

DEPARTMENT OF REVENUE

NOTICE OF PROPOSED AMENDMENT

- 1) Heading of the Part: Income Tax
- 2) Code Citation: 86 Ill. Adm. Code 100
- 3) Section Number: 100.3380 Proposed Action: Amendment
- 4) Statutory Authority: 35 ILCS 5/304(f)
- 5) A Complete Description of the Subjects and Issues Involved: This amendment prescribes the proper sales factor treatment of gains and losses from hedging transactions; that is, transactions specifically identified by the taxpayer for federal income tax purposes as entered into by the taxpayer for purposes of hedging against the effect on profits or costs of business transactions that result from fluctuations in interest rates, prices or currency exchange rates. The rulemaking requires taxpayers to treat these gains and losses as adjustments to the dollar amounts of the hedged transactions, rather than as separate transactions, in computing the sales factor.
- 6) Published studies or reports and sources of underlying data used to compose this rulemaking: None
- 7) Will this rulemaking replace any emergency rule currently in effect? No
- 8) Does this rulemaking contain an automatic repeal date? No
- 9) Does this rulemaking contain incorporations by reference? No
- 10) Are there any other rulemakings pending on this Part? Yes

<u>Section Number:</u>	<u>Proposed Action:</u>	<u>Illinois Register Citation:</u>
100.3450	New Section	38 Ill. Reg. 21758; November 21, 2014
- 11) Statement of Statewide Policy Objective: This rulemaking does not create a State mandate, nor does it modify any existing State mandates.
- 12) Time, Place and Manner in which interested persons may comment on this rulemaking: Persons who wish to submit comments on this rulemaking may submit them in writing by no later than 45 days after publication of this Notice to:

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217/524-3951

- 13) Initial Regulatory Flexibility Analysis:
 - A) Types of small businesses, small municipalities and not-for-profit corporations affected: This rulemaking applies to all partnerships, subchapter S corporations and trusts on income passed through to their partners, shareholders and beneficiaries.
 - B) Reporting, bookkeeping or other procedures required for compliance: None
 - C) Types of professional skills necessary for compliance: None
- 14) Regulatory Agenda on which this rulemaking was summarized: January 2015

The full text of the Proposed Amendment begins on the next page:

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100.2120	Jobs Tax Credit; Enterprise Zone and Foreign Trade Zone or Sub-Zone and River Edge Redevelopment Zone (IITA Section 201(g))
100.2130	Investment Credit; High Impact Business (IITA 201(h))
100.2140	Credit Against Income Tax for Replacement Tax (IITA 201(i))
100.2150	Training Expense Credit (IITA 201(j))
100.2160	Research and Development Credit (IITA Section 201(k))
100.2163	Environmental Remediation Credit (IITA 201(l))
100.2165	Education Expense Credit (IITA 201(m))
100.2170	Tax Credits for Coal Research and Coal Utilization Equipment (IITA 206)
100.2171	Angel Investment Credit (IITA 220)
100.2180	Credit for Residential Real Property Taxes (IITA 208)
100.2185	Film Production Services Credit (IITA Section 213)
100.2190	Tax Credit for Affordable Housing Donations (IITA Section 214)
100.2193	Student-Assistance Contributions Credit (IITA 218)
100.2195	Dependent Care Assistance Program Tax Credit (IITA 210)
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100.2197	Foreign Tax Credit (IITA Section 601(b)(3))

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- 100.2210 Net Operating Losses Occurring Prior to December 31, 1986, of Unitary Business Groups: Treatment by Members of the Unitary Business Group (IITA Section 202) – Definitions
- 100.2220 Net Operating Losses Occurring Prior to December 31, 1986, of Unitary Business Groups: Treatment by Members of the Unitary Business Group. (IITA Section 202) – Current Net Operating Losses: Offsets Between Members
- 100.2230 Net Operating Losses Occurring Prior to December 31, 1986, of Unitary Business Groups: Treatment by Members of the Unitary Business Group. (IITA Section 202) – Carrybacks and Carryforwards
- 100.2240 Net Operating Losses Occurring Prior to December 31, 1986, of Unitary Business Groups: Treatment by Members of the Unitary Business Group: (IITA Section 202) – Effect of Combined Net Operating Loss in Computing Illinois Base Income
- 100.2250 Net Operating Losses Occurring Prior to December 31, 1986, of Unitary Business Groups: Treatment by Members of the Unitary Business Group: (IITA Section 202) – Deadline for Filing Claims Based on Net Operating Losses Carried Back From a Combined Apportionment Year

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- 100.2430 Addition and Subtraction Modifications for Transactions with 80-20 and Noncombination Rule Companies
- 100.2435 Addition Modification for Student-Assistance Contribution Credit (IITA Sections 203(a)(2)(D-23), (b)(2)(E-16), (c)(2)(G-15), (d)(2)(D-10))
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Include Members Using Three-Factor and Single-Factor Formulas

AUTHORITY: Implementing the Illinois Income Tax Act [35 ILCS 5] and authorized by Section 1401 of the Illinois Income Tax Act [35 ILCS 5/1401].

SOURCE: Filed July 14, 1971, effective July 24, 1971; amended at 2 Ill. Reg. 49, p. 84, effective November 29, 1978; amended at 5 Ill. Reg. 813, effective January 7, 1981; amended at 5 Ill. Reg. 4617, effective April 14, 1981; amended at 5 Ill. Reg. 4624, effective April 14, 1981; amended at 5 Ill. Reg. 5537, effective May 7, 1981; amended at 5 Ill. Reg. 5705, effective May 20, 1981; amended at 5 Ill. Reg. 5883, effective May 20, 1981; amended at 5 Ill. Reg. 6843, effective June 16, 1981; amended at 5 Ill. Reg. 13244, effective November 13, 1981; amended at 5 Ill. Reg. 13724, effective November 30, 1981; amended at 6 Ill. Reg. 579, effective December 29, 1981; amended at 6 Ill. Reg. 9701, effective July 26, 1982; amended at 7 Ill. Reg. 399, effective December 28, 1982; amended at 8 Ill. Reg. 6184, effective April 24, 1984; codified at 8 Ill. Reg. 19574; amended at 9 Ill. Reg. 16986, effective October 21, 1985; amended at 9 Ill. Reg. 685, effective December 31, 1985; amended at 10 Ill. Reg. 7913, effective April 28, 1986; amended at 10 Ill. Reg. 19512, effective November 3, 1986; amended at 10 Ill. Reg. 21941, effective December 15, 1986; amended at 11 Ill. Reg. 831, effective December 24, 1986; amended at 11 Ill. Reg. 2450, effective January 20, 1987; amended at 11 Ill. Reg. 12410, effective July 8, 1987; amended at 11 Ill. Reg. 17782, effective October 16, 1987; amended at 12 Ill. Reg. 4865, effective February 25, 1988; amended at 12 Ill. Reg. 6748, effective March 25, 1988; amended at 12 Ill. Reg. 11766, effective July 1, 1988; amended at 12 Ill. Reg. 14307, effective August 29, 1988; amended at 13 Ill. Reg. 8917, effective May 30, 1989; amended at 13 Ill. Reg. 10952, effective June 26, 1989; amended at 14 Ill. Reg. 4558, effective March 8, 1990; amended at 14 Ill. Reg. 6810, effective April 19, 1990; amended at 14 Ill. Reg. 10082, effective June 7, 1990; amended at 14 Ill. Reg. 16012, effective September 17, 1990; emergency amendment at 17 Ill. Reg. 473, effective December 22, 1992, for a maximum of 150 days; amended at 17 Ill. Reg. 8869, effective June 2, 1993; amended at 17 Ill. Reg. 13776, effective August 9, 1993; recodified at 17 Ill. Reg. 14189; amended at 17 Ill. Reg. 19632, effective

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November 1, 1993; amended at 17 Ill. Reg. 19966, effective November 9, 1993; amended at 18 Ill. Reg. 1510, effective January 13, 1994; amended at 18 Ill. Reg. 2494, effective January 28, 1994; amended at 18 Ill. Reg. 7768, effective May 4, 1994; amended at 19 Ill. Reg. 1839, effective February 6, 1995; amended at 19 Ill. Reg. 5824, effective March 31, 1995; emergency amendment at 20 Ill. Reg. 1616, effective January 9, 1996, for a maximum of 150 days; amended at 20 Ill. Reg. 6981, effective May 7, 1996; amended at 20 Ill. Reg. 10706, effective July 29, 1996; amended at 20 Ill. Reg. 13365, effective September 27, 1996; amended at 20 Ill. Reg. 14617, effective October 29, 1996; amended at 21 Ill. Reg. 958, effective January 6, 1997; emergency amendment at 21 Ill. Reg. 2969, effective February 24, 1997, for a maximum of 150 days; emergency expired July 24, 1997; amended at 22 Ill. Reg. 2234, effective January 9, 1998; amended at 22 Ill. Reg. 19033, effective October 1, 1998; amended at 22 Ill. Reg. 21623, effective December 15, 1998; amended at 23 Ill. Reg. 3808, effective March 11, 1999; amended at 24 Ill. Reg. 10593, effective July 7, 2000; amended at 24 Ill. Reg. 12068, effective July 26, 2000; emergency amendment at 24 Ill. Reg. 17585, effective November 17, 2000, for a maximum of 150 days; amended at 24 Ill. Reg. 18731, effective December 11, 2000; amended at 25 Ill. Reg. 4640, effective March 15, 2001; amended at 25 Ill. Reg. 4929, effective March 23, 2001; amended at 25 Ill. Reg. 5374, effective April 2, 2001; amended at 25 Ill. Reg. 6687, effective May 9, 2001; amended at 25 Ill. Reg. 7250, effective May 25, 2001; amended at 25 Ill. Reg. 8333, effective June 22, 2001; amended at 26 Ill. Reg. 192, effective December 20, 2001; amended at 26 Ill. Reg. 1274, effective January 15, 2002; amended at 26 Ill. Reg. 9854, effective June 20, 2002; amended at 26 Ill. Reg. 13237, effective August 23, 2002; amended at 26 Ill. Reg. 15304, effective October 9, 2002; amended at 26 Ill. Reg. 17250, effective November 18, 2002; amended at 27 Ill. Reg. 13536, effective July 28, 2003; amended at 27 Ill. Reg. 18225, effective November 17, 2003; emergency amendment at 27 Ill. Reg. 18464, effective November 20, 2003, for a maximum of 150 days; emergency expired April 17, 2004; amended at 28 Ill. Reg. 1378, effective January 12, 2004; amended at 28 Ill. Reg. 5694, effective March 17, 2004; amended at 28 Ill. Reg. 7125, effective April 29, 2004; amended at 28 Ill. Reg. 8881, effective June 11, 2004; emergency amendment at 28 Ill. Reg. 14271, effective October 18, 2004, for a maximum of 150 days; amended at 28 Ill. Reg. 14868, effective October 26, 2004; emergency amendment at 28 Ill. Reg. 15858, effective November 29, 2004, for a maximum of 150 days; amended at 29 Ill. Reg. 2420, effective January 28, 2005; amended at 29 Ill. Reg. 6986, effective April 26, 2005; amended at 29 Ill. Reg. 13211, effective August 15, 2005; amended at 29 Ill. Reg. 20516, effective December 2, 2005; amended at 30 Ill. Reg. 6389, effective March 30, 2006; amended at 30 Ill. Reg. 10473, effective May 23, 2006; amended by 30 Ill. Reg. 13890, effective August 1, 2006; amended at 30 Ill. Reg. 18739, effective November 20, 2006; amended at 31 Ill. Reg. 16240, effective November 26, 2007; amended at 32 Ill. Reg. 872, effective January 7, 2008; amended at 32 Ill. Reg. 1407, effective January 17, 2008; amended at 32 Ill. Reg. 3400, effective February 25, 2008; amended at 32 Ill. Reg. 6055, effective March 25, 2008; amended at 32 Ill. Reg. 10170, effective June 30, 2008; amended at 32 Ill. Reg. 13223, effective July 24, 2008;

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amended at 32 Ill. Reg. 17492, effective October 24, 2008; amended at 33 Ill. Reg. 1195, effective December 31, 2008; amended at 33 Ill. Reg. 2306, effective January 23, 2009; amended at 33 Ill. Reg. 14168, effective September 28, 2009; amended at 33 Ill. Reg. 15044, effective October 26, 2009; amended at 34 Ill. Reg. 550, effective December 22, 2009; amended at 34 Ill. Reg. 3886, effective March 12, 2010; amended at 34 Ill. Reg. 12891, effective August 19, 2010; amended at 35 Ill. Reg. 4223, effective February 25, 2011; amended at 35 Ill. Reg. 15092, effective August 24, 2011; amended at 36 Ill. Reg. 2363, effective January 25, 2012; amended at 36 Ill. Reg. 9247, effective June 5, 2012; amended at 37 Ill. Reg. 5823, effective April 19, 2013; amended at 37 Ill. Reg. 20751, effective December 13, 2013; recodified at 38 Ill. Reg. 4527; amended at 38 Ill. Reg. 9550, effective April 21, 2014; amended at 38 Ill. Reg. 13941, effective June 19, 2014; amended at 38 Ill. Reg. 15994, effective July 9, 2014; amended at 38 Ill. Reg. 17043, effective July 23, 2014; amended at 38 Ill. Reg. 18568, effective August 20, 2014; amended at 38 Ill. Reg. 23158, effective November 21, 2014; emergency amendment at 39 Ill. Reg. 483, effective December 23, 2014, for a maximum of 150 days; amended at 39 Ill. Reg. 1768, effective January 7, 2015; amended at 39 Ill. Reg. 5057, effective March 17, 2015; amended at 39 Ill. Reg. 6884, effective April 29, 2015; amended at 39 Ill. Reg. _____, effective _____.

SUBPART M: BUSINESS INCOME OF PERSONS OTHER THAN RESIDENTS

Section 100.3380 Special Rules (IITA Section 304)

- a) Determining Business Activity Within Illinois
 - 1) Petition

IITA Section 304(f) provides that *if the allocation and apportionment provisions of subsections (a) through (e) and of subsection (h) do not fairly represent the extent of a person's business activity in this State, the person may petition for, or the Director may require, in respect of all or any part of the person's business activity, if reasonable:*

 - A) *Separate accounting;*
 - B) *The exclusion of any one or more factors;*
 - C) *The inclusion of one or more additional factors which will fairly represent the person's business activities in this State; or*
 - D) *The employment of any other method to effectuate an equitable*

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allocation and apportionment of the person's business income.

2) Director's Determination

The Director has determined that, in the instances described in this Section, the apportionment provisions provided in subsections (a) through (e) and (h) of IITA Section 304 do not fairly represent the extent of a person's business activity within Illinois. For tax years beginning on or after the effective date of a rulemaking amending this Section to prescribe a specific method of apportioning business income, all nonresident taxpayers are directed to apportion their business income employing that method in order to properly apportion their business income to Illinois. Taxpayers whose business activity within Illinois is not fairly represented by a method prescribed in this Section and who do not want to use that method for a tax year beginning after the effective date of the rulemaking adopting that method must file a petition under Section 100.3390 of this Part requesting permission to use an alternative method of apportionment. For tax years beginning prior to the effective date of the rulemaking adopting a method of apportioning business income, the Department will not require a taxpayer to adopt that method; provided, however, if any taxpayer has used that method for any such tax year, the taxpayer must continue to use that method that tax year. Moreover, a taxpayer may file a petition under Section 100.3390 of this Part to use a method of apportionment prescribed in this Section for any open tax year beginning prior to the effective date of the rulemaking adopting that method, and such petition shall be granted in the absence of facts showing that such method will not fairly represent the extent of a person's business activity in Illinois.

b) Property Factor. The following special rules are established in respect to the property factor in IITA Section 304(a)(1):

- 1) If the subrents taken into account in determining the net annual rental rate under Section 100.3350(c) of this Part produce a negative or clearly inaccurate value for any item of property, another method that will properly reflect the value of rented property may be required by the Director or requested by the person. In no case however shall the value be less than an amount that bears the same ratio to the annual rental rate paid by the person for the property as the fair market value of that portion of the property used by the person bears to the total fair market value of the

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rented property.

Example: A corporation rents a 10-story building at an annual rental rate of \$1,000,000. The corporation occupies two stories and sublets eight stories for \$1,000,000 a year. The net annual rental rate of the taxpayer must not be less than two-tenths of the corporation annual rental rate for the entire year, or \$200,000.

- 2) If property owned by others is used by the person at no charge or rented by the person for a nominal rate, the net annual rental rate for the property shall be determined on the basis of a reasonable market rental rate for such property.
- c) Sales Factor. The following special rules are established in respect to the sales factor in IITA Section 304(a)(3):
 - 1) In the case of sales ~~in which~~~~where~~ neither the origin nor the destination of the sale is within this State, and the person is taxable in neither the state of origin nor the state of destination, the sale will be attributed to this State (and included in the numerator of the sales factor) if the person's activities in this State in connection with the sales are not protected by the provisions of P.L. 86-272, 15 USC 381-385. Although P.L. 86-272, by its terms covers only sales of tangible personal property, its rules regarding a state's power to impose a net income tax, for purposes of this special rule, will be applied whether the sale is of tangible or intangible property.

Example: A corporation's salesman operates out of an office in Illinois. He regularly calls on customers both within and without Illinois. Orders are approved by him and transmitted to the corporation's headquarters in State A. If the property sold by the salesman is shipped from a state in which the corporation is not taxable to a purchaser in a state in which the corporation is not taxable, the sale is attributable to Illinois.
 - 2) ~~When~~~~Where~~ gross receipts arise from an incidental or occasional sale of assets used in the regular course of the person's trade or business, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.
 - 3) ~~When~~~~Where~~ the income producing activity in respect to business income

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from intangible personal property can be readily identified, such income is included in the denominator of the sales factor and, if the income producing activity occurs in this State, in the numerator of the sales factor as well. For example, usually the income producing activity can be readily identified in respect to interest income received on deferred payments on sales of tangible property (see Section 100.3370(a)(1)(A) ~~of this Part~~).

- 4) ~~When~~Where business income from intangible property cannot readily be attributed to any income producing activity of the person, the income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. The following provisions illustrate this concept:
 - A) Subpart F (26 ~~USC~~USCA 951-964) income is passive income generated by the mere holding of an intangible. For taxable years ending on or after December 31, 1995, ~~subpart~~Subpart F income is excluded from the sales factor under IITA Section 304(a)(3)(D). For prior taxable years, there is a rebuttable presumption that ~~subpart~~Subpart F income is not includable in either the numerator or the denominator of the sales factor. If a taxpayer wishes to include ~~subpart~~Subpart F income in either the numerator or the denominator of the sales factor, the burden of proof is on the taxpayer to identify the income producing activities and to situs those activities within a particular state, or
 - B) ~~When~~where business income in the form of dividends received on stock during taxable years ending before December 31, 1995, or interest received on bonds, debentures or government securities results from the mere holding of intangible personal property by the person, ~~those~~such dividends and interest shall be excluded from the denominator of the sales factor.
- 5) In the case of sales of business intangibles (including, by means of example, without limitation, patents, copyrights, bonds, stocks and other securities), gross receipts shall be disregarded and only the net gain (loss) shall be included in the sales factor.

EXAMPLE: In 1990, Corporation A, a calendar year taxpayer, sells stock

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with an adjusted basis of \$98,000,000 for \$100,000,000, realizing a federal net capital gain of \$2,000,000. Only the net capital gain of \$2,000,000 is reflected in A's sales factor for the taxable year ending December 31, 1990.

6) Hedging Transactions

A) A "hedging transaction" is a transaction entered into by a taxpayer in the normal course of business primarily to manage interest rate risk or the risk of price or currency fluctuations. (See 26 USC 475(c)(3), 1221(b)(2)(A) and 1256(e)(2).) The purpose of the sales factor in IITA Section 304(a) is to apportion the business income of a taxpayer conducting an interstate business to this State based on this State's relative share of the marketplace for the goods and services sold by the taxpayer in the course of its business. Gains and losses on hedging transactions entered into to manage the risks associated with the acquisition of resources by a taxpayer (for example, price fluctuations in commodities consumed in the taxpayer's business) do not reflect the market for the taxpayer's goods and services and, therefore, should be excluded from the sales factor. Gains and losses on hedging transactions entered into to manage risks associated with the gross income the taxpayer expects from its sales of goods and services (for example, the effect of foreign currency fluctuations on the dollar amount of gross income the taxpayer will receive from sales to a particular foreign country) are best accounted for in the sales factor as adjustments to the gross receipts from the transactions whose risks are being hedged. Gains and losses on hedging transactions that manage risks associated with both acquisitions and sales of the taxpayer (for example, interest rate risks of a bank), or that otherwise cannot be associated with a particular transaction or class of transactions in the computation of the sales factor, should be excluded from the sales factor. Federal income tax law provides a framework for identifying gains and losses from hedging transactions to the transactions or class of transactions being hedged and for keeping records necessary to support the identifications. The federal practice should be followed for State purposes.

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- B) General Rule. Except as provided in subsection (c)(6)(C), any income, gain or loss from a transaction defined as a hedge under the Internal Revenue Code (such as under 26 USC 1221(b)(2)(A) or 475(c)(3)) is excluded from the numerator and denominator of the sales factor.
- C) Special Rule. With respect to any hedging transaction described in subsection (c)(6)(B) as to which identification requirements of subsection (c)(6)(D) are satisfied, any income, gain or loss from the hedging transaction shall be included in the denominator of the sales factor if the gross receipts from the hedged item are included in the denominator. That income, gain or loss shall be included in the numerator of the sales factor if the gross receipts from the hedged item are included in the numerator of the sales factor, and shall be excluded from the numerator of the sales factor if the gross receipts from the hedged item are excluded from the numerator of the sales factor. If the hedging transaction relates to an identified group of hedged items, the income, gain or loss from the hedging transaction is included in the numerator of the sales factor in the same proportion that the gross receipts from the group of hedged items are included in the numerator of the sales factor.
- D) Identification Required. The identification requirements of this subsection (c)(6)(D) are met if the taxpayer's books and records clearly identify a hedging transaction as managing risk relating to a particular item or items of gross receipts, including anticipated items of gross receipts, that must be included in the sales factor. The identification must be made at the time and in the manner required under 26 CFR 1.1221-2(f) and must identify the statutory basis for assigning gross receipts from the hedged item or items and the extent to which gross receipts from the hedged item or items are assigned to the numerator of the sales factor or expected to be assigned to the numerator of the sales factor. If the taxpayer enters into a hedging transaction managing risk relating to a particular item or items of gross receipts that must be included in the sales factor but fails to satisfy the requirements of this subsection (c)(6)(D) and, based on all the facts and circumstances, the Department determines that the item or items of gross receipts are in substance hedged, the Department may apply the provisions

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of subsection (c)(6)(C) as if the taxpayer had satisfied the requirements of this subsection (c)(6)(D).

- E) This subsection (c)(6) does not apply to any hedging transaction that, for federal income tax purposes, is integrated with the hedged item, such as under 26 CFR 1.988-5 or 1.1275-6.
- F) EXAMPLES: The provisions of this subsection (c)(6) may be illustrated by the following examples:
- i) Taxpayer expects that, during its next production cycle, it will need 10 tons of commodity Y for its interstate manufacturing business. Commodity Y is a raw material used by Taxpayer in the manufacture of its inventory. In order to hedge against exposure to changes in the price of commodity Y, Taxpayer enters into a forward contract to purchase 10 tons of commodity Y. The forward contract is a hedging transaction under IRC section 1221(b)(2)(A). Under subsection (c)(6)(B), any income, gain or loss recognized with respect to the forward contract is excluded from the numerator and denominator of the sales factor.
- ii) On January 1, 2008, Taxpayer owns 10 tons of commodity X, which it holds for sale in the ordinary course of business and expects to sell during its taxable year ending December 31, 2008. To hedge against price fluctuations in commodity X, on January 10, 2008, while Taxpayer still owns commodity X, it sells the equivalent of 10 tons of commodity X futures contracts on a futures exchange. Taxpayer expects to sell commodity X to customers in various states, including Illinois. The futures contract is a hedging transaction under IRC section 1221(b)(2)(A), and Taxpayer properly identifies the futures contract as required under subsection (c)(6)(D) as hedging gross receipts from sales of commodity X. Under subsection (c)(6)(C), any gain or loss taken into account by Taxpayer during its taxable year with respect to the futures contract is included in the denominator of the sales factor, and is included in the numerator of the sales factor in the same

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proportion that gross receipts from actual sales of commodity X during the taxable year are included in the numerator of the sales factor. If a loss is recognized on the futures contract, the loss is treated as a reduction (but not below zero) of the gross receipts from the sale of commodity X in computing the sales factor.

- iii) Taxpayer is a corporation on the accrual method of accounting with the U.S. dollar as its functional currency. On January 1, 2008, Taxpayer acquires 1,500 British pounds (£) for \$2,250 (£1 = \$1.50). The acquisition of £1,500 is properly identified by Taxpayer as a hedging transaction under IRC section 1221(b)(2)(A). On February 5, 2008, when the spot rate is £1 = \$1.55, Taxpayer purchases inventory from its supplier by paying £1,500. Accordingly, Taxpayer recognizes \$75 exchange gain for federal income tax purposes upon disposition of the British pounds. The \$75 exchange gain is excluded from both the numerator and denominator of the sales factor under subsection (c)(6)(B).
- iv) Taxpayer is a calendar year corporation with the U.S. dollar as its functional currency. Based on past experience, Taxpayer anticipates making 2009 first quarter sales to customers in New Zealand of 100,000 New Zealand dollars (NZD). In order to hedge against currency fluctuations related to the anticipated first quarter sales, on December 31, 2008, Taxpayer enters into a forward contract to sell 100,000 NZD on March 31, 2009 for \$48,000. The forward contract is a hedging transaction under 26 USC 1221(b)(2)(A), and the Taxpayer properly identifies the transaction as hedging its anticipated New Zealand sales in accordance with subsection (c)(6)(D). During the first quarter of its 2009 taxable year, Taxpayer makes sales to its New Zealand customers of 90,000 NZD. Under IITA Section 304(a), gross receipts from its New Zealand sales are included in the denominator of the Taxpayer's sales factor and are excluded from the numerator of the sales factor. Under subsection (c)(6)(C), any gain or loss

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recognized on the forward contract is included in the denominator of the Taxpayer's sales factor and is excluded from the numerator of the factor. This treatment is required even though the Taxpayer's sales to New Zealand customers were less than anticipated. Any loss recognized on the forward contract is treated as a reduction (but not below zero) of the gross receipts from sales to New Zealand customers that are included in the denominator of the sales factor.

7) Section 988 Transactions

- A) Section 988 Transactions. For sales factor purposes, foreign currency gain or loss that is computed under 26 USC 988, with respect to accrued interest income or expense, gain or loss on a debt instrument, a payable, a receivable or a forward contract payable in a foreign currency described in 26 CFR 1.988-1(a)(2) is treated as an adjustment to the income, expense, gain or loss. Accordingly, the foreign currency gain or loss is included in the numerator and denominator of the sales factor only to the extent that the interest income to which the foreign currency gain or loss relates is included in the numerator and denominator of the sales factor. Foreign currency gains and losses with respect to interest expense are excluded from the numerator and denominator of the sales factor.

EXAMPLES: The provisions of this subsection (c)(7)(A) may be illustrated by the following examples:

- i) Taxpayer is a corporation on the accrual method of accounting with the U.S. dollar as its functional currency. On January 1, 2008, Taxpayer converts \$13,000 to 10,000 British pounds (£) at the spot rate of £1 = \$1.30 and loans the £10,000 to Y for 3 years. The terms of the loan provide that Y will make interest payments of £1,000 on December 31 of 2008, 2009 and 2010 and will repay Taxpayer's £10,000 principal on December 31, 2010. Based on average spot rates for 2008, 2009 and 2010 of £1 = \$1.32, £1 = \$1.37 and £1 = \$1.42, respectively, Taxpayer accrues

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interest income of \$1,320 for 2008, \$1,370 for 2009, and \$1,420 for 2010. Under IITA Section 304(a), the accrued interest income is included in the denominator of Taxpayer's sales factor, but is excluded from the numerator of its sales factor. Based on spot rates on December 31, 2008, December 31, 2009 and December 31, 2010 of £1 = \$1.35, £1 = \$1.40 and £1 = \$1.45, respectively, Taxpayer recognizes for federal income tax purposes exchange gain of \$30 upon receipt of the interest on December 31 of 2008, 2009 and 2010. In addition, Taxpayer recognizes, for federal income tax purposes, exchange gain of \$1,500 upon repayment of the loan principal on December 31, 2010. Under subsection (c)(7)(A), the \$30 of exchange gain recognized with respect to the accrued interest for 2008, 2009 and 2010 is included in the denominator of Taxpayer's sales factor and is excluded from the numerator of its sales factor. The \$1,500 of exchange gain with respect to the repayment of principal on December 31, 2010 is excluded from both the numerator and denominator of Taxpayer's sales factor because repayment of principal on a loan is not included in the sales factor.

- ii) Taxpayer is a corporation on the accrual method of accounting with the U.S. dollar as its functional currency. On January 15, 2008, Taxpayer sells inventory for 10,000 Canadian dollars (C\$). The spot rate on January 15, 2008 is C\$1 = U.S. \$.55. Under IITA Section 304(a), \$5,500 in gross receipts from this sale is included in the denominator of Taxpayer's sales factor, and is excluded from the numerator of the sales factor. On February 23, 2008, when Taxpayer receives payment of the C\$10,000, the spot rate is C\$1 = U.S. \$.50. For federal income tax purposes, Taxpayer recognizes (\$500) of exchange loss upon receipt of C\$10,000 on February 23, 2008. Under subsection (c)(7)(A), the (\$500) exchange loss with respect to the January 15, 2008 sale is included in the denominator of the Taxpayer's sales factor and is excluded from the numerator of the sales factor. The exchange loss is reflected as a reduction of the denominator of the Taxpayer's sales factor.

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- B) Section 986(c)(1) Foreign Exchange Gain or Loss on Distributions of Previously Taxed Income. For taxable years ending on or after December 31, 1995, foreign currency gain or loss recognized pursuant to 26 USC 986(c)(1) on distributions of amounts previously taxed to the recipient as subpart F income or as earnings of a qualified electing fund shall be excluded from both the numerator and denominator of the sales factor because those distributions are excluded from federal gross income and, therefore, from the sales factor.
- d) Unitary Partners: Inclusion of shares of partnership unitary business income and factors in combined unitary business income and factors of partners.
- 1) IITA Section 304(e) provides that whenever *2 or more persons are engaged in a unitary business as described in IITA Section 1501(a)(27), a part of which is conducted in this State by one or more members of the group, the business income attributable to this State by any such member or members shall be apportioned by means of the combined apportionment method.* Because partnerships may be members of a unitary business group within the meaning of IITA Section 1501(a)(27), this provision requires a partnership to use combined apportionment when it is engaged in a unitary business with one or more of its partners. However, partners who are not engaged in a unitary business with the partnership are required to include their shares of the partnership's business income apportioned to Illinois in their Illinois net incomes under IITA Section 305(a), and those partners' business activities in Illinois would not be represented fairly by their shares of partnership income computed by combining the business income and apportionment factors of the partnership with the business income and apportionment factors of its unitary partners.
 - 2) Accordingly, except in a case in which substantially all of the interests in the partnership (other than a publicly-traded partnership under section 7704 of the Internal Revenue Code) are owned or controlled by members of the same unitary business group, when the business activities of a partnership and any of its partners' business activities constitute a unitary business:

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- A) The partner's distributive share of the business income and apportionment factors of the partnership shall be included in that partner's business income and apportionment factors. In determining the business income of the partnership, transactions between the unitary partner (or members of its unitary business group) and the partnership shall not be eliminated. However, all transactions between the unitary business group and the partnership shall be eliminated for purposes of computing the apportionment factors of the partner and of any other member of the unitary business group.

EXAMPLE: Partner and Partnership are engaged in a unitary business. Partner owns a 20% interest in Partnership. Partnership has \$10,000,000 in sales everywhere, \$3,000,000 of which are to Partner, and \$4,000,000 in Illinois sales, \$1,000,000 of which are to Partner. In computing its apportionment factor, Partner will include \$1,400,000 from Partnership in its everywhere sales (20% of Partnership's \$10,000,000 in everywhere sales, after eliminating the \$3,000,000 in sales to Partner) and \$600,000 from Partnership in its Illinois sales (20% of Partnership's \$4,000,000 in Illinois sales, after eliminating the \$1,000,000 in sales to Partner). Also, Partner must eliminate any sales it made to Partnership.

- B) If a partnership and one of its partners are engaged in a unitary business and the partnership is itself a partner in a second partnership:
- i) If the partner is not engaged in a unitary business with the second partnership, the partner's share of the first partnership's share of the business income and apportionment factors of the second partnership shall not be included in the partner's business income and apportionment factors. Instead, the partner's share of the first partnership's share of the base income apportioned to Illinois by the second partnership will be included in the partner's Illinois net income.
 - ii) If the partner is engaged in a unitary business with the second partnership, the partner's share of the first

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partnership's share of the business income and apportionment factors of the second partnership shall be included in the partner's business income and apportionment factors.

- 3) This subsection (d) shall not apply to a partner's shares of business income and apportionment factors from any partnership that cannot be included in a unitary business group with that partner because:
 - A) the partner and the partnership are required to apportion their business income using different apportionment formulas under IITA Section 304, and therefore cannot be members of a unitary business group under IITA Section 1501(a)(27); or
 - B) the business activities of either the partner or the partnership outside the United States are equal to or greater than 80% of the total worldwide business activities of that partner or partnership, as determined under Section 1502(a)(27) of the IITA. In applying this 80-20 test to a taxpayer, no apportionment factors of any partnership shall be included in the apportionment factors of that taxpayer pursuant to this subsection (d).

If the partnership is itself a partner in a second partnership, and one of its partners is engaged in a unitary business with the second partnership and is not prohibited from being a member of a unitary business group that includes the second partnership under subsection (d)(3)(A) or (B), that partner shall include in its business income and apportionment factors its share of the partnership's share of the second partnership's business income and apportionment factors.

- 4) If substantially all of the interests in a partnership (other than a publicly-traded partnership under section 7704 of the Internal Revenue Code) are owned or controlled by members of the same unitary business group, the partnership shall be treated as a member of the unitary business group for all purposes, and, for purposes of applying IITA Section 305(a) to any nonresident partner who is not a member of the same unitary business group, the business income of the partnership apportioned to this State shall be determined using the combined apportionment method prescribed

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by IITA Section 304(e). For purposes of this subsection (d), substantially all of the interests in a partnership are owned or controlled by members of the same unitary business group if more than 90% of the federal taxable income of the partnership is allocable to one or more of the following persons:

- A) any member of the unitary business group;
 - B) any person who would be a member of the unitary business group if not for the fact that 80% or more of such person's business activities are conducted outside the United States;
 - C) any person who would be a member of the unitary business group except for the fact that such person and the partnership apportion their business incomes under different subsections of IITA Section 304; or
 - D) any person who would be disallowed a deduction for losses by paragraphs (b), (c), and (f)(1) of section 267 of the Internal Revenue Code by virtue of being related to any person described in subsections (d)(4)(A), (B) or (C) of this Section, as well as any partnership in which a person described in subsections (d)(4)(A), (B) or (C) is a partner.
- 5) **EXAMPLE:** Corporation A owns a 50% interest in P-1, a partnership. Corporation A and P-1 are engaged in a unitary business within the meaning of IITA Section 1501(a)(27). P-1 itself conducts no business activities in Illinois, and the Illinois numerator of its apportionment factor is zero. P-1 holds a 50% interest in P-2, a partnership doing business exclusively in Illinois. P-1 has \$1.4 million of taxable business income, not including any income from P-2. P-2 has base income of \$1 million, all of which is business income, and on a separate-entity basis, all of its business income would be apportioned to Illinois.

If Corporation A and P-2 are not members of the same unitary business group, Corporation A would compute its business income apportioned to Illinois by including \$700,000 (50% of \$1.4 million) of P-1's business income in Corporation A's business income, and 50% of P-1's apportionment factors in its apportionment factors. Corporation A also

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would include in its Illinois net income its 50% share of P-1's 50% share of the base of P-2 apportionable to Illinois, or \$250,000 (50% of 50% of \$1 million).

If Corporation A, P-1 and P-2 are members of the same unitary business group, P-1 will include 50% of P-2's business income and 50% of P-2's apportionment factors in its own business income and apportionment factors. Accordingly, P-1's business income will be \$1.9 million (the \$1.4 million it earned directly plus its 50% share of P-2's \$1 million in business income). Corporation A will then compute its business income apportioned to Illinois by including its 50% share of P-1's business income, or \$950,000 (50% of \$1.9 million) with its business income and its 50% share of P-1's apportionment factors (which will include P-1's share of P-2's apportionment factors) in its apportionment factors.

If Corporation A, P-1 and P-2 are unitary, but P-1 cannot be included in a unitary business group with Corporation A and P-2 because those entities apportion their business income under IITA Section 304(a) and P-1 is a financial organization that apportions its business income under IITA Section 304(c), Corporation A will include in its business income and apportionment factors its 50% share of P-1's 50% share of the business income and apportionment factors of P-2. Also, Corporation A's Illinois net income will include 50% of the business income of P-1 apportioned to Illinois by P-1 using its own apportionment factors. Because, in this example, P-1 is not doing business in Illinois, none of its business income will be included in Corporation A's Illinois net income.

- e) Apportionment of Business Income by Foreign Taxpayers.
- 1) Under 26 USCA 882, foreign corporations include only effectively-connected income in their federal taxable income. Foreign taxpayers may exclude other items of income from their federal taxable income if authorized under treaty, as provided in 26 USCA 894. Using a foreign taxpayer's worldwide apportionment factors to determine how much of its domestic business income should be apportioned to Illinois would not fairly represent that taxpayer's business activities within Illinois. Accordingly, a foreign taxpayer shall use only the apportionment factors related to its domestic business income when apportioning its business income to Illinois. Similarly, in determining whether 80% or more of a

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foreign taxpayer's total business activity is conducted outside the United States for purposes of IITA Section 1501(a)(27), that taxpayer must use only the apportionment factors related to the business income included in its federal taxable income (plus addition modifications), rather than use all of its worldwide factors.

- 2) Foreign Sales Corporations. Under 26 USC 921, "exempt foreign trade income" of a foreign sales corporation is treated as foreign source income excluded from gross income. "Exempt foreign trade income" is defined in 26 USC 923 to equal the sum of the amounts of income derived from various categories of transaction, with the income from each category multiplied by specific percentages. As a general rule, there is no systematic relationship between transactions qualifying for this treatment and any particular item of property or payroll of a foreign sales corporation. Accordingly, the provisions of subsection (e)(1) of this Section shall not apply to a foreign sales corporation and, in apportioning its business income and in determining whether 80% or more of its business activity is conducted outside the United States, a foreign sales corporation shall use all of its apportionment factors.

(Source: Amended at 39 Ill. Reg. _____, effective _____)