

IT 19-0018-GIL 10/25/2019 Foreign Income Tax Credit

Compensation paid in Illinois under IITA Section 304(a)(2)(B) does not qualify for the credit for taxes paid to other states. (This is a GIL.)

October 25, 2019

Re: Illinois income tax

Dear XXX:

This is in response to your letter received July 15, 2019, in which you request information regarding Illinois income tax. The nature of your request and the information you have provided require that we respond with a General Information Letter, which 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 found on the Department's web site at www.tax.illinois.gov.

Your letter states as follows:

The taxpayers received the attached "Taxpayer Statement" assessing \$\$\$\$ in additional taxes, interest, and penalties relating to their 2017 Illinois return. The taxpayers disagree with the assessment and are requesting a General Information Letter to address their return position.

The taxpayers own 100% of a business, COMPANY (S Corporation), that provides emergency management consulting services all over the country. The company's mission is to help clients prepare for and recover from disasters. The business has offices in STATES. Due to the uniqueness and unpredictability of their business, they staff their workforce with professionals who live all over the US. This gives them the flexibility to respond quickly depending on the urgency of the situation or disaster. As an example, the company currently has 15 staff in the corporate office in State, and about 250 professionals working on various project locations throughout the country. As the key employee in his company, the taxpayer travels frequently out of town to generate new business, maintain business relationships, and oversee the status of projects. Because of these factors, the company is registered to do business and files income tax returns in close to 40 states. Since the company is an S corporation, the taxpayers also file individual income tax returns in all these states.

During 2017, the business had a significant contract with CITY. For income tax purposes, the STATE sources revenue to STATE if the benefit of the services is received in STATE (STATE Tax Law Section 210-A(10)(b)(1)). Of the company's \$\$\$\$ in gross receipts, \$\$\$\$ was sourced to STATE using this rule, representing about %%% of the taxpayers' business. Due to the size of this engagement, the company dedicated significant resources in STATE, in the form of professional service providers. In 2017, a total of 97,927 man-hours were spent on-site on the CITY project. Total company man-hours for the 2017 amounted to 150,333

hours. The CITY project began in 2013 and over the years, the taxpayer has travelled frequently to STATE to oversee all aspects of the engagement. Due to the increased business generated in STATE, the company's revenues were about \$\$\$\$ higher in 2017 than in 2016, which resulted in net income of about \$\$\$\$. Through November 2017, the taxpayer paid himself about \$\$\$\$ in wages, so a decision was made in December 2017 to distribute \$\$\$\$ of profit to the taxpayer. For convenience, the distribution was run through the normal year-end payroll rather than as a shareholder distribution. A copy of the year-end pay stub is attached for your review. Since this payment came out of the profit generated in STATE, under STATE law, a portion of the payment relating to the work performed in STATE was taxable in STATE. As a result, the taxpayers paid income taxes in STATE on \$\$\$\$ of income sourced to STATE, which represented close to %%% of the taxpayers' gross income for 2017. Attached for your review is a copy of the taxpayers' Nonresident STATE income tax return indicating that they paid \$\$\$\$ in STATE income taxes. The STATE income and taxes are reflected on Illinois Form CR, also attached for your review, and should be included in determining the \$\$\$\$ credit for taxes paid to other states.

Since the taxpayer owns %%% of the company, the income tax implications of the \$\$\$\$ payment being taxed as wages versus as a shareholder distribution are very similar. Given the nature and timing of the \$\$\$\$ payment, it does not seem proper that the character of the payment should result in a substantially different result for Illinois income tax purposes. Attached are drafts of the STATES returns if the \$\$\$\$ payment was treated as a shareholder distribution instead of wages. The results show the same amount of tax as the original returns filed with STATES.

Based on the information provided, we respectfully request that you accept their return as originally filed and reverse the assessment of \$\$\$\$ in taxes, interest, and penalties.

RULING

In Article 3 of the Illinois Income Tax Act, Section 301(a) of the Illinois Income Tax Act (35 ILCS 5/301) provides:

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.

The credit for taxes paid to other states is allowed by Section 601(b)(3) of the Illinois Income Tax Act (35 ILCS 5/601), which also provides:

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 taxable year.

In other words, a resident is entitled to a credit for any taxes paid to other states on income taxed by Illinois, but the total credit cannot exceed a limit. The limit equals the amount of Illinois income tax attributable to the income that is sourced outside Illinois using Illinois' allocation and apportionment provisions, determined by taking the taxpayer's Illinois tax before credits, and multiplying it by a fraction equal to the base income that would be allocated or apportioned to other states if they all used Illinois allocation and apportionment rules, divided by the taxpayer's total base income.

In the allocation and apportionment provisions of Article 3 of the Illinois Income Tax Act, Section 302(a) (35 ILCS 5/302) provides:

All items of compensation paid in this State (as determined under Section 304(a)(2)(B)) to an individual who is a nonresident at the time of such payment and all items of deduction directly allocable thereto, shall be allocated to this State.

Section 304(a)(2)(B) of the Illinois Income Tax Act (35 ILCS 5/304) provides that, for employees other than professional athletes:

Compensation is paid in this State if:

- (i) The individual's service is performed entirely within this State;
- (ii) The individual's service is performed both within and without this State, but the service performed without this State is incidental to the individual's service performed within this State; or
- (iii) Some of the service is performed within this State and either the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is within this State, or the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this State.

According to the information provided, it appears as if no portion of the taxpayers' income would be sourced to the STATE under Section 304(a)(2)(B) because the taxpayers' services were only partially performed in STATE, the taxpayers' base of operations was in Illinois and the taxpayers are Illinois residents. The fact that, under STATE law, some or all of the income may be taxable by STATE is not relevant. Accordingly, you have not provided us with any information that would show that our assessment is incorrect.

Further guidance on when compensation is "paid in this State" can be found at 86 Ill. Adm. Code Section 100.7010, which can be found at:

<http://www.ilga.gov/commission/jcar/admincode/086/086001000S70100R.html>

and in Publication 130, which can be found at:

<https://www2.illinois.gov/rev/research/publications/pubs/Documents/pub-130.pdf>

Based on the information provided, it appears as if the subject income could be properly classified as business income by the entity that would flow through to the shareholders. If so the taxpayers could amend their federal and state returns to properly classify the income as business income rather than compensation. At that time the income would be apportionable under Section 304 of the Illinois Income Tax Act, 35 ILCS 5/304 and the shareholders would only owe Illinois income tax on their distributive share of the amount of business income properly apportioned to this state.

As stated above, this is a general information letter which 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 are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b). If you have any further questions regarding this letter, you may contact me at (217) 782-2844.

Sincerely,

Michael D. Mankowski
Associate Counsel - Income Tax