TAX FACTS

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Revisiting Exclusion of Retirement Income from the Illinois Income Tax Base

By Dr. Natalie Davila

Natalie Davila is an economist with an extensive background in public finance. She was Director of Research for the Illinois Department of Revenue for 10 years.

Illinois is virtually unique in how it taxes what is characterized as "retirement income:" social security, public and private pensions, IRAs, 401 (k) plans, 457s, Thrift Savings Plans, deferred compensation, payments to retired partners, etc. Such plans are funded with "pre-tax contributions," meaning the income is set aside and not taxed when earned. The federal government and most states delay taxation and tax payments to individuals from the plans (except for a portion of social security); Illinois never taxes the income. Only Illinois, Pennsylvania and Mississippi exempt all "retirement income" from taxation.

This article updates a research article published by TFI in 2007.[1] In addition, it presents a brief discussion of recent research findings on how taxation of retirement income influences state out-migration, and develops revenue

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NOTES FROM THE INSIDE. . .

By Carol S. Portman

This month's issue of *Tax Facts* contains two important articles. One is a backward-looking summary of recent developments, while the other addresses an issue that is likely to be hotly debated in the very near future.

First, David Kupiec and Natalie Martin have written an excellent update of recent state and local tax cases in Illinois. (Excluding property taxes—see the Summer 2014 issue of *Tax Facts* for those cases) Some of these decisions have made headlines, but there are others that readers may not be familiar with and warrant a closer look.

Next, Natalie Davila provides an in-depth review of Illinois' largest tax expenditure, the decision not to impose state income tax on ***any*** type of retirement income.

Natalie's analysis makes several important points:

- Illinois is a true outlier, as one of only three states that completely passes up on this revenue source.
- Had Illinois treated retirement income like the IRS and most other states, it would have generated an extra $2.3 billion in 2012.
- One in four Illinois tax returns contains a retirement income subtraction.
- The retirement income subtraction is growing faster than federal Adjusted Gross Income or Net Income (Illinois taxable income).
- Much of the tax benefit is received by those under 65.
- The largest benefit goes to filers with the highest income, with 45 percent of the retirement income subtraction tax savings flowing to taxpayers with AGI over $100,000.

This is the kind of information we hope will help policy makers as Illinois struggles to deal with both its financial problems and the desire to have a tax code that encourages economic growth.

estimates for taxing some or all retirement income in Illinois. The report is laid out as follows:

1. How much tax are we foregoing by not taxing retirement income? What can we learn about who benefits from this exemption?

2. How did we get here?
    - History of exclusion;
    - Changes in poverty and labor force participation rates for those 65 years of age and older;
    - Expansion of retirement saving options.
3. What do other states do in terms of taxing retirement income?
4. Presentation of several retirement income taxation options.
5. Discussion of the taxation or non-taxation of retirement income within the framework of sound tax policy principles.

Summary of Findings

- Illinois treats retirement income for tax purposes significantly different from the federal government and most other states.
- If Illinois treated retirement income like the IRS and most other states, it would have generated $2.3 billion in 2012.
- Retirement income is growing at a significantly higher annual rate than either Adjusted Gross Income (AGI) or Net Income (NI).
- The growth in the newly authorized "pre-tax" defined contribution plans means that Illinois' retirement subtraction al-

lows an ever larger portion of Illinois income to go untaxed.
- One in four Illinois personal income tax returns contains a retirement income subtraction.
- Taxpayers with higher incomes have higher retirement income subtractions.
- Poor seniors who have to work pay income tax on their wages. Retirees who do not have to work because they have sufficient retirement income do not pay income tax.
- The population of seniors living at or below the poverty line has declined significantly since Illinois excluded retirement income from taxation; the poverty rate for those under 65 has increased during this same period.
- Much of the tax benefit is received by those below 65 years of age.

The time has come to reexamine the policy reasons behind why Illinois has a complete retirement income subtraction and raise questions such as should the subtraction be modified to target those who are of retirement age and/or have low to moderate income?

Illinois Retirement Income Subtraction

The federal government excludes a portion (between 15 to 100 percent) of social security income from taxation and taxes other components of retirement income. Many states follow this lead. However, in Illinois – in contrast with the general tendency to be coupled to the federal tax code – no retirement income is taxed. Only two other states provide for such a comprehensive exclusion. As a consequence, any discussion of taxing some portion of retirement income should be viewed in the context of taxing income in Illinois in a way that is more comparable to how the federal government, and most other states, treat this income stream.

Most recent data provided by the Illinois Department of Revenue indicates that in 2012 one in four returns claimed a retirement income subtraction and that, at a 5 percent tax rate, the Illinois retirement income subtraction has an associated tax expenditure value of around $2.3 billion.[2] **Table 1 on page 4** illustrates how Adjusted Gross Income (AGI), Net Income (NI) and the retirement income subtraction in Illinois have changed during the period 2007-2012.[3] Net income is income to which the Illinois individual income tax rate is applied

First, note that the number of resident returns as a whole actually decreased slightly during this period, while those returns with retirement income subtraction increased by 9 percent. This is significant as it illustrates an increasing number of Illinois residents are becoming eligible for the retirement income subtraction, while a decreasing number of residents are filing an Illinois return.

However, more alarming than the trend in number of returns is the income trend when comparing AGI, NI and Retirement Income Subtraction. While AGI and NI of Illinois' residents grew by 7.5 percent and 6.5 percent

TABLE 1: ILLINOIS' RETIREMENT INCOME SUBTRACTION, 2007-2012					
Tax Year	**Number of Resident Returns**	**AGI**	**Net Income**	**Resident Returns with Retirement Income**	**Retirement Income Subtraction**
2007	**5,627,395**	**$364,026,772,210**	**$308,705,658,167**	**1,319,540**	**33,427,666,675**
2008	**5,642,389**	**$362,832,131,816**	**$308,310,656,362**	**1,338,556**	**35,162,685,250**
2009	**5,506,933**	**$329,026,247,598**	**$276,972,670,973**	**1,352,431**	**34,362,303,304**
2010	**5,531,602**	**$348,177,983,589**	**$289,212,830,524**	**1,386,723**	**39,391,762,599**
2011	**5,551,381**	**$358,556,780,229**	**$300,806,610,768**	**1,400,096**	**41,687,827,405**
2012	**5,596,956**	**$391,225,950,142**	**$328,712,973,827**	**1,437,933**	**45,461,776,149**
Percent Change 2007-2012	**-0.5%**	**7.5%**	**6.5%**	**9.0%**	**36.0%**

Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-017
Note: This table contains information for residents only.

respectively during the period 2007-2012, the retirement income subtraction grew by 36.0 percent. In sum, retirement income is taking up a larger and larger part of the total income pie in Illinois.

It is important to note that the retirement income subtraction illustrated in Table 1 does not necessarily translate directly into a revenue estimate for repeal of the subtraction. Any change in behavior arising from taxation of retirement income has to be factored into making a revenue estimate. Would taxation cause retirees to relocate from Illinois to states with more favorable tax treatment? Research on this topic suggests that there is not strong evidence to indicate that seniors' mobility is significantly influenced by state tax policies.[4] This finding suggests any adjustment to the tax expenditure figure due to relocation would be minimal.

Tables 2(a) and 2 (b) provide some general characteristics about retirement income by AGI in 2012. In Table 2(a) we see that the percent of returns with retirement income varies significantly by AGI. The largest number of returns with a retirement income subtraction fall within the $0 to $25,000 AGI category. The largest amount of the retirement income subtraction falls in the $100,001 to $250,000 category.

Table 2(b) illustrates that the percent of retirement income received by those over 65 varies dramatically with levels of AGI. At higher

TABLE 2 (a): GENERAL RETIREMENT INCOME SUBTRACTION STATISTICS, 2012				
Adjusted Gross Income Bracket	Number of Resident Returns with Retirement Income Subtraction	Value of Resident Retirement Income Subtraction	Share of All Returns with Retirement Income	Share of Total Retirement Income Subtraction
$0-$25,000	342,647	$3,386,792,594	23.8%	7.4%
$25,001-$50,000	309,414	$6,101,104,236	21.5%	13.4%
$50,001-$75,000	252,888	$7,924,595,695	17.6%	17.4%
$75,001-$100,000	189,661	$7,639,933,639	13.2%	16.8%
$100,001-$250,000	289,592	$15,249,623,226	20.1%	33.5%
$250,001-$500,000	36,462	$2,581,145,185	2.5%	5.7%
$500,001-$1,000,000	10,641	$975,012,025	0.7%	2.1%
More than $1,000,000	6,628	$1,603,569,549	0.5%	3.5%
Total	1,437,933	$45,461,776,149	100.0%	100.0%

Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-017
Note: This table contains information for residents only.

TABLE 2 (b): ILLINOIS RETURNS WITH RETIREMENT INCOME SUBTRACTION: ADDITIONAL STATISTICS, 2012			
Adjusted Gross Income Bracket	Percent of Filers 65 and Older (1)	Average AGI Per Return	Average Retirement Income Subtraction Per Return
$0-$25,000	65.8%	$9,514	$9,884
$25,001-$50,000	43.7%	$36,878	$19,718
$50,001-$75,000	36.7%	$62,075	$31,336
$75,001-$100,000	33.9%	$86,690	$40,282
$100,001-$250,000	28.0%	$143,701	$52,659
$250,001-$500,000	27.4%	$332,743	$70,790
$500,001-$1,000,000	28.4%	$681,716	$91,628
More than $1,000,000	30.3%	$3,603,975	$241,939
Total	40.3%	$91,588	$31,616

Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-017
Note: This table contains information for residents only.
(1): Information in this column takes the total number of 65+ Exemptions and divides by Total Exemptions for each AGI bracket.

levels of AGI, a smaller percentage of those claiming a retirement income subtraction are 65 or older. For example, in the $25,000 or less bracket some 65.8 percent of individuals were 65 or older, while at the AGI bracket of $1,000,000 or greater only 30.3 percent of individuals were 65 or older.

On average, retirement income makes up 34.5 percent of total AGI. Looking at the extremes, the retirement income subtraction, on average, is larger than AGI for the lowest income group, but represents only 7 percent of average AGI for the highest group. However, in absolute terms, the average retirement income subtraction for the highest group is 25 times larger than for the lowest.

Table 3 shows 2012 Illinois returns with retirement income split between those that claim a 65 or older exemption and those that do not. Almost half of returns (claiming one-third of the total Illinois retirement income subtraction) are from households that do not claim a 65 or older exemption. This is because any retirement income stream is completely tax exempt in Illinois, irrespective of the age or income of the individual earning the income stream.

Having presented information that sheds light on the magnitude of the retirement income subtraction in Illinois and some general characteristics of returns that claim this exemption, the next step in our research is to

TABLE 3: ILLINOIS RETIREMENT INCOME RETURNS PROFILE, 65 OR OLDER COMPARED TO THOSE UNDER 65, 2012

Adjusted Gross Income Bracket	Retirement Income Subtraction on Returns That Claim a 65 or Over Exemption			Retirement Income Subtraction on Returns That Do Not Claim a 65 or Over Exemption		
Range	Returns	Amount	Average	Returns	Amount	Average
$0-$25,000	254,824	$2,792,291,723	$10,958	98,150	$725,014,878	$7,387
$25,001-$50,000	175,112	$4,494,693,206	$25,668	147,540	$1,779,999,824	$12,065
$50,001-$75,000	132,382	$5,648,067,352	$42,665	134,068	$2,574,849,373	$19,206
$75,001-$100,000	95,889	$5,432,015,387	$56,649	106,465	$2,576,931,844	$24,204
$100,001-$250,000	135,131	$10,321,887,815	$76,384	183,473	$6,210,258,661	$33,848
$250,001-$500,000	19,980	$1,956,482,290	$97,922	24,737	$1,175,927,424	$47,537
$500,001-$1,000,000	7,160	$866,696,758	$121,047	7,689	$466,445,002	$60,664
More than $1,000,000	7,125	$2,143,050,316	$300,779	6,012	$1,267,418,489	$210,815
Total	827,603	$33,655,184,847	$40,666	708,134	$16,776,845,495	$23,692

Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-014
Note: This table contains information for both residents and non-residents.

analyze how this retirement income subtraction lowers effective tax rates for returns that claim the subtraction.

Even though the legal tax rate in Illinois was 5 percent in 2012, no one likely paid that percent of all their income in Illinois income tax. For most people, the tax rate they pay is less than 5 percent because the state permits many adjustments to AGI. The retirement income subtraction is by far the largest subtraction permitted on the IL-1040.

Table 4 calculates effective tax rates for Illinois residents under current tax law and compares that with what the effective tax rate would be if retirement income were taxable. We can see that the current average effective tax rate is 2.9 percent. Should retirement income become taxable, the average effective tax rate increases to 4.6 percent. This data suggests that policy proposals to tax retirement income should contemplate a mechanism to protect those at the lower end of the income scale.

TABLE 4: EFFECTIVE TAX RATES FOR RETURNS WITH A RETIREMENT SUBTRACTION

Adjusted Gross Income Bracket	Effective Tax Rate (Net Tax Divided by Adjusted Gross Income)	Effective Tax Rate if Retirement Income Were Taxed
$0-$25,000	1.3%	N/A
$25,001-$50,000	1.7%	4.4%
$50,001-$75,000	2.0%	4.5%
$75,001-$100,000	2.2%	4.5%
$100,001-$250,000	2.7%	4.6%
$250,001-$500,000	3.6%	4.7%
$500,001-$1,000,000	4.1%	4.7%
More than $1,000,000	4.2%	4.6%
Total	2.9%	4.6%

Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-017
Note: This table contains information for residents only.

How Did We Get Here?

After litigation and a Supreme Court case, in 1972 the Illinois General Assembly passed legislation that excluded all income from state, local and federal pensions, social security and all qualified private pensions from taxation.[5] One interpretation of making this broad based exclusion is offered by Nowlan.[6] He suggests that the legislation was enacted as a way of making the flat-rate income tax somewhat more progressive, out of a belief that the elderly had higher levels of poverty than the general population. Transcripts of the 1972 debate estimated the projected revenue loss to the state in 2002 at $200 million.

At the time the retirement income subtraction was passed by the legislature, the poverty rate for seniors was close to 24.6 percent. As initially documented by Nowlan (2007), the poverty rate for seniors has continued to decline, whereas the poverty rate for the under

18 and 18-64 cohorts has increased.[7] The senior poverty rate has continued to decline since 2007, and in 2010 stood at 8.3 percent.[8] During approximately the same period the percent of working seniors has risen from 11.5 percent in 1992 to 18.5 percent in 2012.

As **Table 5** indicates, the US Bureau of Labor Statistics is forecasting the labor force participation rate for seniors will increase from 18.5 percent in 2012 to 23.0 percent in 2022. It is important to note that working seniors have to pay income tax on their earnings, while seniors who can live on their retirement income do not pay Illinois income tax on that income.

Retirement Saving Options

Since enactment of the Illinois retirement income subtraction, many new retirement options have become available and are now widespread. Individual Retirement Accounts (IRAs) were authorized in 1974 for employees without employer sponsored plans. This was followed, in 1978, by the authorization of 401(k) plans.[9] These type of plans have evolved to such a degree that defined contribution plans are now the most common retirement savings vehicle.[10] It is important to note that these new options more often than not are funded through "pretax contributions," wages set aside and not taxed at the federal or state level. The assumption is that the income will be taxable when individuals retire and withdraw the funds. However, in Illinois, because of the retirement income subtraction this income stream is never taxed.

TABLE 5: LABOR FORCE PARTICIPATION RATE, BY AGE

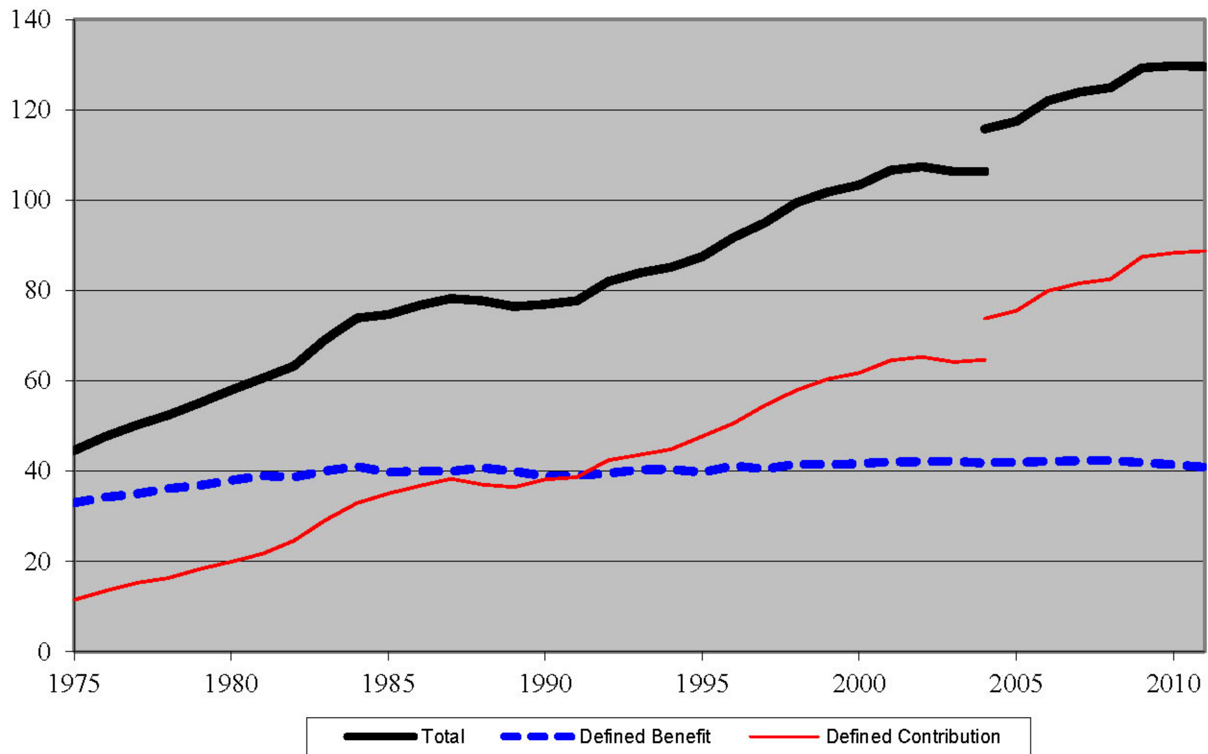
Group	Labor Participation Rate			
	1992	2002	2012	2022
Total, 16 years and older	66.4%	66.6%	63.7%	61.6%
16 to 24	66.1%	63.3%	54.9%	49.6%
25 to 54	83.6%	83.3%	81.4%	81.0%
55 to 64	56.2%	61.9%	64.5%	67.5%
55 to 59	67.4%	70.7%	72.5%	75.5%
60 to 64	45.0%	50.5%	55.2%	59.8%
65 and older	11.5%	13.2%	18.5%	23.0%
65 to 69	20.6%	26.1%	32.1%	38.3%
70 to 74	11.1%	14.0%	19.5%	24.0%
75 and older	4.5%	5.1%	7.6%	10.5%
75 to 79	6.3%	7.4%	11.4%	14.9%

Source: http://www.bls.gov/emp/ep_table_303.htm

Chart 1 illustrates the dramatic growth in participation in defined contribution retirement investment vehicles. This is in contrast to the stagnating number of participants in defined benefit pensions. **Chart 2 on page 10** illustrates the growth in assets in both defined benefit and defined contribution plans. The growth in defined contribution plan assets has increased at a higher rate than defined benefit plan assets.

Unlike traditional defined benefit pensions where participants cannot collect benefits until they reach a certain age, people with defined contribution plans may withdraw funds from these plans at any time if they meet certain conditions or are willing to pay penalties. These withdrawals are tax-free in Illinois because they fall under the definition

CHART 1: NUMBER OF PARTICIPANTS IN PENSION PLANS, BY TYPE OF PLAN, 1975-2011 (thousands)



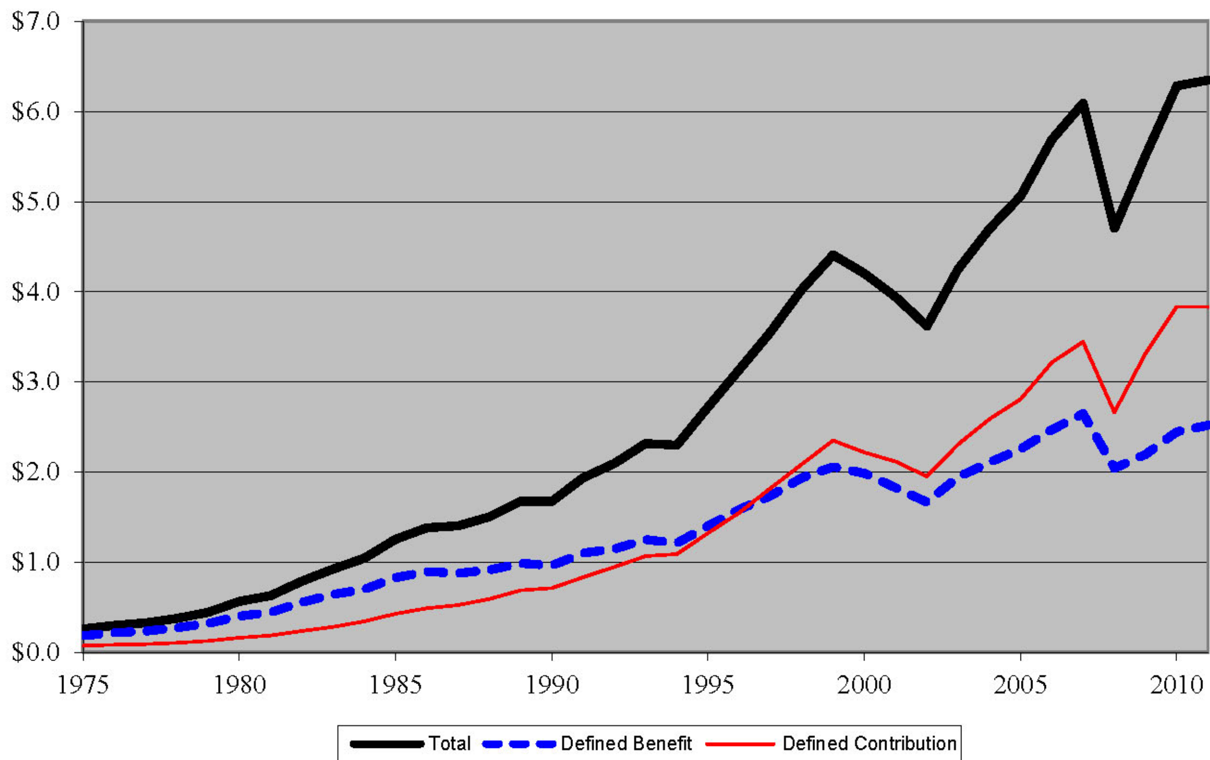
Source: http://www.dol.gov/ebsa/publications/form5500dataresearch.html. Note: total participant and active participant definitions were changed beginning with the 2005 Private Pension Plan Bulletin.

of retirement income. In addition, unlike traditional pensions, beneficiaries of IRAs are not limited to spouses. A beneficiary can be anyone selected by the owner. Anyone may inherit defined contribution retirement investment vehicles, and in Illinois this income stream is not taxed, regardless of age or income level.

How Other States Tax Retirement Income

Of the 43 states with an individual income tax, all offer a partial or full exemption for Social Security benefits. Thirty-one exempt all Social Security benefits, while the remaining states tax Social Security either to the extent that it is taxed at the federal level or based on income levels.[11] Ten states tax government pensions, while the remaining 33 states provide either a full or partial exclusion. Nine states differ in the way they tax private and public sector retirement income sources.

Illinois, Mississippi and Pennsylvania are the only states that do not impose income tax on any retirement income, while at the other end of the spectrum California, Minnesota, Nebraska, North Dakota, Rhode Island, Utah and Vermont tax all non-social security retirement income sources. Seventeen states provide an age-based retirement income deduction.



Some Examples of Revenue Generating Potential of Taxing Some Portion of Retirement Income

The revenue estimates, presented in Tables 6 and 7 may be useful in any future debate about whether and how Illinois should tax retirement income. This analysis uses 2012 data (with its 5 percent tax rate) and assumes that, similar to almost all states, Illinois would continue to exempt social security income from taxation in a manner that mirrors the federal tax code.

The Taxation of Retirement Income: Adequate, Simple, Efficient and/or Fair?

Next we evaluate the taxation of retirement income in the context of the principles of sound tax policy. Illinois' fiscal crisis is well documented. One could argue that any additional revenue used to pay down the deficit, albeit partially, meets the adequacy principle. As **Tables 6 and 7** illustrate, the incremental revenue from taxing retirement income falls away quickly as the exemption level is increased.

From an administration and compliance standpoint, taxing retirement income is straightforward, as witnessed by the fact that most other states tax at least some portion of retirement income.

The remaining two tax policy principles, economic neutrality (efficiency) and equity (fairness) are much more difficult to evaluate. From an efficiency standpoint, since retirement income streams are not taxed in Illinois while all

TABLE 6: REVENUE ESTIMATES, LIMITING RETIREMENT INCOME SUBTRACTION PER RETURN	
Options	**Revenue Estimate ($ Millions)**
No exclusion	$2,273
$20k exclusion per return	$1,033
$25k exclusion per return	$816
$30k exclusion per return	$620
$35k exclusion per return	$470
$40k exclusion per return	$336

Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-017
Note: Estimates based on resident retirement income subtraction only.

TABLE 7: REVENUE ESTIMATES, LIMITING RETIREMENT INCOME SUBTRACTION TO THOSE 65 AND OLDER	
Options	**Revenue Estimate ($ Millions)**
$20k per 65 exclusion	$1,341
$25k per 65 exclusion	$1,170
$30k per 65 exclusion	$1,011
$35k per 65 exclusion	$863
$40k per 65 exclusion	$729
$50k per 65 exclusion	$500

Source: Illinois Department of Revenue, Report ID TDWR-IITEOY-017
Note: Estimates based on resident retirement income subtraction only.

other personal income streams are taxed, the current tax code should be considered inefficient (the code treats different income streams differently). Taxing all retirement income would eliminate this inefficiency. Research cited above suggests that retirees are not very mobile and as such the taxation of retirement income or the lack thereof will not incent behavior to change in any significant way.

Providing a partial exclusion for retirement income or a greater exclusion for those 65 or older is inefficient since similar exclusions do not exist for other income streams. However, having exclusions for retirement income would be considered by many to be fairer than taxing all retirement income. While fairness is a matter of subjectivity, excluding or reducing the effective tax rate on some amount of income for those at the lower end of the economic spectrum is widely accepted. In determining how to give relief to lower income persons, policymakers must weigh the Illinois Constitution's prohibition against imposing a tax at a "non-graduated" rate and the concern that exclusions that vary by income could run afoul of the Constitution.

One final thought: the Illinois retirement income subtraction creates a classic tax policy dilemma. At the lower income levels the retirement income subtraction makes Illinois' flat rate tax less regressive. However, it does so at a very high price, with the largest benefit going to those with the highest incomes.

ENDNOTES

[1] Jim Nowlan, State of Illinois Retirement Income Tax Policy – A Review, Tax Facts, 62.5/December 2009, Taxpayers' Federation of Illinois.

[2] Illinois Department of Revenue, Report ID: TDWR-IITEOY-017, Report date 7 August, 2014. We exclude the retirement income subtraction claimed by part time and nonresidents as it seems unlikely that they would be legally liable for tax on their retirement income in Illinois if they do not live in the state.

[3] Adjusted gross income comes from the federal income tax return and is the starting point for the Illinois individual income tax return (Il-1040). On the other hand, Net Income (NI) is the income to which the Illinois individual income tax rate is applied.

[4] For a review of the literature see Full Exclusion of Retirement Income from State Taxation: Evaluating the Impact in Wisconsin, Workshop in Public Affairs, University of Wisconsin- Madison, June 4, 2013.

[5] Shortly after the Illinois Income Tax was instituted, taxpayers brought lawsuits claiming that Illinois could not tax income such as pensions and capital gains whose benefits had actually accrued prior to the date of enactment (Thorpe v. Mahin, 43 Ill.2d 36 (1969)). As a result of the Supreme Court finding, and the inability to find a compromise that was satisfactory to all parties, the General Assembly enacted P.A.77-2062, expanding the exclusion to apply to all retirement income in 1972.

[6] For more detail see Jim Nowlan, State of Illinois Retirement Income Tax Policy – A Review, Tax Facts, 62.5/December 2009, Taxpayers' Federation of Illinois.

[7] https://www.census.gov/hhes/www/poverty/data/incpovhlth/2012/figure5.pdf

[8] http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?src=bkmk

[9] These are investment vehicles whereby employees can elect to have their employer contribute a portion of their wages on a pretax basis.

[10] Other examples include 403(b)s, 457s and Thrift Savings Plans

[11] http://www.ncsl.org/documents/fiscal/taxonpensions2011.pdf

RECENT ILLINOIS INCOME & SALES TAX CASE SUMMARIES

By David Kupiec and Natalie Martin

Kupiec and Martin LLC is a state tax law firm that is uniquely positioned to address and resolve state sales, income and franchise tax issues facing multi-state companies through an understanding and appreciation of the often conflicting technical, political and practical issues facing tax professionals. With over 35 years of combined experience in various state tax specific roles, Kupiec and Martin provides a unique service perspective combining governmental, legal, industry and public accounting experience.

Provided below are brief summaries of some of the recent Illinois income and sales tax court cases appearing in chronological order. As you can see, the Illinois courts have been quite active addressing various state tax issues. If you have any questions concerning the items presented below please contact us.

Con-Way Transportation Services, Inc. v. Brian Hamer, 2013 IL App (1st) 113410-U, January 17, 2013 – The Appellate Court reversed the Administrative Law Judge Decision and Circuit Court decision by finding in favor of Con-Way Transportation Services, Inc., (hereafter "Con-Way" or "Taxpayer") that Con-Way's amnesty overpayment should be refunded as the amended tax return at issue was timely filed under Section 911(b) of the Illinois Income Tax Act.

Under the 2003 Illinois Amnesty Act, participating taxpayers who paid delinquent taxes for any taxable period after June 30, 1983, and prior to July 1, 2002, received a waiver of penalties and interest. Non amnesty participants were subject to double interest and penalties. To participate in the amnesty program, Taxpayers were required to make full payment of delinquent tax from October 1, 2003, through November 17, 2003. The Department also adopted emergency rules providing that a taxpayer under federal audit could participate in the amnesty program by making a good-faith payment of its estimated liability. The emergency amnesty rules generally prohibited amnesty participants from seeking a refund but the rules did permit a limited exception for those taxpayers whose refund was based upon a final determination of the Internal Revenue Service.

Prior to the beginning of the 2003 amnesty program, the IRS began an audit of Con-Way that pertained to 1997, the year at issue. On November 17, 2003, the last day of the amnesty program, Con-Way filed an amended 1997 amended return and payment based on its estimate of the ongoing IRS audit. On August 18, 2004, the IRS completed its audit with an assessment smaller than the amount reflected the November 17th amended return. On November 29, 2004, Con-Way submitted a

second amended 1997 return requesting a refund of its November 17, 2003 amnesty overpayment. The Department denied the refund contending that the claim was not filed within one year of the tax payment or within 3 years of the originally filed return.

The Appellate Court determined that there was clear error in the Department's decision as Con-Way's refund request was timely filed within the 2-year statute of limitations provided in Section 911(b) of the Illinois Income Tax Act. Accordingly, the Appellate Court reversed the Circuit Court's judgment.

Frederick and Janice Grede v. The Illinois Department of Revenue, 2013 IL App (2d) 120731-U, April 22, 2013 - The Illinois Appellate Court found that Frederick Grede was not an Illinois resident during the period he was employed full-time in Hong Kong. Mr. Grede moved to Hong Kong with the hope that his employment might last for 10-years and his move was based on long-term incentives. Although his employment contract was not renewed after approximately 3 years in Hong Kong, he still stayed in Hong Kong and looked for other employment and started a consulting company.

The trial court overruled the administrative law judge by finding that the main focus of the case was intent and that Grede had intended to go to Hong Kong on a permanent basis. The court also found that domicile is not dispositive of an individual's residency. The Appellate Court reasoned that the "Tax Act appears to indicate that an individual who is domiciled in Illinois but is absent from the state for other than a temporary or transitory purpose would qualify as a nonresident."

Metropolitan Life Insurance Company, et al., v. Brian Hamer, 2013 IL 114234, June 20, 2013 - The Illinois Supreme Court in agreeing the Illinois Appellate Court's *Marriott* decision and with Justice Hoffman's Appellate Court dissent in the instant case, held that the plain and ordinary meaning of the phrase "all taxes due" in the 2003 Amnesty Act refers to taxes that are due at the time the taxpayer's tax return is required to be filed. The Illinois Supreme Court also held that 200% interest does not violate substantive due process.

Metropolitan Life Insurance Company (hereafter "MetLife" or "Taxpayer") timely filed its 1998 and 1999 corporate income tax returns and paid all tax liability reflected on the returns. The Illinois General Assembly enacted the Tax Delinquency Amnesty Act in 2003 which applied to "all taxes due" for any taxable period between June 30, 1983 and July 1, 2002.

On December 12, 2000, the IRS started auditing Taxpayer's 1997-1999 federal tax returns. The IRS audit was completed in July 2004 after the amnesty program ended. On or after August 2004, Taxpayer provided the final IRS adjustments to the Illinois auditor as part of the ongoing Illinois audit. The Illinois auditor determined that additional Illinois income tax was owed for 1998 and 1999 as a result of the federal changes.

The Taxpayer paid the additional tax owed at the conclusion of the Illinois audit in May

2007. The Illinois auditor applied the 200% amnesty interest to the additional tax. Taxpayer argued that the 200% interest should not be applied as the additional tax was not assessed or due at the time of the amnesty application. The circuit court concluded that Taxpayer's tax obligation at issue was not determined until August 2004, after the amnesty period concluded. The Illinois Appellate Court affirmed the circuit court but the Illinois Supreme Court reversed.

Edmund J. Sweeney v. State of Illinois, Department of Revenue, Case No. 10 L 050524, June 26, 2013. - The Cook County Circuit Court found that the balance of the factors in determining residency weighed in the favor of the plaintiff that Florida was his domicile in 2002 and 2003. The court found that although the plaintiff had ties with both Illinois and Florida, the majority of those ties shifted to Florida in 2002. The Court weighed the following factors: 1) Plaintiff's move to Florida (including home ownership and rental agreements, driver's license, voter's registration, club memberships, filing income tax returns, telephone and utility usage, location of doctors, bank accounts, mailing address, and business interests); 2) Plaintiff's abandonment of first residence; 3) Plaintiff's intention not to return to the first domicile; and 4) Plaintiff's intention of making the last-acquired domicile a permanent home.

Web Innovations & Technology Services, Inc. v. The Department of Revenue, 2013 IL App (4th) 120749-U, August 28, 2013. - The Appellate court held that the decision by the Illinois Department of Revenue denying the taxpayer's request for charitable exemptions from the Retailers' Occupation Tax Act and Property Tax Act was not erroneous. The Administrative Law Judge relied on a number of factors including that the majority of funding was from the sale of scrap materials from recycling rather than public or private charity and the primary use of the Danville properties was to operate a recycling business from which it made money rather than to provide charity. The Appellate Court agreed.

ILMO Products Company v. The Department of Revenue, 2013 IL App (4th) 120973-U, September 5, 2013. - The Appellate Court affirmed the trial court determination that "HAZMAT" fees the plaintiff imposed on its high-pressure gas cylinders were not subject to the Retailers' Occupation Tax because they concerned a nontaxable rental and the plaintiff's cryogenic systems were exempt from the use tax as manufacturing machinery. In its analysis the Court found that the fees imposed on gas cylinders were not subject to the Retailers' Occupation Tax because they concerned a non-taxable rental, rather than a taxable sale as defendants agreed that the HAZMAT fee was collected as part of the rental of the gas cylinders and to comply with hazardous materials laws and regulations. The Court also found that the cryogenic systems were manufacturing machinery and equipment because the systems "use mixers, vaporizers and pressure-building devices to convert the cryogenic liquid from its liquid state to a gaseous state usable by its customers." The Court reasoned that the

systems are integral to the manufacturing process of converting liquid gas to gaseous gas because they *are* the conversion systems to manufacture the gas.

<u>Witte Brothers Exchange, Inc. v. The Department of Revenue</u>, 2013 IL App (1st) 120850, September 30, 2013 – The Illinois Appellate Court ruled that Taxpayer's pass-through miles established a physical and economic presence in Illinois which must be taxed according to Illinois Income Tax Act Section 304(d)(1). The Appellate Court added that no where in Illinois case law does it state that physical presence must be fixed within Illinois in order to be "in this State" and that the Appellate Court in *Panhandle* determined that the phrase "in this State" is more broadly defined to include, not only being within Illinois borders, but also having a presence or existence in Illinois. Thus, the Appellate Court held that this physical presence and economic connection established that Taxpayer is "in this State" and that pass-through miles must be included in the numerator of the apportionment factor because those miles were traveled in Illinois for a consideration.

Witte Brothers Exchange, Inc. (hereafter "WBE" or "Taxpayer") is an interstate trucking company that was audited by the Illinois Department of Revenue for tax years 2005-2009. During the audit, the Illinois Auditors assessed additional income tax against WBE based on the inclusion of pass-through miles in the sales factor numerator. The pass-through miles at issue represented miles WBE drove through Illinois without picking up or delivering goods. WBE contested the audit assessment , the Circuit Court held that the Illinois Department of Revenue cannot tax pass-through miles under Section 304(d)(1) of the Illinois Income Tax Act, 35 ILCS 5/ 304(d)(1), but the ruling was reversed by the Appellate Court.

<u>Stasko v. City of Chicago</u>, 2013 Ill App (1st) 120265, September 30, 2013. - The Appellate Court ruled that the sale or transfer of permanent seat licenses (hereafter "PSL") giving license holders the right to purchase tickets for Chicago Bears' home football games are subject to the City of Chicago's Amusement Tax. The Court found that the tax was not preempted by section 8-11-6a of the Municipal Code. The Court reasoned that "the purchaser of a PSL is really paying for the privilege of viewing and amusement" and the true benefit is to view a Bears game from a particular seat.

<u>Wendy's International, Inc. v. Brian Hamer</u>, 375 Ill. Dec. 194, 996 N.E.2d 1250 (4th Dist. October 7, 2013) – The Illinois Appellate Court reversed the Circuit Court and granted Wendy's International, Inc.'s (hereafter "Wendy's" or "Taxpayer") motion for summary judgment holding that Scioto was a bona fide insurance company for Illinois income tax purposes and federal income tax law as it met the requirements during the applicable years and engaged in the necessary risk shifting and risk distribution.

Wendy's formed and licensed Scioto Insurance Company in the State of Vermont as a captive insurance company to provide various types of insurance to Wendy's and its affiliates. Scioto

used actuarially determined rates to set the premiums charged Wendy's and its affiliates and was sufficiently capitalized to cover all of its insurance obligations as required by Vermont law. Accordingly, Wendy's excluded Scioto from its Illinois unitary group pursuant to the non-combination rule because an insurance company is required to apportion its income using insurance company specific apportionment provisions.

The Illinois Department of Revenue concluded during its audit that Scioto was not a true insurance company as: 1) there was not actual risk shifting and distribution to constitute insurance for federal income tax purposes; 2) the majority of Scioto's income was derived from intercompany royalty income; and 3) Scioto was not regulated in all states in which it writes premiums. Wendy's contested the audit findings by paying the tax assessed under protest and initiating a case in Circuit Court. The Circuit Court found that Scioto was not an insurance company, but was overruled by the Appellate Court.

Citibank, N.A. v. Illinois Department of Revenue, No. 13 L 050072 (Cir. Ct. Cook County), October 17, 2013 – The Circuit Court held that there was no requirement that a taxpayer must be a retailer to claim a retailers' occupation tax refund under Section 6 of the Illinois Retailers' Occupation Tax Act. The Circuit Court found that Citibank was entitled to the credit or refund as: 1) it incurred the tax at issue; 2) the retailers did not reimburse Citibank for the tax Citibank paid; and 3) no agreement or understanding existed allowing Citibank to be relieved of the tax burden. Retailers had transferred receivables to Citibank that represented the purchase price and Illinois Retailers' Occupation Tax of financed purchases of the retailers' customers. After some of these customers defaulted on the amounts they owed Citibank, Citibank wrote off the bad debt and filed a claim for Retailers' Occupation Tax credit or refund based on the amount of the defaults. The Department denied the claim stating that Citibank must be a retailer to request a refund under Section 130.1960, but the Court found in favor of Citibank.

Performance Marketing Association, Inc, v. Brian Hamer, 2013 IL 114496, October 18, 2013 – The Illinois Supreme Court determined that the relevant provisions of Public Act 96-1544 impose a discriminatory tax on electronic commerce within the meaning of the Internet Tax Freedom Act (hereafter "ITFA"), (47 U.S.C. Section 151). Accordingly, the Illinois Supreme Court affirmed the Circuit Court's judgment and held that the definition provisions of Public Act 96-1544 at issue are expressly preempted by the ITFA and are therefore void and unenforceable.

Performance Marketing, Inc. (hereafter "PMA" or "Taxpayer") alleged that part of the new Illinois "click-through" nexus law, Public Law 96-1544, was preempted by federal law and violated the commerce clause of the United States Constitution. The Illinois Circuit Court granted PMA's request for summary judgment on both counts. The Department appealed directly to the Illinois Supreme Court based on the federal law challenges.

At issue were the changes under Public Act 96-1544, effective March 10, 2011, to the definitions of a retailer or serviceman "maintaining a place of business in this State" in the Illinois Use Tax and Service Use Tax Acts. Based on these changes, out-of-state internet retailers and servicemen would be required to collect state use tax if they had a contract with a person in Illinois who displayed a link on his or her website that connected an Internet users to that remote retailer or serviceman's website if the referral contracts at issue generated more than $10,000 per year. However, Public Act 96-1544 did not require use tax collection by out-of-state retailers who entered into performance marketing contracts with "offline" Illinois print publishers and over-the-air broadcasters. This differential treatment was the basis of the Illinois Supreme Court's decision to invalidate the statute as a violation of ITFA.

Mattoon Kawasaki Yamaha, Inc. v. The Department of Revenue, 2013 IL App (4th) 12116-U, October 23, 2013. - The Appellate Court held that the plaintiff's receipt of "dealer reserve payments" from the manufacturer do not constitute gross receipts from the sale of its vehicles to customers, but rather are nontaxable reimbursements from amounts previously paid as part of plaintiff's purchase of the vehicle from the manufacturer. In these transactions, the plaintiff would pay a dealer invoice with wholesale cost, shipping and dealer reserve payment and after a sale of a vehicle, the manufacturer would send a check back to plaintiff for the amount paid as the "dealer reserve payment" included in the original invoice.

The Court reasoned that the dealer reserve payments were not incentives and were not gross receipts because they did not add to the total selling price of a particular vehicle to the plaintiff's benefit. It further went on to note that "the return of the 'dealer reserve payment' to plaintiff was contingent only upon the occurrence of a retail sale, not upon the amount of the retail sale, it was not included in the selling price and the same should not be included in plaintiff's gross receipts."

Hartney Fuel Oil Company et al, v. Brian A. Hamer, 2013 IL 115130, November 21, 2013 – The Illinois Supreme Court concluded that the "business of selling" under the local Retailers' Occupation Tax Acts is a fact-intensive "composition of many activities" consontant with the Court's holing in *Ex-Cell-O*. Accordingly, the Supreme Court held that the regulations at issue were inconsistent with the statutes and case law and were therefore invalid. The Supreme Court also held that the Department has a duty under the Taxpayers' Bill of Rights Act to abate Hartney Fuel Oil Company's (hereafter "Hartney") tax and penalties for the audit period.

The Illinois Department of Revenue audited Hartney and determined that Hartney's retail fuel sales were attributable to its Forest View Office rather its Village of Mark office as reported on its tax returns. The proposed audit change would result in Hartney being subject to retail occupation taxes imposed by the Village of Forest View, Cook County, and

the Regional Transportation Authority. The principal question before the Illinois Supreme Court was the determination of the proper situs for the "business of selling." Hartney argued that the law and regulations supported a bright-line test: where the purchase order is accepted for a sale at retail in Illinois, and the purchaser takes delivery in Illinois, the sale has its situs where seller accepts the purchase order. The circuit court concluded that the sales and tax liability incurred in the Village of Mark under the bright-line test. The Appellate Court had affirmed.

Lewis Linn, as Trustee v. The Department of Revenue, 2 N.E.3d 1203, December 18, 2013. - The Illinois Appellate Court found insufficient contacts existed between Illinois and the Trust at issue to satisfy due process and that the income tax imposition was unconstitutional. A trust was originally created in Illinois in the 1960s in accordance with the laws of the State of Illinois. It subsequently went through changes and was reformed to have the trust governed by Texas law. During the periods at issue, the trust had no connections to Illinois as neither the trust's property, trustee, protector nor beneficiaries were located in Illinois. Notwithstanding, the IDOR claimed that the trust owed its existence to Illinois and that Illinois provided the trust with benefits. In reaching its determination the Court explained that the trust had no connections to Illinois, the fact that the grantor was an Illinois resident did not satisfy due process, the trust reformation provided for the application of Texas law, and the trust had nothing in and sought nothing from Illinois.

IPC Aviation, Inc. v. Illinois Department of Revenue, Case No. 08 L 050974, February 19, 2014. - The Circuit Court found that the Plaintiff purchased tangible personal property (the fractional ownership in an aircraft) subject to the Illinois Use Tax Act and there existed a substantial nexus between Illinois and the aircraft. The Court discussed that "this case presented an issue of first impression: whether Plaintiff's 18.75% fractional ownership in the Aircraft is subject to use tax pursuant to the Illinois Use Tax Act." In reaching its decision the Court looked to whether the Plaintiff purchased tangible personal property at retail from a retailer and if the Plaintiff used its purchased tangible personal property in Illinois.

The Court found that tangible personal property was purchased as the Plaintiff has rights or powers over the Aircraft that are incident to the ownership of an Aircraft, likening the fractional ownership to a timeshare and finding that transportation services were not purchased. The Court then found that the essence of the transaction was flights made on the Flexjet fleet, not only flights made on the Aircraft itself (use of alternative aircraft was a part of the contract). The Court explained that you should "not look at how many time Plaintiff used the Aircraft itself, but how many times the Plaintiff used the Aircraft to obtain flights from Flexjet" (using substitute planes).

Reed Smith LLP v. Zahra Ali and Horwood Marcus & Berk, CHTD v. The Cook County Department of Revenue, 2014 IL App (1st) 132646-U, August 4, 2014. - The Appellate

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Court held that the 2012 Cook County Use of Non-Titled Personal Property Tax Ordinance is invalid as it violates section 1009 of the Counties Code. The Appellate Court stated that the trial court did not err in granting Plaintiffs' motions for summary judgment as the Cook County use tax ordinance at issue is an improper use tax on the selling or purchase price of personal property that is prohibited by section 5-1009 of the Counties Code. The Appellate Court added that since it held that the Ordinance is plainly prohibited by the Counties Code, it declined to address the additional arguments concerning whether the Ordinance violates the provision of the Illinois constitution abolishing ad valorem taxes on personal property or the dormant Commerce Clause of the federal constitution.

Chicago Bears Football Club v. The Cook County Department of Revenue, 2014 Ill App (1st) 122892, August 6, 2014. - The Appellate Court found that the value of amenities that are charged to the ticket holder as part of the ticket price are subject to the Cook County Amusement Tax. The Court discussed the issue of whether the prices paid for club seats and luxury suite constitute "admission fees or other charges paid for the privilege to enter, witness or view such amusement." The Court found that these fees could not be separated from the price of their ticket as they couldn't watch the game without paying the price attendant to those seats and that amenities associated with club seats and luxury suites are not "non-amusement services."