IT 24-0005-GIL 04/29/2024 ALLOCATION

> General Information Letter: In computing the credit for taxes paid to other states, residents are required to allocate credits to out-of-state income due to the United States Supreme Court decision in *Lunding v. New York Tax Appeals Tribunal*. (This is a GIL.)

April 29, 2024

NAME
OCCUPATION
ADDRESS

Re: NAME
Allocation of HSA Deduction
Account ID: ########
Tax Year Ended: MM/DD/YEAR

Dear NAME:

This is in response to your letter dated August 4, 2023, in which you requested a private letter ruling regarding the allocation of the Health Savings Account (HSA) deduction on the Illinois Schedule CR, Credit for Tax Paid to Other States, as non-Illinois sourced income.

The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120(b) and (c). You may access our website at www.tax.illinois.gov to review regulations, letter rulings, and other types of information relevant to your inquiry.

The nature of your request and the information you have provided require that we respond with a GIL. In your letter, you have stated and made inquiry as follows:

> I am submitting this request for a private letter ruling on behalf of my clients, NAME. Enclosed, please find a power of attorney confirming I am authorized to submit this request on my clients' behalf. The taxpayer is a non-equity partner in a partnership and receives guaranteed payments as compensation for work performed in Illinois for Illinois-based clients. At the partnership

level, some states require guaranteed payments be allocated based on the partnership's apportionment percentage, regardless of where the partner worked and earned their compensation. As a result, some of his income has been allocated to other states.

Their YEAR Illinois tax return was filed claiming the resident credit for taxes paid to other states for non-Illinois income. The taxpayers also have a $$$$$ HSA deduction on their YEAR tax return. The IL Schedule CR page 2 automatically requires that column B, Non-Illinois portion, include the full amount of HSA deduction as non-Illinois sourced. This does not accurately represent the source or character of the HSA deduction, as this is a personal deduction that should be allocated to a taxpayer's home state. For example, in an instance where a taxpayer earned wages sourced to IL, had an HSA deduction and had an out of state rental, the IL law currently requires that the HSA deduction be allocated 100% to the out of state rental income, thus reducing the out of state income by a HSA deduction, even though the taxpayer would incur the $$$$$ HSA expense regardless of having the out of state rental, and the taxpayer would not deduct the HSA expense on the nonresident return, due to it being an expense allocable to their resident state since it is a personal expense. However, if the taxpayer merely had W2 income and no resident credit for other state taxes paid, the taxpayer will get the benefit of the HSA deduction against his IL sourced wages. This HSA expense would exist regardless of having an out of state rental and should not automatically be fully allocated to out of state income sources, reducing the resident credit.

In the taxpayers' case specifically, NAME has guaranteed payments from a partnership in which he is a non-equity partner. Certain states require his partnership allocate his guaranteed payments based on the partnership's apportionment percentage, even though his guaranteed payment is like a wage to him and he has no equity ownership in the partnership. As a result, he files returns in STATE1, STATE2, and STATE3 in addition to his home state of Illinois. Illinois is currently requiring that he allocate 100% of his HSA deduction to non-Illinois sources. However, this expense is a personal expense, and has nothing to do with the income allocated to other states. Additionally, the taxpayer did not deduct any HSA expense to his nonresident states, so Illinois allocating it to non-resident states results in the taxpayer getting no state tax benefit from the deduction whatsoever. However, if NAME had no out of state sourced income, he would get the benefit of his HSA deduction. We believe the fair treatment would be to allocate the HSA deduction to his home state of Illinois, since it is not related to his out of state income and is a personal expense, and he did not deduct it on any nonresident returns. Since he contributed to his HSA (a personal expense) while a resident of Illinois, this deduction is clearly an Illinois deduction and should not be allocated to nonresident states.

We see no authority that is to the contrary of our position. According to 35 ILCS 5/203, base income for individuals is an amount equal to the taxpayers federal AGI for the year, adjusted for modifications listed in section 203(a)(2). There is no modification for HSA deduction, and therefore, according to 35 ILCS 5/203, the Illinois tax base for individuals allows for a deduction of the HSA contributions. Illinois requiring that the HSA deduction be sourced fully to nonresident states where the taxpayer did not get the benefit of the deduction deprives the taxpayer from any benefit at the state level and is contrary to the intent of 35 ILCS 5/203. The current law does not accurately reflect the tax base for the nonresident states, as it reduces the nonresident income by the HSA deduction when it was not actually deducted on those nonresident returns, as the taxpayer is not entitled to deduct an expense that is personal and therefore related to his resident state against nonresident income. Reducing the taxpayer’s out of state income by the HSA deduction that they did not get to deduct on the nonresident return is effectively disallowing the deduction in full for the taxpayer, which does not align with the fact that Illinois residents should be entitled to reduce their income by their HSA contributions.

The current law requiring 100% of the HSA deduction to be allocated to out of state income regardless of the percentage of out of state income to in state income is inequitable, and it is not logical to allocate a deduction for an expense that a taxpayer incurs personally in full to reduce to out of state income that was not reduced by the HSA contribution. We are requesting that the treatment of HSA deductions for taxpayers claiming the resident credit be reevaluated to allocate the HSA deduction in full to Illinois for Illinois residents, or to at the very least allocate, it based on the percentage of income earned in Illinois.

To the best of the knowledge of both the taxpayers and the taxpayers’ representative, the Department has not previously ruled on the same or similar issue for the taxpayer or a predecessor, and the taxpayers and/or their representatives have not previously submitted the same or a similar issue to the Department but withdrew it before a letter ruling was issued.

> We appreciate your attention to this matter and the time taken to consider our request.

RULING

Section 601(b)(3) of the Illinois Income Tax Act (IITA) (35 ILCS 5/601) allows Illinois residents a credit for taxes paid to other states. That section provides, in part:

> The aggregate amount of tax which is imposed upon or measured by income and which is paid by a resident for a taxable year to another state or states on income which is also subject to the tax imposed by subsections 201(a) and (b) of this Act shall be credited against the tax imposed by subsections 201(a) and (b) otherwise due under this Act for such taxable year.
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> ………
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> *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.* (Emphasis added.)
>
> ………
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> The credit provided by this paragraph shall not be allowed if any creditable tax was deducted in determining base income for the taxable year. Any person claiming such credit shall attach a statement in support thereof and shall notify the Director of any refund or reductions in the amount of tax claimed as a credit hereunder all in such manner and at such time as the Department shall by regulations prescribe.

The italicized language above limits the amount of tax paid to other states that may otherwise qualify for the credit. That limitation is determined by multiplying the amount of Illinois income tax otherwise imposed for the taxable year by a fraction, the numerator of which is the amount of the taxpayer's base income that would be allocated or apportioned outside of Illinois assuming that all other states adopted Illinois' allocation and apportionment rules as set forth in Article 3 of the IITA, and the denominator of which is the taxpayer's total base income for the taxable year. Under this provision, only income that would have been taxable by other states applying Illinois law is included in the numerator of the fraction thereby increasing the credit limitation.

In *Lunding v. New York Tax Appeals Tribunal*, 522 U.S. 287 (1998), the United States Supreme Court held that states could not discriminate against nonresidents by denying them the same deduction for alimony paid that would be allowed to residents. Therefore,
nonresidents are allowed to allocate to Illinois the full amount of the federal deduction for alimony paid in determining their Illinois net income. See 11-0014-GIL and 20-0005-GIL. Consistent with this allocation, the limit on the credit for taxes paid to other states in Section 601(b)(3) of the IITA must be computed by allocating the deduction for alimony paid to other states as if they followed the same allocation principles as Illinois.

The holding in *Lunding* similarly applies to the HSA deduction at issue here. As a result, if any of the other states in which taxpayer filed a return had adopted Article 3 of the IITA, the taxpayer's HSA deduction would have been allowed in full. Accordingly, the HSA deduction must be allocated to the other states in computing the numerator of the taxpayer's limitation fraction. Illinois allows nonresidents to allocate the full amount of the HSA deduction to Illinois in determining their Illinois net income. The instructions to the Illinois Schedule CR correctly apply the statute.

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.

I hope this information is helpful. If you require additional information, please visit our website at www.tax.illinois.gov or contact the Department's Taxpayer Assistance Division at (217) 782-3336.

Sincerely,

Jennifer Uhles
Associate Counsel (Income Tax)