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# COMPLIANCE ALERT



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## Compliance Problem

We have determined that a significant number of taxpayers are incorrectly subtracting income from a variety of sources, either as U.S. government obligations or mutual fund distributions as Other Subtractions, that are deemed taxable in Illinois. Specifically, the most problematic items are:

- ◆ Securities known as Government National Mortgage Association (GNMA) "Pass-Through Securities,"
- ◆ Federal National Mortgage Association (FNMA),
- ◆ Income received from Federal Home Loan Mortgage Corporations (FHLMC), and
- ◆ Daily Investment Deposit Accounts (DID) under Federal Home Loan Banks.

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## Solution

- ① Tax professionals preparing tax returns for clients and taxpayers should remember to include these amounts in Illinois taxable income. Tax professionals should also inform their clients that the amounts are taxable and not to subtract any income or distributions from the above-named sources.
- ② Tax professionals and taxpayers using tax software packages should check with their providers to ensure that the software is not automatically deducting income or distributions for any of the above-named sources.

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## Background

Under the Illinois Income Tax Act, base income includes all items of income that are subject to federal taxable income, unless a specific provision allows a subtraction. There is no Illinois provision that exempts interest on federal obligations from Illinois tax, so all federal obligation interest that is subject to federal income tax is also subject to Illinois income tax unless federal law expressly prohibits state taxation.

### ***GNMA, FNMA, and FHLMC***

Federal law prohibits the taxation of GNMA, FNMA and FHLMC themselves, but does not prohibit state taxation of interest on obligations issued by or guaranteed by GNMA, FNMA, or FHLMC. Federally-taxable interest on GNMA, FNMA, and FHLMC obligations cannot be subtracted in computing base income.

## Did you know?

Many items that are exempt from Illinois Income Tax are done so based on federal law. If the item is not listed in Publication 101 as specifically exempt from Illinois Income Tax, the item is taxable in Illinois.

### ***Federal Home Loan Banks***

Federal law prohibits state taxation of interest on notes, debentures, bonds and other obligations issued by the Federal Home Loan Banks. However, in 1987, the Oklahoma Supreme Court held that interest paid by the Federal Home Loan Banks on demand and overnight deposits is taxable by states, and no federal legislation or case has overruled that decision. Interest on daily investment accounts with the Federal Home Loan Banks cannot be subtracted in computing base income.

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## Where can I get more information?

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In the past 30 years, the Illinois Department of Revenue has published several resources to assist taxpayers in determining what items may be deducted from Illinois taxable income. Some suggestions of items you might wish to research or read include:

- ✓ General Inquiry Letters,
- ✓ Legal Letter Rulings,
- ✓ Informational Bulletins, FY81-0002 and FY87-0025, and
- ✓ Publication 101, Income Exempt from Illinois Tax.

To view this information, visit our web site at [tax.illinois.gov](http://tax.illinois.gov).