

General Information Letter: The IITA authorizes composite returns to be filed only for the immediate, individual owners of a Subchapter S corporation or partnership.

December 29, 2008

Dear:

This is in response to your letter dated November 12, 2008. The nature of your letter and the information provided require that we respond with a General Information Letter (GIL). A GIL 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 accessed from the Department's web site at www.Iltax.com.

Your letter states as follows:

Our client ("Company") seeks approval to file a composite tax return in Illinois. This filing methodology would benefit both Illinois and Company by providing the same information and at least the same tax revenue that would be due if composite filing were not used, while substantially reducing the number of required income tax filings. A summary of the relevant facts follows.

Facts.

Company is registered to conduct business and has a tax filing obligation in many states, including Illinois. Company is engaged in the business of merchandising, distributing, and trading of commodities. Company is treated as a partnership for federal income tax purposes, and is owned by four entities (two limited partnerships and two limited liability companies) that are also treated as partnerships for federal income tax purposes (the "Partnership Owners"). The Partnership Owners are not organized or registered to do business in Illinois. In turn, these entities are owned by individuals, entities (corporations and limited liability companies) treated as corporations for federal income tax purposes, or other entities treated as partnerships for federal income tax purposes. The ultimate indirect owners of Company that pay federal income tax are individuals, trusts or estates, or entities treated as corporations. These collectively are referred to as the "Taxpayer Owners." An organizational chart of Company's structure is attached as Exhibit A.

It is also important to note that both the Taxpayer Owners and the Partnership Owners are passive investors in Company, rather than active managers, and are not engaged in a unitary business with Company.

Law

Illinois provides that partnerships and LLCs taxed as partnerships may file a composite return on behalf of certain partners. 35 ILCS Sec. 5/502(f); 86 Ill. Adm. Code 100.5130. For Illinois purposes, LLCs are treated as either partnerships or corporations. Illinois provides that only individuals, estates, and trusts that are members of the same partnership may participate in the composite filing. Illinois does not permit other owners to be included in the composite filing, such as corporations and other pass-throughs. 86 Ill. Adm. Code 100.5100(b).

The composite filing is generally for nonresidents of Illinois who have no Illinois income other

than the income reported on Form IL-1023-C. However, the partnership may seek permission from the Illinois Department of Revenue to include:

1. A member who is an Illinois resident;
2. A member whose residency cannot be determined; or
3. A nonresident member required to file an independent Form IL-1040, Individual Tax Return, or Form IL-1041, Fiduciary Income and Replacement Tax Return, to report other Illinois income and who will claim a credit on that return for its share of the composite tax paid on Form IL-1023-C.

An "entity"-level net operating loss is not permitted in computing composite income of nonresident partners or members.

Request

Because Company is directly owned by the Partnership Owners and only ultimately owned by the Taxpayer Owners, Illinois generally would not allow the Partnership Owners to be included in a composite return filed by Company. However, Company represents to Illinois that a composite return including the Partnership Owners would provide Illinois with at least as much tax revenue, if not more, as returns filed separately by the Taxpayer Owners. Company strongly desires to simplify the significant compliance burden for its direct and indirect owners as much as possible, and filing a composite return would significantly decrease the number of required returns that Company's direct and indirect owners would be required to prepare and that Illinois would be required to process. A composite return also reduces the chance of reporting errors by each Taxpayer Owner. Such errors potentially could cause Illinois to receive less than the full amount of tax owed. As a result, Company requests permission to file a composite return using the methodology detailed below.

Company will file a composite return that includes the Partnership Owners. The composite return will relieve all direct and indirect owners of Company (including the Taxpayer Owners) from the requirement of filing an Illinois income tax return as a result of any Illinois source income generated by Company.

Because the Taxpayer Owners would have the significant compliance burden of filing their own returns to pay Illinois income tax if a composite return were not used, Company is willing to incur a higher Illinois tax liability to achieve this compliance simplification. Company represents that its composite return would calculate an Illinois income tax amount that would equal or exceed the amount that would be calculated, in the aggregate, on separate returns to be filed by the Taxpayer Owners. Company would use the following methodology to achieve this result: First, Company will determine its Illinois source income by multiplying its net income using its Illinois apportionment percentage. Company would then apply a tax rate of 7.3 percent to its entire Illinois source income. This rate is the higher of the total corporate tax rate (the 4.8 percent corporate income tax rate plus the 2.5 percent personal property replacement tax rate) and the highest marginal individual income tax rate (3 percent).

Company prefers that the composite return include all of the Partnership Owners and, as a consequence, all of the Taxpayer Owners. However, if Illinois strongly disagrees with the indirect inclusion of corporations in the composite return, Company would be willing to exclude them, as some reduction in the overall compliance burden still would be alleviated by indirectly

including the rest of the Taxpayer Owners. In such a case, Company will apply the highest marginal individual income tax rate to the distributive share of Company's Illinois source income indirectly received by individuals, trusts and estates.

Again, even though Company requests to file a composite return in lieu of separate returns being filed by each Taxpayer Owner, the aggregate Illinois income tax liability should be identical or higher than if each Taxpayer Owner filed a separate Illinois income tax return reporting Company's Illinois source income. As described below, this result should occur because all the Taxpayer Owners are passive investors in Company and are not engaged in a unitary business with Company.

States typically use one of two methods for calculating a partner's distributive share of state-source partnership income. The first method, often referred to as "partner-level apportionment," requires that partners include their share of partnership income and apportionment factors with their income and apportionment factors (or the income and apportionment factors from interests in other partnerships). The partner then multiplies the combined income by the combined apportionment factor to determine the partner's overall state taxable income. This method only should be applied to situations in which the partner and the partnership(s) are part of a single unitary business. The second method, often referred to as "partnership-level apportionment," requires that the partnership's income be apportioned to a particular state using only the partnership's apportionment factors. The resulting state-source income is then treated by the partners as a direct allocation of income to the particular state (i.e., the income is not re-apportioned at the partner level). This method generally is applied to situations in which the partner and partnership are not part of a single unitary business.

In this case, because the Partnership Owners, the Taxpayer Owners, and any intermediate partnerships are passive investors of Company, rather than active managers, Company's Illinois-source income should be apportioned at the Company level regardless of whether the resultant Illinois income tax is reported on a composite return at the Company level or on separately filed returns at the Taxpayer Owner level. For this reason, Company represents to Illinois that a composite return filing including the Partnership Owners will provide the same or a greater amount of income tax revenue than would be provided by separate filings at the Taxpayer Owner level.

In summary, a composite return filing for Company will be advantageous for Illinois because it will provide Illinois income tax revenue that equals or exceeds the amount that separately filed returns would provide, while significantly decreasing the number of returns that Illinois must process and that Company's direct and indirect owners must prepare. A composite return filing also will avoid potential errors at the Taxpayer Owner level that potentially could understate Illinois income tax liability.

RULING

The general rule under Section 502(a) of the Illinois Income Tax Act ("the IITA"; 35 ILCS 5/101 *et seq.*) is that every person liable for Illinois income tax must file an income tax return. Section 502(f) of the IITA creates an exception to this general rule in the case of certain taxpayers who are partners or S corporation shareholders. The section provides:

The Department may promulgate regulations to permit nonresident individual partners of the same partnership, nonresident Subchapter S corporation shareholders of the same Subchapter S corporation, and nonresident individuals transacting an insurance business in Illinois under a Lloyds plan of operation, and nonresident individual members of the same limited liability company that is treated as a partnership under Section 1501(a)(16) of [the IITA], to file composite individual income tax returns reflecting the composite income of such individuals allocable to Illinois and to make composite individual income tax payments.

Under the authority of IITA Section 502(f), Illinois Income Tax Regulations Section 100.5100 sets out the requirements for a taxpayer to be eligible to be included on a composite return. Section 100.5100(a) states:

In general. A composite return may be filed on behalf of nonresident individuals, trusts, and estates who derive income from Illinois and who are partners, or S corporation shareholders, or who transact insurance business under a Lloyds plan of operation. The respective partnership, S corporation or insurance business shall file such composite return and shall make composite income tax payments.

Section 100.5100(b) states:

Eligibility. The right to be included in a composite return is limited to nonresident and resident individuals, trusts, and estates who are partners of the same partnership, shareholders of the same S corporation, or individuals transacting an insurance business in Illinois under a Lloyd's plan of operation. The eligibility of resident individuals, trusts, and estates is conditioned upon compliance with subsection (c) of this Regulation.

Example: The Acme partnership consists of a general partner and fifty(50) limited partners. The general partner is a regular corporation, and the limited partners consist of twenty-six (26) nonresident individuals, twenty (20) resident individuals, an S Corporation, a partnership, a nonresident trust, and a estate. The twenty-six (26) nonresident individuals, the nonresident trust, and the nonresident estate are automatically eligible to be included in a composite return. The twenty (20) resident individuals may be included in the composite return with the nonresidents if the Department grants their petition. None of the other entities may be included in the composite return.

Applying the provisions of the IITA and Regulations discussed above to the facts here, Company may not file an Illinois composite return on behalf of its partners. Regulations section 100.5100(a) and (b) specifically limit the right to be included in a composite return to individuals, trusts and estates. The Partnership Owners are not individuals, trusts or estates. Accordingly, they may not be included in a composite return and must file separate Illinois income tax returns in accordance with IITA Section 502(a). In addition, the Taxpayer Owners, unless they are individuals, trusts or estates properly included on a composite return of another partnership within the organizational structure, must file separate Illinois income tax returns.

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. If you have questions regarding this GIL you may contact Legal Services at (217) 782-7055. If you have further questions related to Illinois income tax laws, visit our website at www.revenue.state.il.us or contact the Department's

IT 08-0042-GIL
December 29, 2008
Page 5

Taxpayer Information Division at (217) 782-3336.

Sincerely,

Brian L. Stocker
Staff Attorney (Income Tax)