

Subtraction modification for retirement payments to retired partners applies only to payments described in IRC Section 1402(a)(10).

September 2, 2016

Re: COMPANY
FEIN: #####

Dear Xxxxx:

This is in response to your letter dated July 25, 2016, in which you request a general information letter (GIL) on behalf of the above-named taxpayer. 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.tax.illinois.gov.

In your letter you state the following:

COMPANY ("COMPANY" or "We" or "Our") is submitting this request for a General Information Letter ("GIL"), pursuant to the provisions of 2 Ill. Adm. Code Sec. 1200.120 on behalf of our CLIENT ("CLIENT") and its retired members seeking written confirmation from the Illinois Department of Revenue ("Department") upon which our client and its retired member may affirmatively rely that, as described below, payments to retired members qualify for the subtraction modification in 35 ILCS 5/203(a)(2)(F). A copy of said written confirmation will be attached to annual Illinois individual income tax returns for each CLIENT retired member in an effort to provide clarity and prevent notices from the Department. To the best of CLIENT's and our knowledge, neither CLIENT nor any of its affiliated companies is subject to any pending audit or litigation in Illinois involving the issues raised in this GIL request. Additionally, neither CLIENT nor COMPANY is aware of any contrary rulings, cases, statutes, or regulations to the position requested in this letter. A power of attorney authorizing our representation of CLIENT is attached.

Relevant Facts

CLIENT is a professional services firm that provides engineering services to the power industry. CLIENT is a limited liability company treated as a partnership for federal and Illinois income tax purposes. CLIENT has two types of members: active and retired. Each type of member includes both Illinois residents and non-residents for income tax purposes. The active members provide services to CLIENT on a full-time basis. The active members also pay self-employment tax on income earned from the LLC. Pursuant to the LLC operating agreement, upon retirement a retired member of CLIENT ceases to

be a member and ceases to provide services to CLIENT. On the last day of the tax year during which a member retires, the retiring member is paid an amount equal to his full value of the LLC units. In other words, all of his capital as determined under the LLC operating agreement is paid to the retiring partner. The partner ceases to be a state law member. The only amounts to be paid to such retired member are those determined under the retirement plan.

Pursuant to the LLC operating agreement, the retired members receive payments from CLIENT on an annual basis for the remainder of their lives. The income earned by the retired members is not a guaranteed payment but is instead an allocation of all types of income, deductions and credits earned by the LLC. For federal and Illinois income tax purposes, the retired partners continue to be treated as partners for as long as they are receiving these payments. After retirement the member is allocated and taxed on retirement income in the same year in which the income is generated by the LLC even if the amount has not been paid to the member in the year it was earned. Historically the retirement income is paid to the member in subsequent years after it was earned and taxed. The retirement income earned and taxed in one year that is paid to retired members in the subsequent years is accounted for as an obligation of the LLC. As the retired members are treated as partners for federal income tax purposes these obligations from the LLC are reported as capital on the retired partner's federal K-1.

Following is an example of the earnings and payments made to a retired member:

On December 31, 2013, the member (who retired on December 31, 2010) is owed \$\$\$ of retirement income from CLIENT. The \$\$\$ that the member is owed will be paid to the member in 2012 and 2013 and is also reported as distributive share because the income is paid out of current net profits of the company. Thus, it is reflected in the capital account of the retired partner. Because it is not paid before the end of the year, it is also reflected in ending capital on his federal K-1. Of this amount \$\$\$ was earned in 2012 and \$\$\$ was earned in 2013. The retired member included these amounts in federal taxable income in 2012 and 2013, respectively.

The amounts were earned and paid to the retired member as follows:

<u>Date of Payment</u>	<u>Year Retirement Income Earned</u>	<u>% of Retirement Income Paid</u>	<u>Retirement Income</u>
January 14, 2014	2012	100%	\$\$\$
April 15, 2014	2013	40%	\$\$\$
June 15, 2014	2013	20%	\$\$\$
September 15, 2014	2013	20%	\$\$\$
January 15, 2015	2013	20%	\$\$\$
Total due as of December 31, 2013			\$\$\$

For Federal and Illinois income tax purposes, the retired members continue to be allocated taxable income, deductions and credits, because, as noted above, retirement

amounts are paid out of net current profits of the company. Therefore, these amounts are reported to the retired members on a federal Schedule K-1 and Illinois Schedule K-1-P and is subject to federal income tax but not subject to self-employment tax under section 1402(a)(10). It is CLIENT's understanding that the members are not subject to Illinois Individual Income Tax on these retirement payments because they qualify for the subtraction modification in 35 ILCS 5/203(a)(2)(F).

Legal Analysis and Authorities

In computing an individual's base income subject to Illinois Individual Income Tax, under 35 ILCS 5/203(a)(2)(F), Illinois provides a subtraction for retirement payments that are excluded from net earnings from self-employment under the Internal Revenue Code (hereinafter "IRC"). Section 1402(a) defines net earnings from self-employment as: [T]he gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle [IRC Sections 1 et. seq.] 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 a partnership of which he is a member.

Section 1402(a)(10) provides an exception to the general definition of net earnings from self-employment, which reads in whole:

[T]here 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) during the taxable year of 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).

Application of Section 1402(a)(10)

Section 1402(a)(10)(A)

Income earned by CLIENTS retired members meet the requirements of section 1402(a)(10)(A) – (C) to be excluded from net earnings from self-employment. First of all, retired members cease rendering services to CLIENT upon retirement in compliance with section 1402(a)(10)(A). In the present case, the Member retired in 2010. He ceased providing services under state law during 2010. Any payments made during 2014 and 2015 were not made in years during which he provided services to the company. Thus section 1402(a)(10)(A) is met.

Section 1402(a)(10)(B)

Secondly, all obligations to the retired members outside the scope of section 1402 have been paid to them prior to December 31, 2011. There is no definition under section 1402(a)(10) for obligations. As a general matter, this amount should include any loans that the company may have made to the members. However, no such obligations exist. The only obligation is to pay amounts to the retired member earned under the retirement plan, which is allowed by statute. Thus the taxpayer meets the requirement of section 1402(a)(10)(B).

Section 1402(a)(10)(C)

Finally, retired members were paid in full for their capital accounts in the year in which they retired. The Schedules K-1 currently reflect a capital account for such partners. This is because the terms of the retirement plan are such that the income is paid out of current earnings pursuant to section 736(a)(1), which is discussed below. Because the capital balance relates solely to the retirement income, this meets the requirements of section 1402(a)(10)(C).

Revenue Ruling 79-34

Because of the lack of clarity of definitions in the statute, one might ask if retirement income earned but treated as distributive share could fall within the provisions of paragraphs (B) and (C) discussed above. The Ruling does not specifically cover paragraph (C) however, the facts are such that the retirement income is paid out of current earnings pursuant to section 736(a)(1). The Ruling never concludes that the income violates the requirements of paragraph (C). This was discussed in more detail in GCM 37701, discussed below.

Paragraph (B) is specifically addressed in Revenue Ruling 79-34, which provides:

Payments made by a partnership retirement plan to a retired partner from current partnership earnings are excepted from “net earnings from self-employment” for purposes of section 1402 of the Code even though receipt of part of the payments is deferred until shortly after the beginning of the following year. Rev. Rul. 79-34.

Revenue Ruling 79-34 states that “dollars unpaid at the close of the partnership’s taxable year [are] an integral part of the partnership’s retirement plan. Despite deferral of its payment for a short time after year end, the ... dollars [are] not an obligation within the intent of *section 1402(a)(10)(B) of the Code*, but [are] a retirement payment.” Revenue Ruling 79-34 then clarifies that for purposes of section 1402(a)(10), the payments are considered to be made during the year in which the earnings facilitating the retirement payments were earned, regardless of whether a portion of those periodic retirement payments were distributed during the following year.

General Counsel Memorandum 37701

This was released in 1978. It also included a proposed revenue ruling that ultimately would be released as Revenue Ruling 79-34. This internal IRS guidance specifically discussed the fact that retirement income can be paid out of current profits and thus affect

the member's capital account; and still qualify under Paragraph (C). The IRS concluded, "Thus, Congress intended that retirement payments under section 1402(a)(10) can be payable out of the current income of the partnership." In a footnote it also suggests that payments of income subject to significant delay can become an interest in capital. It is important to note that the footnote nor the subject of the footnote were not incorporated into the published Revenue Ruling 79-34. Thus, retirement payment that is allocated out of current profits under section 736(a)(1) qualifies as retirement payment under section 1402(a)(10) even though the amounts are not paid before the close of the taxable year in which it was allocated.

Reliance on Authorities

Revenue Rulings are substantial authority that must be followed by revenue agents. Treas. Reg. §1.6662-4(d)(3)(iii). GCMs are not authority, need not be followed by revenue agents, and merely express the opinion of the author. This is important because of the footnote in GCM 37701 noted above implies that if the cash payment of the retirement income is not paid by year end or within a reasonable time following year end, that the payment might be considered an obligation other than an obligation solely under the retirement plan. As noted above, this footnote appeared only in the GCM, which is not authoritative. It also did not appear in the issued Revenue Ruling, which is authoritative. Further, the income in this case was paid out within a reasonable period of time and the retired partners received only the amount owed under the retirement plan.

Conclusion

For the reasons stated above, we believe that income and payments made to the CLIENTS retired members meet the exception under section 1402(a)(10), thereby qualifying for the subtraction in 35 ILCS 5/203(a)(2)(F) and respectfully request that the Department provide the general information letter requested. In addition, we request that the identity of CLIENT and the other parties described herein be redacted from any published version of a GIL that the Department does issue to CLIENT.

RULING

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 subtraction for retirement payments to retired partners applies only to payments described in Internal Revenue Code (IRC) Section 1402(a)(10) and Treasury Regulations Section 1.1402(a)-17.

IRC Section 1402(a)(10) excludes from the definition of net earnings from self-employment:

- (10) [A]mounts 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).

Treasury Regulations Section 1.1402(a)-17(b) states that to qualify as payments on account of retirement, the payments must constitute bona fide retirement income. For purposes of this ruling, it is assumed that the S&L retirement plan meets the requirements of Treasury Regulations Section 1.1402(a)-17(b).

Your letter indicates that upon retirement, the partner ceases to be a member and ceases to provide services to CLIENT. Further, your letter indicates that the income paid to the retired member is considered under IRC Section 736(a)(1) as a distributive share of partnership income, and that historically the income is actually paid to the member in years subsequent to the year the retired partner must take into account the distributive share of partnership income. The retirement income earned and taxed in one year that is paid to retired members in subsequent years is accounted for as an obligation of the LLC. Your letter provides an example in which the retired member's distributive share for the 2012 taxable year of the partnership is not actually paid to the retired member until January 14, 2014, and in which the distributive share for the 2013 taxable year of the partnership is actually paid to the retired member in installments between April 14, 2014 and January 15, 2015. You have indicated that the retired members of CLIENT have taken the position on their federal income tax returns that the payments are excluded from net earnings from self-employment under IRC Section 1402(a)(10).

In Revenue Ruling 79-34, the IRS determined that payments made to a retired partner from current partnership earnings satisfy the exclusion under IRC Section 1402(a)(10) where payment is deferred until shortly after the beginning of the following year. General Counsel Memorandum (GCM) 37701 (1978) included a proposed revenue ruling subsequently released as Revenue Ruling 79-34. In the GCM, the IRS noted, "[w]e believe it is critical that there is no significant delay between the time the distributive share is determined and the time any excess distributive share is distributed. If any amount is retained by the partnership, it may be an

obligation under section 1402(a)(10)(B) or a share in partnership capital under section 1402(a)(10)(C).”

Neither the GCM nor the revenue ruling indicate what period of delay would be considered a “significant delay.” Revenue Ruling 79-34 indicates only that a distribution shortly after the beginning of the following year does not cause the distributive share to fail to satisfy the exclusion under IRC Section 1402(a)(10). It is therefore not clear whether the amounts retained in this case, some of which were retained until the beginning of the second succeeding year, constitutes a “significant delay” that may result in a disallowed obligation or disallowed share in partnership capital. Accordingly, absent a federal change, as defined under IITA Section 506(b), with respect to the treatment of the retired member’s share of CLIENT’s income for federal self-employment tax purposes, the Department will respect the taxpayer’s federal position as correct. Consequently, the distributive shares of the retired members of CLIENT will qualify for the subtraction modification under IITA Section 203(a)(2)(F).

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) 782-2844. If you have additional questions regarding Illinois income tax laws, please visit the Department’s web site at www.tax.illinois.gov.

Sincerely,

Brian L. Stocker
Associate Counsel (Income Tax)