

Non-resident partner includes in Illinois net income his or her distributive share of the business income of the partnership apportioned to Illinois.

February 9, 2016

Re: Illinois income tax

Dear Xxxxx:

This is in response to your letter dated December 29, 2015 in which you request a letter ruling. The nature of your request and the information provided 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 2 Ill. Adm. Code § 1200.120(b) and (c), which may be accessed from the Department's web site at www.tax.illinois.gov.

Your letter states as follows:

I am an out of state tax preparer who recently took over a new client. The client is a general partnership made up of three individual musical artists that combined make up a musical band.

These artists have four primary sources of income.

Recording – They make records, which are either owned or licensed by a record company in which the record company pays them a royalty for records sold.

Publishing – They are paid royalties for music sold or played via the airways or streamed.

Touring – They perform via musical touring.

Merchandising – They license their name to merchandisers who sell product with the band's name on it (i.e. hats, shirts, etc.)

The band has not recorded an album in several years. However, when they did record, a few of their albums were written and recorded in Illinois. Currently they are no longer active with respect to business in Illinois. One band member is a resident of Illinois, while two of the band members are not residents of Illinois.

The question we have is with respect to the royalties they earn and their sourcing (if any) to the State of Illinois. The record company pays a royalty primarily with respect to three parts:

1. For their actual services for performance on the recording (done many years ago in Illinois).
2. For the writer's share (for writing the songs many years ago in Illinois).
3. For the publisher's share (licensing the rights to the songs).

The record company does not manufacture or distribute recordings out of Illinois. CDs are sold to customers around the world, including a small portion of that (we presume) to persons located in Illinois. In addition, music is played all around the world (either through the airways or streaming), including (we presume) to persons living in Illinois.

Our question: How much, if any, of the royalties earned by the band members should be sourced to Illinois? With respect to the Illinois resident, this is not at issue, since he will pick up 100% of all income to Illinois.

RULING

Your question concerns the manner in which Illinois taxes a nonresident partner with respect to his or her distributive share of certain partnership royalty income.¹ Section 305 of the Illinois Income Tax Act (“IITA”; 35 ILCS 5/305) provides for the allocation or apportionment of a nonresident partner’s distributive share of partnership income. The section states, in pertinent part, as follows:

§ 305. Allocation of Partnership Income by partnerships and partners other than residents. (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.

(c) Allocation or apportionment of base income by partnership. Base income of a partnership shall be allocated or apportioned to this State pursuant to Article 3, in the same manner as it is allocated or apportioned for any other nonresident.

Section 1501(a)(1) of the IITA defines the term “business income” as follows:

Business income. The term “business income” means all income that may be treated as apportionable business income under the Constitution of the United States. Business income is net of the deductions allocable thereto. Such term does not include compensation or the deductions allocable thereto. For each taxable year beginning on or after January 1, 2003, a taxpayer may elect to treat all income other than compensation as business income. This election shall be made in accordance with rules adopted by the Department and, once made, shall be irrevocable.

Under IITA Section 1501(a)(13), nonbusiness income is defined as all income other than business income or compensation.

Under Article 3 of the IITA, base income that constitutes nonbusiness income is allocated to Illinois under IITA Sections 301(c)(2) and 303. Base income that constitutes business income is apportioned to Illinois under IITA Section 304. IITA Section 304(a) provides that for taxable years ending on or after December 31, 2000, the apportionment factor for a taxpayer deriving business income from Illinois and one or more other states (other than an insurance company, financial organization, or transportation company) shall be equal to its sales factor. Section 304(a)(3)(A) defines the sales factor as a fraction, the numerator of which is the total sales of the person in Illinois during the taxable year, and the denominator of which is the total sales of the person everywhere. IITA Section 304(a)(3)(B-1) defines the numerator of the sales factor with respect to gross receipts from patents, copyrights, trademarks, and similar items of intangible personal property. The section provides:

¹ Note that Illinois also imposes an entity level tax on a partnership. 35 ILCS 5/201(c) and (d). The tax is imposed on the “net income” of the partnership at the rate of 1.5% (35 ILCS 5/202).

(B-1) Patents, copyrights, trademarks, and similar items of intangible personal property.

(i) Gross receipts from the licensing, sale, or other disposition of a patent, copyright, trademark, or similar item of intangible personal property, other than gross receipts governed by paragraph (B-7) of this item (3), are in this State to the extent the item is utilized in this State during the year the gross receipts are included in gross income.

(ii) Place of utilization.

(I) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If a patent is utilized in more than one state, the extent to which it is utilized in any one state shall be a fraction equal to the gross receipts of the licensee or purchaser from sales or leases of items produced, fabricated, manufactured, or processed within that state using the patent and of patented items produced within that state, divided by the total of such gross receipts for all states in which the patent is utilized.

(II) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If a copyright is utilized in more than one state, the extent to which it is utilized in any one state shall be a fraction equal to the gross receipts from sales or licenses of materials printed or published in that state divided by the total of such gross receipts for all states in which the copyright is utilized.

(III) Trademarks and other items of intangible personal property governed by this paragraph (B-1) are utilized in the state in which the commercial domicile of the licensee or purchaser is located.

(iii) If the state of utilization of an item of property governed by this paragraph (B-1) cannot be determined from the taxpayer's books and records or from the books and records of any person related to the taxpayer within the meaning of Section 267(b) of the Internal Revenue Code, 26 U.S.C. 267, the gross receipts attributable to that item shall be excluded from both the numerator and the denominator of the sales factor.

In addition, IITA Section 304(a)(3)(B-2) states:

(B-2) Gross receipts from the license, sale, or other disposition of patents, copyrights, trademarks, and similar items of intangible personal property, other than gross receipts governed by paragraph (B-7) of this item (3), may be included in the numerator or denominator of the sales factor only if gross receipts from licenses, sales, or other disposition of such items comprise more than 50% of the taxpayer's total gross receipts included in gross income during the tax year and during each of the 2 immediately preceding tax years; provided that, when a taxpayer is a member of a unitary business group, such determination shall be made on the basis of the gross receipts of the entire unitary business group.

Based on the information you have provided, it appears that the royalty income of the partnership constitutes business income. Such income should be apportioned to Illinois applying the rules of IITA Section 304, including the provisions set forth above. Under IITA Section 305, the nonresident partners must include in their Illinois net income their distributive shares of the partnership's business income apportioned to Illinois.

In addition, note that IITA Section 709.5 imposes a withholding obligation with respect to a nonresident partner's distributive share. That section states, in pertinent part, as follows:

(a) In general. For each taxable year ending on or after December 31, 2008, every partnership (other than a publicly traded partnership under Section 7704 of the Internal Revenue Code or investment partnership), Subchapter S corporation, and trust must withhold from each nonresident partner, shareholder, or beneficiary ... an amount equal to the sum of (i) the share of business income of the partnership, Subchapter S corporation, or trust apportionable to Illinois plus (ii) for taxable years ending on or after December 31, 2014, the share of nonbusiness income of the partnership, Subchapter S corporation, or trust allocated to Illinois under Section 303 of this Act (other than an amount allocated to the commercial domicile of the taxpayer under Section 303 of this Act) that is distributable to that partner, shareholder, or beneficiary under Sections 702 and 704 and Subchapter S of the Internal Revenue Code, whether or not distributed, (iii) multiplied by the applicable rates of tax for that partner, shareholder, or beneficiary under subsections (a) through (d) of Section 201 of this Act, and (iv) net of the share of any credit under Article 2 of this Act that is distributable by the partnership, Subchapter S corporation, or trust and allowable against the tax liability of that partner, shareholder, or beneficiary for a taxable year ending on or after December 31, 2014.

(b) Credit for taxes withheld. Any amount withheld under subsection (a) of this Section and paid to the Department shall be treated as a payment of the estimated tax liability or of the liability for withholding under this Section of the partner, shareholder, or beneficiary to whom the income is distributable for the taxable year in which that person incurred a liability under this Act with respect to that income.

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 questions regarding this GIL you may contact Legal Services at (217) 782-2844. If you have further questions related to Illinois income tax laws, visit our website at www.revenue.state.il.us or contact the Department's Taxpayer Information Division at (217) 782-3336.

Sincerely,

Brian L. Stocker
Staff Attorney (Income Tax)