COMPLIANCE ALERT

STATE OF Illinois DEPARTMENT OF REVENUE

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Compliance Problem

We have determined that a significant number of taxpayers that took the "Extraterritorial Income Exclusion" (EIE) for federal income tax purposes, under Internal Revenue Code (IRC) Section 114, are not correctly completing their Illinois business tax returns. Specifically, taxpayers are not properly taking into account the EIE when computing the Illinois sales factor.

Solution

1. If you take the EIE, you must exclude the corresponding portion of your foreign trading gross receipts from both the numerator and denominator of your Illinois sales factor. See the example on Page 2 of this alert, which may help you make the correct calculations.
2. Review Illinois regulations 86 ILCS 100.3370(a)(2)(B) for guidance in correctly computing your sales factor.
3. If you made an error in the computation on your original return, you should file an amended return to correctly report the EIE for Illinois Income and Replacement Tax purposes.

Background

In 2000, Congress enacted IRC Section 114, which excludes extraterritorial income from gross income and disallows related deductions. The exclusion is limited to the amount of the qualifying foreign trade income, which is defined as the gross income from a qualifying transaction that, if excluded, would result in a reduction of taxable income equal to the greatest amount of:

(1) 30 percent of foreign sales and leasing income;

(2) 1.2 percent of foreign trading gross receipts; or

(3) 15 percent of foreign trade income.

In 2004, Congress repealed IRC Section 114, but included a phase-out provision that allowed an 80 percent exclusion of extraterritorial income for 2005 and a 60 percent exclusion for 2006. The exclusion is calculated on U.S. Form 8873, Extraterritorial Income Exclusion.

For Illinois Income Tax purposes, department regulations state that gross receipts that are excluded from or deducted in the computation of federal taxable income, and that are not added back in the computation of base income, are excluded from both the numerator and denominator of the taxpayer's sales factor. Therefore, if a taxpayer has claimed the exclusion from gross income for extraterritorial income, the taxpayer must exclude from its sales factor an amount of gross receipts attributable to the excluded gross income. In general, this may be done by excluding

Background (continued)

from the sales factor that amount of foreign trading gross receipts which bears the same ratio as the taxpayer's qualifying foreign trade income bears to its total extraterritorial income. For transactions subject to the 80 percent or 60 percent exclusion, the sales factor exclusion should be reduced accordingly.

Did you know?

The department found that most taxpayers correctly calculate the exclusion for the "Illinois sales factor," or the numerator. The most common error is that taxpayers fail to exclude the required amount from the "Everywhere sales factor," or the denominator.

Example of EIE calculation for Illinois Income Tax Purposes

✓ Assume a taxpayer has the following scenario for its 2003 taxable year:

Foreign trading gross receipts	$1,000.00
(less) allocable cost of goods sold	$ 600.00
Total extraterritorial income	$ 400.00
Other allocable expenses and deductions	$ 100.00
Foreign sale and leasing income	$ 10.00

✓ The taxpayer's Section 114 exclusion is the amount of its extraterritorial income that is qualifying foreign trade income.

✓ The taxpayer's qualifying foreign trade income is $60 (*i.e.*, 15 percent of foreign trade income of $45 grossed up for disallowed deductions of $15).

✓ Accordingly, the taxpayer must exclude from the numerator and denominator of its Illinois sales factor $150 or ($1,000 × $60/$400).