IT 16-0001-PLR 7/11/2016 SUBTRACTION MODIFICATIONS

Distributive Share of income from Partnership's engineering services business allocated to retired partner qualifies for the subtraction modification under IITA Section 203(d)(2)(H).

July 11, 2016

Re: Request for Private Letter Ruling
COMPANY

Dear Xxxxx:

This is in response to your letter dated January 28, 2016 in which you request a Private Letter Ruling on behalf of COMPANY. Review of your request for a Private Letter Ruling indicates that all information described in paragraphs 1 through 8 of subsection (b) of 2 Ill. Adm. Code 1200.110 is contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY. Issuance of this ruling is conditioned upon the understanding that COMPANY and/or any related taxpayer(s) is not currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them are as follows:

COMPANY is a professional services firm that provides engineering services to the electric power industry. COMPANY is a limited liability company (hereinafter "LLC") treated as a partnership for federal and Illinois income tax purposes.

COMPANY has two types of members: active and retired. The active members are all trained engineers and most all of them practice engineering. All active members provide services to the firm as their livelihood. They pay self-employment tax on income received from the LLC.

Pursuant to the LLC operating agreement, upon retirement a retired member of COMPANY ceases to be a member and ceases to provide services to the firm. Pursuant to the LLC operating agreement, the retired members receive payments from COMPANY on an annual basis for the remainder of their life. The income earned by the retired members is not a guaranteed payment but is instead an allocation of all types of income, deductions and credits earned by COMPANY. For federal and Illinois income tax purposes, the retired partners continue to be treated as partners for as long as they are receiving these payments. Therefore, these payments are reported to the retired members on a federal schedule K-1 and Illinois schedule K-1-P. These payments are not self-employment earnings under Internal Revenue Code §1402. It is COMPANY's understanding that the members are not subject to Illinois income tax on these retirement payments because they qualify for the subtraction modification under 35 ILCS 5/203(a)(2)(F).

Conclusion of the Taxpayer

For the reasons stated in our analysis below, we respectfully request the following ruling:

That the payments to the retired members qualify for the subtraction modification in 35 ILCS 5/203(d)(2)(H).

Analysis

In computing a partnership's income subject to the Illinois Replacement Tax, Illinois provides a subtraction for personal services income. 35 ILCS 5/203(d)(2)(H). The statute defines personal service income by reference to the Internal Revenue Code (hereinafter "IRC") section 1348 as effective in 1981.

The Illinois statutory definition reads in whole:

Any income of the partnership which constitutes personal service income as defined in Section 1348(b)(1) of the Internal Revenue Code (as in effect December 31,1981) [repealed] or a reasonable allowance for compensation paid or accrued for services rendered by partners to the partnership, whichever is greater. 35 ILCS 5/203(d)(2)(H).

The IRC as in effect December 31, 1981 defined personal services income as:

[A]ny income which is earned income within the meaning of section 401(c)(2)(C) or section 911(b) or which is an amount received as a pension or annuity which arises from an employer-employee relationship or from tax-deductible contributions to a retirement plan. IRC Sec.1348(b)(1)(A). (Emphasis added.)

Section 401(c)(2)(C) as in effect in 1981 dealt with gains from the sale of property by an individual whose personal efforts created such property and is irrelevant for the present analysis. Section 919(b) (as it existed in 1981) was the definition of earned income and stated that it was amounts received as compensation for services rendered. It did not, however, provide any specific guidance into payments to retired members.

Section 1348 as in effect December 31, 1981, included "an amount received as a pension or annuity which arises from an employer-employee relationship or from tax-deductible contributions to a retirement plan." IRC Sec. 1348(b)(1)(A). (Emphasis added.) The legislative history and earlier adoptions of this code section provide insight into this issue. As originally enacted as part of the Tax Reform Act of 1969, section 1348 specifically

excluded deferred compensation from the definition of earned income. P.L. 91-172, §804.

However, the statute was amended in 1976 to include pensions and annuities as earned income. P.L. 94-445, §302. According to the General Explanation of P.L. 94-455, this extension applied to pensions and annuities that were personal services income. Id. The change was intended by Congress to correct the situation where an individual would retire on a pension; and, even though his or her before-tax income would fall, his or her after-tax income would rise because he or she would lose the benefits of the maximum tax. Id.

Section 1348 was amended again in 1978 as a clarification. The Tax Reform Act of 1978 amended section 1348(b)(1)(A) striking out "pension or annuity" and inserting in lieu thereof "pension or annuity which arises from an employer-employee relationship or from tax-deductible contributions to a retirement plan." P.L. 95-600, §701(x)(1). The General Explanation of P.L. 95-600 further clarified the legislative intent of this provision when it stated that personal services income was intended to include a pension or annuity when that pension or annuity arises from a situation where personal services were rendered either as an employee or as a self-employed person. This clarification applied to "pensions and annuities established by an employer for his employee (whether or not made under a qualified pension plan) and to amounts received from H.R. 10 plans and individual retirement accounts, annuities, and bonds." P.L. 95-600, §701(x)(1).

The legislative history further stated that "[p]ensions or annuities that are not connected with earned income from personal services do not qualify. However, this amendment was not intended to deny the benefits of the maximum tax provisions to other deferred compensation arrangements where the compensation is 'earned income' within the meaning of 911(b)… For example, payments to a retired partner where the payments are for personal services actually performed prior to retirement are eligible for the 50-percent maximum tax rate." P.L. 95-600, §701(x)(1).

While the 1981 version of section 1348 did not provide guidance into whether payments to retired partners or members should be included in the definition of personal service income, the above legislative analysis clearly shows that it was Congress' intent to include such payments. Therefore, since the payments are included under section 1348 as in effect December 31, 1981, they should be deductible by the LLC under 35 ILCS 5/203(d)(2)(H).

Furthermore, the statutory purpose of 35 ILCS 5/203(d)(2)(H) supports allowing a subtraction for retirement payments to partners. The purpose of the subtraction modification in 35 ILCS 5/203(d)(2)(H) is to put partnerships

on par with S corporations. IT 98-0036-PLR. For federal income tax purposes, S Corporations are allowed to deduct salaries paid to their shareholders for personal services rendered as employees. Likewise, S Corporations are allowed a deduction for deferred compensation, such as pension and retirement payments to shareholders who are employees. These deductions enter into the computation of Illinois net income of the S Corporation, because Illinois' starting point in computing an S Corporation's Illinois Replacement Tax liability is federal taxable income before federal net operating loss deduction. 35 ILCS 5/203(b)(1). However, partners of partnerships cannot be employees. As a result, for federal income tax purposes partnerships are not allowed the same deduction for payments made to partners for their personal services. 35 ILCS 5/203(d)(2)(H) grants partnerships a subtraction for the personal services rendered by the partners. As a result, similarly situated partnerships and S Corporations pay the same amount of Illinois Replacement Tax. As stated above, S Corporations are generally allowed to deduct payments to pension plans and retirement plans for shareholders who are employees. Therefore, partnerships should be able to subtract similar payments.

It is irrelevant whether or not the individual partners pay Illinois Income Tax on these retirement payments. Individuals are allowed a subtraction for income received from certain retirement plans under 35 ILCS 5/203(a)(2)(F). Retirement payments to S Corporations shareholders who are employees usually qualify for this subtraction, even though the S Corporation received a deduction for the expense. Therefore, it is not inconsistent for the partnership to receive a subtraction under 35 ILCS 5/203(d)(2)(H) for payments made to retired partners and for the retired partner to receive a subtraction under 35 ILCS 5/203(a)(2)(F). In fact, such treatment would be similar to the treatment of S Corporations.

Summary

35 ILCS 5/203(d)(2)(H) provides a subtraction modification to partnerships for personal service income and in defining "personal service income" references section 1348 of the IRC (1981). Since the intent of the Revenue Act of 1978 which modified section 1348 as in effect in 1981 was to include payments made to retired partners who had previously rendered services to the partnership, COMPANY payments to retired members should qualify for the deduction available in computing Illinois Replacement Tax liability.

Statement of Authorities Contrary to the Taxpayer's View

The Department ruled on this issue and published guidance to COMPANY consistent with the position stated above in a PLR dated September 22, 2004. Neither the Taxpayer nor the Taxpayer's representatives are aware

of any contrary rulings, cases, statutes or regulations to the position requested in this letter.

**RULING**

Section 203(d)(2)(H) of the Illinois Income Tax Act ("IITA," 35 ILCS 5/203(d)(2)(H)) allows a partnership, for purposes of computing its personal property tax replacement income tax under IITA Section 201(c) and (d), the following subtraction modification:

> Any income of the partnership which constitutes personal service income as defined in Section 1348(b)(1) of the Internal Revenue Code (as in effect December 31, 1981) or a reasonable allowance for compensation paid or accrued for services rendered by partners to the partnership, whichever is greater.

Section 1348(b)(1) of the Internal Revenue Code, as in effect on December 31, 1981, provided that "personal service income" means:

> Any income which is earned income within the meaning of section 401(c)(2)(C) or section 911(b) or which is an amount received as a pension or annuity which arises from an employer-employee relationship or from tax-deductible contributions to a retirement plan.

Section 911(b) of the Internal Revenue Code (as in effect on December 31, 1981) provided:

> For purposes of this section, the term "earned income" means wages, salaries, or professional fees, and other amounts received as compensation for services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings and profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of such trade or business, shall be considered earned income.

Note that Section 1348(b)(1)(A) provided:

> For purposes of this subparagraph, section 911(b) shall be applied without regard to the phrase ", not in excess of 30 percent of his share of net profits of such trade or business".

Regarding the Code definition of earned income, Treasury Regulations §1.911-2(b)(3) provided as follows:

> Earned income includes all fees received by a taxpayer engaged in a professional occupation (such as a doctor or lawyer) in the performance of professional activities. Professional fees constitute earned income even though the taxpayer employs assistants to perform part or all of the services rendered, provided the taxpayer's patients or clients look to the taxpayer as the person responsible for the services.

Treasury Regulations §1.1348-3(a)(2) provided:

> The entire amount received as professional fees shall be treated as earned income if the taxpayer is engaged in a professional occupation, such as a doctor, dentist, lawyer, architect, or accountant, even though he employs assistants to perform part or all of the services, provided that the patients or clients are those of the taxpayer and look to the taxpayer as the person responsible for the services performed.

In Revenue Ruling 74-231, 1974-1 C.B. 240, the Service ruled that the professional fees of a partnership derived from consulting services performed by its partners, both of whom were licensed engineers, qualified as earned income within the meaning of former IRC Section 1348(b)(1). As your letter points out, the legislative history of the Tax Reform Act of 1978 makes clear that income qualifying as earned income under this provision does not lose that characterization in the case of a retired partner whose share of partnership income is received under a retirement plan maintained for retired partners. See Senate Committee Report, H.R. 6715. Therefore, COMPANY may include in its subtraction modification under IITA Section 203(d)(2)(H) the distributive share of the income from the partnership's engineering services business allocated to a retired partner pursuant to the COMPANY retirement plan for retired partners.

This ruling shall bind the Department as provided herein. The facts upon which this ruling is based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited and incorporated in this ruling are correct and complete. This ruling shall bind the Department for all taxable years, except as limited pursuant to 2 Ill. Adm. Code 1200.110(d) and (e).This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Sincerely,

Brian L. Stocker
Chairman, PLR Committee (Income Tax)