IT 19-0016-GIL 08/07/2019 BASE INCOME

Shareholder of PFIC Includes in Base Income PFIC Income Included in Federal .AGI

August 7, 2019

Re: Illinois income tax

Dear Xxxx:

This is in response to your letter dated June 14, 2018. The nature of your request and the information you have 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 86 Ill. Adm. Code 1200.120(b) and (c), which may be accessed from the Department's web site at www.ILtax.com.

In your letter you have stated the following:

> Taxpayer's submitted Federal Amended Income Tax returns for 2007-2014 under the Federal Voluntary Disclosure Program ("OVDP"). On these Federal Amended Income Tax returns, their Federal Adjusted Gross Income ("AGI") was modified. Accordingly, Taxpayer's filed Amended Illinois Personal Income Tax returns reflecting these modified AGI figures for the respective years.
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> In addition to the changes in federal AGI, the OVDP required a separate computation of income or loss on each tax year's passive foreign investments ("PFIC Income" and "PFIC loss"). Note that PFIC income and PFIC loss is not included in federal AGI. Please see the attached schedule.
>
> In years 2007, 2009, 2010, 2012, and 2013 there was net PFIC income. In those years there was a special federal 20% tax on the PFIC income. The tax was added to federal income tax for the respective years. However, in 2008, 2011, and 2014 there was a net PFIC loss. 20% of this loss was subtracted from the federal income tax for the respective years: 2008, 2011, and 2014.
>
> PFIC income is not enumerated either as an addition or subtraction to Federal AGI in Illinois Part 100. Regardless, on the amended Illinois personal income tax returns the taxpayers added the PFIC income to their federal AGI in Step 2 Line 3 in those years that there was PFIC income (2007, 2009, 2010, 2012, and 2013) and subtracted PFIC loss from the federal AGI in the years there was PFIC loss (2008, 2011, and 2014).
>
> Illinois disallowed the subtraction of PFIC loss stating that there is no space on the preprinted IL-1040 for a subtraction modification from federal AGI. See the 2014 notice attached.
>
> This result does not seem to be equitable. A large portion of the PFIC income was for an increase in the market value of PFIC. Yet in the years that the value decreased Illinois is disallowing the reduction in Market Value, the PFIC Loss, as modifications of Federal AGI.
>
> Possible equitable solutions:

1. Allow the PFIC losses a negative number on Step, Line 3. This is the method we have used in other states.

2. Allow the PFIC loss to be an adjustment to Federal AGI in arriving at Step 2 Line 1.

In the alternative, the Taxpayers would consider refiling their Illinois Amended Income Tax Returns for 2007 – 2014 removing all PFIC Income and all PFIC Losses.

Please advise as to how Taxpayer should proceed.

Thank you for your kind attention in this matter.

## 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, corporation, trust and estate for the privilege of earning or receiving income in or as a resident of this State.

The starting point in calculating "net income" for purposes of Section 201 is the taxpayer's "base income" as defined under IITA Section 203. The computation of base income starts with federal adjusted gross income, which is then modified by statutorily prescribed addition and subtraction modifications. Unless there is an applicable addition or subtraction modification, an item of income or deduction is treated the same for Illinois purposes as it is for purposes of computing federal adjusted gross income. See IITA Section 203(h). IITA Section 203 does not provide a specific modification applicable to income or loss from a "passive foreign investment company" (PFIC) as defined under section 1297 on the Internal Revenue Code (IRC). Accordingly, Illinois taxation of a shareholder of a PFIC follows the federal tax treatment.

IRC Section 1291 provides, in part:

(a) Treatment of distributions and stock dispositions

(1) Distributions If a United States person receives an excess distribution in respect of stock in a passive foreign investment company, then—

(A) the amount of the excess distribution shall be allocated ratably to each day in the taxpayer's holding period for the stock,

(B) with respect to such excess distribution, the taxpayer's gross income for the current year shall include (as ordinary income) only the amounts allocated under subparagraph (A) to—

(i) the current year, of

(ii) any period in the taxpayer's holding period before the 1st day of the 1st taxable year of the company which begins after December 31, 1986, and for which it was a passive foreign investment company, and

(C) the tax imposed by this chapter for the current year shall be increased by the deferred tax amount (determined under subsection (c)).

(2) Dispositions
If the taxpayer disposes of stock in a passive foreign investment company, then the rules of paragraph (1) shall apply to any gain recognized on such disposition in the same manner as if such gain were an excess distribution.

(3) Definitions For purposes of this section—

(A) Holding period The taxpayer's holding period shall be determined under section 1223; except that—

(i) for purposes of applying this section to an excess distribution, such holding period shall be treated as ending on the date of such distribution, and

(ii) if section 1296 applied to such stock with respect to the taxpayer for any prior taxable year, such holding period shall be treated as beginning on the first day of the first taxable year beginning after the last taxable year for which section 1296 so applied.

(B) Current year - The term "current year" means the taxable year in which the excess distribution or disposition occurs.

Pursuant to this provision, any excess distribution from a PFIC or gain from the disposition of PFIC shares, is treated as earned ratably over the shareholder's holding period of the stock of the PFIC. The portion allocated to the current year and to years when the foreign corporation was not a PFIC must be included in the shareholder's gross income for the year of the sale or distribution. The remainder of such gain or distribution is not included in gross income, but the shareholder is required to pay a deferred tax amount with respect to this portion as determined under IRC section 1291(c).

Because the IITA does not include a modification for that portion of an excess distribution not included in gross income under IRC Section 1291, the amount of such distribution subject to the deferred tax amount under IRC Section 1291(c) is not included in Illinois base income.

In lieu of taxation under IRC Section 1291, the shareholder of a PFIC may make an election under IRC section 1295 to treat the PFIC as a qualified electing fund (QEF). If such election is made, IRC section 1293 provides:

Current taxation of income from qualified electing fund

(a) Inclusion.—

(1) In general.--Every United States person who owns (or is treated under section 1298(a) as owning) stock of a qualified electing fund at any time during the taxable year of such fund shall include in gross income—

(A) as ordinary income, such shareholder's pro rata share of the ordinary earnings of such fund for such year, and

(B) as long-term capital gain, such shareholder's pro rata share of the net capital gain of such fund for such year.

(2) Year of inclusion.--The inclusion under paragraph (1) shall be for the taxable year of the shareholder in which or with which the taxable year of the fund ends.

(b) Pro rata share.--The pro rata share referred to in subsection (a) in the case of any shareholder is the amount which would have been distributed with respect to the shareholder's stock if, on each day during the taxable year of the fund, the fund had distributed to each shareholder a pro rata share of that day's ratable share of the fund's ordinary earnings and net capital gain for such year. To the extent provided in regulations, if the fund establishes to the satisfaction of the Secretary that it uses a shorter period than the taxable year to determine shareholders' interests in the earnings of such fund, pro rata shares may be determined by using such shorter period.

Because the IITA does not contain a modification related to amounts included in gross income under IRC section 1293 in the case of a QEF, all such amounts are included in the taxpayer's Illinois base income.

In lieu of taxation under IRC Section 1291, the shareholder of a PFIC may make the mark-to-market election under IRC section 1296. If such election is made, IRC section 1296 provides:

(a) General rule In the case of marketable stock in a passive foreign investment company which is owned (or treated under subsection (g) as owned) by a United States person at the close of any taxable year of such person, at the election of such person—

(1) If the fair market value of such stock as of the close of such taxable year exceeds its adjusted basis, such United States person shall include in gross income for such taxable year an amount equal to the amount of such excess.

(2) If the adjusted basis of such stock exceeds the fair market value of such stock as of the close of such taxable year, such United States person shall be allowed a deduction for such taxable year equal to the lesser of—

(A) the amount of such excess, or

(B) the unreversed inclusions with respect to such stock.

Because the IITA does not contain a modification related to amounts included in gross income under IRC section 1296, any amount included in gross income under IRC section 1296(a)(1) is included in Illinois base income, and any deduction allowed under IRC section 1296(a)(2) that is taken into account in computing the taxpayer's adjusted gross income thereby reduces the taxpayer's Illinois base 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 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,

Brian L. Stocker
(Associate Counsel – Income tax)