IT 09-0020-GIL 07/09/2009 CREDITS – FOREIGN TAX

General Information Letter: Correct computation of income taxed by both Illinois and Iowa explained.

July 9, 2009

Dear:

This is in response to your letter dated June 9, 2009, which was forwarded to me for response. 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:

> This is in response to your notice of June 3, 2009, copy attached, and proposing additional tax on taxpayers' 2008 Illinois tax return. Please be advised that no tax is owed and taxpayer is due a $91 refund.
>
> Your letter claims that taxpayer cannot get a credit for Iowa taxes paid on wages earned in the State of Iowa. We agree. The income reported for Iowa and paid taxes to the State of Iowa for farm rental operations. I am forwarding a complete copy of his Illinois and Iowa tax returns plus a copy of Federal Form 4835 for his farm rental operation. All the farming operations were in the state of Iowa.
>
> We are aware of the reciprocal agreements that the State of Illinois has with Iowa, Kentucky, Wisconsin and Michigan regarding earned income such as wages, tips, salaries, or other employee compensation where such compensation is taxed by the home state of the employee. The income from Iowa that Mr. Z received was rental income and not any form of compensation received from an employer.

**<u>Response</u>**

The credit computed on Schedule CR is allowed under Section 601(b)(3) of the Illinois Income Tax Act (35 ILCS 5/601), which provides:

> 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.

Illinois income tax regulation 86 Ill. Adm. Code Section 100.2197(b)(4) refers to a taxpayer's "base income subject to tax both by such other state or states and by this State" as "double-taxed income," and provides:

> "double-taxed income" means items of income minus items deducted or excluded in computing the tax for which credit is claimed, to the extent such items of income, deduction or exclusion are taken into account in the computation of base income under IITA Section 203 for the person claiming the credit.

As explained in more detail in 86 Ill. Adm. Code Section 100.2197(b)(4), an item of income is included in “double-taxed income” only to the extent it is included in the tax base of the other state and in base income in Illinois, and an expense is deducted in computing “double-taxed income” only to the extent both states allow its deduction. 86 Ill. Adm. Code 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 in-state 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.

Iowa is one of the states to which this subsection applies.

Detailed guidance on the application of the statute and regulation is provided in Publication 111. Under the Publication 111 for 2008, income double-taxed by Iowa and Illinois is computed by starting with “net income” of $140,207 on Line 26 of the Zs’ Form IA 1040. This amount is their federal adjusted gross income (which is the starting point for the computation of Illinois base income) with certain adjustments. Some of the adjustments are also made by Illinois, such as the inclusion of interest on municipal bonds which is taxed by both states but not the federal government. Accordingly, with some exceptions, “net income” includes all items of income taxed by both states and allows all deductions allowed by both states. The one exception that is applicable to the Zs is the taxation of pension income. Iowa allowed the Zs to exclude $12,000 of pension income, while none of their $70,998 in federally-taxed pension income is taxed by Illinois. Accordingly all pension income is excluded from double-taxed income, which Publication 111 directs the taxpayers to do by adding back to their “net income” the Iowa exclusion of $12,000 and subtracting the $70,998 in total taxable pension income. The result is $89,840 in income that is included in the tax base of both states for their residents.

Under 86 Ill. Adm. Code Section 100.2197(b)(4)(G), this amount is multiplied by the percentage of the Zs’ income that is from Iowa sources. This computation matches how Iowa taxes nonresidents. As nonresidents of Iowa, the Zs reduce their $6,989 in Iowa tax computed on their “net income” to an amount equal to that tax times a fraction equal to their $67,235 in income from Iowa sources divided by their $148,838 in total Iowa income, or 45.2%. By computing tax on nonresidents in this manner, Iowa is, in effect, taxing 45.2% of each item of the Zs' income, regardless of geographic source, including their pension income net of the Iowa exclusion. Because Illinois does not tax any pension income, no credit can be given for the Iowa tax on the Zs, pension income.

Accordingly, their double-taxed income is 45.2% of the $89,840, or $40,607. Using this amount on the Schedule CR, their credit is $1,164, rather than the $1,927 claimed on the original return.

In our original computations, the Zs' $8,631 in wage income was erroneously subtracted in computing double-taxed income before applying the 45.2%. This reduced double-taxed income to $36,706 and the credit to $1,052. I apologize for this error.

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