IT 00-0041-GIL 04/24/2000 APPORTIONMENT – SALES FACTOR

General Information Letter: Payments to a partner for services rendered to a partnership are not expenses under GAAP and thus are not a "cost of performance" for purposes of determining whether a sale is sourced to Illinois.

April 24, 2000

Dear:

This is in response to your letter dated April 19, 2000, in which you request a letter ruling. The nature of your request and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. *See* 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www.revenue.state.il.us.

In your letter you have stated the following:

> The purpose of this letter is to request a general information letter, under 2 Ill Adm. Code 1200.120, to confirm that the activities of General Partner 2, as set forth below, will not create "cost of performance" in Illinois for its Investment Partnership for purposes of the Illinois personal property tax replacement tax. Immediately below are the facts which we believe would be relevant to those issues.
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> **FACTS**
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> 1. Our client is a limited investment partnership (hereafter "Investment Partnership") organized under the laws of xxxxxxxx. The Investment Partnership engages in speculative trading of commodity interests.
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> 2. The Investment Partnership has one limited partner (hereafter "Limited Partner"), and two general partners (hereafter "General Partner 1" and "General Partner 2").
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> 3. The Investment Partnership does not have any employees within Illinois or elsewhere. Likewise, the Investment Partnership does not own or lease any real or tangible personal property within Illinois or elsewhere. The Investment Partnership does not have an office in Illinois.
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> 4. The Limited Partner has invested in units of the Investment Partnership. The Limited Partner is excluded from management of the Investment Partnership and is not entitled to any salary, draw, or compensation from the Investment Partnership on account of an investment in the Investment Partnership.
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> 5. General Partner 1 is the Investment Partnership's commodity pool operator and is a xxxxxxxx corporation. General Partner 1 administers all the business and affairs of the Investment Partnership other than making the commodity trading decisions. General Partner 1's principal place of operations is outside the State of Illinois. General Partner 1 has no property or payroll in Illinois. All activities performed by General Partner 1 on behalf of the Investment Partnership are performed outside of the State of Illinois.

6. General Partner 2 has no tangible or real property or payroll and is a xxxxxxxx corporation. General Partner 2 is a subsidiary of the Investment Partnership's clearing broker (hereafter "Clearing Broker"). General Partner 2's principal place of business is in Illinois according to the prospectus issued to potential investors in the investment partnership.

7. General Partner 2 has agreed to perform certain administrative services for the Investment Partnership. Since General Partner 2 has no employees, these services are performed by the Clearing Broker. The Clearing Broker performs these functions in Illinois.

8. The Investment Partnership has entered into a brokerage services contract with a Clearing Broker (hereafter "Clearing Broker"). The Clearing Broker provides brokerage services to the Investment Partnership and other unrelated third parties from its principal place of business in Illinois.

9. The Investment Partnership has entered into an advisory contract with a corporation (hereafter "Advisor") to act as the Investment Partnership's commodity trading advisor. General Partner 1 has delegated all of the Investment Partnership's trading decisions to the Advisor and all trading decisions are made by the Advisor. The Advisor does not have any Illinois property or Illinois payroll.

10. The income of the Investment Partnership is from trading activities and is limited to interest, dividends and capital gains from the sale of intangible assets.

CONCLUSION OF THE TAXPAYER

The activities of General Partner 2 will not create "costs of performance" in Illinois for the Investment Partnership pursuant to the provisions of IITA Section 304 and Illinois Administrative Code Section 100.3370(c)(3)(A) because General Partner 2 has no Illinois property or Illinois payroll. Accordingly, the Investment Partnership does not have Illinois cost of performance because the Investment Partnership has no Illinois property, no Illinois employees and the activities of General Partner 1, General Partner 2, the Clearing Broker, and the Trading Advisor do not create Illinois cost of performance for the Investment Partnership.

Response

Section 304 of the Illinois Income Tax Act (the "IITA"; 35 ILCS 5/101 *et seq.*) provides the framework for apportioning a taxpayer's business income to Illinois by formula. The formula applicable to persons other than insurance companies, financial organizations and transportation companies is provided in Section 304(a) of the IITA, which provides that business income shall be apportioned to Illinois:

> by multiplying the income by a fraction, the numerator of which is the sum of the property factor (if any), the payroll factor (if any) and 200% of the sales factor (if any), and the denominator of which

> is 4 reduced by the number of factors other than the sales factor which have a denominator of zero and by an additional 2 if the sales factor has a denominator of zero. For tax years ending on or after December 31, 1998, and except as otherwise provided by this Section, persons other than residents who derive business income from this State and one or more other states shall compute their apportionment factor by weighting their property, payroll, and sales factors as provided in subsection (h) of this Section.

For purposes of computing the sales factor, Section 304(a)(3)(C) of the IITA provides:

> Sales, other than sales of tangible personal property, are in this State if:
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> (i) The income-producing activity is performed in this State; or
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> (ii) The income-producing activity is performed both within and without this State and a greater proportion of the income-producing activity is performed within this State than without this State, based on performance costs.

These provisions are explained in more detail by regulation in 86 Ill. Admin. Code Section 100.3370(c)(3)(A), which provides:

> Income producing activity defined. The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a person, such as those conducted on its behalf by an independent contractor.

86 Ill. Admin. Code Section 100.3370(c)(3)(B) provides:

> Costs of performance defined. The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the person.

You have represented that General Partner 2 conducts activities in Illinois on behalf of Investment Partnership. Because General Partner 2 has no employees, these activities are actually carried out by employees of Clearing Broker. You have asked whether these activities may create a "cost of performance" for Investment Partnership that could have the effect of allocating some of its sales to Illinois for sales factor purposes.

In Beams, ADVANCED ACCOUNTING (5th Ed. -- Prentice-Hall, Inc. 1992), it is stated on page 646:

> Although agreements to share profits and losses equally or in specified ratios are common, other more complex profit sharing agreements are also encountered in practice. An equitable division of profits (and losses) frequently requires that consideration be given to the time that partners devote to the partnership business and the capital invested in the business by individual partners. If

> one partner manages the partnership, the partnership agreement may allow the managing partner a salary allowance equal to the amount he or she could earn in an alternative employment opportunity before remaining profits are allocated. *Such salary allowances are, of course, only provisions of the profit sharing agreement and are not expenses of the partnership.* Similarly, if one partner invests significantly more than another in a partnership venture, the agreement may provide an interest allowance on capital investments before remaining profits are divided. As in the case of salary allowances, *interest allowances are merely provisions of the partnership agreement and have no effect on the measurement of partnership income.* (emphasis in the original)

See also Haried, Imdieke & Smith, ADVANCED ACCOUNTING 629, 634 (2d Ed. – John Wiley & Sons 1982); Cameron, Woelfel & Pattillo, ADVANCED ACCOUNTING: THEORY AND PRACTICE 389 (Houghton Mifflin Company 1979); Pahler & Mori, ADVANCED ACCOUNTING: CONCEPTS AND PRACTICE 628-34 (Harcourt Brace Jovanovich, Inc. 1981); Pyle and Larson, FUNDAMENTAL ACCOUNTING PRINCIPLES 472 (10th Ed. -- Richard D. Irwin, Inc. 1984); and Fischer, Taylor & Leer, ADVANCED ACCOUNTING 632-34 (2d Ed. South-Western Publishing Co. 1982).

Accordingly, no amount paid to General Partner 2 for its activities conducted on behalf of Investment Partnership is an expense under generally accepted accounting principles. Under 86 Ill. Admin. Code Section 100.3370(c)(3)(B), therefore, the activities of General Partner 2 cannot result in any cost of performance occurring within Illinois. Furthermore, 86 Ill. Admin. Code Section 100.3370(c)(3)(A) provides that activities performed for a taxpayer by third parties, such as the Clearing Broker in this case, are not income producing activities of the taxpayer. Accordingly, the activities of General Partner 2 (including those actually performed by employees of Clearing Broker) cannot cause any gross receipts of the Investment Partnership to be characterized as Illinois sales.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of the enclosed copy of Section 1200.110(b). If you have any further questions, you may contact me at (217) 782-7055.

Sincerely,

Paul S. Caselton
Deputy Chief Counsel -- Income Tax