

General Information Letter: Discussion of correct computation and apportionment of partnership's Illinois net income.

February 4, 2011

Dear:

The original and amended returns you prepared for COMPANY1 LLC for its 2008 taxable year have been forwarded to me for review. Based on my review, it appears to me that you do not understand the basic structure of Illinois income taxation of partners and partnerships, as reflected in the Form IL-1065, Partnership Replacement Tax Return, the Schedule K-1-P, Partner's or Shareholder's Share of Income, Deductions, Credits, and Recapture, and their instructions. As a result, the net income and tax liability reported on these forms is incorrect.

In your letter dated February 23, 2010, you state that COMPANY1 LLC is based in STATE, and has invested in several real estate partnerships, including two that are located in Illinois. The amended returns includes copies of Schedules K-1-P provided to COMPANY1 LLC by COMPANY2 LLC and COMPANY3, LLC, for 2008, and I assume those are the two partnerships.

The Schedule K-1-P from COMPANY2 LLC reports various items of business income and modifications for special depreciation. The net amount of these items is \$2,091,233, and Line 4 of the Schedule K-1-P indicates that 100% of these amounts should be apportioned to Illinois. The Schedule K-1-P from COMPANY3, LLC shows \$212 in nonbusiness interest income and a \$11,312 nonbusiness rental loss. The rental loss is allocated to Illinois in the Schedule K-1-P. As a general rule, partners may rely on the accuracy of Schedules K-1-P they receive and, for purposes of this letter, I assume that these schedules are correct.

Section 305 of the Illinois Income Tax Act (35 ILCS 5/305) provides, in part:

(a) Allocation of partnership business income by partners other than residents. The respective shares of partners other than residents in so much of the business income of the partnership as is allocated or apportioned to this State in the possession of the partnership shall be taken into account by such partners pro rata in accordance with their respective distributive shares of such partnership income for the partnership's taxable year and allocated to this State.

(b) Allocation of partnership nonbusiness income by partners other than residents. The respective shares of partners other than residents in the items of partnership income and deduction not taken into account in computing the business income of a partnership shall be taken into account by such partners pro rata in accordance with their respective distributive shares of such partnership income for the partnership's taxable year, and allocated as if such items had been paid, incurred or accrued directly to such partners in their separate capacities.

Under Section 305(a), and as shown in the Schedule K-1-P provided by COMPANY2 LLC, 100% of COMPANY1 LLC's \$2,091,233 share of the net business income of COMPANY2 LLC should be allocated to Illinois by COMPANY1 LLC.

Under Section 305(b), COMPANY1 LLC's share of each item of nonbusiness income of COMPANY3, LLC, should be allocated as if COMPANY1 LLC had received that item directly. The Schedule K-1-P

from COMPANY3, LLC, indicates that no interest is allocable to Illinois. This is consistent with Section 301(c)(2) of the Illinois Income Tax Act (35 ILCS 5/302), which provides that nonbusiness interest is allocated to the commercial domicile of a taxpayer that is a partnership. The Schedule K-1-P from COMPANY3, LLC, also indicates that all of the rental loss is allocated to Illinois, which would be correct if the rental loss is from real property located in Illinois. See Section 303(c)(1) of the Illinois Income Tax Act (35 ILCS 5/303).

The Schedule NB, Nonbusiness Income, attached to both the original and amended returns reports a total of \$2,142,657 in nonbusiness income allocable to Illinois. This matches the amounts of some (but not all) items of income and modifications reported on the Schedules K-1-P from COMPANY1 LLC by COMPANY2 LLC and COMPANY3, LLC. Because of this match, and your statement that COMPANY1 LLC is based in STATE, I assume that the items passed through from these partnerships are the only Illinois-sourced items of COMPANY1 LLC. Even disregarding the omissions, the Schedule NB is incorrect because the amounts passed through by COMPANY2 LLC are business income, not nonbusiness income, and should not be reported on the Schedule NB. Also, the \$212 in nonbusiness interest income from COMPANY3, LLC, should not be allocated to Illinois. When these corrections are made, the Schedule NB should show only \$11,312 in rental loss COMPANY3, LLC, as allocated to Illinois.

In Step 6 of the Form 1065, the statutory provisions for allocation of a partner's income passed through from a partnership are implemented as follows. First, on line 37, any nonbusiness income passed through from a partnership will be subtracted from base income, along with any other nonbusiness income of the partner. Accordingly, the \$11,100 in net nonbusiness income from COMPANY3, LLC, should have been reported here. Second, on line 38, any business income passed through by a partnership should be subtracted. This would include the entire \$2,091,233 from COMPANY2 LLC. The remainder on Line 40 would be the business income earned by the partner directly, and would be multiplied by the partner's own apportionment factor on Line 43 to compute the partner's Illinois business income on Line 44. Then any nonbusiness income allocated to Illinois on the Schedule NB would be included on Line 45 and the partner's share of any business income apportioned to Illinois by a partnership (and reported as such on the Schedule K-1-P from the partnership) would be included on Line 46, and the two would be added to the taxpayer's Illinois business income to compute total Illinois-sourced income.

If the only connection between COMPANY1 LLC and Illinois is its interest in COMPANY2 LLC and COMPANY3, LLC, the precise amounts that should be reported on Lines 37 and 38 are not relevant. Whatever business income remains on Line 40 will not be apportioned to Illinois, because COMPANY1 LLC would have no Illinois sales on Line 42. Also, the only Illinois nonbusiness income on Line 45 would be the \$11,312 rental loss reported by COMPANY3, LLC, and the only Illinois partnership business income on Line 46 would be the \$2,091,233 from COMPANY2 LLC, as reported on its Schedule K-1-P.

Accordingly, if the Schedules K-1-P are correct and COMPANY1 LLC has no other connection with Illinois, its Illinois net income should be \$2,079,921.

This framework should also have been followed by COMPANY1 LLC in preparing the Schedules K-1-P for its partners. The entire \$2,091,233 in business income from COMPANY2 LLC should be divided among the partners and reported as Illinois-sourced business income on the Schedules K-1-P provided to them. Similarly, the \$11,312 in nonbusiness rental loss would be divided among the

partners and reported as nonbusiness loss allocable to Illinois by the partners on the Schedules K-1-P.

Finally, the \$2,091,233 in business income sourced to Illinois would be subject to pass-through withholding on the Form IL-1000, Pass-through Entity Payment Income Tax Return. Nonbusiness income or loss is not taken into account on that form.

If this all makes sense to you, please prepare a new amended return reporting the correct amounts. You may send it directly to me. There is no need to file an original or amended pass-through withholding return at this point, since the partners should have long since filed their own returns with Illinois, any adjustments to their liabilities will be worked out with them directly after we are certain that we have properly determined the Illinois income of COMPANY1 LLC.

If you have any questions, please do not hesitate to call me at the number above or write to me. My email address is Paul.Caselton@Illinois.gov.

Sincerely,

Paul S. Caselton
Deputy General Counsel – Income Tax