Code and the related Treasury regulations."¹⁰ Under Federal Treasury Regulations, investment funds often do not have a "fixed place of business". See, 26 C.F.R. § 1.864-7.

¹ 86 Ill. Admin. Code 100.3370, a copy of the proposed regulation is accessible [here](#).

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

³ Once the first notice is closed a second notice period will start when the Department submits the proposed changes to the Joint Committee on Administrative Rules. 5 ILCS § 100/5-40(c). The Committee will take comments regarding proposed changes prior to their public hearing. Id. If the Committee finds "No Objection" to the proposed amendments, the Department may adopt the proposed amendments and the final rule will be published in the Illinois Register. 5 ILCS § 100/5-40(d).

⁴ 35 ILCS § 5/304(a)(3)(c-5)(iv).

⁵ Proposed 86 Ill. Admin. Code 100.3370(c)(6)(D)(iii).

⁶ See, Proposed 86 Ill. Admin. Code 100.3370(c)(6)(D)(iii) Example 5.

⁷ Id.

⁸ Id.

⁹ 35 ILCS § 5/304(a)(3)(c-5)(iv).

¹⁰ 86 Ill. Admin. Code 100.3405(b)(1).

In the case of an entity without a fixed place of business in the state, 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."¹¹ 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."¹²

In the proposed regulation, 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 proposed regulation, 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.¹³

In attempting to reconcile the proposed 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.

Considerations

Based on the potential changes to sourcing of services, investment management taxpayers should consult with their tax advisers to analyze the implications for their Illinois income tax obligations. While the proposed regulations have yet to be adopted, any promulgated changes may potentially be retroactive to tax years ending on or after December 31, 2008.

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¹¹ 35 ILCS § 5/304(a)(3)(c-5)(iv).

¹² Id.

¹³ Proposed 86 Ill. Admin. Code 100.3370(c)(6)(D)(iv).