

General Information Letter: Resident is allowed a credit for local income taxes paid to Kentucky municipalities.

July 31, 2012

Dear:

This is in response to your letter dated February 26, 2012 in which you state the following:

I am writing to request clarification as to why my credit for taxes paid to another state (line 17-IL 1040) has been denied. I was initially informed of this on December 6 through a Return Correction Notice.

My first response to this was to call the Illinois Department of Revenue to ask why. I am sorry that I did not get the name of the person that I spoke to at the time, but he stated that it was because of the reciprocal agreement between Illinois and Kentucky. I pointed out that I was taking a credit for local taxes, not State, as there is no reciprocal agreement between Illinois and Kentucky at the local level. He agreed with my assessment and simply instructed me to return the second page of that notice with my explanation. I did so by certified letter on December 28, within the 30 day limit, and provided supporting documentation, including another copy of my Kentucky W2 stating the local income tax withheld and a pay stub documenting what the tax was (i.e., COUNTY Tax). To date, I have not received a response to this explanation.

However, I did receive a Taxpayer Notification Response dated February 15, but it appears that it completely ignored my previous response. It simply states again that line 17 of my 2010 Form IL 1040 has been changed from \$927.00 to \$0.00 with no further explanation. I am enclosing copies of both notices with this letter.

BACKGROUND

For most of 2010, I worked in CITY, Kentucky commuting there weekly and staying in a hotel Monday through Thursday nights. Therefore, most of my income for that tax year was earned in Kentucky. There was a minimal portion earned in Illinois, but that had to do with work performed at an Illinois firm in 2009 and not paid out until 2010. Both income sources are documented on my Schedule CR.

My Kentucky employer initially started withholding Kentucky state taxes when I began working there, but I pointed out to them the reciprocal agreement and that by all possible means tests I was domiciled in Illinois (i.e., property taxes, vehicle registration, voter registration, utility bills, etc). I also provided them with a Certificate of Non-Residence and they promptly stopped withholding state income tax. However, they continued to withhold the local COUNTY tax, which amounted to \$927.48 for the year. I did not take a credit on my Schedule CR for the state taxes initially withhold in error. Rather, I applied for a refund through Kentucky's Department of Revenue.

CONCLUSION

Your Publication 111 does little to clarify what is already in the Schedule CR General instruction. The instructions state specifically with respect to local taxes:

*The reciprocal agreements do not prohibit subdivisions of these states from imposing a tax on your compensation. For example, if you were subject to a tax by a city in Kentucky while you were an Illinois resident, **you may claim a credit for that local tax.***

The instructions also state that:

To qualify for this credit, a tax must be deductible as state and local income taxes paid on your federal Schedule A, Itemized Deductions, whether or not you actually claimed the deduction.

In fact, I recently amended my Federal return (copy enclosed) to specifically include this tax as I overlooked it when filing my first return. The IRS has already allowed the deduction and processed my refund. However, I do not need to amend my IL state return because the adjustment did not affect my Federal AGI. It merely increased the amount of my itemized deductions.

To confirm that I completed the Schedule CR correctly, I took it to my local H&R Block office and spoke to the manager/senior tax consultant who was familiar with this schedule. He stated that normally Schedule CR's are not filed for reciprocal states, but in the case of withholding for Kentucky local taxes, my schedule was correct. The credit flows from the amount entered on line 1 column B. The instructions state:

*Write the amount of wages not shown as Illinois wages on the state copy of the W-2 form(s) you received. Do not include wages taxed by another state if they are also shown as Illinois wages. Also, do not include wages you received for working in Iowa, Michigan or Wisconsin while you were an Illinois resident or any wages you received for working in Kentucky **unless you paid a Kentucky city or county tax on these wages.***

As I paid Kentucky's COUNTY tax on these wages, I used the Kentucky wages to compute my credit.

To summarize, I believe that I am being taxed twice for the same income earned and that by all accounts from all of your publications and instructions, I am entitled to this credit. If I am missing something, please clarify my error. In addition, I would greatly appreciate it if you would do so in a timely manner as I am currently being assessed additional interest due to these delays in responding appropriately to my responses. In fact, I received a Final Notice of Tax Due with the Taxpayer Notification Response that has a due date of March 16, 2012.

According to the Department of Revenue ("Department") regulations, the Department may issue only two types of letter rulings: Private Letter Rulings ("PLR") and General Information Letters ("GIL"). The regulations explaining these two types of rulings issued by the Department can be found in 2 Ill.Admin.Code §1200, or on the website <http://www.tax.illinois.gov/LegalInformation/regs/part1200>.

Due to the nature of your inquiry and the information presented in your letter, we are required to respond with a GIL. GILs are designed to provide background information on specific topics. GILs, however, are not binding on the Department.

Under the Illinois Income Tax Act, a resident of Illinois is taxable on income earned in Kentucky. Specifically, Section 301(a) of the Illinois Income Tax Act (35 ILCS 5/301) provides:

- (a) Residents. All items of income or deduction which were taken into account in the computation of base income for the taxable year by a resident shall be allocated to this State.

Under Section 203(a) of the Illinois Income Tax Act (35 ILCS 5/203), "base income" is the amount reported on Line 9 of the Form IL-1040, and is equal to your "adjusted gross income" as properly reported on your federal income tax return and on Line 1 of your Form IL-1040, after taking into account the modifications reported on Lines 2 through 8.

In order to prevent an Illinois resident from paying state income tax twice on the same income, Section 601(b)(3) of the Illinois Income tax Act (35 ILCS 5/601) allows a credit for taxes paid to another state on income taxed by both that state and by Illinois. The statutory language is as follows:

- (3) Foreign tax. The aggregate amount of tax which is imposed upon or measured by income and which is paid by a resident for a taxable year to another state or states on income which is also subject to the tax imposed by subsections 201(a) and (b) of this Act shall be credited against the tax imposed by subsections 201(a) and (b) otherwise due under this Act for such taxable year. ... For taxable years ending on or after December 31, 2009, the credit provided under this paragraph for tax paid to other states shall not exceed that amount which bears the same ratio to the tax imposed by subsections 201(a) and (b) otherwise due under this Act as the amount of the taxpayer's base income that would be allocated or apportioned to other states if all other states had adopted the provisions in Article 3 of this Act bears to the taxpayer's total base income subject to tax by this State for the taxpayer year. The credit provided by this paragraph shall not be allowed if any creditable tax was deducted in determining the base income for the taxable year. Any person claiming such credit shall attach a statement in support thereof and shall notify the Director of any refund or reductions in the amount of tax claimed as a credit hereunder all in such manner and at such time as the Department shall by regulations prescribe.

Section 302(b) of the Illinois Income Tax Act (35 ILCS 5/302) provides:

- (b) Reciprocal exemption. The Director may enter into an agreement with the taxing authorities of any state which imposes a tax on or measured by income to provide that compensation paid in such state to residents of this State shall be exempt from such tax; in such case, any compensation paid in this State to residents of such state shall not be allocated to this State.

Under that authority, the States of Illinois and Kentucky entered into a "reciprocal agreement" effective January 28, 1971, pursuant to which neither state taxes, or requires withholding from, wages earned in the state by a resident of the other state.

The instructions to the Schedule CR under "General Information" expressly provide

If you earned wages, salaries, tips, or other employee compensation from an employer in Iowa, Kentucky, Michigan, or Wisconsin while you were a resident of Illinois, you are covered

by a reciprocal agreement between that state and Illinois and are not taxed by that state on your compensation. However, you may be taxed on other income.

If your employer withheld tax or you paid tax to these states on your compensation, you must claim a refund from that state. You **may not** claim a credit on Schedule CR for that tax. You must file the appropriate forms with that state to receive a refund of tax withheld in error.

Thus, Illinois residents are not allowed a credit against their Illinois income tax liability for taxes paid to Kentucky on wage income. To correct Kentucky income tax withholdings from Illinois residents, taxpayers must file a refund claim with Kentucky. Taxpayers may only claim a foreign tax credit on Schedule CR for taxes paid to Kentucky on non-wage income taxable by that state.

However, your situation is unusual in that there were local taxes withheld on your wage income which is not covered by the reciprocal agreement. The COUNTY (Kentucky) taxes are not imposed by the State of Kentucky so the withholding is not prohibited by the agreement. Currently the regulations do not address this situation, the result of which is a double taxation. We have reviewed your Kentucky W-2 information and agree that you are entitled to a credit for the amount of local income tax withholdings.

The Illinois Department of Revenue regulations provide information regarding calculating the foreign tax credit and what documentation is required to support claims for credit. 86 Ill.Admin.Code 100.2197(g) states:

- g) Documentation required to support claims for credit. Any person claiming the credit under IITA Section 601(b)(3) *shall attach a statement in support thereof and shall notify the Director of any refund or reductions in the amount of tax claimed as a credit under IITA Section 601(b)(3) all in such manner and at such time as the Department shall by regulations prescribe.* No credit shall be allowed under this Section for any tax paid to another state nor shall any item of income be included in base income subject to tax in that state except to the extent the amount of such tax and income is evidenced by the following documentation attached to the taxpayer's return (or, in the case of an electronically-filed return, to the taxpayer's Form IL-8453, Illinois Individual Income Tax Electronic Filing Declaration), amended return or claim for refund:
 - 1) credit must attach a copy of the tax return filed for taxes paid to the other Unless otherwise provided in this subsection (g), a taxpayer claiming the state or states to the taxpayer's Illinois income tax return, Form IL-8453, amended return or claim for refund.
 - 2) If the tax owed to the other state is satisfied by withholding of the tax from payments due to the taxpayer without the necessity of a return filing by the taxpayer, the taxpayer must attach a copy of the statement provided by the payor evidencing the amount of tax withheld and the amount of income subject to withholding.
 - 3) A taxpayer claiming a credit for taxes paid by a Subchapter S corporation or partnership on the taxpayer's behalf must attach a copy of the statement

provided to the taxpayer by the Subchapter S corporation or partnership pursuant to subsection (f) of this Section, showing the taxpayer's share of the taxes paid and the income of the taxpayer on which the taxes were paid.

The documentation you have provided is sufficient to support your claim for the foreign tax credit. As stated above, this is a general information letter which does not constitute a statement of policy that either applies, interprets or prescribes tax law. It is not binding on the Department. Should you have additional questions, please do not hesitate to contact our office.

Sincerely,

Heidi Scott
Associate Counsel -- Income Tax