IT 08-0027-GIL 09/17/2008 CREDITS – FOREIGN TAX

General Information Letter: Correct computation of income double taxed by Illinois and Minnesota explained.

September 17, 2008

Dear:

This is in response to your letter dated June 4, 2008. The nature of your letter 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* 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www. tax.illinois.gov.

In your letter you have stated the following:

> We are writing in an attempt to resolved an issue regarding a proposed change to our 2006 IL-1040 contained in the enclosed copy of your original notice, dated May 24, 2007 (labeled Exhibit I, pages 1-3). We continue to maintain the position that our 2006 IL-1040 is correct, as originally filed, and that your proposed change is incorrect.
>
> We replied in a timely manner, by way of a letter dated June 20, 2007, a copy of which is attached and labeled Exhibit II, pages 1 & 2. We received no further contact from your department, regarding this matter, until we received your "Final Notice of Intent to Withhold Federal Warrants" dated February 6, 2008 a copy of which is attached and labeled Exhibit III, pages 1 & 2. This correspondence contained a demand for payment by April 7, 2008. On or about March 24, 2008 (2 weeks prior to your demand due date) we became aware that this matter had been turned over to a collection agency!
>
> Your department proposes to decrease our Credit for Tax Paid to Other States on Sch CR from $3,237.00 to $1,904.00! Included with our original notice (Exhibit I) was a copy of our original Sch CR, a copy of which is attached and labeled Exhibit IV. In rather sloppy hand writing, someone in your department wrote different amounts on line 2, column b, and lines 4, 6, 7, & 8 of our original Sch CR and marked thru our original amounts! Your notice contained no explanation as to how this person arrived at these amounts!
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> In an attempt to resolve this matter, our accountant spent 3 to 4 hours from March 26, 2008 to April 4, 2008 speaking to five different individuals in your department (Mr. Z., Ms. Y, Ms. X, Ms. W, & Mr. V) and none of them could explain how the figures penciled in on our original Sch CR were calculated! Your department did send us a copy of Publication 111, a copy of which is attached and labeled Exhibit V, pages 1-3.
>
> Our accountant recently spent in excess of 2 hours going thru your worksheet (Exhibit V, page 3) in detail and plugging in our specific amounts in an attempt to determine how your representative arrived at the $65,792.00 that is penciled in on our Sch CR (Exhibit IV) when we had wages from Minnesota of $111,842.00 that we paid $7,205.00 in Minnesota tax on! Thru this process of going thru your Publication 111 worksheet (Exhibit V, page 3) he identified nearly a half dozen misstatements and inconsistencies such as incorrect line numbers according to the line item description, improper sections of the state return where various items are added or subtracted, etc.). We do not see

any need to go into the details of these items, at this time, but he did document them in the event this matter ends going before the Board of Appeals for an ultimate resolution!

After completing this process, he concluded that your representative must have inadvertently taken the amount from line 1 of the wrong form to apply the Minnesota % to. Column 3 of your publication 111 worksheet (Exhibit V, page 3) states "Schedule M1NR, line 24 (.58122) times the sum of IL-1040, line 1 (192,428) plus various line items and minus various line items, which are non applicable. He noticed that .58122 times Sch CR, line 1 of $113,196.00 (instead of IL-1040, Line 1 of 192,428.00) equals $65,791.78, (Exhibit VI, calc 1) which would round to the $65,792.00 which is the amount penciled in on our Sch CR, line 2, column B!

Regarding the Publication 111 worksheet (Exhibit V, page 3), the only item of the additions to and subtractions from IL-1040, Line 1 that could possibly apply would be the subtraction of $40.00 of U.S. Savings Bond Interest, because this item of income is <u>treated the same by both states (IL & MN)</u>, in that it is a subtraction in arriving at taxable income for both states! If you subtract $40.00 from IL-1040, Line 1 and then multiply the difference by .58122 the result is $111,819.75. (Exhibit VI, calc 3) Our accountant plugged this amount in on Sch CR, line 2, column B and it did not change the bottom line, or ultimate outcome of our 2006 IL-1040. He did say that it did decrease our credit on Sch CR by $1.00, but our credit for property tax paid on our home increased by $1.00!

Of the five different individuals, with your department, that our accountant spoke to the only one that attempted to discuss the details of your position was Mr. Z. and after about 45 minutes he informed our accountant that he had no authority to do anything. However, before they ended their telephone conversation he advised our accountant that it appeared to him that the problem has to do with our retirement income. If your proposed calculation of Sch CR, line 2, column B was made by subtracting our retirement income of $79,129.00 I would direct your attention to Exhibit V, page 2 where it explains how to figure the amount of double taxed income. There it states that an item of income is double-taxed only to the extent that both Illinois and the other state include it in income. It goes ahead to say that items are included or excluded (added or subtracted) only to the extent that they are added or subtracted by both Illinois and the other state, which is consistent and makes sense. Near the bottom of the left column it refers to some states that determine income by first figuring income as if the person were a resident of that state (Minnesota does this) and then multiplying the income or the tax by a fraction equal to the percentage of income from sources in that state. Minnesota calculates tax on all income and then multiplies the tax by the fraction or % referred to above. We have enclosed a copy of our 2006 Minnesota Return, labeled Exhibit VII, pages 1-4. The first paragraph of the right column of Exhibit V, page 2 states that double-taxed income for any of these states is calculated by first figuring income according to the rules above, and then multiplying that income by a fraction equal to the percentage of income from sources in that state. The "rule above" state that items are included or excluded to the extent that they are treated the same by both states. Illinois tax law allows the subtraction of retirement income from Adjusted Gross Income in arriving at Illinois Taxable Income. Minnesota, on the other hand, does not allow the subtraction of retirement income so, obviously, retirement income <u>is not</u>

treated the same by both states. From a common sense standpoint is seems obvious that a taxpayer would be double penalized or harmed if you subtract an item of income, that represents a subtraction for that state (IL) and then multiply it by a % from another state that does not allow that item as a subtraction, but the % itself, the denominator, of which includes that item!

We are confident that once you consider the above stated facts as well as the instructions in Publication 111 you will conclude that your proposed change is incorrect and that our 2006 IL-1040 is correct, as originally filed!

Response

Section 601(b)(3) of the Illinois Income Tax Act (35 ILCS 5/601) 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. The aggregate credit provided under this paragraph 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 subject to tax both by such other state or states and by this State bears to his total base income subject to tax by this State for the taxable year.

The Department's regulation at 86 Ill. Adm. Code Section 100.2197(b)(4) provides that, in order to compute the "base income subject to tax by both such other state or states and by this State" (referred to as "double-taxed income"):

B) An item of income is not included in double-taxed income to the extent it is excluded or deducted in computing the tax for which the credit is claimed. For example, State X allows a deduction or exclusion equal to 60% of long-term capital gains and for 100% of winnings from the State X lottery. Only 40% of long-term capital gains is subject to tax in that state. Similarly, an individual subject to the Washington, D.C. unincorporated business tax is allowed to deduct from taxable income a reasonable allowance for compensation for personal services rendered. This deduction is in fact an exclusion for the "personal income" of the individual, which Congress has forbidden Washington, D.C. to tax except in the case of residents. Accordingly, double-taxed income is net of this deduction.

C) An item of income that is excluded, subtracted or deducted in the computation of base income under IITA Section 203 cannot be included in double-taxed income. For example, IITA Section 203(a)(2)(L) allows a subtraction for federally-taxed Social Security and Railroad Retirement benefits, while dividends received from a Subchapter S corporation are excluded from federal gross income and therefore from base income. Accordingly, even if another state taxes such benefits or dividends, these amounts are not included in double-taxed income.

D) An item of expense is deducted or subtracted in computing double-taxed income only to the extent that item is deducted or subtracted in computing the tax base in the other state and in computing base income under IITA Section 203.

In Publication 111, Illinois Schedule CR Comparison Formulas for Individuals, these provisions are paraphrased by stating that, in computing double-taxed income, a taxpayer should take into account only those items of income taxed by both states and should deduct only those expenditures for which both states allow a deduction.

Section 100.2197(b)(4)(G) provides:

> Some states compute the tax liability of a nonresident by first computing the tax on all income of the nonresident from whatever source derived, and then multiplying the resulting amount by a percentage equal to instate sources of income divided by total sources of income or by allowing a credit based on the percentage of total income from sources outside the state. Other states determine the tax base of a nonresident by computing the tax base as if the person were a resident and multiplying the result by the percentage equal to in-state sources of income divided by total sources of income. The use of either of these methods of computing tax does not mean that income from all sources is included in double-taxed income. See Comptroller of the Treasury v. Hickey, 114 Md. App. 388, 689 A.2d 1316 (1997); Chin v. Director, Division of Taxation, 14 N.J. Tax 304 (T.C. N.J. 1994). When a state uses either of these methods of computation, double-taxed income shall be the base income of the taxpayer from all sources subject to tax in that state, as computed in accordance with the rest of this subsection (b)(4), multiplied by the percentage of income from sources in that state, as computed under that state's law; provided, however, that no compensation paid in Illinois under IITA Section 304(a)(2)(B) shall be treated as income from sources in that state in computing such percentage in any taxable year beginning prior to January 1, 2006.

The provisions in Publication 111 for computing income that is double-taxed by Minnesota and Illinois follow these provisions. In applying them to your return, the computation starts with federal adjusted gross income for the taxable year. This starting point was picked because the computation of Illinois base income starts with federal adjusted gross income, while the computation of Minnesota taxable income begins with federal taxable income. Because federal taxable income is federal adjusted gross income, minus exemptions and either itemized deductions or the standard deduction, both states necessarily include in their tax base every item of income (and only those items of income) included in federal adjusted gross income and allow every deduction (and only those deductions) taken in computing federal adjusted gross income, unless a specific adjustment is made somewhere on the form of one of the states. Exemptions and itemized or standard deductions taken from adjusted gross income in computing federal taxable income are ignored because Illinois does not allow these deductions.

Only two relevant adjustments to federal adjusted gross income are made on either state's form. First, Illinois does not tax retirement income, and so the retirement income you included in your federal adjusted gross income must be subtracted in order that only items of income taxed by both states will be included in double-taxed income. Second, neither state taxes interest income from U.S. savings bonds, so the amount of that interest included in federal adjusted gross income must also be subtracted. Publication 111 expressly states that, in computing income double-taxed by Minnesota and Illinois, amounts subtracted on Line 5 of the Form IL-1040 (retirement income) and Line 6 of the Minnesota Form M1 (federal obligation interest) must be subtracted.

Finally, as provided in Section 100.2197(b)(4)(G) and Publication 111, the resulting amount is multiplied by the percentage of income from Minnesota sources that is multiplied against the Minnesota income tax computed as if you were a Minnesota resident in order to determine your nonresident liability.

Following these instructions, your double-taxed income is 58.122% times the sum of your $192,428 in federal adjusted gross income, minus the $70,192 in retirement income and the $40 of U.S. savings bond interest included in federal adjusted gross income, for a net result of $65,792. This amount was used in our correction to your Schedule CR.

This is the correct computation of your income that was taxed by both states, because the Minnesota computation actually taxed you on 58.122% of all items of income included in your federal adjusted gross income and not subtracted on your Minnesota return. Rather than taxing you only on the $111,842 in wages from Minnesota sources, you were taxed on 58.122% of those wages and on 58.122% of your retirement income and 58.122% of your taxable interest and dividends. This can be seen by computing Minnesota tax that would be imposed if Minnesota had allowed you to exclude your retirement income from the tax base. By my computation, your tax would have been $6,355, even if you treated all of your other income as Minnesota sourced, rather than the $7,205 tax you actually paid. The difference is cause by Minnesota's tax on your retirement income, which Illinois does not tax. Because the credit is allowed only for taxes paid to Minnesota on income that is also taxed by Illinois, no credit can be allowed for this portion of your Minnesota tax.

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, you may contact me at (217) 782-7055.

Sincerely,

Paul S. Caselton
Deputy General Counsel – Income Tax