

**ILLINOIS INDEPENDENT TAX TRIBUNAL
CHICAGO, ILLINOIS**

HFF HOLDINGS LLC,)	
)	
v.)	15-TT-75
ILLINOIS DEPARTMENT OF REVENUE,)	
Respondent.)	

ANSWER

NOW COMES the Department of Revenue of the State of Illinois (the “Department”), through its attorney, Lisa Madigan, Attorney General of and for the State of Illinois, and for its Answer to HFF Holdings LLC’s (the “Petitioner”) Petition, filed April 16, 2015 (the “Petition”), respectfully pleads as follows:

PARTIES

1. Petitioner is a Delaware limited liability company and is located at 301 Grant Street, Suite 1100, Pittsburgh, Pennsylvania 15219. Petitioner can be reached at 412-222-2033.

ANSWER: The Department admits the statements contained in Paragraph 1.

2. Petitioner is represented by Dechert LLP attorneys Carl Volz, Frederick Gerhart and Steven Koliass. Mr. Volz is resident in Dechert LLP’s Chicago office, located at 77 West Wacker Drive, Suite 3200, Chicago, Illinois, 60601, and can be reached by telephone at (312) 646-5812 and by email at carl.volz@dechert.com. Mr. Gerhart is resident in Dechert LLP’s Philadelphia office, located at 2929 Arch Street, Philadelphia, PA 19104, and can be reached by telephone at (215) 994-2838 and by email at fred.gerhart@dechert.com. Mr. Koliass is resident in Dechert LLP’s Washington, DC office, located at 1900 K Street, NW, Washington, DC 20006, and can be reached by telephone at (202) 261-3443 and by email at steven.koliass@dechert.com.

ANSWER: The information contained in paragraph 2 is required by Illinois Independent Tax Tribunal Regulation (“Rule”) 310(a)(1)(B) (86 Ill. Adm. Code § 5000.310(a)(1)(B)) and is not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

3. Petitioner’s FEIN is 83-0355528.

ANSWER: The Department admits the statement contained in Paragraph 3.

4. The Department is an agency of the Executive Department of the State Government and is tasked with the enforcement and administration of Illinois laws. 20 ILCS 5/5-15.

ANSWER: The Department admits the statements contained in Paragraph 4.

NOTICES

5. On February 20,2015, the Department issued two Notices of Deficiency that pertain to the Partnership Replacement Tax Returns filed by Petitioner on Forms IL-1065 and IL-1065-X for the taxable years ended December 31, 2007 and December 31, 2008 (“Years at Issue”). These Notices of Deficiency (the “IL-1065 Notices”) reflect the following:

- For the taxable year ended December 31, 2007, the Department listed a tax deficiency of \$312,899.00, a penalty of \$125,159.60 and interest of \$140,161.04 for a total deficiency of \$578,219.64 as of the date of the related IL-1065 Notice.
- For the taxable year ended December 31, 2008, the Department listed a tax deficiency of \$3,572.00, a penalty of \$1,428.80 and interest of \$1,190.24 for a total deficiency of \$6,191.04 as of the date of the related IL-1065 Notice. The

balance due listed on this IL-1065 Notice was reduced to \$5,930.04 to reflect certain payments totaling \$261.00.

ANSWER: The Department admits the statements contained in Paragraph 5.

6. On March 3, 2015, the Department issued two additional Notices of Deficiency that pertain to the Composite Income and Replacement Tax Returns filed by Petitioner on Forms IL-1023-C and IL-1023-C-X for the Years at Issue. These Notices of Deficiency (the “IL-1023-C Notices” and, together with the IL-1065 Notices, the “Notices”) reflect the following:

- For the taxable year ended December 31, 2007, the Department listed a tax deficiency of \$607,999.00, a penalty of \$243,199.60 and interest of \$273,448.46 for a total deficiency of \$1,124,647.06 as of the date of the related IL-1023-C Notice.
- For the taxable year ended December 31, 2008, the Department listed a tax deficiency of \$6,938.00, a penalty of \$2,775.20 and interest of \$1,984.64 for a total deficiency of \$11,697.84 as of the date of the related IL-1023-C Notice. The balance due listed on such Notice was reduced to \$11,193.84 to reflect certain payments totaling \$504.00.

ANSWER: The Department admits the statements contained in Paragraph 6.

7. A true and accurate copy of each of the four Notices is included in the attached Exhibit A.

ANSWER: The Department admits the statements contained in Paragraph 7.

JURISDICTION

8. Petitioner brings this action pursuant to the Illinois Independent Tax Tribunal Act (“Tribunal Act”), 35 ILCS 1010/1-1 to 35 ILCS 1010/1-100 and the Illinois Income Tax Act (“Income Tax Act”), 35 ILCS 5/101 et. seq.

ANSWER: The Department admits the statements contained in Paragraph 8.

9. This Tribunal has jurisdiction over this matter pursuant to Sections 1-15, 1-45 and 1-50 of the Tribunal Act and Section 908(a) of the Income Tax Act because Petitioner timely is filing this petition within 60 days of the issuance of the Notices.

ANSWER: The Department admits that the Tribunal has jurisdiction over this matter pursuant to the Tribunal Act sections cited in Paragraph 9. The Department admits that the petition was timely filed pursuant to Section 908(a) of the Income Tax Act.

BACKGROUND

10. Petitioner is a validly existing and duly organized limited liability company, with a separate and distinct legal existence, and is treated as a partnership for both federal and Illinois income tax purposes.

ANSWER: Paragraph 10 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

11. Petitioner has approximately 40 members who are treated as its partners for income tax purposes. All of Petitioner’s members are individuals.

ANSWER: The Department admits the statements contained in Paragraph 11.

12. On its 2007 and 2008 Illinois Forms IL-1065, Partnership Replacement Tax Returns, Petitioner reported certain capital gains (the “Capital Gains”) as nonbusiness income. This treatment is also reflected on the 2007 and 2008 Forms IL-1023-C, Composite Income and Replacement Tax Returns, that Petitioner filed on behalf of its members.

ANSWER: The Department admits the statements contained in Paragraph 12.

13. The Capital Gains arose in January 2007 when Petitioner sold a portion of its ownership interests in entities that conducted business operations in 17 states, including Illinois (the “2007 Sale”). The Capital Gains reported on Petitioner’s 2008 returns consisted of a deferred installment payment from that 2007 Sale.

ANSWER: The Department lacks sufficient knowledge or information to form a belief as to the truth or falsity of the statements contained in Paragraph 13, and therefore neither admits nor denies said statements, but demands strict proof thereof.

14. Petitioner’s only activity prior to the 2007 Sale was owning investments. These investments consisted of: (1) a 99% limited partnership interest in each of Holliday Fenoglio Fowler, L.P., and HFF Securities, L.P. (the “Operating Partnerships”) and (2) all of the stock of a third entity, Holliday GP Corp. (“GP Corp.”), a C corporation that held the 1% general partnership interest in the Operating Partnerships.

ANSWER: The Department denies the Petitioner’s statement in Paragraph 14 with respect to “Petitioner’s only activity prior to the 2007 Sale was owning investments.” The Department admits that, prior to the Petitioner’s sale of a portion of its ownership interests in the entities described in the second sentence of Paragraph 14, the Petitioner

owned the interests described in such sentence, except that the Department lacks sufficient knowledge and information to form a belief as to the truth or falsity of the statement that Holliday GP Corp. was a C corporation, and therefore neither admits nor denies said statement, but demands strict proof thereof.

15. The Operating Partnerships provide commercial real estate and capital markets services to the U.S. commercial real estate industry.

ANSWER: The Department admits the statements contained in Paragraph 15.

16. Illinois is one of 17 states in which the Operating Partnerships operate.

ANSWER: The Department lacks sufficient knowledge and information to form a belief as to the truth or falsity of the statement contained in Paragraph 16, and therefore neither admits nor denies said statement, but demands strict proof thereof.

17. Petitioner has never engaged in any activity other than the passive ownership of its investments in the Operating Partnerships and GP Corp. Petitioner has always functioned solely as a passive investor in the Operating Partnerships and GP Corp. and has never conducted any business activity of its own.

ANSWER: The Department denies the statements contained in Paragraph 17.

18. Petitioner itself has no connection with Illinois. Petitioner's only office is in Pittsburgh, Pennsylvania, where its books are kept and its investment activities are managed by its

sole managing member, a Pennsylvania resident. Petitioner's commercial domicile is in Pennsylvania.

ANSWER: The Department denies the statements contained in Paragraph 18.

19. Petitioner filed tax returns in Illinois solely because it was a partner in the Operating Partnerships. For the same reason, Petitioner also filed returns in the 16 other states where the Operating Partnerships conduct their activities.

ANSWER: The Department denies the statements contained in Paragraph 19.

20. Petitioner has never been involved in the management of the Operating Partnerships or GP Corp. As a limited partner, Petitioner cannot be actively involved in the management of the Operating Partnerships without losing limited liability protection.

ANSWER: The Department denies the statements contained in Paragraph 20.

21. GP Corp., as the general partner of the Operating Partnerships, is responsible for managing the Operating Partnerships. This management responsibility is carried out by GP Corp.'s board of directors and its officers. Throughout 2007 and 2008, each of the Operating Partnerships had an operating committee that managed the partnership's day-to-day operations.

ANSWER: The Department lacks sufficient knowledge and information to form a belief as to the truth or falsity of the statements contained in Paragraph 21, and therefore neither admits nor denies said statements, but demands strict proof thereof.

22. Each Operating Partnership's operating committee consisted of the officers of GP Corp. plus other senior managers employed by that Operating Partnership. The members of the operating committees were compensated for their services entirely by the Operating Partnerships. GP Corp. paid no salaries and had no payroll during 2007 and 2008.

ANSWER: The Department lacks sufficient knowledge and information to form a belief as to the truth or falsity of the statements contained in Paragraph 22, and therefore neither admits nor denies said statements, but demands strict proof thereof.

23. GP Corp. reported its share of the Operating Partnerships' income on Illinois corporate income tax returns for 2007 and 2008.

ANSWER: The Department lacks sufficient knowledge and information to form a belief as to the truth or falsity of the statement contained in Paragraph 23, and therefore neither admits nor denies said statement, but demands strict proof thereof.

24. Petitioner reported the Capital Gains as nonbusiness income not only on its 2007 and 2008 Illinois partnership returns, but also on the returns it filed in the 16 other states where it filed partnership returns.

ANSWER: The Department lacks sufficient knowledge and information to form a belief as to the truth or falsity of the statements contained in Paragraph 24, and therefore neither admits nor denies said statements, but demands strict proof thereof.

25. As nonbusiness income, the Capital Gains were allocable to the state of residence (commercial domicile) of each individual member of the Petitioner.

ANSWER: Paragraph 25 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

26. Petitioner's Illinois resident members were responsible for paying Illinois income tax on 100% of their share of the Capital Gains. Petitioner's Illinois nonresident members were responsible for reporting 100% of the Capital Gains to their states of residence.

ANSWER: Paragraph 26 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

27. Petitioner carefully considered whether the Capital Gains were business income or nonbusiness income in preparing its 2007 and 2008 state tax returns for Illinois and the 16 other states in which it filed state partnership returns.

ANSWER: The Department lacks sufficient knowledge and information to form a belief as to the truth or falsity of the statements contained in Paragraph 27, and therefore neither admits nor denies said statements, but demands strict proof thereof.

28. Petitioner concluded that the 2007 Sale was purely and simply the sale of an investment. The sale was not part of, and had nothing to do with, the businesses activities of the Operating Partnerships. For that reason Petitioner reported the Capital Gains as nonbusiness income on the 2007 and 2008 partnership returns it filed in Illinois and 16 other states.

ANSWER: Paragraph 28 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

29. Petitioner showed that it was not unitary on its Forms IL-1065 for 2007 and 2008 by not checking Box H on page 1 of the return. Inadvertently, however, Petitioner did not show its distributive share of the Operating Partnerships' income on the non-unitary Lines 38 and 46 of Form IL-1065. The Department of Revenue took this inadvertent omission as an indication that Petitioner intended to be unitary with the Operating Partnerships. To set the record straight and to dispel any misconception that may have resulted from its inadvertent omission, Petitioner filed amended Forms IL-1065 for 2007 and 2008. For the same reason, Petitioner filed amended Forms IL-1023-C for 2007 and 2008 that conformed with the amended Forms IL-1065.

ANSWER: With respect to the Petitioner's statement regarding checking Box H on page 1 of the return, this statement contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2). With respect to the Petitioner's statement regarding lines 38 and 46 of Form IL-1065, the Department admits that the Petitioner did not show any income on such lines, but the Department lacks sufficient knowledge and information to form a belief as to the truth or falsity of the statement that the omission of any income on such lines was "inadvertent," and therefore neither admits nor denies said statement, but demands strict proof thereof. The Department denies all other statements contained in Paragraph 29.

30. Of the 17 states in which Petitioner filed state tax returns for 2007 and 2008, only Illinois has questioned the reporting of the Capital Gains as nonbusiness income.

ANSWER: The Department lacks sufficient knowledge and information to form a belief as to the truth or falsity of the statements contained in Paragraph 30, and therefore neither admits nor denies said statements, but demands strict proof thereof.

31. Respondent audited Petitioner and concluded, as reflected in the Notices, that the Capital Gains were subject to Illinois tax on the grounds that they represented business income and Petitioner had a unitary business relationship with the Operating Partnerships.

ANSWER: The Department admits the statements contained in Paragraph 31.

ERROR I

Respondent erred in asserting that the Capital Gains Petitioner recognized on the 2007 Sale constituted unitary business income because Petitioner was engaged only in its nonbusiness investment activities and was not engaged in a unitary business with the Operating Partnerships.

32. Petitioner realleges and incorporates by this reference the allegations made in paragraphs 1 through 31, inclusive.

ANSWER: The Department incorporates and repeats its answers to Paragraphs 1 through 31 as if fully set forth herein.

33. The Income Tax Act provides that the term “nonbusiness income” means all income other than business income or compensation. 35 ILCS 5/1501(a)(13).

ANSWER: The Department admits the statement contained in Paragraph 33. The statute speaks for itself.

34. The Income Tax Act provides that the term “business income” means all income that may be treated as apportionable business income under the Constitution of the United States. 35 ILCS 5/1501(a)(1).

ANSWER: The Department admits the statement contained in Paragraph 34. The statute speaks for itself.

35. As nonbusiness income, the Capital Gains are not taxable in Illinois because Petitioner did not have its commercial domicile in Illinois at the time of the 2007 Sale or at any other time. 35 ILCS 5/303(b)(3).

ANSWER: The Department denies the statements contained in Paragraph 35.

36. Only if (1) the Capital Gains represent business income and (2) Petitioner was engaged in a unitary business with the Operating Partnerships, would Petitioner and its nonresident members be taxable on the Capital Gains in Illinois, to the extent apportionable to Illinois. 35 ILCS 5/304(a), (h).

ANSWER: Paragraph 36 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

37. The United States Constitution’s Due Process and Commerce Clauses permit a state to apportion and tax a gain on a nonresident’s sale of a business conducted in the state only if the seller has a “unitary business relationship” with the business. *E.g., Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 787 (1992).

ANSWER: Paragraph 37 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

38. The United States Supreme Court has held that a unitary business relationship requires that there be “some sharing or exchange of value not capable of precise identification or measurement—beyond the mere flow of funds arising out of a passive investment or a distinct business operation ... “ *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 166 (1983). *See also Hercules, Inc. v. Dep’t of Rev.*, 753 N.E.2d 418, 425; 324 Ill. App. 3d 329, 336 (1st Dist. 2001).

ANSWER: Paragraph 38 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

39. The definition of a unitary business relationship is given further detail by the Illinois statute’s definition of a “unitary business group” as “a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other.” 35 ILCS 5/1501(a)(27)(A). (Emphasis added.)

ANSWER: Paragraph 39 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

40. The statute cited in Paragraph 39 goes on to describe unitary business activity as follows:

Unitary business activity can ordinarily be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining,

refining, and marketing); and, in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member).

35 ILCS 5/1501(a)(27)(A).

ANSWER: Paragraph 40 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

41. A unitary business relationship could not exist between Petitioner and the Operating Partnerships because Petitioner does not conduct a business. Petitioner's only function in 2007 and 2008 was to hold its investments in the Operating Partnerships and GP Corp. The unitary business principle only applies to business activities and does not apply to the ownership of investments. The unitary business principle thus cannot apply to combine Petitioner's gain from the sale of its investment assets, including the Capital Gains, with the "pass-through" business income of the Operating Partnerships.

ANSWER: The Department denies all statements contained in Paragraph 41.

42. Even if Petitioner's passive investment activities could conceivably be considered a "business," Petitioner still cannot be considered part of a unitary business group with the Operating Partnerships. Apart from owning the Operating Partnerships, at no relevant time did Petitioner satisfy any of the conditions that are required under the Illinois statute to establish the existence of a unitary business relationship. For example:

- (i) Petitioner's limited activities were not part of, and played no role in, the business of the Operating Partnerships because the Operating Partnerships

were in the business of providing commercial real estate and capital markets services while Petitioner only owned its passive investments;

- (ii) Petitioner and the Operating Partnerships were not steps in a vertically structured enterprise;
- (iii) there is no centralized management because the Operating Partnerships were managed by their internal operating committees and Petitioner, as a passive investor and a limited partner, was not involved in the Operating Partnerships' business operations; and
- (iv) there was no intercompany flow of products or services between Petitioner and the Operating Partnerships.

ANSWER: The Department denies all statements contained in Paragraph 42.

WHEREFORE, the Department prays that the Tribunal enter an Order that:

- a. Denies each prayer for relief in Error I of the Petitioner's Petition;
- b. Finds the Notices of Deficiency are correct;
- c. Orders judgment in favor of the Department and against the Petitioner; and
- d. Grants any further relief this Tribunal deems just and appropriate.

ERROR II

Respondent erred in asserting that the Capital Gains constituted unitary business income because Petitioner's ownership of the Operating Partnerships served no operational function in the Operating Partnerships' businesses.

43. Petitioner realleges and incorporates by this reference the allegations made in paragraphs 1 through 42, inclusive.

ANSWER: The Department incorporates and repeats its answers to Paragraphs 1 through 42 as if fully set forth herein.

44. Absent a unitary business relationship, a capital gain on the sale of an asset can only be apportioned as business income under the United States Constitution if the asset that generates the gain has an “operational function” with respect to business income. The U.S. Supreme Court clearly stated and limited the scope of the operational function test in *Allied-Signal, Inc.*, 504 U.S. at 787 and *MeadWestvaco Corp. v. Ill. Dep ’t of Revenue*, 553 U.S. 16, 29 (2008).

ANSWER: Paragraph 44 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

45. The U.S. Supreme Court stated that “the concept of operational function simply recognizes that an asset can be a part of a taxpayer’s unitary business even if what we term a unitary relationship does not exist between the ‘payor and payee’.” *MeadWestvaco*, 553 U.S. at 29.

ANSWER: Paragraph 45 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

46. “The relevant inquiry in determining whether a capital transaction involving an asset serves an investment or operational function ‘focuses on the objective characteristics of the asset’s use and its relation to the taxpayer and its activities within the taxing state.’” *Hercules*, 324 Ill. App. 3d at 337 (quoting *Allied-Signal, Inc.*, 504 U.S. at 785).

ANSWER: Paragraph 46 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

47. In this case, the assets in question are Petitioner's limited partnership interests in the Operating Partnerships and stock in GP Corp. It was the sale of those assets that generated the Capital Gains. Under the operational function principle, the only way that Petitioner's Capital Gains could be considered business income is if Petitioner's mere ownership of those assets somehow played a role in the operation of the Operating Partnerships' businesses.

ANSWER: Paragraph 47 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

48. It is difficult to imagine that the mere passive ownership of a business entity can have an operational function in that same entity's business. Two hypothetical examples illustrate this point:

- Example 1. A corporation has business operations in Illinois. The president of the corporation, who is also one of its significant shareholders, resides in Indiana and files income tax returns in both Illinois and Indiana because he works in Illinois and resides in Indiana. The president decides to sell his shares in the corporation to a third party and recognizes a gain on the sale. The president's status as a shareholder and his act of selling his shares are not business activities that could be considered unitary with the corporation's business. Also, the asset generating the gain - the stock in the corporation -- serves no operational role in the corporation's business that could satisfy the operational function test. Accordingly, the president's gain on the sale of stock cannot be apportioned as business income under the United States Constitution. Under the U.S. Constitution, Illinois can no more tax the president's gain on the stock sale than it could tax the gain of another nonresident shareholder who is not employed by the corporation.
- Example 2. A limited partnership has business operations in Illinois. One of its limited partners resides in Indiana. The limited partner files income tax returns in Illinois to report his share of the partnership's business income. The limited partner

sells his limited partnership interest to a third party and recognizes a gain on the sale. As with the stock in Example 1, the limited partnership interest is an investment asset that serves no operational role in the partnership's business that could satisfy the operational function principle. Accordingly, the selling partner's gain cannot be apportioned as business income under the U.S. Constitution.

ANSWER: Paragraph 48 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

49. Petitioner's case is identical in principle to these two examples.

ANSWER: Paragraph 49 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

50. At all relevant times Petitioner's activities were limited to owning passive investments in the Operating Partnerships and GP Corp.

ANSWER: The Department denies the statements contained in Paragraph 50.

51. Petitioner has never been involved in the management of either the Operating Partnerships (it could not be as a limited partner) or GP Corp.

ANSWER: The Department denies the statements contained in Paragraph 51.

52. Petitioner's oversight of the activities of the Operating Partnerships and GP Corp. has at all times been entirely consistent with and appropriate to its role as a passive investor and constitutes the same level of oversight that any owner of an investment would exercise.

ANSWER: The Department denies the statements contained in Paragraph 52.

53. Petitioner's ownership of the limited partnership interests and stock therefore served purely a passive investment function, and in no way served an operational function in the businesses of the Operating Partnerships or GP Corp.

ANSWER: The Department denies the statements contained in Paragraph 53.

54. The United States Supreme Court's holding in *MeadWestvaco* provides direct support for both examples as well as Petitioner's position that its Capital Gains are nonbusiness income.

ANSWER: The Department denies the statements contained in Paragraph 54.

55. *MeadWestvaco* involved two commonly owned businesses that clearly had significant and substantial operational interaction, and yet the United States Supreme Court still held that the operational function principle did not apply. Petitioner's case is much stronger because it had no operational interaction with the Operating Partnerships. Petitioner was not engaged in any business at all, and its ownership of passive investments in the Operating Partnerships and GP Corp. could not have served an operational function in their underlying businesses.

ANSWER: The Department denies the statements contained in Paragraph 55.

WHEREFORE, the Department prays that the Tribunal enter an Order that:

- a. Denies each prayer for relief in Error II of the Petitioner's Petition;
- b. Finds the Notices of Deficiency are correct;
- c. Orders judgment in favor of the Department and against the Petitioner; and

d. Grants any further relief this Tribunal deems just and appropriate.

ERROR III

Even if for the sake of argument Respondent was correct in treating Petitioner's Capital Gains as apportionable business income, which as shown in Counts I and II is contrary to both Illinois law and the U.S. Constitution, Respondent erred in excluding the Capital Gains from the denominator of the sales factor in apportioning the Capital Gains to Illinois.

56. Petitioner realleges and incorporates by this reference the allegations made in paragraphs 1 through 55, inclusive.

ANSWER: The Department incorporates and repeats its answers to Paragraphs 1 through 55 as if fully set forth herein.

57. If Petitioner's capital gain on the sale of its passive investments in the Operating Partnerships and GP Corp. were to be treated as apportionable business income, which as shown in Counts I and II would run counter to Illinois law and US Supreme Court case law, such gain would also need to be included in the denominator of the sales factor ("total sales everywhere") for apportionment purposes.

ANSWER: The Department denies the statements contained in Paragraph 57.

58. Soon after the auditor expressed agreement with Petitioner's view that if any Capital Gains are treated as business income, they should also be included in the sales factor denominator, the Department reversed the auditor's position, citing 86 ILAC 100.3380(c)(2).

ANSWER: The Department denies the statements contained in Paragraph 58.

59. Section 100.3380(c)(2) excludes from the sales factor “an incidental or occasional sale of assets” and reads as follows:

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.

ANSWER: The Department admits the statements contained in Paragraph 59.

60. The Department’s proposal to apply this provision in section 100.3380(c)(2) to Petitioner’s Capital Gains results in an inconsistent application of the law. On the one hand, the Department is claiming that Petitioner’s one-time sale of its interests in GP Corp. and the Operating Partnerships is by itself a business. On the other hand, the Department is claiming that the sale – the purported business activity – is incidental or occasional. Thus, the Department is saying that the one-time 2007 Sale that supposedly constitutes a business is incidental or occasional even though the 2007 Sale is the entire business.

ANSWER: The Department denies the statements contained in Paragraph 60.

61. Petitioner’s view is supported by the example in the regulation quoted above dealing with the sale of a factory or plant. A factory produces goods and it is the sale of those goods that is the primary income-producing activity. Thus, the sale of the factory would be incidental or occasional in relation to that primary income-producing activity of selling the goods produced by the factory. In Petitioner’s case, however, the sale of stock and limited partnership interests is not just the primary, but the only income producing activity of its alleged “business.” Where a one-time event is the income-producing

activity, it by definition cannot be considered “incidental” or “occasional.” Accordingly, 86 ILAC 100.3380(c)(2) was not intended to apply to a situation like Petitioner’s Capital Gains arising from the 2007 sale.

ANSWER: The Department denies the statements contained in Paragraph 61.

WHEREFORE, the Department prays that the Tribunal enter an Order that:

- a. Denies each prayer for relief in Error III of the Petitioner’s Petition;
- b. Finds the Notices of Deficiency are correct;
- c. Orders judgment in favor of the Department and against the Petitioner; and
- d. Grants any further relief this Tribunal deems just and appropriate.

ERROR IV

Respondent erred in asserting penalties because Petitioner had reasonable cause for all of the actions it took with respect to its Illinois tax returns for 2007 and 2008.

62. Petitioner realleges and incorporates by this reference the allegations made in paragraphs 1 through 61, inclusive.

ANSWER: The Department incorporates and repeats its answers to Paragraphs 1 through 61 as if fully set forth herein.

63. Illinois law provides that penalties do not apply if a taxpayer shows that its failure to pay tax at the required time was due to reasonable cause. 35 ILCS 735/3-8.

ANSWER: The Department admits the statements contained in Paragraph 63.

64. The most important factor to be considered in making a determination to abate a penalty is the extent to which the taxpayer made a good faith effort to determine and pay its proper tax liability in a timely fashion. 86 ILAC 700.400(b).

ANSWER: Paragraph 64 contains a legal conclusion, not a material allegation of fact, and therefore does not require an answer pursuant to Rule 310(b)(2).

65. A taxpayer is considered to have made a good faith effort to determine and pay its proper tax liability if it exercised ordinary business care and prudence in doing so. 86 ILAC 700.400(c).

ANSWER: Paragraph 65 contains a legal conclusion, not a material allegation of fact, therefore does not require an answer pursuant to Rule 310(b)(2).

66. Petitioner exercised ordinary business care and prudence because before it filed its tax returns, it thoroughly and carefully analyzed how the Capital Gains should be reported for income tax purposes. Petitioner also consulted with its professional tax advisors. Relying on its own analysis, its professional tax advisors, Illinois law, and U.S. Supreme Court precedent, Petitioner concluded that the clearly correct result was that the Capital Gains should be treated as nonbusiness investment income and not as unitary business income.

ANSWER: The Department denies the Petitioner's statement regarding ordinary business care and prudence being exercised by the Petitioner. The Department lacks sufficient knowledge and information in order to form a belief as to the truth or falsity of

all other statements contained in Paragraph 66, and therefore neither admits nor denies said statements, but demands strict proof thereof.

67. Petitioner exercised ordinary business care and prudence in reporting the Capital Gains not only in Illinois, but also in the 16 other states where it filed returns in 2007 and 2008. Petitioner took the same position that the Capital Gains constituted nonbusiness investment income in all 17 states where it filed returns. Petitioner's position that the Capital Gains represent nonbusiness investment income has been accepted by all 16 of the other states (i.e., every state but Illinois).

ANSWER: The Department denies the Petitioner's statement that it exercised ordinary business care and prudence in reporting the Capital Gains in Illinois. The Department lacks sufficient knowledge and information in order to form a belief as to the truth or falsity of the Petitioner's statements regarding the 16 other states in which the Petitioner filed a return for 2007 and 2008, and therefore neither admits nor denies said statements, but demands strict proof thereof.

68. Petitioner's good faith is further demonstrated by the fact that it did not take protective action to guard against double taxation in the event the Illinois Department of Revenue took the positions it eventually took in this case. The Department's positions that the Capital Gains represented business income and that Petitioner was engaged in a unitary business with the Operating Partnerships both came as complete surprises to Petitioner even though Petitioner had carefully considered such issues before filing its 2007 and 2008 returns. More important, in the audit of its 2007 and 2008 returns, Petitioner did not

receive a preliminary audit report from the Department characterizing the Capital Gains as business income until February 8, 2012, and was not informed of the Department's unitary business position until May 2013. By that time it was too late under applicable statutes of limitations for Petitioner's members to claim a credit for the newly asserted Illinois tax against the income tax they had already paid to their home states. The unnecessary and preventable double taxation of the Capital Gains in both Illinois and the members' home states is a clear indication that Petitioner was acting in good faith with the reasonable and true belief that the Capital Gains represented nonbusiness investment income.

ANSWER: The Department denies the Petitioner's statements regarding good faith being demonstrated by the Petitioner. The Department lacks sufficient knowledge and information to form a belief as to the truth or falsity of all other statements contained in Paragraph 68, and therefore neither admits nor denies said statements, but demands strict proof thereof. In addition, the Department affirmatively states that the Petitioner's representative and the Department's auditor were communicating via mail and email prior to the issuance of the Notices in this case.

69. Petitioner's decision to report the Capital Gains as nonbusiness income on its 2007 and 2008 Illinois tax returns is supported by reasonable cause.

ANSWER: The Department denies the statements contained in Paragraph 69.

70. The Department's determination that Petitioner owes penalties on late payment of tax is not supported by fact or law.

ANSWER: The Department denies the statements contained in Paragraph 70.

WHEREFORE, the Department prays that the Tribunal enter an Order that:

- a. Denies each prayer for relief in Error IV of the Petitioner's Petition;
- b. Finds the Notices of Deficiency are correct;
- c. Orders judgment in favor of the Department and against the Petitioner; and
- d. Grants any further relief this Tribunal deems just and appropriate.

Respectfully Submitted,

LISA MADIGAN
Attorney General
State of Illinois

By: /s/ Daniel A. Edelstein
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Special Assistant Attorney General

/s/ Ronald Forman
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**ILLINOIS INDEPENDENT TAX TRIBUNAL
CHICAGO, ILLINOIS**

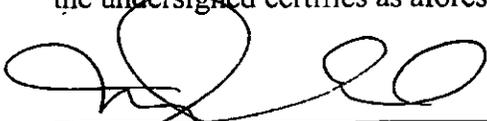
HFF HOLDINGS LLC,)	
)	
v.)	15-TT-75
ILLINOIS DEPARTMENT OF REVENUE,)	
Respondent.)	

AFFIDAVIT OF MICHAEL J. PASQUARELLO
PURSUANT TO TRIBUNAL RULE 5000.310(b)(3)

Under penalties as provided by Section 1-109 of the Code of Civil Procedure, 735 ILCS §5/1-109, I, Michael J. Pasquarello, being first duly sworn on oath, depose, and state as follows:

1. I am currently employed by the Illinois Department of Revenue.
2. My current title is Revenue Auditor.
3. I reviewed HFF Holdings LLC's (the "Petitioner") Illinois income tax audit for the tax years ending December 31, 2007 and December 31, 2008.
4. I lack the requisite knowledge to either admit or deny the allegations alleged in the Petitioner's Petition, Paragraphs 13, 14, 16, 21-24, 27, 29, 30, and 66-68.
5. I am an adult resident of the State of Pennsylvania and can truthfully and competently testify to the matters contained herein based upon my own personal knowledge.

Under penalties as provided by law pursuant to Section 1-109 of the Code of Civil Procedure, the undersigned certifies that the statements set forth in this instrument are true and correct, except as to matters therein stated to be on information and belief and as to such matters the undersigned certifies as aforesaid that he verily believes the same to be true.



Michael J. Pasquarello
Revenue Auditor
Illinois Department of Revenue

Date: 5/14/15