

General Information Letter: Payment to retired federal employee that is subject to FICA tax is not eligible for subtraction as a payment under a government retirement plan.

December 10, 2012

Dear:

This is in response to your letter dated November 13, 2012. The nature of your letter requires 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 from the Department's web site at www.ILtax.com.

Your letter states as follows:

I am a retired Special Agent with the AGENCY, retiring X/30/20XX and currently residing in CITY1, Illinois. I have lived in CITY1 since the date of my retirement. During my active duty with the AGENCY I was a Supervisory Special Agent for nearly X years. At that time in 20XX there was in place a policy by DIRECTOR Z that a Supervisory Agent must either move up in promotion or step down and return to a basic Special Agent status after a five year period in a supervisory status. I chose to step down at the time rather than transfer to CITY2.

Recently I was notified by the AGENCY that I was going to be compensated for the additional amount I would have received in my pension had I stayed in the supervisory position and not been forced out. The compensation was approved by the GOVERNMENT for X agents who were affected by this policy. Attached is a copy of a letter from the AGENCY to me, dated September X, 20XX (with a one-page copy of the disbursement amounts) explaining the compensation. The letter indicates that my pension would have been increased by \$X per month. However, the AGENCY chose to compensate me and all the other agents by providing a lump sum payment based upon life expectancy rather than add it to our pension amount each month. My amount was \$XX. Of course I paid federal income tax on that amount. The AGENCY also made a mistake and paid \$XXX to STATE and \$XXX to CITY3 for earnings taxes. This was a mistake because I moved out of STATE and back to Illinois immediately after my retirement. After I reported the error, the AGENCY then pulled back the STATE and CITY3 taxes and directed the STATE tax amount to the State of Illinois. The additional amount from CITY3 is reportedly being sent to me but has yet to arrive.

I am writing this letter because I do not believe as a federal retiree this compensation should be subject to Illinois State taxes. As the attached letter indicates, the compensation is related to my federal pension amount. Page 2 of the letter states, "this amount is authorized to be paid during the current fiscal year in lieu of adding it to the remaining life of your retirement annuity." Given that language and the overall reason for the compensation I would ask that this amount not be subject to Illinois State taxes.

RULING

Section 201(a) of the Illinois Income Tax Act ("IITA" ; 35 ILCS 5/201) imposes a tax, measured by "net income," upon every individual for the privilege of earning or receiving income in or as a resident of this State. In the case of an individual, the starting point in calculating "net income" for purposes of Section 201 is the taxpayer's adjusted gross income (AGI) for federal income tax purposes. See IITA Sections 202 and 203. Therefore, in general, any item of income that is included in the computation of

a taxpayer's AGI is likewise included in the computation of the taxpayer's Illinois net income. However, the IITA provides various subtraction modifications that allow certain items of income included in federal AGI to be deducted when computing Illinois net income. One such subtraction modification is the subtraction for certain retirement income under IITA Section 203(a)(2)(F). That section provides a subtraction modification for the following amount:

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.

Although there is no general Illinois tax exemption for federal retirees, as indicated above the subtraction modification for certain retirement income extends to distributions under the provisions of a government employees plan. This subtraction would apply to your AGENCY pension, with the result that such income would not be subject to tax in Illinois. In this case, however, it appears that the compensation at issue is classified for federal income tax purposes as wage income. In particular, wage income, but not retirement pay, is subject to FICA and Medicare taxes, and the documents you provided indicate that your payment of \$XX has been subject to both taxes. Under Illinois law, an item classified as wages for federal income tax purposes must also be classified as wages for Illinois income tax purposes. See IITA Section 102.

Accordingly, based on the information you have provided, the compensation paid to you does not appear to qualify for the subtraction modification for retirement income under IITA Section 203(a)(2)(F). Further, because you were an Illinois resident at the time the compensation was paid, the entire amount would be subject to Illinois income tax. See IITA Section 301(a).

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.

Sincerely,

Brian L. Stocker
Associate Counsel (Income Tax)