Illinois Department of Revenue

SECOND NOTICE OF PROPOSED RULEMAKING

1) Agency: Illinois Department of Revenue

2) Title and Ill. Adm. Code Citation of Proposed Rulemaking: Income Tax, 86 Ill. Adm. Code 100.7034 and 100.9730

3) Date, Issue, and page number of the Illinois Register in which the First Notice was published: December 15, 2023, Issue 50, 47 Ill. Reg. 18412

4) Text and Location of any Changes Made to the Proposed Rulemaking During the First Notice Period: See attached First Notice Changes.

5) Final Regulatory Flexibility Analysis:

   A. Summary of the issues raised by affected small businesses during the First Notice Period: Small businesses did not raise any issues during the First Notice Period.

   B. Description of actions taken on any alternatives to the proposed rule suggested by small businesses during the First Notice Period, including reasons for rejecting alternatives not utilized: Not applicable.

6) Analysis of the Economic and Budgetary Effects of the Proposed Rulemaking: See attachment.

7) Response to Recommendations Made by the Administrative Code Division for Changes in the Rule to Make It Comply with the Codification Scheme: No changes were requested by the Administrative Code Division.

8) Evaluation of the comments received by the agency from interested persons during the first notice period (but not including any questions raised by the Joint Committee in a preliminary review) including:

   A. Date of any public hearing held during the first notice period. Name of the person or group requesting a hearing: No public hearing requested.

   B. The names and addresses of all individuals or groups making comments or requesting the opportunity to make comments:

   Comments were submitted by:

1. Maurice Scholten
   President
   Taxpayers' Federation of Illinois
   430 East Vine Street, Suite A
   Springfield, IL 62703

2. David Stricklin
   Stricklin & Associates
   970 Old Green Bay Road
   Winnetka, IL 60093

3. Thomas Blaze
   Partner
   RSM US LLP
   30 South Wacker Drive, Suite 300
   Chicago, IL 60606

C. A list of all specific criticisms and suggestions raised in the comments:

The Department received the following criticisms and suggestions from Maurice Scholten, made in a letter dated January 29, 2024:

> The Taxpayers' Federation of Illinois has reviewed proposed Regulation 100.7034 and the revisions to Regulation 100.9730. We appreciate the Department's continued efforts to provide timely guidance to reflect changes made by the General Assembly. We believe the Department has done well to ensure the proposed regulations reflect the intention of the relevant portion of P.A. 103-0009.
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> We do, however, have several comments on Proposed Regulation 100.7034. While we acknowledge the Department cannot provide examples for every scenario, we believe there are some common scenarios that would benefit from additional examples. Additionally, the Department could provide some guidance in areas where none has been provided. Specifically:
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> - The Department does not provide any guidance in the proposed regulation as to when a partnership interest, in the hands of a partnership, would qualify as a "security" within the meaning of 15 U.S.C § 77(b). Furthermore, the Department does not provide any guidance in the instructions for the 2023 partnership income tax forms other than referencing the new statute. While we understand that this is a federal statute, with

a substantial amount of case law, some basic guidance would be appreciated as this determination will need to be made by a significant number of partnerships and there are partnerships that do not consider themselves to be "investment partnerships," but likely meet the new definition.

- In paragraph (c)(2), we assume this netting is possible whether or not the lower-tier partnerships are themselves investment partnerships. It would be helpful if the regulation clarified that point.

- Additional guidance of how these investment partnership rules would affect unitary business groups would be helpful. Could the Department provide an example of the consequences when the investment partnership is in a unitary group with some or all of the other relevant entities--both the partners of the investment partnership and the underlying partnership? For example, what if, in Example 7, instead of Partner B making the business income election under IITA 1501(a)(1), the entities were unitary?

- The law provides that an investment partnership does not have to withhold if a partner is exempt under 501(a) of the Internal Revenue Code or Section 205 of the Illinois Income Tax Act. Can the Department provide an example similar to Example 5, but Partner G is a non-resident exempt entity? It appears the credit would exceed partner B's withholding liability—is that amount refundable?

- Finally, there have been questions if an investment partnership would have to withhold for non-resident partners for income generated by the investment partnership from the sale of a partnership; the examples appear to focus solely on the investment partnership's share of income from ongoing partnership activities. It would be helpful if the Department provided an example where an investment partnership receives income from the sale of a partnership.

We have a single comment on the proposed changes to Regulation 100.9730:

- Under IITA 1501(a)(11.5)(A-5)(ii), "gross income" for purposes of determining whether a partnership is an investment partnership "does not include income from partnerships that are operating at a federal taxable loss." This provision is restated in subsections (b)(2) and (f)(1). The term "federal taxable loss" is not commonly used; it would be very helpful if the Department explained how this provision will be applied. Does it mean that, if the partnership's distributive share of partnership income or loss is negative, that amount is excluded from the gross income calculation? Or does it apply more literally—only when the distributive share is income (and not a loss), but the underlying partnership itself operated at a loss? (This would be possible if the partnership agreement allocates items of income and loss differently among the partners.) What if there are Illinois addition or subtraction modifications that turn a federal loss into income, or vice versa? An example or two of how this calculation is to be made would also be helpful.

We also have a few fairly technical comments to Proposed Regulation 100.7034, as follows:

- In subsection (i), line 6, there appears to be some missing, or possibly extra, words.

- Throughout the examples, it is not always obvious how some of the calculations were made. It would be helpful to spell them out a bit more, and to specifically state each partner's ownership percentage.

- Example 3 states that there is an Article 2 credit from a prior tax year. It would be helpful if the example stated why this credit was not passed through to the partners in that earlier tax year, and then also explain what happens to that credit, since it can't be used to offset the withholding tax. Example 4 similarly deals with a credit, and again it is not clear what happens to the excess credit (other than that it cannot be used against future withholding tax obligations).

- Example 5 contains a cross-reference to subsection (f)(2), regarding Partner B's $6.60 credit. We believe this should be

to (f)(3).

The Department received the following criticisms and suggestions from David Stricklin, made in an email dated January 9, 2024:

1. Much of the DOR's draft regulation tracks the statutory language so there is no need to comment on that. There are, however, some provisions in the draft regulation that, as far as I can tell, go beyond the scope of the statute. I would be curious to know the DOR's rationale and basis for including these provisions. The ones that caught my attention are:
   - Losses and deductions from other investments of the investment partnership may not be netted against income subject to withholding for purposes of computing the amount of withholding tax owed.
   - Only credits and losses passed through in the current year of the investment partnership may reduce the required withholding amount. Any excess credits and losses from other years may not be carried over in determining the amount of withholding tax owed.
   - Nonresident taxpayers (other than individuals) that are commercially domiciled in Illinois and have income from an investment partnership are allowed a credit for their shares of withholding tax paid by the investment partnership. I'm also not sure what the DOR means by "nonresident taxpayers…that are commercially domiciled in Illinois.

2. The reduction of the PTE base and still subjecting the income to withholding may further limit the PTE benefit. IL is already one of the few states that does not allow the PTE tax on the full federal income for residents, so this will only reduce the base. I understand from example 6 that lower tier nonbusiness income would be in the PTE base since not subject to withholding so it may be a minimally impactful detriment. Can you also subtract losses from lower tier partnerships? This could be a slight benefit.

3. I saw that the reg outlined QIPs with income subject to withholding are required to file. It did not address QIPs who do

not have income subject to withholding. Previously QIPs were not required to file - will all QIPs be required to file?

4. The new guidance allows withholding credits to be issued to residents which means overpayments are only allowed for when there is netting of allowed losses/income creating excess credits and/or entities with partners that are not subject to income tax. I think this will be difficult to enforce and potentially create cash considerations for entities with a lot of residents who were expecting any withholding credits (and had the residents making estimated payments).

   - Historically non-resident individuals would be able to net IL sourced income and losses. Now if one of their holdings becomes an investment partnership (and this holding is in income), it will not be able to offset losses, as the income/withholding would not flow-up to the non-resident individual. In total, more tax would be paid to the state.

   - Confirming, if a lower-tier partnership is an investment partnership who has a non-investment partnership as a partner (upper-tier partnership). The upper-tier partnership would be able to claim the withholding credit it receives from the lower tier and would be able to get that amount refund, if the upper-tier has no withholding obligations (i.e. the upper tier has all IL resident partners)?

   - Example 2 – To confirm, the resident partners in Partnership B would be able to claim a credit for their share of the withholding paid by Partnership A (under f(4))? Trying to trace all this through and don't want to end up in a situation with trapped withholding that can't be refunded or ends up double paid.

   - Section 100.9730(c)(13) – Any way to expand upon the definition of security within 77b? Would like clarification if this applied to GP's who are not passively holding the partnership interest. Is this something the state is going to argue? The securities

attorney's we've spoken with generally agree GP's will not qualify as holding a partnership interest as a security due to the control they generally have.

5. Overall, the existing regulation addressing investment partnerships (Section 100.9730) was consistent with the statute, while we felt the proposed nonresident withholding regulation (Section 100.7034) could clarify a number of areas.

   - Assume a tiered partnership structure where Partnership A, not an investment partnership, apportions income both inside and outside of IL (for example, it generates income in all 50 states). Partner B is an investment partnership that receives a distributable share of income from Partnership A. Partner C is a partner of Partner B, is commercially domiciled in IL, and is not an investment partnership. Partner B withholds IL tax from Partner C based on Partner C's allocable share of Partner B's IL business income (business income without regard to Partner B being an investment partnership). The examples all seem clear on that up to this point. However, there is some concern that Partner C treats all income from Partner B as non-business income allocable to Illinois and pays IL replacement tax on that income. This is an odd result given Partnership A, the entity that generates the income, is operating in all 50 states and not just Illinois. An example something like the following might be helpful:

     Example #. Assume the same facts as in Example 1, except that Partnership A also has distributive share of business income of $1,000 that is apportioned outside of Illinois under IITA Section 305(a). Partner B's distributive share of business income apportioned outside of Illinois is not allocable to Illinois purely because Partner B's state of domicile is Illinois.

   - Please confirm whether or not there is a mechanism to avoid IL withholding on an IRC 501(a) tax-exempt investor that holds any interest through multiple

> investment partnerships. For example, Partnership A, an investment partnership, receives a business income apportioned to IL from another partnership. Partnership B, an investment partnership, is an investor in Partnership A. Partnership A withholds 4.95% of the IL business income allocable to Partnership B. Does a tax-exempt investor that is a partner in Partnership B get to claim the withholding credit similar to a partner of Partnership B that is an Illinois resident? Or does Partnership B get to claim a refund with respect to the tax-exempt investor's share of the withholding credit?

The Department received the following criticisms and suggestions from Thomas Blaze, made in an email dated December 15, 2023:

> I hope all is going well. I wanted to reach out and get your thoughts on the new investment partnership definition. How is Illinois interpreting "a partnership interest, in the hands of the partnership, qualifies as a security within the meaning of subsection (a)(1) of Subchapter 77b of Chapter 2A of Title 15 of the United States Code"?
> Specifically, assume I have a partnership (Operating Partnership) in a trade or business and also assume that Operating Partnership is owned by another partnership (Holdco Partnership). Will Holdco Partnership's interest in Operating Partnership meet the very broad definition in Subchapter 77b?
>
> Does the relationship (unitary versus non-unitary) between the partnership come into play? I believe Illinois' position is that in a typical PE Holdco partnership fund structure where the PE Holdco partnership fund solely holds a non-unitary interest in the underlying operating partnerships, Illinois would deem the PE Holdcos partnership interest in the non-unitary operating partnership as a security under Subchapter 77b but wondering what Illinois' position would be if the Holdco Partnership held an interest in an operating partnership where a unitary relationship exists.
>
> I think where we are seeing a lot of issues is with the actual definition of "security" and how that will be interpreted by Illinois as well as which fact pattern will allow the new withholding to be creditable. In a situation where a Holdco partnership has unitary partnership holdings and the Holdco partnership otherwise

qualifies as an investment partnership, would the new withholding be creditable to the owners or is this fact pattern not the one described in subsection (c-5) of Section 305? I think an example illustrating what fact pattern would allow the new withholding tax to be creditable would be helpful as we have many taxpayers that have tiered structures that are struggling to understand if they will now be deemed an investment partnership and if their partners will get a credit for the new withholding tax.

D. The agency's evaluation of each of the specific criticisms and suggestions:

The Department's responses to the comments made by Maurice Scholten are as follows:

1. The Department does not provide any guidance in the proposed regulation as to when a partnership interest, in the hands of a partnership, would qualify as a "security" within the meaning of 15 U.S.C. § 77(b). Furthermore, the Department does not provide any guidance in the instructions for the 2023 partnership income tax forms other than referencing the new statute. While we understand that this is a federal statute, with a substantial amount of case law, some basic guidance would be appreciated as this determination will need to be made by a significant number of partnerships and there are partnerships that do not consider themselves to be "investment partnerships," but likely meet the new definition.

   Response: Please reference the Department's response to Thomas Blaze below.

2. In paragraph (c)(2), we assume this netting is possible whether or not the lower-tier partnerships are themselves investment partnerships. It would be helpful if the regulation clarified that point.

   Response: No change is required. The regulations under Section 100.7034 generally relate to only the determination of the withholding tax liability of an investment partnership under IITA Section 709.5(d). Neither IITA Section 709.5(d) nor the regulations under Section 100.7034 govern the computation of net income under IITA Section 202 and the sourcing under IITA Section 305 related to partnerships which are not investment partnerships. Similarly, neither IITA Section 709.5(d) nor the regulations under Section 100.7034 govern the allocation of the distributive share of a partner of an investment partnership under IITA Section 305(c-5).

3. Additional guidance of how these investment partnership rules would affect unitary business groups would be helpful. Could the Department provide an example of the consequences when the investment partnership is in a unitary group with some or all of the other relevant entities--both the partners of the investment partnership and the underlying partnership? For example, what if, in Example 7, instead of Partner B making the business income election under IITA 1501(a)(1), the entities were unitary?

   Response: Please reference the Department's response to Thomas Blaze below.

4. The law provides that an investment partnership does not have to withhold if a partner is exempt under 501(a) of the Internal Revenue Code or Section 205 of the Illinois Income Tax Act. Can the Department provide an example similar to Example 5, but Partner G is a non-resident exempt entity? It appears the credit would exceed partner B's withholding liability—is that amount refundable?

   Response: No change is required. Section 100.7034(h) allows an investment partnership to claim a credit or refund for an overpayment of withholding, except to the extent an overpayment is attributable to tax withheld on the distributive share of a partner who is allowed a credit for such withholding. Taxpayers may invoke the letter ruling process for additional guidance regarding specific fact patterns.

5. Finally, there have been questions if an investment partnership would have to withhold for non-resident partners for income generated by the investment partnership from the sale of a partnership; the examples appear to focus solely on the investment partnership's share of income from ongoing partnership activities. It would be helpful if the Department provided an example where an investment partnership receives income from the sale of a partnership.

   Response: IITA Section 709.5(d) requires an investment partnership to withhold only with respect to income that would otherwise be apportioned/allocated to Illinois by the investment partnership under IITA Sections 305(a) and (b). IITA Sections 305(a) and (b) govern the allocation by a nonresident partner of the distributive share of income from a partnership. Accordingly, the gain of an investment partnership from the sale of an interest in another partnership is not subject to IITA Section 709.5(d) withholding tax. Taxpayers may invoke the letter ruling process for additional guidance regarding specific fact

patterns.

6. Under IITA 1501(a)(11.5)(A-5)(ii), "gross income" for purposes of determining whether a partnership is an investment partnership "does not include income from partnerships that are operating at a federal taxable loss." This provision is restated in subsections (b)(2) and (f)(1). The term "federal taxable loss" is not commonly used; it would be very helpful if the Department explained how this provision will be applied. Does it mean that, if the partnership's distributive share of partnership income or loss is negative, that amount is excluded from the gross income calculation? Or does it apply more literally—only when the distributive share is income (and not a loss), but the underlying partnership itself operated at a loss? (This would be possible if the partnership agreement allocates items of income and loss differently among the partners.) What if there are Illinois addition or subtraction modifications that turn a federal loss into income, or vice versa? An example or two of how this calculation is to be made would also be helpful.

   Response: Under IITA Section 1501(a)(11.5)(A-5), a partnership qualifies as an investment partnership if at least 90% of both its assets and gross income are derived from qualifying investment securities. For purposes of the 90% gross income test, subparagraph (ii) of paragraph (A-5) provides that "gross income" does not include income from partnerships that are operating at a federal taxable loss. Under this provision, gross income derived from a partnership that computes negative taxable income under Section 703 of the Internal Revenue Code is not taken into account in determining whether the partnership qualifies as an investment partnership. Taxpayers may invoke the letter ruling process for additional guidance regarding specific fact patterns.

7. In subsection (i), line 6, there appears to be some missing, or possibly extra, words.

   Response: The Department has amended Section 100.7034(i) to delete the term "under" and add further clarifying language.

8. Throughout the examples, it is not always obvious how some of the calculations were made. It would be helpful to spell them out a bit more, and to specifically state each partner's ownership percentage.

   Response: The Department has clarified that the partners are equal

partners in Section 100.7034(j) Examples 1 and 5. The calculations are made by multiplying the partner's distributive share of income subject to withholding by the partner's applicable tax rate.

9. Example 3 states that there is an Article 2 credit from a prior tax year. It would be helpful if the example stated why this credit was not passed through to the partners in that earlier tax year, and then also explain what happens to that credit, since it can't be used to offset the withholding tax. Example 4 similarly deals with a credit, and again it is not clear what happens to the excess credit (other than that it cannot be used against future withholding tax obligations).

   Response: No change is required. The regulations under Section 100.7034 generally relate to only the determination of the withholding tax liability of an investment partnership under IITA Section 709.5(d). Neither IITA Section 709.5(d) nor the regulations under Section 100.7034 govern the manner in which credits pass-through from a partnership to its partners.

10. Example 5 contains a cross-reference to subsection (f)(2), regarding Partner B's $6.60 credit. We believe this should be to (f)(3).

    Response: The Department has updated the cross reference in Section 100.7034 (j) Example 5 to (f)(3).

The Department's responses to the comments made by David Stricklin are as follows:

1. Much of the DOR's draft regulation tracks the statutory language so there is no need to comment on that. There are, however, some provisions in the draft regulation that, as far as I can tell, go beyond the scope of the statute. I would be curious to know the DOR's rationale and basis for including these provisions. The ones that caught my attention are:

   - Losses and deductions from other investments of the investment partnership may not be netted against income subject to withholding for purposes of computing the amount of withholding tax owed.

     Response: No change is required. IITA Section 709.5(d) provides that the tax base for the withholding tax is the income of the investment partnership that otherwise would be

apportioned to Illinois by the investment partnership under IITA Section 305(a) plus the nonbusiness income that otherwise would be allocated to Illinois by the investment partnership under IITA Section 305(b) (other than an amount allocated to the commercial domicile of the taxpayer under IITA Section 303). Accordingly, only the investment partnership's distributive share of income and losses from other partnerships is taken into account in computing the tax base for the withholding tax. Income and losses from other sources are not taken into account. Similarly, IITA Section 709.5(d) does not incorporate the deduction allowed under IITA Section 207 for net operating losses, or otherwise provide for the carryover of losses in computing the withholding tax base. Therefore, Section 100.7034(c)(3) is consistent with the statutory language.

- Only credits and losses passed through in the current year of the investment partnership may reduce the required withholding amount. Any excess credits and losses from other years may not be carried over in determining the amount of withholding tax owed.

  Response: No change is required. IITA Section 709.5(d) provides that the withholding tax liability of an investment partnership is to be determined net of the investment partnership's distributive share of any credit under Article 2 of the IITA that is distributable by the partnership and first allowable against the tax liability of a nonresident partner for a taxable year ending on or after December 31, 2023. Substantially similar language appears in IITA Section 709.5(a) governing the withholding tax liability of partnerships, S corporations, and trusts. For purposes of determining the withholding liability under IITA Section 709.5(a), only current year credits are taken into account. Accordingly, excess credits from one taxable year may not be carried over to another taxable year in computing the withholding tax liability under IITA Section 709.5(d).

- Nonresident taxpayers (other than individuals) that are commercially domiciled in Illinois and have income from an investment partnership are allowed a credit for their shares of withholding tax paid by the investment partnership. I'm also not sure what the DOR means by "nonresident taxpayers…that

are commercially domiciled in Illinois."

Response: No change is required. IITA Section 709.5(d) provides that, except in cases where the income of the investment partnership is business income in the hands of the partner under IITA Section 305(c-5), partners of an investment partnership are not allowed a credit for their share of the investment partnership's withholding tax liability. Thus, credit is allowed with respect to a partner whose distributive share of investment partnership income constitutes business income.

Consistent with this provision, Section 100.7034(f) specifies two additional instances allowing a partner to claim credit for a share of withholding tax in order to prevent double taxation of the same income. First, where a partner's commercial domicile is Illinois, the partner's distributive share of investment partnership income is allocable to Illinois under IITA Section 305(c-5). Second, where an Illinois resident is a partner, and income from an investment partnership ends up in that partner's hands through a tiered structure, the partner's share of investment partnership income is allocable to Illinois under IITA Section 301. In these additional instances, the partner may claim credit for that partner's share of the withholding tax paid by the partnership. The regulation is consistent with the statutory intent, and beneficial to taxpayers.

IITA Section 1501(a)(20) defines the term "resident" to include certain individuals, trusts, and estates. IITA Section 1501(a)(14) defines the term "nonresident" to mean any person who is not a resident. The term "person" is defined in IITA Section 1501(a)(18) to include individuals, trusts, estates, corporations, and partnerships. Under the IITA, then, a person's status as a resident or nonresident is not determined by reference to commercial domicile. For example, all corporations are nonresidents by statutory definition, regardless of the location of the corporation's commercial domicile.

2. The reduction of the PTE base and still subjecting the income to withholding may further limit the PTE benefit. IL is already one of the few states that does not allow the PTE tax on the full federal income for residents, so this will only reduce the base. I understand from example 6 that lower tier nonbusiness income would be in the PTE base since not subject to withholding so it may be a minimally impactful detriment. Can you also subtract losses from lower tier

partnerships? This could be a slight benefit.

Response: No change is required. The elective Pass-Through Entity (PTE) tax under IITA Section 201(p) applies independently of the withholding tax obligation under IITA Section 709.5(d). Section 100.7034(g) provides that an investment partnership making the election under IITA Section 201(p) is not exempt from the withholding tax imposed under IITA Section 709.5(d). As discussed below, the withholding tax is a tax on the investment partnership. Therefore, Section 100.7034(g) allows the investment partnership to elect to subtract its income subject to the withholding tax of IITA Section 709.5(d) in computing its PTE tax under IITA Section 201(p).

3. I saw that the reg outlined QIPs with income subject to withholding are required to file. It did not address QIPs who do not have income subject to withholding. Previously QIPs were not required to file - will all QIPs be required to file?

   Response: No change is required. This is not a new issue. Section 100.7034(e) provides that an investment partnership required to withhold tax under IITA Section 709.5(d) is required to file a return reporting the amount withheld with the Department and pay the amount withheld by the due date of a tax return for the taxable year of a partnership. Investment partnerships are exempt from Illinois income and replacement taxes pursuant to IITA Section 205(b). If an investment partnership does not elect to be subject to PTE tax under IITA Section 201(p) and does not meet the requirements for filing a return under IITA Section 502, then that investment partnership is not required to file a return with the Department. However, any investment partnership that elects to pay PTE tax is not exempt from the withholding requirement, as so provided in Section 100.7034(g).

4. The new guidance allows withholding credits to be issued to residents which means overpayments are only allowed for when there is netting of allowed losses/income creating excess credits and/or entities with partners that are not subject to income tax. I think this will be difficult to enforce and potentially create cash considerations for entities with a lot of residents who were expecting any withholding credits (and had the residents making estimated payments).

   - Historically non-resident individuals would be able to net IL sourced income and losses. Now if one of their holdings becomes an investment partnership (and this holding is in

income), it will not be able to offset losses, as the income/withholding would not flow-up to the non-resident individual. In total, more tax would be paid to the state.

Response: No change is required. The withholding tax is a tax on the investment partnership. Under IITA Section 305(c-5), a nonresident partner's distributive share of the income of an investment partnership is generally deemed nonbusiness income allocable to the partner's state of residence or commercial domicile. Accordingly, if the nonresident partner has Illinois source losses from investments or activities other than the investment partnership, such losses properly do not offset the partner's share of income from the investment partnership. Given the expansion of the definition of qualifying investment securities, it appears far more likely that Public Act 103-9 will result in Illinois collecting less tax as compared to prior law.

- Confirming, if a lower-tier partnership is an investment partnership who has a non-investment partnership as a partner (upper-tier partnership). The upper-tier partnership would be able to claim the withholding credit it receives from the lower tier and would be able to get that amount refund, if the upper-tier has no withholding obligations (i.e., the upper tier has all IL resident partners)?

  Response: No change is required. Section 100.7034(f)(3) allows an investment partnership that is itself a partner in a second investment partnership a credit against its withholding tax obligation for its share of withholding tax paid by the second investment partnership. In addition, under Section 100.7034(h), an investment partnership may claim a credit or refund for an overpayment of withholding tax, except to the extent the overpayment is attributable to tax withheld with respect to the distributive share of a partner who is allowed a credit for such withholding.

- Example 2 – To confirm, the resident partners in Partnership B would be able to claim a credit for their share of the withholding paid by Partnership A (under f(4))? Trying to trace all this through and don't want to end up in a situation with trapped withholding that can't be refunded or ends up double paid.

Response: The Department has clarified the language in Section 100.7034(f)(4). Example 2 in Section 100.7034(j) does not identify the partners of Partnership B. However, if Partnership B had resident partners, then Section 100.7034(f)(4) allows resident partners to claim a credit for their respective shares of withholding tax paid, less any credit claimed by Partnership B against its own tax liability.

- Section 100.9730(c)(13) – Any way to expand upon the definition of security within 77b? Would like clarification if this applied to GP's who are not passively holding the partnership interest. Is this something the state is going to argue? The securities attorney's we've spoken with generally agree GP's will not qualify as holding a partnership interest as a security due to the control they generally have.

  Response: Please reference the Department's response to Thomas Blaze below.

5. Overall, the existing regulation addressing investment partnerships (Section 100.9730) was consistent with the statute, while we felt the proposed nonresident withholding regulation (Section 100.7034) could clarify a number of areas.

   - Assume a tiered partnership structure where Partnership A, not an investment partnership, apportions income both inside and outside of IL (for example, it generates income in all 50 states). Partner B is an investment partnership that receives a distributable share of income from Partnership A. Partner C is a partner of Partner B, is commercially domiciled in IL, and is not an investment partnership. Partner B withholds IL tax from Partner C based on Partner C's allocable share of Partner B's IL business income (business income without regard to Partner B being an investment partnership). The examples all seem clear on that up to this point. However, there is some concern that Partner C treats all income from Partner B as non-business income allocable to Illinois and pays IL replacement tax on that income. This is an odd result given Partnership A, the entity that generates the income, is operating in all 50 states and not just Illinois. An example something like the following might be helpful:

Example #. Assume the same facts as in Example 1, except that Partnership A also has distributive share of business income of $1,000 that is apportioned outside of Illinois under IITA Section 305(a). Partner B's distributive share of business income apportioned outside of Illinois is not allocable to Illinois purely because Partner B’s state of domicile is Illinois.

Response: No change is required. A taxpayer allocating passive income (nonbusiness income) to its state of residence or commercial domicile, even where the underlying economic source of that income is the business profits of another entity operating in multiple jurisdictions, is not an “odd result” or unusual. For example, a shareholder in receipt of a nonbusiness dividend is required to allocate that income for tax purposes to its state of commercial domicile even though the profits of the payor corporation derive from business conducted in multiple jurisdictions. The investment partnership sourcing rule under IITA Section 305(c-5) can be viewed in certain instances as a departure from the otherwise applicable flow-through regime that determines the character and source of a partner’s distributive share of partnership income. The general rule under IITA Section 305(c-5) deems each partner’s distributive share of investment partnership income as nonbusiness income allocable to the partner’s state of residence or commercial domicile. Thus, where an investment partnership invests capital in another partnership which conducts a trade or business, as the business profits of the operating partnership ultimately pass through to the partners of the investment partnership, IITA Section 305(c-5) transforms the character of the income in the partner’s hands to nonbusiness income. This “odd result” was possible before the amendments of Public Act 103-9, although the occurrence will undoubtedly become more common as the definition of a qualifying investment security is expanded to include certain partnerships. Indeed, it is this transformation in character by operation of IITA Section 305(c-5) which motivated the new withholding tax imposed under IITA Section 709.5(d). The withholding tax on investment partnerships that derive income from other partnerships is an entity level tax on the investment partnership, requiring the

income of the investment partnership which otherwise would be sourced to Illinois under IITA Sections 305(a) and (b) to be subject to tax. Public Act 103-9 did not amend IITA Section 305(c-5), which continues to treat such income in the hands of its partners as nonbusiness income allocable to the partner's state of residence or commercial domicile.

- Please confirm whether or not there is a mechanism to avoid IL withholding on an IRC 501(a) tax-exempt investor that holds any interest through multiple investment partnerships. For example, Partnership A, an investment partnership, receives a business income apportioned to IL from another partnership. Partnership B, an investment partnership, is an investor in Partnership A. Partnership A withholds 4.95% of the IL business income allocable to Partnership B. Does a tax-exempt investor that is a partner in Partnership B get to claim the withholding credit similar to a partner of Partnership B that is an Illinois resident? Or does Partnership B get to claim a refund with respect to the tax-exempt investor's share of the withholding credit?

  Response: No change is required. Under IITA Section 709.5(d), the withholding tax computation does not include the distributive share of a partner who is exempt from tax under Section 501(a) of the Internal Revenue Code or under Section 205 of the IITA. Section 100.7034(f)(3) allows an investment partnership that is itself a partner in a second investment partnership a credit against its withholding tax obligation for its share of withholding tax paid by the second investment partnership. In addition, under Section 100.7034(h), an investment partnership may claim a credit or refund for an overpayment of withholding tax, except to the extent the overpayment is attributable to tax withheld with respect to the distributive share of a partner who is allowed a credit for such withholding. Thus, regarding your example where a tiered structure results in an overpayment of withholding tax because the ultimate owner of the income is a tax-exempt partner, a claim for credit or refund is allowed with respect to the investment partnership that computes an overpayment.

The Department's responses to the comments made by Thomas Blaze are as follows:

1. How is Illinois interpreting "a partnership interest, in the hands of the partnership, qualifies as a security within the meaning of subsection (a)(1) of Subchapter 77b of Chapter 2A of Title 15 of the United States Code?" Specifically, assume I have a partnership (Operating Partnership) in a trade or business and also assume that Operating Partnership is owned by another partnership (Holdco Partnership). Will Holdco Partnership's interest in Operating Partnership meet the very broad definition in Subchapter 77b? Does the relationship (unitary versus non-unitary) between the partnership come into play? I believe Illinois' position is that in a typical PE Holdco partnership fund structure where the PE Holdco partnership fund solely holds a non-unitary interest in the underlying operating partnerships, Illinois would deem the PE Holdco's partnership interest in the non-unitary operating partnership as a security under Subchapter 77b but wondering what Illinois' position would be if the Holdco Partnership held an interest in an operating partnership where a unitary relationship exists. In a situation where a Holdco partnership has unitary partnership holdings and the Holdco partnership otherwise qualifies as an investment partnership, would the new withholding be creditable to the owners or is this fact pattern not the one described in subsection (c-5) of Section 305? I think an example illustrating what fact pattern would allow the new withholding tax to be creditable would be helpful as we have many taxpayers that have tiered structures that are struggling to understand if they will now be deemed an investment partnership and if their partners will get a credit for the new withholding tax.

   Response: The Department has added Example 8 to Section 100.7034(j) to illustrate a tiered structure scenario.

   The Department considered the inclusion of additional guidance in Section 100.9730(c)(13) addressing the term "security" but ultimately declined to add such guidance. The definition of "security" is a question of federal securities law. Whether a partnership interest, or an interest in an LLC taxed as a partnership, is a "security" for purposes of IITA Section 709.5(d) depends on federal securities law, not the state tax apportionment concept of a unitary business. While the element of control is relevant in both the determination of a unitary business and the determination of whether a partnership or membership interest constitutes an investment contract (see, e.g., *Great Lakes Chemical v. Monsanto Co.*, 96 F. Sup. 2d 376 (D. Del. 2000) ("[Defendant's] authority to remove managers gave it the power

to directly affect the profits it received from [LLC]. Thus the court finds that [Defendant's] profits from [LLC] did not come solely from the efforts of others."); *Steinhardt Group v. Citicorp*, 126 F.3d 144, 153 (3d Cir. 1997), *quoting Goodwin v. Elkins & Co.*, 730 F.2d 99, 107 (3d Cir. 1984) ("whether a partnership interest constitutes a security depends on the legal rights and powers enjoyed by the investor.")), the existence of a unitary relationship for state income tax purposes is not determinative of the question whether an interest constitutes a security under the federal Securities Act. Taxpayers should reference federal securities law for appropriate guidance.

A partnership that satisfies the definition of an investment partnership under IITA Section 1501(a)(11.5) is deemed to be engaged in purely passive investment activity. As such, the partnership is exempt under IITA Section 205 from replacement income tax, and the respective distributive shares of income in the hands of its nonresident partners is generally deemed to be nonbusiness income under IITA Section 305(c-5). Those instances in which a nonresident partner's distributive share of the income of the investment partnership may be considered business income under IITA Section 305(c-5) relate to instances in which the partner has made the election under IITA Section 1501(a)(1) to treat all of its income as business income and, broadly speaking, where the nonresident partner's interest in the partnership serves an operational function with respect to a business of the nonresident partner. Accordingly, an investment partnership may not itself be a member of a unitary business group. If an investment partnership invests in another partnership that is unitary with another taxpayer, then the investee partnership must comply with IITA Section 304(e) and applicable regulations which determine the investment partnership's income that otherwise would be apportioned to Illinois by the investment partnership under IITA Section 305(a) and thus subject to the withholding tax of IITA Section 709.5(d).

E. A statement that the agency has considered all comments received during the first notice period: The Department has reviewed and considered all comments received during the first notice period.

9) An analysis of the expected effects of the proposed rulemaking, including:

A. Impact on the public: This rulemaking implements Public Act 103-9 which requires investment partnerships to withhold an amount from each nonresident partner for taxable years ending on and after December 31, 2023.

B. Changes in the agency's programs or structure resulting from implementation of the rulemaking: None.

C. Impact of proposed rule on small businesses. Methods used by Agency to comply with 5 ILCS 100/5-30, including reasons for rejecting any methods not utilized: The Department has considered each method under 5 ILCS 100/5-30. This rulemaking implements Public Act 103-9 and only impacts small businesses to the extent that such a business is making a withholding report and payment to the Department for its nonresident members. The investment partnership withholding requirement is created by statute with specific requirements for computation. Therefore, none of the methods under 5 ILCS 100/5-30 are legal or feasible. The Department does not possess the authority to establish less stringent compliance or reporting requirements or deadlines; consolidate or simplify compliance or reporting requirements; establish performance standards; or exempt small businesses from the requirements of the rule. Prior to the first notice period, a draft rulemaking was reviewed by representatives of the venture capitalist business community as well as tax practitioners, and no adverse consequences for small businesses were noted.

10) A justification and rationale for the proposed rulemaking, including:

A. Any changes in statutory language requiring the proposed rulemaking: This rulemaking implements the investment partnership withholding requirement in the Illinois Income Tax Act, 35 ILCS 5/709.5(d), adopted by Public Act 103-9.

B. Any changes in agency policy, procedures, or structure requiring the proposed rulemaking: None

C. Relationship to any relevant federal rules, regulations, or funding requirements: None

D. Court orders or rulings which are related to the rulemaking: None

E. A complete explanation of any other reasons for the proposed rulemaking: No other reasons exist.

11) Does this rulemaking include an incorporation by reference pursuant to Section 5-75 of the Illinois Administrative Procedure Act? This rulemaking includes reference to 15 U.S.C. 77b(a)(1).

Agency Personnel Who Will Respond to Joint Committee Questions Regarding the Proposed Rulemaking:

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