

General Information Letter: No subtraction is allowed for state income tax refunds included in taxable income of a trust, even when the federal deduction for payment of the tax was added back when the trust claimed a credit for those taxes.

April 20, 2009

Dear:

Your letter has recently been forwarded to the Legal Department for a response. In your letter dated June 20, 2008 you state the following:

We have been informed that the Illinois Department of Revenue has disallowed the above taxpayers' tax year 2006 Line 4g subtraction for refunds received from other states.

The Illinois Department of Revenue is of course aware that its refusal to allow these subtractions is counter to Illinois law and contrary to the Equal Protection clauses of both the United States and Illinois Constitutions.

Illinois IITA Section 203(c)(2)(J) expressly allows subtraction of amounts "included in taxable income as modified by ... Section 203(c)(2)(F) and which are exempt from taxation by this State by reason of ... statutes of the United States." The operative U.S. statute is Internal Revenue Code Section 111, which proscribes treating as income the recovery of a deduction for which no tax benefit was derived. This is clearly the case with refunds of state tax payments that (as in the taxpayers' case) were added back to Illinois base income. These state tax payments were not deducted in arriving at the taxpayers' Illinois taxable income; therefore, their recovery is not taxable by Illinois.

Moreover, your position violates the Equal Protection clauses of both the U.S. and Illinois Constitutions, in that it taxes citizens differently solely on the basis of their ability to estimate their tax liabilities to other states. No valid legal or fiscal distinction can be made between refunds of Illinois tax payments (the subtraction of which you allow) and refunds of tax payments made to other states that were added back to prior tax years' Illinois base income.

You are completely and totally aware your position is unlawful and untenable, and therefore your adherence to it cannot be construed as anything other than a knowing and deliberate fraud designed to retain taxpayer dollars to which you know you are not entitled.

Abate any and all penalty and interest amounts you have assess the taxpayers based on your clearly erroneous and wrongful interpretation of Illinois law, and restore the taxpayers' accounts as shown on their 2006 Illinois tax returns.

According to the Department of Revenue ("Department") regulations, the Department may issue only two types of letter rulings: Private Letter Rulings ("PLR") and General Information Letters ("GIL"). The regulations explaining these two types of rulings issued by the Department can be found in 2 Ill.Adm.Code §1200, or on the website <http://www.tax.illinois.gov/LegalInformation/regs/part1200>.

Due to the nature of your inquiry and the information presented in your letter, we are required to respond with a GIL. GILs are designed to provide background information on specific topics. GILs, however, are not binding on the Department.

Section 203(c)(1) of the Illinois Income Tax Act ("IITA"; 35 ILCS 5/101 et seq.) states that a trust or estate's base income is the amount equal to its taxable income as properly computed for federal income tax purposes modified by various addition and subtraction modifications found in IITA Section 203(c)(2). Pursuant to IITA Section 203(h), no addition or subtraction modifications are allowed unless specifically provided for in IITA Section 203(b)(2):

203(h): Legislative intention. Except as expressly provided by this Section there shall be no modifications or limitations on the amounts of income, gain, loss or deduction taken into account in determining gross income, adjusted gross income or taxable income for federal income tax purposes for the taxable year, or in the amount of such items entering into the computation of base income and net income under this Act for such taxable year, whether in respect of property values as of August 1, 1969 or otherwise.

Your letter indicates that you are seeking an Illinois subtraction for refunds received from other states. You rely on IITA Section 203(c)(2)(J) which allows taxpayers to deduct:

(J) An amount equal to the amount of any tax imposed by **this Act** which was refunded to the taxpayer and included in such total for the taxable year.

Emphasis added. Based on the statutory language, only Illinois income tax refunds included in federal taxable income may be subtracted. This is the correct treatment, because state income tax refunds are included in federal taxable income only if the tax was deducted when paid, and IITA Section 203(c)(2)(C) disallows the deduction of Illinois taxes.

You also refer to IITA Section 203(c)(2)(F), an addition modification, which states:

(F) For taxable years ending on or after January 1, 1989, an amount equal to the tax deducted pursuant to Section 164 of the Internal Revenue Code if the trust or estate is claiming the same tax for purposes of the Illinois foreign tax credit under Section 601 of this Act.

This simply disallows a double tax benefit from paying foreign taxes: a federal deduction and an Illinois tax credit on the foreign tax amounts paid. When a trust elects to take a credit rather than a deduction for taxes paid to another state, it still receives an Illinois tax benefit, and including a subsequent refund in the trust's net income is appropriate. Accordingly, there is nothing unlawful or untenable about these provisions.

As stated above, this is a general information letter which does not constitute a statement of policy that either applies, interprets or prescribes tax law. It is not binding on the Department. Should you have additional questions, please do not hesitate to contact our office.

Sincerely,

Heidi Scott
Staff Attorney -- Income Tax