

General Information Letter: Information provided by the taxpayer does not support the claim that payments from a partnership qualify as retirement payments.

March 23, 2011

Dear:

This is in response to your letter dated March 4, 2011 regarding the above-named taxpayer. The nature of your request and the information you have provided require that we respond with a General Information Letter (GIL). A GIL 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 accessed at www.revenue.state.il.us.

In your letter you have stated the following:

This letter is in response to my discussion with Ms. Z of the Illinois Department of Revenue (hereinafter referred to as IDOR) in reference to a notice received by the above named taxpayers in connection with the adjustment made to the taxpayer's 2009 Illinois income tax return by the IDOR. We have attached the recent notice received by the taxpayers for your reference. The taxpayers had originally received a notice from the IDOR adjusting the overpayment credit reflected on the above named taxpayer's 2009 Illinois income tax return. The return as filed requested a refund of \$8,040 and a credit to 2010 estimated tax of \$16,200. Your notice dated July 19, 2010 reduced the overpayment reflected on the return from \$24,240 to \$10,588 and only credited \$8,629 to the taxpayer's 2010 estimated tax liability. In that notice, it was stated that the subtraction for social security and retirement income has been disallowed since the taxpayers did not reflect any social security or qualified retirement plan income on form 1040.

The taxpayers believe that the payments received from COMPANY LLP during 2009 meet the definition of retirement pay under Illinois Section 203(a)(2)(F) and respectfully request that the return be accepted as filed. Attached to the Illinois income tax return as filed was a statement that the taxpayer is a retired partner of COMPANY LLP and received retirement payments that were characterized for federal income tax purposes as interest income and capital gain. Accordingly, there was no amount to include on Line 17 as retirement income from COMPANY LLP; rather the amounts were reflected on Lines 8a and 13 of the form 1040.

The taxpayer retired from COMPANY LLP (FEIN XX-XXXXXXX) on March 31, 2007. In accordance with the partnership agreement, the partner is entitled to monthly retirement payments for 84 months starting 12 months after retirement. Notwithstanding the 84 month provision, if the annual payment under the retirement provisions of the agreement exceed the partners annual income prior to retirement, the annual retirement benefit will be payable over a period of time longer than 18 months. The taxpayer started receiving payments for retirement April 1, 2008. The retirement plan payments are not funded or in trust and are made from the general assets of the partnership generated from ongoing operations. All of the retirement payments are excluded in computing net earnings from self-employment by Section 1402 of the Internal Revenue Code and regulations adopted pursuant thereto.

Illinois statutes have provided have provided for a subtraction modification for retirement payments to retired partners since the Illinois income tax was adopted August 1, 1969. Section 203(a)(2)(F) of the Illinois Income Tax Act states, in part, as follows:

(a) Individuals

(2) Modifications. The adjusted gross income referred to in paragraph (1) shall be modified by adding thereto the sum of the following amounts

and by deducting from the total so obtained the sum of the following amounts:

(F) An amount equal to all amounts included in such total pursuant to the provisions of Sections 402(a), 402(c), 403(a), 403(b), 406(a), 407(a) and 408 of the Internal Revenue Code, or included in such total as distributions under the provisions of any retirement or disability plan for employees of any governmental agency or unit, **or retirement payments to retired partners, which payments are excluded in computing net earnings from self employment by Section 1402 of the Internal Revenue Code and regulations adopted pursuant thereto; (emphasis added).**

The relevant paragraph of Section 1402 of the Internal Revenue Code reads as follows:

(a) Net earnings from Self Employment- The term "net earnings from self employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by the partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss –

(3) there shall be excluded any gain or loss –

A which is considered as gain or loss from the sale or exchange of a capital asset.

Section 736 of the Internal Revenue Code entitled "Payments to a retiring or a deceased partner's successor in interest" provide that payments to a retiring partner can either be payments which constitute a distributive share of partnership profits (subsection a) or payments which are considered payments for an interest in the partnership (subsection b). The payments characterized as distributive share payments to the retiring partner are Section 736(a) payments and are treated as a distribution of partnership profits, subject to self employment tax and taxable in Illinois. The payments that are at issue in this situation are payments detailed in the partnership agreement as 736(b) payments. These payments are not considered distributive share payments but rather retirement payments to the partner in exchange for their partnership interest. Under the partnership agreement, the payment is a payment under Section 736(b), which provides a payment to a retiring partner shall be considered a distribution of the partnership and not a distributive share or guaranteed payment. Under the self employment provisions of Section 1402 of the Internal Revenue Code, the payments made to a retiring partner under Section 736(b) are not subject to self employment income.

Consistent with the above statutes, the taxpayer retired from the partnership March 31, 2007 and is entitled to receive retirement payments under the partnership agreement. Under the self

employment provisions of the Internal Revenue Code, these payments are not considered net earnings from self employment. The income tax treatment of the payments at the federal level are reported on schedule D and interest income imputed under the deferred payment rules of Section 483. Accordingly, the retirement payments received in 2009 totaled \$520,654 consisting of \$152,464 reported on Schedule B and \$368,190 reported on schedule D. These payments clearly meet the definition of retirement payments described in the Illinois Statutes Article 2 Section 203(b)(2)(F).

The key provision in the Illinois statute requires that the payments made by the partnership do not meet the definition of self employment earnings under the Internal Revenue Code. Nothing contained in the Illinois statute requires the Illinois subtraction for retirement payments to be allowed only if the subtraction amount agrees with the amounts reflected on lines 15b, 16b, or 20b of the federal 1040. In fact, the IDOR has ruled in at least 2 situations that payments that are characterized as capital gain can be excluded as retirement payments. See specifically IT 04-0003-PLR issued September 22, 2004 and IT 03-0009-PLR issued November 30, 2003 where capital gain payments were held to be allowable as retirement pay subtractions. While we realize a PLR cannot be relied on by the above named taxpayers, the fact remains that the payments meet the definition contained in Illinois statute 203(a)(2)(F) and should be allowed.

We trust that the above information is sufficient to allow you to adjust your records and accept the taxpayer's return as originally filed. As mentioned above, the return as filed reflected a refund of \$8,040 and a credit to 2010 estimated tax of \$16,200. For your convenience, we have attached the statement that was included with the originally filed return setting forth the facts related to the retirement payments. You should have in your files, the information previously supplied to the IDOR in response to the IDOR notice dated July 19, 2010.

RULING

As explained below, the subtraction modification for retirement payments to retired partners under IITA Section 203(a)(2)(F) applies only in respect of payments that are excluded from the federal self employment tax under the provisions of IRC Section 1402(a)(10) and Treasury Regulations § 1.1402(a)-17 for retirement payments to retired partners. Based on the information you have provided, the payments at issue in this case, which are either payments made in liquidation of a partner's interest in partnership property under IRC Section 736(b) or installment payments in connection with the sale of a partnership interest, do not meet the conditions for exclusion under IRC Section 1402(a)(10). Accordingly, the payments do not qualify for the subtraction modification under IITA Section 203(a)(2)(F). Department properly disallowed the claimed subtraction modification.

IITA Section 203(a)(2)(F) sets forth the following subtraction modification in the computation of Illinois base income:

An amount equal to all amounts included in such total pursuant to the provisions of Sections 402(a), 402(c), 403(a), 403(b), 406(a), 407(a), and 408 of the Internal Revenue Code, or included in such total as distributions under the provisions of any retirement or disability plan for employees of any governmental agency or unit, or retirement payments to retired partners, which payments are excluded in computing net earnings from self employment by Section 1402 of the Internal Revenue Code and regulations adopted pursuant thereto.

The language in respect of retirement payments to retired partners was added to Section 203 in 1984 by Public Act 83-1500, and derives from an amendatory veto of House Bill 2345 and Senate Bill 1385. These bills, as originally passed by the Illinois General Assembly, proposed the following amendment to what is now Section 203(a)(2)(F):

An amount equal to all amounts included in such total pursuant to the provisions of Sections 402(a), 402(c), 403(a), 403(b), 406(a), 407(a), and 408 of the Internal Revenue Code, or included in such total as distributions under the provisions of any retirement or disability plan for employees of any governmental agency or unit, or payments pursuant to Section 736(a) of The Internal Revenue Code;

During floor debate on House Bill 2345, Representative Matijevich described the purpose of the amendment.

There is a quirk in the law where the partners in a partnership are subject to retirement taxation where the members of that plan are not. It doesn't affect many, but this would now put, with the concurrence of this Amendment and Senate Amendment #1, in conformance to Senate Bill 1385, which we passed out of here last week, unanimously. (House of Representatives Transcription Debate, 137th Legislative Day, p.84 (June 21, 1984))

Concerned, however, that the reference to IRC Section 736(a) would result in an overly broad subtraction, the Governor's amendatory veto proposed that such reference be replaced with the current language regarding retirement payments to retired partners under IRC Section 1402. The Governor's veto message states, in pertinent part, as follows:

House Bill 2345 amends the Income Tax Act to make two changes with respect to retirement income. First of all, the bill allows individuals to subtract from taxable income any Social Security or Railroad Retirement benefits included pursuant to federal law. The intent is to continue to exempt such retirement benefits from Illinois tax, even though it may be taxed federally under certain circumstances. I fully support this provision. The bill also contains a provision intended to exempt from income tax partnership income for retired partners. This would be consistent with the exemption of Social Security and other retirement benefits. The language is broader than the intent, however, and for that reason it is problematic.

...

In addition to the Social Security provision, the bill was amended late in the session relative to partnerships. The intent of the amendment was to allow retired partners receiving payments under the partnership agreement an exclusion from state income taxation on such payments. Currently, retired partners do not have to pay tax on distributions from certain qualified retirement plans, such as Keoghs and Individual Retirement Accounts. However, there is a concern about older partners who may have retired before the advent of Keogh plans and similar arrangements. In those cases, a schedule of retirement payments was often included in the actual partnership agreement. Evidently, there are some older retirees currently being taxed on such distributions, and the General Assembly felt this was inappropriate.

Unfortunately, there are some technical problems with this provision. First of all, the section of the Internal Revenue Code which is cited deals specifically with the tax treatment accorded the

remaining partners in the event of payments made to a retired or deceased partner. It would be more appropriate to reference an IRC Section which deals specifically with tax treatments of payments to the retired partner. Also, the IRC Section referenced in the bill is overly broad. Under the language in the bill, it would be possible for the tax exemption to apply to relatively young partners who have not retired in the traditional sense of the word. Indeed, it would be possible for the exemption to apply to someone, regardless of age, who merely decided to leave a partnership and is receiving a liquidation of his or her capital account. This would, in effect, exclude from taxation income derived from the sale of a business. Therefore, I propose drawing the exemption more narrowly, to clearly apply to retired, and not merely disassociated, partners. (Journal of the House of Representatives, pages 5102-4 (September 9, 1984))

During floor debate regarding the Governor's amendatory veto, Representative Matijevich stated as follows in urging the House to accept the Governor's recommendation:

I move to accept the specific recommendations of the Governor as to House Bill 3178... House Bill 2345, rather. House Bill 2345 excludes from taxation those Social Security and retirement... railroad retirement benefits subject to federal taxation. We all know that part of the Bill is very familiar to us. The other part of the Bill exempted the pension benefits of retired partners of partnerships. The first part of the bill the Governor did not change at all. The Governor did change that part of the Bill regarding excluding the pension benefits of retired partners of partnerships. He believes the language in the Bill referring to Section 736(a) of the Internal Revenue Code is too broad and may lead to inadvertent exemption for income earned by a partner. He substitutes, rather than 736(a), the replacement tax based upon Section 1402 of the Internal Revenue Code, the Section headed Retirement Payments to Retired Partners. I agree with the Governor that the other Section could be interpreted in being too broad and; therefore, I move to accept his amendatory veto and ask for your support.

The legislative history set forth above makes clear two points regarding the scope the subtraction modification under IITA Section 203(a)(2)(F). First, the provision was never intended to cover either payments described in IRC Section 736(b) or gain from the sale of a partnership interest. Based on the information you have provided, the payments at issue in this case are either IRC Section 736(b) payments or derive from the sale taxpayer's partnership interest.

Second, the subtraction for retirement payments to retired partners applies only to payments described in IRC Section 1402(a)(10) and Treasury Regulations Section 1.1402(a)-17. The Governor's veto message indicates that the current language was substituted in order to reference an IRC section that deals specifically with payments to a retired partner. While IRC Section 1402 defines net earnings from self employment, enumerates those items excluded from the definition, and contains certain other provisions, the provision that deals specifically with retirement payments to a retired partner is found in subsection (a)(10). In addition, the language in IITA Section 203(a)(2)(F), which refers to "retirement payments to retired partners" matches the heading given to Treasury Regulations Section 1.1402(a)-17 relating to the exclusion from self employment tax for "Retirement payments to retired partners." This understanding is further confirmed by the testimony of Representative Matijevich, who pointed out in floor debate that the reference to IRC Section 736(a) was being removed in order to reference the IRC Section "headed Retirement Payments to Retired Partners."

It may also be pointed out that limiting the subtraction modification under IITA Section 203(a)(2)(F) to

IRC Section 1402(a)(10) payments addresses the concerns with the original language cited by the Governor, namely, that the legislation as introduced would potentially allow to go tax-free payments to non-retired partners as well as payments for partner capital accounts. IRC Section 1402(a)(10) states:

(10) there shall be excluded amounts received by a partner pursuant to a written plan of the partnership, which meets such requirements as are prescribed by the Secretary, and which provides for payments on account of retirement, on a periodic basis, to partners generally or to a class or classes of partners, such payments to continue at least until such partner's death, if

- (A) such partner rendered no services with respect to any trade or business carried on by such partnership (or its successors), ending within or with his taxable year, in which such amounts were received, and
- (B) no obligation exists (as of the close of the partnership's taxable year referred to in subparagraph (A)) from the other partners to such partner except with respect to retirement payments under such plan, and
- (C) such partner's share, if any, of the capital of the partnership has been paid to him in full before the close of the partnership's taxable year referred to in subparagraph (A).

As can be seen, in order for a payment to qualify under IRC Section 1402(a)(10) the partner must render no services on behalf of the partnership and must have been first paid his share of partnership capital. In other words, the partner must be retired from the partnership and the payment must not be in exchange for the partner's interest in the partnership.

In sum, the Governor's veto language, accepted by the General Assembly, thus removed an IRC reference dealing with liquidation of a partner's interest and replaced it with reference to an IRC section dealing with retirement plans similar to the qualified plans reference in Section 203(a)(2)(K). Based on the language of IITA Section 203(a)(2)(K) and the legislative history discussed above, it is clear that the payments at issue in this case do not qualify for the subtraction.

In your letter you reference IT 03-0009-PLR and IT 04-0003-PLR in support of the position that the subtraction modification for retirement payments to retired partners may apply to capital gain. These letters involve the same or very similar facts, in which the Department ruled that payments under a Partnership Defeasance Program qualified for the subtraction under Section 203(a)(2)(F). However, as stated in IT 04-0003, such ruling is based on the conclusion that the payments were made as part of a retirement program qualifying under IRC Section 1402(a)(10).

As stated above, this is a GIL. A GIL 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 have further questions regarding this GIL, please call (217) 782-7055. If you have additional questions regarding Illinois income tax laws, please visit the Department's web site at www.Iltax.com.

Sincerely,

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Associate Counsel (Income Tax)