

IT 12-03

Tax Type: Income Tax

Issue: Claim For Refund On Retirement Income

**STATE OF ILLINOIS  
DEPARTMENT OF REVENUE  
OFFICE OF ADMINISTRATIVE HEARINGS  
CHICAGO, ILLINOIS**

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**THE DEPARTMENT OF REVENUE  
OF THE STATE OF ILLINOIS**

v.

**JOHN AND JANE DOE,  
Taxpayers**

No. XXXX  
Account ID XXXX  
Letter ID XXXX  
XXXX  
Tax Year XXXX

**Ted Sherrod  
Administrative Law Judge**

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**RECOMMENDATION FOR DISPOSITION REGARDING  
DEPARTMENT'S MOTION FOR PARTIAL SUMMARY JUDGMENT**

**Synopsis:**

This matter involves the Illinois Department of Revenue's ("Department") denial of an amended return claim for refund that John and Jane Doe ("Taxpayers") filed for the tax year ended December 31, 2009. On their amended return, the Taxpayers reported that Illinois income tax had been paid in error on income to the Taxpayers in the form of distributions from a non-negotiable promissory note covering payments pursuant to a Retirement Agreement entered into between John Doe, one of the Taxpayers, and ABC Business on March 24, 2008. The Department denied the Taxpayers' refund claim finding that the income the Taxpayers seek to exclude was not retirement income

deductible pursuant to section 35 **ILCS 5/203(a)(2)(F)** of the Illinois Income Tax Act (“IITA”).

The Taxpayers protested the Department’s determination regarding the denial of the Taxpayers’ deduction for retirement income, and other adjustments made to the Taxpayers’ amended return filed June 29, 2010. The parties have stipulated to the resolution of all but one of the issues raised in the Taxpayers’ protest, and the only unresolved issue is the Department’s denial of the Taxpayers’ deduction claimed for retirement income. With regard to this issue, the Department has filed a Motion for Partial Summary Judgment based upon a Stipulation of Facts agreed to by both parties, seeking affirmation of its refund claim denial disallowing the Taxpayers’ deduction of retirement income. The Taxpayers have filed a “Taxpayer’s Brief” contesting the Department’s refund claim denial. After a careful consideration of the record, including all of the documentary evidence presented in this matter, I recommend that Partial Summary Judgment, regarding the only issue protested by the Taxpayers that remains in dispute, be entered for the Department.

**Stipulated Facts Not In Dispute**

1. On February 22, 2010, the Taxpayers filed an Illinois Individual Income Tax Return (“IL-1040”) on a joint basis for the tax year ending December 31, 2009. Stipulation of Facts (“Stip.”) 1.
2. On MJohn Doe 5, 2010, the Taxpayers filed an Illinois Individual Amended Income Tax Return (“IL-1040-X or amended return”) on a joint basis for the tax year ending December 31, 2009. Stip. 2.

3. The Department reviewed the amended return and made the following adjustments to the amounts shown on the following lines of the amended return:
  - a. Line 6 – Illinois Income Tax overpayment included in U.S. 1040, Line 10 was reduced from \$2,337 to \$237.
  - b. Line 7 - other subtractions to income was reduced from \$161,027 to \$2,000 (backing out the 2009 1099-INT payment of \$115,072 and Long Term Capital Gains of \$43,955).
  - c. Line 13 - Tax amount was changed from \$18,276 to \$23,111.
  - d. Line 19 - Property tax credit was reduced from \$960 to zero.
  - e. Line 20 - nonrefundable credits were reduced from \$2,111 to \$1,151.
  - f. Line 21 - tax after refundable credits was changed from \$16,165 to \$21,960.
  - g. Line 22 - total of all previous overpayments was changed from \$4,724 to \$322.
  - h. Line 31 - underpayment was changed from zero to \$242.  
Stip. 3
4. Thereafter the Department issued two Notices of Claim Denial, one dated June 28, 2010 and one dated June 29, 2010. The Notice of Claim Denial at issue in these proceedings is the one dated June 29, 2010. Stip. 4.
5. On July 21, 2010, the Taxpayers timely protested and contested the Department's changes to line entries on the Taxpayers' amended return as indicated below:
  - a. Reduction of Line 6; this issue has been resolved, having been conceded by the Department.

- b. Reduction of Line 7; this adjustment, which is at issue pursuant to the Department's Motion for Partial Summary Judgment, concerns the treatment of certain payments received from ABC Business ("ABC Business") by Terry B. John Doe ("John Doe"), one of the Taxpayers, who was formerly a ABC Business partner, which Taxpayers assert are in the nature of "retirement" income.
- c. Increases in the tax amount reported on Line 13; by agreement of the parties, this amount will be determined by the results of the Department's Motion for Partial Summary Judgment and the calculation of amounts pertaining to issues conceded by the Department.
- d. Reduction in property tax (Line 19); this issue has been conceded by the Department based upon the Department's finding that the Taxpayers had adequate evidence of the amount and payment of property taxes.
- e. Line 20 claim for nonrefundable credit for taxes paid to other states; the Department has recalculated the amount of this credit and the Taxpayers have agreed to this recalculation.
- f. The Department's adjustment to the amount reported by the Taxpayers on Line 21 of their return; this issue has been conceded by the Taxpayers.
- g. Reduction to Line 22 overpayments claimed by the Taxpayers; by agreement of the parties, this will be determined by the results of the Department's Motion for Partial Summary Judgment and the calculation of issues conceded by the Department.

- h. Line 31 underpayment; the propriety of the Department's underpayment determination is being contested, and will be determined based upon the results of the Department's Motion for Partial Summary Judgment and the calculation of issues conceded by the Department. Stip. 5
6. John Doe joined ABC Business as a partner in 1999 and remained until his retirement on April 1, 2008. Stip. 6.
  7. On April 1, 2008, John Doe executed a "Retirement Agreement" and a Non-Negotiable Promissory Note with ABC Business. Stip. 7.
  8. For ABC Business's tax year April 1, 2008 through and including March 31, 2009, the Taxpayers received from ABC Business a U.S. Form 1065, Schedule K-1 reporting \$303,130 as ordinary income and \$30,085 as guaranteed payments. Stip. 8.
  9. With their IL-1040 for 2009, the Taxpayers filed with the Department a Schedule K-1-P, IL Form 1065 that John Doe had received from ABC Business for its taxable year April 1, 2008 through and including March 31, 2009 reporting \$303,130 as ordinary income from trade or business and \$30,085 as guaranteed payments to partner. Stip. 9.
  10. John Doe received from ABC Business a 2009 U.S. Form 1099-INT reporting \$115,072 in interest payments. This amount was not reported as federal net earnings from self-employment by ABC Business. Stip. 10.

11. John Doe reported on his 2009 U.S. Form 1040, Schedule D, Capital Gains and Losses, a payment of \$43,955 received from ABC Business which was reported as “One Capital/ABC Business.” Stip. 11.

12. Taxpayer received a letter from ABC Business dated January 19, 2010 which indicated, in part, the following:

During calendar year 2009, ABC Business LLP made payments to you aggregating \$159,026 under promissory note evidencing our obligation to you. This figure is comprised of interest income and capital gain income in the amounts of \$115,072 and \$43,955, respectively. You have already received a Form 1099-INT that formally reports Interest income. The purpose of this correspondence is to formally report the capital gain payments that were remitted to you during 2009, so that you may have appropriate records for your personal tax files.

Stip. 12; Stip. Exhibit (“Ex.”) 9.

13. The Taxpayers reported the 2009 U.S. Form INT interest payment of \$115,072 received from ABC Business on the Taxpayers’ 2009 Form US-1040, Schedule B. Stip. 14.

**Conclusions of Law:**

The issue to be determined pursuant to the Department’s Motion for Partial Summary Judgment and the Taxpayer’s Brief is whether the payments, received by one of the Taxpayers, John Doe (“John Doe”), a former partner at ABC Business LLP (“ABC Business”), under a promissory note John Doe received from ABC Business given pursuant to a Retirement Agreement entered into between John Doe and ABC Business, were properly deductible from Illinois taxable income as “retirement income” pursuant to section 203(a)(2)(F) of the Illinois Income Tax Act. John Doe retired from ABC Business in 2008. Stip. 6. In 2009, John Doe received retirement payments from ABC Business pursuant to a Retirement Agreement entered into between John Doe and ABC

Business on March 25, 2008. Stip. Ex. 2. These retirement payments were reported federally as capital gain in the amount of \$43,955 and as interest income in the amount of \$115,072. Stip. 3; Stip. Ex.7, 8. The Taxpayers deducted this capital gain income and interest income as retirement income from Illinois taxable income on their amended return filed for 2009. Stip. 2, 3. These proceedings concern the Taxpayers' deduction of this capital gain and interest income received as retirement income by the Taxpayers. The Taxpayers argue that these amounts paid to John Doe under the aforementioned Retirement Agreement constituted deductible retirement income pursuant to section 203(a)(2)(F) of the IITA. Taxpayer's Brief pp. 3-5. The Department disputes this claim.

The Department has requested that this matter be conclusively resolved upon Motion for Partial Summary Judgment and has filed such a motion in this case. A motion for summary judgment is appropriate where the pleadings, affidavits, and other documents on file show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. 735 ILCS 5/2-1005(c); People ex rel. Department of Revenue v. National Liquors Empire, Inc., 157 Ill. App. 3d 434 (4<sup>th</sup> Dist. 1987). Summary judgment is also appropriate where the parties agree on the facts, but dispute the construction of an applicable statute. Bezan v. Chrysler Motors Corp., 263 Ill. App. 3d 858, 864 (2d Dist. 1994). Since both parties in this matter have entered into an agreed Stipulation of Facts, I find that there is no genuine issue of material fact with regard to the issue presented in this case. Since the only disputed issue in this case is a legal one, I find that an action for summary judgment is appropriate here.

Section 203(a)(2)(F) of the IITA prescribes that a deduction is to be given for "retirement payments to retired partners." The Taxpayers contend that they are entitled

to this deduction. Taxpayer's Brief pp. 3-5. When a taxpayer seeks to take advantage of deductions, credits or other tax benefits allowed by statute, the burden of proof is on the taxpayer. Balla v. Department of Revenue, 96 Ill. App. 3d 293, 295-96 (1<sup>st</sup> Dist. 1981). Since the Taxpayers are claiming a refund of tax previously paid over to the State based upon the deduction allowed by section 203(a)(2)(F) of the IITA, the Taxpayers have the burden of proof in this matter. Balla, supra at 295-96.

Both parties refer to section 5/203(a)(2)(F) as the legal basis for their respective arguments. Section 5/203(a)(2)(F) provides for a deduction for:

(F) 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 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; (emphasis added)

The plain language of section 5/203(a)(2)(F), allows a deduction from Illinois taxable income of retirement income paid to partners that is excludable in computing net earnings from self employment by section 1402 of the Internal Revenue Code, and regulations adopted pursuant thereto. The Taxpayers argue that retirement income paid to partners that is excludable under any provision of section 1402 of the Internal Revenue Code can be deducted pursuant to section 5/203(a)(2)(F). Taxpayer's Brief p. 4. The Department disagrees. It argues that only partner retirement income that is excludable in computing net earnings from self employment pursuant to section 1402(a)(10) is deductible pursuant to section 5/203(a)(2)(F). Department's Brief pp. 11-14. I agree with the Department on this point.

Section 1402(a)(10) of the Internal Revenue Code provides as follows:

(10) there shall be excluded amounts received by a partner pursuant to a written plan of partnership, which meets such requirements as 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 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);

26 U.S.C.A. 1402(a)(10)

A perusal of section 1402 of the Internal Revenue Code indicates that section 1402(a)(10) is the only provision of this measure that addresses the exclusion of partner retirement income from net income from self employment. The Taxpayers, in their brief, have failed to identify any subdivision of section 1402 other than section 1402(a)(10) that would exclude from self employment income the partner retirement income at issue in this case.

Moreover, section 5/203(a)(2)(F) defines the exemption available for “retirement payments to retired partners” with reference to “Section 1402 of the Internal Revenue Code and regulations adopted pursuant thereto.” The only reference to “retirement payments to partners” contained in section 1402 of the Internal Revenue Code and the regulations adopted pursuant to this statute appears in Treas. Reg. 1.1402(a)-17, 26 C.F.R. 1.1402(a)-17, where this phrase appears in the title of this regulation as “§

1.1402(a)-17 Retirement payments to retired partners.” Given this fact, the term “retirement payments to retired partners” in section 5/203(a)(2)(F) can only be construed to mean “retirement payments to retired partners” as enumerated in Treas. Reg. 1.1402(a)-17, 26 C.F.R. section 1.1402(a)-17, since this is the only regulation pursuant to section 1402 that enumerates this term. The text of Treas. Reg. 1402(a)-17 indicates that this regulation pertains solely to section 1402(a)(10).

As pointed out by the Department in its brief, a construction of section 5/203(a)(2)(F) that limits the deduction for retirement income only to retirement income excludable from self employment income outlined in section 1402(a)(10) of the Internal Revenue Code is also dictated by legislatively prescribed rules of statutory construction set forth in section 5/102 of the IITA, 35 ILCS 5/102, requiring that terms used in the state’s income tax statutes be given the same meaning as identical terms when used in the Internal Revenue Code and related provisions. Specifically, noting that excludable “retirement payments to retired partners” in section 5/203(a)(2)(F) is identical to the phrase “Retirement payments to retired partners” describing amounts deductible from net income from self employment contained in Treas. Reg. 1.1402(a)-17, the Department concludes that the term “retirement payments to retired partners”, when used in section 5/203(a)(2)(F), must be construed to have the same meaning as this term has under federal law. Department’s Motion for Partial Summary Judgment, pp. 13, 14. Since Treas. Reg. 1.1402(a)-17 confines excludable “retirement payments to partners” to payments that are excludable from self employment income pursuant to section 1402(a)(10), the Department concludes that section 5/203(a)(2)(F) must be interpreted as

being similarly limited. *Id.* In support of this claim, the Department points out the following:

A rule of statutory construction is found in IITA Section 102 (35 ILCS 5/102):

Construction. Except as otherwise expressly provided or clearly appearing from the context, any term used in this Act shall have the same meaning when used in a comparable context in the United States Internal Revenue Code of 1954 or any successor law or laws relating to federal income taxes and other provisions of the statutes of the United States relating to federal income taxes as such code, laws and statutes are in effect for the taxable year.

The insertion of the language “retirement pay for retired partners” [in section 203(a)(2)(F)] identical to the language in ...Treas. Reg. 1.1402(a)-17 ..requires the interpretation of that language to have the same meaning as the same language contained in ... the Treas. Reg. 1.1402(a)-17 interpreting [IRC section 1402(a)(10)].  
Department’s Brief pp. 13, 14.

For the aforementioned reasons, I conclude that only partner retirement income that is excludable from self employment income pursuant to section 1402(a)(10) of the Internal Revenue Code can be deducted from Illinois income pursuant to section 5/203(a)(2)(F) of the IITA.

As previously noted, section 1402(a)(10) provides as follows:

(10) there shall be excluded amounts received by a partner pursuant to a written plan of partnership, which meets such requirements as 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 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);  
26 U.S.C.A. 1402(a)(10)

Section 1402(a)(10) clearly enumerates three factual prerequisites that must be shown to exist in order for income paid to a retired partner pursuant to a retirement plan to be excluded from self employment income under the Internal Revenue Code. These are:

1. That retirement payments to the retiring partner be received at a time when the partner is no longer being compensated for services to the partnership;
2. That, with the exception of retirement payments, no payment obligations to the retiree from the partnership exist at the time retirement payments commence; and
3. That the partner's share of the partnership's capital be paid to him in full before retirement payments commence.

With respect to the requirement that a partner not render services for the partnership making retirement payments during the year retirement benefits are received (section 1402(a)(10)(A)) in order for retirement income to be excluded from self employment income under section 1402, the stipulated record in this case is devoid of any factual basis for deciding whether or not John Doe rendered any services for ABC Business during 2009, the year in which payments pursuant to John Doe's Retirement Agreement with ABC Business began. Nor do any of the documents contained in the record provide any clue whether this prerequisite for excluding retirement income from self-employment income pursuant to section 1402(a)(10) has been met. This prerequisite to exclusion of retirement income from self employment income under section

1402(a)(10)(A) is simply not addressed in the record. As noted previously, the burden of proof is upon the taxpayer to establish that it is entitled to a deduction. Balla, *supra*. Consequently, it was incumbent upon John Doe to produce evidence showing that all payments he received met this requirement for exclusion of retirement income pursuant to section 1402(a)(10).

The application of section 1402(a)(10) to exclude retirement income from self employment income also requires a showing that the only payment obligation to the retiring partner from the partnership existing after the partner retires is the payment of retirement income. See section 1402(a)(10)(B). The record in this case contains no stipulation of fact or other evidence that this prerequisite for the exclusion of income pursuant to John Doe's Retirement Agreement has been satisfied. At most, the record indicates that no such obligation is identified in the Retirement Agreement, or in any of the other partnership documents that the record includes. While an inference that no such payment obligation existed can be drawn from the documents contained in the record that would support a stipulation to this fact, no such stipulation is included in the record before me. Therefore, I have been provided with no basis for concluding that the retirement payments described in the Retirement Agreement between John Doe and ABC Business constituted ABC Business's sole continuing payment obligation to John Doe after John Doe retired. Accordingly, the Taxpayers have failed to carry their burden of proof with respect to showing that the requirements of subdivision (B) of section 1402(a)(10) have been met. Balla, *supra*.

Finally, the application of section 1402(a)(10) to exclude retirement income from self employment income requires a showing that a partner's share of partnership capital

has been paid in full before retirement payments begin. See section 1402(a)(10)(C). The record regarding whether this criteria for coming within section 1402(a)(10) of the Internal Revenue Code has been met in the instant case is, at best, ambiguous. The record indicates that the retirement payments John Doe received were not from a typical capital account (such as ABC Business's "tangible capital account" consisting of partnership equity and each partner's share of partnership profits and losses). Taxpayer's Brief p. 2. Nevertheless the type of accounts from which John Doe received payments under his retirement agreement with ABC Business were very similar to capital accounts. The accounts from which he was paid, called "memo accounts", had significant features of typical capital accounts because partner accruals to these accounts were based upon the firm's profits and losses. *Id.* Moreover, amounts accruing to these memo accounts were based upon "capital share value" suggesting that these payments were related to John Doe's equity in ABC Business. See Stip. Ex. 2.

Furthermore, the record indicates that the retirement payments to John Doe from ABC Business at issue in this case were reported as interest and capital gains on the Taxpayers' federal returns. Stip. 3; Stip. Ex. 7, 8. The Department has previously indicated that such capital gains and interest income to partners will be deemed to be income related to the liquidation of a partnership interest rather than retirement income and treated as income from a partner's capital investment in the partnership unless the partner can show why it is not this type of income. See Department of Revenue IT 11-0008-GIL dated March 23, 2011. In the instant case, John Doe has not even attempted to explain why his retirement income, classified as capital gain and interest income on his federal return, did not constitute liquidation payments terminating John Doe's equity in

ABC Business, and therefore run afoul of the requirements for exclusion of retirement income from self employment income under section 1402(a)(10)(C).

For the foregoing reasons, I find that the Taxpayers have failed to prove that the type of income the Taxpayers received pursuant to John Doe's Retirement Agreement with ABC Business was excludable from self employment income under section 1402(a)(10) of the Internal Revenue Code. Since a showing that income has been excluded pursuant to section 1402(a)(10) is required before such income can be deducted under section 203(a)(2)(F) of the IITA, the Taxpayers have failed to carry the burden of proof that must be met in order to deduct the income at issue in this case as deductible retirement income under section 203(a)(2)(F). *Balla, supra* at 295 (“when a taxpayer claims that he is exempt from a particular tax, or where he seeks to take advantage of deductions or credits allowed by statute, the burden of proof is on the taxpayer.”).

Moreover, even if the record indicated that all of the foregoing prerequisites for the exclusion of John Doe's retirement income from self employment income under section 1402(a)(10) were satisfied, the retirement payments at issue in this case would still run afoul of the requirements of section 1402(a)(10) and therefore fail to qualify for deduction under section 203(a)(2)(F). Notably, section 1402(a)(10) provides, in part, as follows:

(10) there 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 ...[.] emphasis added.

The record in this case indicates that John Doe was to be paid consecutive monthly payments in equal amounts commencing upon his retirement, and that the total he was entitled to receive was \$1,484,244. Stip. Ex. 3. As pointed out in the Department's brief, given the foregoing, it will take ABC Business no more than seven years to complete all of the payments to which John Doe is entitled under ABC Business's Retirement Agreement with John Doe. Department's Brief p. 2. In light of this fact, it is difficult to conclude that the Retirement Agreement entered into between John Doe and ABC Business called for "payments to continue at least until such partner's death" which, as noted above, is a prerequisite to coming within the exclusion of retirement income paid to partners from self employment income under section 1402, and therefore a necessary condition for income exclusion under section 203(a)(2)(F) of the IITA.<sup>1</sup>

**WHEREFORE**, for the reasons stated above, **IT IS ORDERED THAT:**

1. The Department's Motion for Partial Summary Judgment is hereby granted, and summary judgment on the sole contested issue in this case is entered for the Department; and

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<sup>1</sup> The Taxpayers also argue that their income from the promissory note John Doe received upon cessation of his partnership status cannot be taxed because it was not his "property" and was not properly reportable on the Taxpayers' 2009 Federal return at the time it was reported as taxable for Federal and Illinois income tax purposes. This argument does not negate the legality of the inclusion of the Taxpayers' retirement income at issue in the Taxpayers' Illinois tax base. The record shows that this income was included in the Taxpayers' adjusted gross income for 2009 for federal income tax purposes. Stip. 10, 11; Stip. Ex. 8, 9. A showing that the income at issue in this case was included in the Taxpayers' 2009 Federal adjusted gross income is all that is required to include it in the Taxpayers' Illinois tax base pursuant to section 5/203(a)(1) of the Illinois Income Tax Act. Accordingly, irrespective of the status of the Taxpayers' income as "property" or their claim that the income at issue should not have been included in the Taxpayers' Federal 2009 return, I find that the taxation of this income is completely authorized by Illinois law.

2. The Notice of Claim Denial at issue is hereby affirmed as to the sole contested issue in this case, and is otherwise concluded in accordance with the agreement of the parties as enumerated in the Stipulation of Facts agreed to by the parties.

**Ted Sherrod**  
**Administrative Law Judge**

**Date: May 2, 2012**