# Chapter 18: Illinois Department of Revenue



**Please note.** Corrections for all of the chapters are available at **www.ace.uiuc.edu/taxschool**. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

This year's Illinois Department of Revenue (IDOR) chapter focuses on issues affecting individual taxpayers. The chapter begins with an in-depth discussion of IRC §529 college savings plans, specifically focusing on plans sponsored by the state of Illinois. This topic also compares and contrasts other means of saving for college and describes the impact of various savings methods on federal student financial aid formulas.

The chapter continues with a discussion of topics important to Illinois senior citizens, including changes made to the Illinois Circuit Breaker program since Medicare Part D triggered changes in the state's prescription assistance program. An update is also provided on the Senior Citizens Assessment Freeze Homestead Exemption.

Issues concerning the taxation of retirement income in Illinois are also discussed. Generally, retirement income is exempt from Illinois tax and disability income is taxable. Exceptions to these generalities are discussed in the section "Taxability/Exclusion of Retirement Plan Income."

Other covered topics include often overlooked state subtractions to income, including the exclusion of proceeds resulting from the sale of employer's securities held in qualified plans. Subtractions for dividends paid by Enterprise Zone and River Edge Redevelopment Zone businesses are also explored, as well as subtractions for dividends paid by designated high impact businesses located in foreign trade zones or sub-zones.

A section on special taxpayer issues covers unique situations affecting certain Illinois taxpayers. This section focuses on subtractions available to railroad workers, specific rules regarding the education expense credit for home-schooled children, and issues arising when married couples are residents of different states. It also discusses injured and innocent spouse relief for Illinois residents.

## IRC §529 COLLEGE SAVINGS PLANS

College degrees have become nearly as commonplace as high school diplomas, and many jobs now require applicants to have achieved some form of higher education. As the cost of education continues to rise, funding becomes an issue. Currently, there are three preferred savings methods for college:

1. Traditional savings and investment accounts
2. Coverdell education savings accounts (formerly known as Education IRAs)
3. IRC §529 plans (also known as Qualified Tuition Programs or QTPs)

## TRADITIONAL SAVINGS AND INVESTMENT ACCOUNTS AND UGMA/UTMA ACCOUNTS

Traditional savings accounts provide no tax advantages. If an account is held in the parents' name, earnings are taxed at the parents' top marginal rate. However, funds placed in the child's name under the **Uniform Gifts to Minors Act (UGMA) or Uniform Transfer to Minors Act (UTMA)** offer a few advantages. However, the disadvantages far outweigh the advantages when it comes to saving for college.

UGMA/UTMA accounts function similarly to trusts, but are less complicated because they can be established directly at financial institutions. Custodians bear fiduciary responsibility for these types of accounts, managing and disbursing funds for the benefit of the named minor beneficiary. UGMA and UTMA accounts are essentially the same, but UTMA accounts are more lenient regarding the types of property that may be transferred into these accounts. Illinois follows UTMA rules.

One advantage to UGMA/UTMA accounts is that earnings on these funds may be taxed at the beneficiary's lower rate. Another advantage is that beneficiaries cannot remove funds from UGMA/UTMA accounts without the custodian's consent. Although the Illinois age of majority is 18, Illinois does not terminate custodianship under UTMA until age 21. This usually allows funds to remain in the account until the beneficiary has nearly completed college.

However, there are many disadvantages to using UGMA/UTMA accounts as college savings vehicles. Kiddie tax rules now apply to age 18, diminishing the tax incentive for placing funds in the child's name. Gifts made under UGMA/UTMA rules are irrevocable. Funds from these accounts can only be used for the minor beneficiary and cannot be transferred. Also, because the child is considered the account's owner, these funds weigh more heavily in the federal financial aid formula and may reduce the amount of financial assistance granted. (See the section "Impact of §529 on Student Financial Aid.")

## COVERDELL EDUCATION SAVINGS ACCOUNTS

Coverdell Education Savings Accounts (ESAs), formerly known as Education IRAs, function similarly to Roth IRAs. Contributions to ESAs are not deducted from income tax, but earnings on contributions accumulate tax free. Distributions used for **qualified elementary, secondary, or higher education expenses** are exempt from federal tax and most states' income taxes. Also like Roth IRAs, annual contributions are subject to limitations and are phased out for higher income taxpayers.

Total ESA contributions are limited to $2,000 **per beneficiary** per year, not per taxpayer. Contributions can only be made for beneficiaries under the age of 18. All funds must be withdrawn when the beneficiary turns 30 or rolled over to a qualified family member of the beneficiary. The earnings' portion of any funds left in the account 30 days after the beneficiary reaches the age of 30 is subject to tax and a 10% penalty.

**Observation.** IRC §529 plans, discussed below, offer many of the same tax advantages as Coverdell ESAs, without all the restrictions. **Beneficiaries may be covered under both §529 plans and Coverdell ESAs.** However, since only ESAs can be used to pay for qualified elementary and secondary educational expenses, taxpayers may want to consider using ESA funds to offset the cost of the beneficiary's private elementary and high school education, and leave §529 plan funds for higher education expenses.

## IRC §529 COLLEGE SAVINGS PLANS

Congress created IRC §529 plans, also known as qualified tuition plans (QTPs), as tax-advantaged vehicles designed to fund the costs of higher education. Introduced by the Small Business Job Protection Act of 1996, §529 plans were further refined in 1997 by the Taxpayer Relief Act and in 2001 by the Economic Growth and Tax Relief Reconciliation Act originally scheduled to expire in 2010, these popular college-savings vehicles were made permanent in 2006 by the Pension Protection Act.

### Tax Advantages of §529 Plans

**Like** Coverdell ESAs, §529 plans:

- Are funded with nondeductible contributions,
- Allows earnings to accumulate tax-free, and
- Exempt qualified distributions from federal income tax and most states' income taxes.

**Unlike** Coverdell ESAs, §529 plans:

- Do not subject high income donors to eligibility restrictions,
- Have no age restriction on beneficiaries,
- Restrict use of qualified distributions for higher education only, and
- Contributions are generally not subject to annual dollar limitations.

Since accounts are intended to fund the higher education costs of a single beneficiary, **total contributions plus earnings should not exceed a reasonable projection of the beneficiary's undergraduate and possible post-graduate educational expenses.** States may impose limits on the aggregate balance of all funds held for the same beneficiary, and can terminate or penalize excessively over-funded plans.

### Features of §529 Plans

Congress intended §529 plans to be flexible, no-hassle investment vehicles to encourage private financing of higher education. Plan distributions can be used to pay for the beneficiary's costs of tuition, books, fees, room and board. Simple, nonrestrictive eligibility rules, relaxed federal gift and estate tax rules on contribution limits, and favorable treatment of fund balances for federal financial aid qualifications combine to make §529 plans attractive investments for college savers.

**Eligibility.** Any U.S. resident who is age 18 or over with a valid social security number or tax identification number can open a §529 account. Each account may have only one beneficiary, but one beneficiary can have several accounts. There are no age restrictions on beneficiaries or income restrictions on donors. An individual may set up an account to benefit himself, a spouse, a child, or anyone else he chooses.

**Contributions.** The federal government does not impose a limit on contributions to §529 plans, although modified gift and estate tax rules apply. Tax-free transfers are allowed from existing Coverdell ESAs and UGMA/UTMA accounts. Proceeds of U.S. savings bonds may also be transferred tax-free, with certain restrictions. Contributions must be made in cash. Consequently, transferred funds must first be liquidated, and any resulting gain or loss must be reported on the owner's tax return before the proceeds can be contributed to a §529 plan.

Since UGMA/UTMA accounts are held in trust for the beneficiary, transferred amounts are subject to rules governing both §529 plans and UGMA/UTMA accounts. Unlike other §529 plans, unused UGMA/UTMA funds cannot be rolled over for use by other beneficiaries. Funds not used for the UGMA/UTMA beneficiary's higher education costs may be considered nonqualified distributions and subject to tax and penalty (see Distributions under this topic).

Contributions to §529 plans are considered completed gifts; however, donors are allowed to retain control of the funds as account custodians. With the exception of UGMA/UTMA accounts, donors can generally withdraw their contribution at any time. However, these distributions may be subject to the nonqualified distribution rules and gift and estate tax rules.

Contributions are eligible for the annual gift tax exclusion, which is currently $12,000 per person per donor. However, recent legislation allows donors to invest up to $60,000 ($120,000 for married donors) in the account of one beneficiary within a single tax year and elect to treat the gift as made over a 5-year period. Even though the donor retains control, the funds are considered removed from the donor's estate at the time of the gift. However, if the gift is revoked, the funds come back into the donor's estate and are subject to the nonqualified distribution rules.

**Observation.** Both the beneficiary and the donor benefit from a large, up-front gift to a §529 plan. The donor reduces the value of his estate and is relieved from paying income tax on investment earnings on the contributed amount, and the beneficiary has the opportunity for tax-free growth on a larger sum for a longer period.

### Impact of §529 Plans on Student Financial Aid

The Deficit Reduction Act of 2005 made favorable changes regarding the treatment of §529 plan funds in the federal student aid eligibility formula. Prior to this change, §529 funds were counted as an asset of the student and 35% of the funds were considered available for use. This reduced the student's eligibility for financial assistance.

Now, §529 funds are treated as parental assets on the Free Application for Federal Student Aid (FAFSA). Parental assets count at only 5.6%, instead of the 20% weighting now applied to student's assets. Since a smaller percentage of the funds are considered available for use, and qualified distributions from §529 are not counted as income on the FAFSA, students with §529 plans may still qualify for federal financial assistance. However, FAFSA rules change frequently and individual schools may consider §529 balances differently in their financial aid formulas.

### Flexible Options for §529 Funds

Some people consider it a gamble to set aside money today for a young child's future college education. What if the child chooses not to attend college? What happens if the child receives a full-ride scholarship? What happens if the family falls on hard times and needs the money to survive? Congress addressed these contingencies by authorizing rollovers and access to account funds through withdrawal of nonqualified distributions.

**Rollovers.** Section 529 plan funds not used by a beneficiary may be rolled over tax-free to another §529 plan for the benefit of a qualified family member of the beneficiary. For purposes of this rule, the following family relationships are considered qualified:

- The beneficiary's
  - Spouse;
  - Child or descendant of a child;
  - Brother, sister, stepbrother, or stepsister;
  - Father or mother, or ancestor of either;
  - Stepfather or stepmother;
  - Son or daughter of a brother or sister;
  - Brother or sister of father or mother;
  - Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law;
- The spouse of any individual listed above; and
- The beneficiary's first cousin.

Federal tax laws allow only one rollover within each 12-month period. To qualify, rollovers must occur within 60 days of the distribution.

**Distributions.** Each §529 plan from which a taxpayer takes a distribution must issue a **Form 1099-Q, *Payments From Qualified Education Programs (Under Sections 529 and 530).*** The taxpayer's gross distribution is shown in Form 1099-Q, box 1. Earnings are shown in box 2 and the taxpayer's basis, or return of investment (ROI) is displayed in box 3. With the exception of funds held in UGMA/UTMA accounts, qualified §529 plan distributions may be withdrawn at any time without incurring federal income tax.

A few states require taxpayers to include the earnings' portion of other states' §529 distributions in taxable income for the year withdrawn. Illinois was one of those states. Illinois legislators unanimously passed Illinois Public Act 95-0023 in the 2007 spring legislative session. This bill, which was signed by the governor on August 3, 2007 and is effective for taxable years beginning on or after January 1, 2007, removes the requirement for Illinois taxpayers to add back to taxable income any amounts earned on out-of-state §529 plan distributions.

To be considered a **qualified distribution,** funds must be used to meet one or more of the following higher education costs required for the beneficiary to enroll or attend an eligible educational institution:

- Tuition
- Fees
- Books
- Supplies
- Equipment
- Certain room and board expenses
- Necessary special needs services (for special needs beneficiaries only)

To qualify for the **room and board** exemption, the plan's beneficiary must be enrolled **at least half-time** at an eligible school. The maximum distribution allowed for room and board expenses equals the amount calculated for the cost of attendance for financial aid purposes. For students living in dorms or other housing facilities owned or operated by an eligible educational institution, the qualified distribution equals the actual amount charged for room and board.

An **eligible educational institution** generally includes any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education.

For **nonqualified withdrawals** (i.e., withdrawals in excess of the beneficiary's adjusted qualified educational expenses for the year), taxpayers may exclude an amount representing the §529 contributions to the plan. However, the portion of nonqualified distributions representing earnings must be included in taxable income for the withdrawal year. In addition, taxpayers may be subject to a 10% penalty on the nonqualified distribution.

**Adjusted qualified educational expenses** equal the beneficiary's total qualified educational expenses reduced by any tax-free educational assistance. Tax-free educational assistance includes:

- The tax-free part of scholarships and fellowships,
- Veterans' educational assistance,
- Pell grants,
- Employer-provided educational assistance, and
- Any other nontaxable payments, other than gifts or inheritances, received as educational assistance.

Beneficiaries with distributions from multiple plans during the year must combine information from all accounts to determine the amount of taxable earnings distributed during the year. Losses from one account may reduce taxable earnings from other accounts. Taxpayers may **claim a loss** on §529 plan investments if all plan funds have been distributed and the total distributions are less than the taxpayer's unrecovered basis in the plan. Losses are claimed on Form 1040 Schedule A, line 22, subject to the 2% adjusted gross income limitation.

**Exceptions to Penalty.** Nonqualified distributions are subject to a 10% penalty. However, the following penalty exceptions apply:

- Distributions pursuant to the beneficiary's death
- Distributions pursuant to the beneficiary's physical or mental disability
- The earnings' portion of distributions included in taxable income because the beneficiary received one or more of the following:
  - Tax-free scholarship or fellowship
  - Veteran's education assistance
  - Employer-provided educational assistance
  - Any other tax-free educational assistance, other than gifts or inheritances
- Distributions made pursuant to the beneficiary's attendance at a U.S. military academy
- The earnings portion of distributions included in taxable income because the qualified education expenses were used to claim education credits

> **Note.** Taxpayers may claim the Hope credit or lifetime learning credit in the same year they receive a tax-free distribution from a §529 plan as long as the qualified distribution, which is excluded from income, is not used for the same expenses on which the credit is claimed.

### Types of §529 Plans

There are two categories of §529 plans — prepaid plans and savings plans — but some states offer plans that blend features of both. While these plans operate differently, they share the same tax advantages. Section 529 plans generally are state-operated, but educational institutions also may offer prepaid plans. Every state and the District of Columbia now offer at least one §529 plan and many states offer several options. Residency restrictions do not apply, so a single beneficiary may have accounts in multiple states.

**§529 Prepaid Tuition Plans.** Prepaid tuition plans may be state-sponsored on behalf of public colleges or run by private educational institutions. Prepaid plans operate on the concept of paying tomorrow's tuition at today's prices. These plans can be either contract plans or unit plans. A contract plan, the most common prepaid plan type, promises to cover future tuition costs at a particular type of college in exchange for a lump-sum payment made up front. Some contract plans also allow payments to be made over time.

**Unit plans** allow the purchase of units or credits that represent a percentage of the average yearly cost of tuition at a participating college. The value of these units or credits can fluctuate each year according to average annual tuition increases. The units or credits are later redeemed to pay tuition costs, with some plans allowing units or credits to be applied toward room and board, books, and other supplies.

Currently, the **Independent 529 Plan** offers the nation's only private school prepaid tuition plan. A consortium of over 230 colleges in 38 states and the District of Columbia sponsor the plan. The plan's members include large research institutions such as Stanford and the University of Chicago, traditional liberal arts colleges like Amherst and Middlebury, women's colleges such as Smith and Wellesley, historically black colleges like Spelman and Dillard, technically oriented institutions like Rice and RIT, and religiously affiliated colleges like Notre Dame and SMU.

**§529 Savings Plans.** Section 529 savings plans are state-sponsored investment accounts run by professional managers. Unlike prepaid plans, which pool investor funds into a common account, investors maintain individual accounts with the §529 savings plan option. Also unlike prepaid plans, there is no guarantee the account's balance will cover the cost of future tuition. The growth of §529 savings plans depend on the amount contributed and performance of the selected fund(s). The investor bears the risk that the account may lose value.

Investors in §529 savings plans are limited to funds offered within a plan's portfolio; however, most portfolios offer a diverse range of investment options. An age-based portfolio is a common component of many plans. Assets are invested based on the beneficiary's age, allocating a larger portion to aggressive investments while the child is young and gradually shifting to more stable, principal-preserving investments as the child grows nearer to college age.

### Factors to Consider When Selecting Plans

Individual considerations must be taken into account when selecting the right §529 plan. When choosing a plan, the following factors should be evaluated:

- The plan's performance history over 1-, 5-, and 10-year periods
- Proficiency of management
- Available investment options
- Plan fees and expenses for both management and underlying portfolios

Another important factor is the availability of state tax incentives. Many states offer tax breaks to residents who purchase in-state plans. The following section discusses incentives available to Illinois residents who invest in Illinois-sponsored §529 plans.

## ILLINOIS §529 PLANS

The state of Illinois sponsors three §529 plans. It offers two savings plans, Bright Start and Bright Directions; and it offers one prepaid tuition plan, College Illinois!. These plans share a common state tax advantage. Illinois residents may deduct up to $10,000 in annual plan contributions ($20,000 for joint filers) from their Illinois taxable income for the year of contribution. Only the principal portion of a rollover contribution is eligible for the deduction. Recapture rules apply for nonqualified distributions. No further contributions may be made after a beneficiary's aggregate Illinois §529 plan balances reach $235,000.

### Bright Start

The Bright Start college savings plan was the first savings plan offered by the state of Illinois. Created in 2000, the fund accumulated over $2 billion in assets in 142,000 separate accounts by early 2007. However, the Bright Start plan ranked 47th out of 48 plans evaluated by independent authority Savingforcollege.com. The plan's low ranking was due to an underperforming investment portfolio and excessively high fees and expenses.

Bright Start underwent an overhaul in early 2007. The state granted the investment firm, Oppenheimer, a 7-year contract to administer the plan with the promise of lower fees and more fund investment options. The state also negotiated for Oppenheimer to create and sponsor a $3.5 million scholarship fund to be awarded to low- and middle-income students in every region of the state. This fund will award scholarships totaling $500,000 per year for seven years, based on selection criteria developed by the State Treasurer's office.

As soon as the transition is complete between Legg Mason Investor Services, Bright Start's former administrator, and Oppenheimer, the fund will start offering a wider selection of better-performing funds. Investors will be able to choose between Oppenheimer and Vanguard managed fund portfolios, as well as three equity index fund options. The actively managed funds offer a greater return potential, but charge slightly higher fees than the lower risk index funds. Overall costs and fees are expected to drop from 0.99% annually under Legg Mason to 0.19–0.21% for index funds and 0.53–0.64% for actively managed portfolios under Oppenheimer.[1]

### Bright Directions

First offered in late 2005, Bright Directions is Illinois' latest §529 college savings vehicle. The plan differs from Bright Start in that it is strictly available through brokers and fee-based financial advisors. Bright Directions is managed by Union Bank and Trust Company of Lincoln, Nebraska, and offers three age-based investment options, which differ according to the investor's risk tolerance, seven blended-fund target portfolios, and over 24 individual fund portfolios. Since Union Bank has no proprietary portfolios to promote, it offers a wide selection of popular investment options, such as PIMCO, Fidelity, DFA, American Century, Northern Funds, Legg Mason, William Blair, AllianceBernstein, Ariel Capital, T. Rowe Price, and more.

### College Illinois!

College Illinois! is the only prepaid tuition plan offered by Illinois. The plan began in 1998 and is administered by the Illinois Student Assistance Commission (ISAC). College Illinois! functions like an insurance policy, representing a contract between the investor and the state. In exchange for a specified sum of money paid upfront, the state ensures future tuition and fee coverage for a stated number of semesters at an in-state public educational institution. The fund is managed by professional brokers, but secured by the state. The Illinois legislature is required to consider appropriations to cover any fund shortfalls.

**Beneficiaries are not locked into Illinois public schools** because benefits can also be used at public and private colleges and universities nationwide. Out-of-state and private institution coverage amounts are equal to the mean-weighted average at Illinois public universities at the time the beneficiary enrolls in college. These amounts may not cover full tuition charges at non-public or out-of-state schools. Recent figures show over 23% of the plan's benefits were used at out-of-state schools and 16% at private Illinois colleges and universities.[2]

Plan prices fluctuate depending on the beneficiary's age, the number of semesters selected, and whether a community college, four-year university, or combination benefit is chosen. Plan prices for the 2006-2007 enrollment period ranged from a one-time $1,445 payment for one semester of community college for a beneficiary who was kindergarten age or younger at the time of enrollment, to $51,323 for nine semesters at an Illinois university for a beneficiary in the ninth grade or higher at enrollment.

Each semester is the equivalent of 15 credit hours. Investors have the option of spreading payments over time if the plan's beneficiary has not entered ninth grade at the time of enrollment. Enrollment periods vary. The 2006–2007 enrollment period was open October 23, 2006, through April 24, 2007, but enrollment for infants under 12 months remained open through August 1, 2007. College Illinois! contracts can be cancelled at any time, but cancellation fees apply.

The chart on the following page compares attributes of the three plans currently sponsored by Illinois.

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1. *State Treasurer Overhauls Bright Start,* Illinois State Treasury press release, March 12, 2007
2. Fact sheet provided by College Illinois!; last updated October 16, 2006

| Feature | Bright Start | Bright Directions | College Illinois! |
|---|---|---|---|
| Type of plan | Savings | Savings | Prepaid tuition |
| Inception date | March 27, 2000 | November 18, 2005 | 1998 |
| Annual allowable state tax deduction | $10,000 ($20,000 MFJ) | $10,000 ($20,000 MFJ) | $10,000 ($20,000 MFJ) |
| Program manager | Oppenheimer | Union Bank & Trust | Illinois Student Assistance Commission |
| Method of enrollment | State of Illinois and participating financial institutions | Financial advisor | State of Illinois |
| Investment options | Actively managed portfolios (age-based, equity, balanced, fixed income; principle protection income); choice of three indexed funds | Three age-based portfolios; seven target portfolios; 25 individual fund portfolios | Contributions are pooled; US Bank and State Street Bank & Trust are current fund custodians |
| Minimum opening investment | $25[a] | Unknown | Varies by age of beneficiary and number of units purchased |
| Minimum contribution | $15[a] | None | Varies by age of beneficiary and number of units purchased |
| Maximum contribution | —[b] | —[b] | N/A |
| Enrollment fees | $30[a] | $10 | N/A |
| Account maintenance fee | $0[a] | $3 per quarter | N/A |
| Program management fees | $0[a] | 0.45% management fee plus servicing fees of 0% to 0.50% | N/A |
| Additional information can be found at | brightstartsavings.com | brightdirections.com | collegeillinois.com |

[a] These amounts are subject to change under Oppenheimer's management (as of the time this chapter was being written, the transition from Legg Mason to Oppenheimer was in process).

[b] No further contributions may be made after the aggregate value of all Illinois §529 plans reaches $235,000.

## Recapture Provisions

Although Illinois offers a generous subtraction for contributions to Bright Start, Bright Directions, and College Illinois! plans, the state intends for these contributions to remain in Illinois-sponsored accounts until withdrawn to fund the beneficiary's higher education costs. Illinois Public Act 95-0023 requires Illinois taxpayers who received a state deduction for §529 contributions but then rolled their Illinois plan funds to an out-of-state plan to add back any amounts previously deducted from Illinois income.

## CIRCUIT BREAKER UPDATE

The Circuit Breaker program protects low-income seniors and disabled individuals age 16 and over from being overloaded by property taxes and prescription costs by "tripping" state grant relief. This relief is intended to reduce the impact of these financial burdens on this vulnerable segment of Illinois' population. Because the Circuit Breaker program was covered extensively in the Illinois chapter of the *2005 University of Illinois Federal Tax Workbook,* this section will provide only a brief overview of the program and focus primarily on changes to the pharmaceutical assistance portion of the program.

The Circuit Breaker program is actually three programs in one, administered by the Illinois Department of Aging.[3] Qualified residents use Form IL-1363, *Application for Circuit Breaker and Illinois Cares Rx,* to apply for the following three program segments:

1. Circuit Breaker grant
2. License plate discount
3. Pharmaceutical assistance

The Circuit Breaker grant provides a partial rebate to qualified individuals who pay property tax on their residence or pay rent or nursing home charges on a residence that is subject to property tax. The license plate discount program provides an annual $54 savings on the fee for qualified applicants to license one Illinois vehicle. The prescription assistance portion of the Circuit Breaker is provided under Illinois Cares Rx. This program was introduced to complement the federal government's Medicare Part D prescription coverage plan.

### MEDICARE PART D

The federal government implemented Medicare Part D, a voluntary prescription drug plan, on January 1, 2006, to help Medicare recipients offset the rising costs of medication. Recipients obtain prescription drug coverage by joining a Medicare prescription drug plan, or joining a Medicare Advantage Plan or other Medicare health plan that offers drug coverage. Plans cover both brand-name and generic prescription drugs. Plan participants may fill prescriptions at locally participating pharmacies.

Applicants may sign up when they first become Medicare eligible, i.e., three months before or after the month they turn age 65. Those qualified for Medicare due to a disability can join from three months before to three months after their 25th month of cash disability payments. Individuals without creditable coverage who fail to apply when first eligible may pay a penalty equal to at least 1% of the average national premium for each month of eligibility for which they were not enrolled. Special enrollment periods apply in certain situations. The next open enrollment period runs from November 15, 2007, to December 31, 2007.

3. Additional Circuit Breaker information may be found at www.cbrx.il.gov.

### Standard Medicare Part D Prescription Plan Benefits

Medicare sets minimum levels of coverage for qualified plans. Everyone eligible for Medicare qualifies for prescription coverage, regardless of income, resources, or health status. The following terms reflect typical coverage offered under a standard plan:

- There is a $250 annual deductible and a 25% co-pay on the next $2,000 of out-of-pocket expenses.
- The insured pays 100% of the next $2,850, an amount referred to as the "coverage gap."
- After the insured's total out-of-pocket expenses reach $3,600, the plan requires the insured to pay the lower of:
  - 5% of prescription costs, or
  - $2 for generics or $5 for name brand drugs, and Medicare covers the balance of prescription costs.

The Illinois Attorney General's office reports the monthly premium for a 2007 Medicare prescription drug plan averaged $32.[4] Annual 2007 deductibles range from $0 to $265.

### Extra Help

Almost one in three Medicare recipients qualifies for "extra help" to pay their Medicare Prescription Drug program premiums, annual deductible, coverage gap and co-payments. To qualify for extra help, applicants must:

- Have existing coverage under Medicare Part A (hospital insurance) and/or Medicare Part B (medical insurance);
- Live in one of the 50 states or the District of Columbia; and
- Possess combined savings, investments, and real estate holdings (excluding the applicant's personal residence) worth no more than:
  - $11,710 if single, or
  - $23,410 if married and living with spouse.

## ILLINOIS CARES RX PROGRAM

The Illinois Cares Rx program was created to complement Medicare Part D prescription coverage benefits. It replaces the state's former Circuit Breaker Pharmaceutical Assistance and Senior Care programs. Illinois Cares Rx is jointly administered by the Illinois Department of Healthcare and Family Services (HFS) and the Illinois Department on Aging (DOA).

### Illinois Cares Rx Eligibility

Illinois Cares Rx is divided into two subprograms: **Illinois Cares Rx Basic**, which replaces the former Circuit Breaker Pharmaceutical Assistance program, and **Illinois Cares Rx Plus**, formerly Senior Care. Applicants first must meet the Circuit Breaker's general requirements. An applicant cannot choose between Illinois Cares Rx Basic and Rx Plus. Each eligible applicant qualifies for only one type of coverage.

The chart on the following page demonstrates the eligibility differences between Illinois Cares Rx Basic and Illinois Cares Rx Plus. **Illinois Cares Rx income thresholds are higher than the income limits for Circuit Breaker eligibility.** The state increased the Illinois Cares Rx income qualification thresholds in April 2007 so applicants receiving social security cost-of-living allowances could remain qualified.

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4. *Illinois Insurance Facts Medicare Prescription Drug Coverage and Illinois Cares Rx*, fact sheet produced by the office of Lisa Madigan, Illinois Attorney General

| | Illinois Cares Rx Basic | Illinois Cares Rx Plus |
|---|---|---|
| Age | 65 years of age or older; or disabled and age 16 or older | 65 years of age or older |
| Residency | Illinois resident (citizenship not required) | Illinois resident who is a citizen or qualified noncitizen |
| Maximum income: household of one | $22,793 | $21,936 |
| Maximum income: household of two | 30,594 | 29,412 |

Eligibility for Medicare is not required to qualify for the Illinois Cares Rx program. However, participants who are Medicare eligible must enroll in a qualified Medicare Part D Prescription Drug Plan that coordinates with the state's benefits. They also **must apply** for Social Security's "extra help" even if they do not qualify.

### Coordinating Prescription Drug Plans

The following Medicare Part D prescription drug plans currently coordinate with Illinois Cares Rx:

- Stand alone plans
  - United AARP MedicareRx
  - UnitedHealth Rx Basic
  - WellCare Signature
- Medicare Advantage plans
  - Group Health Plan
  - Health Alliance Medical Plans
  - HealthSpring
  - OSF Health Plans
  - SecureHorizons by United Healthcare
  - WellCare HMO

Stand-alone prescription drug plans are available statewide, but Medicare Advantage prescription drug plans may be available only in certain counties.

### Illinois Cares Rx Basic and Plus Plan Differences

**Illinois Cares Rx Basic** covers only certain medications and supplies used to treat Alzheimer's disease, arthritis, cancer, diabetes, glaucoma, heart and blood pressure problems, HIV/AIDS,[5] lung disease and smoking-related illnesses, multiple sclerosis, osteoporosis, and Parkinson's disease. **Illinois Cares Rx Plus** covers almost all prescription medications. Prior approval may be required under either program for some prescription medications that are not on the state's preferred drug list.[6]

5. Medicare recipients with HIV/AIDS diagnoses now have wraparound coverage under Illinois Cares Rx; refer to the 2006 Form IL-1363 instructions, page 19, for additional information.

6. Preferred drug lists are available at www.cbrx.il.gov.

### Participants with Medicare Coverage

For those **with** coordinating Medicare Part D coverage, the Illinois Cares Rx plans provide "wraparound" benefits to help participants pay their monthly Part D premium, annual deductible, co-pays, and any coverage gap. For participants **without** coordinating benefits, the state pays only the monthly premium for a basic Medicare drug plan. In lieu of this coverage, participants may elect to receive **a $25 monthly rebate**. This option may be beneficial for participants with other prescription drug benefits.

> **Note.** Regardless of whether the participant is placed in the Illinois Cares Rx Basic plan or Illinois Cares Rx Plus, the state will not cover any premium upcharges for late enrollment.

Both Basic and Plus plans offer the following benefits to participants who are enrolled in a coordinating Medicare Part D prescription drug plan:

- Co-payments for **covered** medications:
  - $2.15 for generic drugs
  - $5.35 for preferred brand name drugs
  - $15 for non-preferred name brand or specialty drugs
- After $1,750 in annual benefits is paid on behalf of a participant, the participant must pay the co-payment plus 20% of costs for covered prescriptions for the remainder of the calendar year.
- After $5,451.25 in prescription drug costs, the participant's share of costs drops to 5%.

Illinois Cares Rx Basic participants receive the basic Medicare Part D benefit for noncovered prescriptions, but do not receive wraparound Illinois benefits for these drugs. Participants in both Illinois Cares Rx Basic and Plus plans must follow the drug formulary established by their coordinating Medicare Part D prescription drug plan. The Illinois Cares Rx rebate is not available to those enrolled in a coordinating Medicare Part D plan.

### Participants without Medicare Coverage

Qualified applicants who are not eligible for Medicare can still receive coverage under Illinois Cares Rx. Both Basic and Plus plans offer the following benefits to participants without Medicare coverage:

- Copayments for **covered** medications:
  - $2.15 for generic drugs
  - $5.35 for brand name drugs with no generic substitute available (participants will be required to pay the price difference between generic and brand name drugs if a generic is available)
- After $1,750 in annual benefits have been paid on behalf of a participant, the participant must pay the copayment plus 20% of costs for covered prescriptions for the remainder of the calendar year.

Covered participants must follow the drug formulary established by the Illinois Cares Rx program. The Illinois Cares Rx Basic plan covers prescriptions to treat only a limited number of diseases and conditions.

## SENIOR CITIZENS PROPERTY TAX FREEZE UPDATE

The Senior Citizens Assessment Freeze Homestead Exemption, commonly referred to as the "Property Tax Freeze" for Illinois senior citizens, was reinstated May 21, 2006, when the governor signed Public Act 94-794. Reinstatement was necessary following a December 2005 Illinois Supreme Court decision voiding Public Act 88-669, which included the assessment freeze. The Court invalidated the act after a taxpayer claimed it violated the single subject clause of the Illinois Constitution.[7]

The rule limiting Illinois legislation to a single subject is designed to prevent "logrolling," the practice of packaging several bills together so popular legislation carries otherwise impassable measures. PA 88-669 began as Senate Bill 1369 and originally amended three criminal statutes, including the Cannabis and Controlled Substances Tax Act. Eventually, legislators modified the bill to encompass a wide-ranging slate of unrelated legislation.

One of these modifications included the addition of the statute authorizing creation of the senior property tax freeze. Governor Jim Edgar vetoed SB 1369, calling the end-of-session legislation a "Christmas tree bill." Both the Senate and House overrode the governor's veto, thereby enacting PA 88-669.[8] In voiding the act, the Court cited portions of the legislative debate, including Representative Mulligan's statement, " …obviously, it's very difficult to vote against a tax break for senior citizens, so we're discussing the senior citizens, but we're not discussing really in depth a lot of the public issues that were tacked into the Bill."[9]

### LEGISLATURE INCREASES PROPERTY TAX RELIEF FOR SENIORS

When the 94th General Assembly reinstated the Senior Citizens Assessment Freeze Homestead Exemption in 2006, it also enhanced measures granting additional property tax relief to the state's senior citizens. The legislation increased the annual amount of the Senior Citizens Homestead Exemption from $3,000 to $3,500 and expanded upper income eligibility limits for the assessment freeze and the Senior Citizens Real Estate Tax Deferral Program.

### EXPANDED ELIGIBILITY FOR REINSTATED PROPERTY TAX FREEZE

Previously, income eligibility for the property tax assessment freeze was capped at $45,000. Beginning with the 2006 assessment year, with taxes payable in 2007, the maximum annual household income level increases to $50,000; however, taxpayers with income between $45,001 and $50,000 receive reduced benefits. Eligible senior homeowners with incomes of $45,000 and below have their home's assessed value frozen at the equalized assessed value (EAV) for their base application year. The EAVs of eligible senior homeowners with incomes over $45,000 are reduced incrementally, according to the following schedule:

| Household Income | Base Value Multiplier |
|---|---|
| $45,001–$46,250 | 0.8 |
| $46,251–$47,500 | 0.6 |
| $47,501–$48,750 | 0.4 |
| $48,751–$50,000 | 0.2 |

7. *The People of the State of Illinois v. Valdy Olender,* 854 N.E.2d 593 (IL. 2005).

8. 88th Illinois General Assembly, Senate Bill 1369, 1994 Session, Governor's Veto at 7532

9. 88th Illinois General Assembly, House Proceedings, November 29, 1994, at 22 (statements of Representative Mulligan)

Eligibility for the assessment freeze does not guarantee that a home's EAV will not increase. The measure is intended to prevent property tax increases due to inflation; the base EAV is subject to change if a homeowner adds or removes property elements that would cause an increase or decrease in the property's value.

**Note.** To apply for the freeze, eligible seniors should complete and file Form PTAX-340, *Senior Citizens Assessment Freeze Homestead Exemption Application and Affidavit,* on an annual basis. This property tax relief measure is administered by each county's Supervisor of Assessments or County Assessor.

## TAXABILITY/EXCLUSION OF RETIREMENT PLAN INCOME

The state of Illinois generally exempts retirement income from state tax; however, income from certain retirement plans is taxable in Illinois.[10]

### RETIREMENT INCOME QUALIFIED FOR EXCLUSION

Income **from the federally taxed portion** of qualified plans may be subtracted from the taxpayer's federal AGI to reduce Illinois taxable income. Amounts received from the following sources are eligible for this exclusion:

- Qualified employee benefit plans described in IRC §§402-408
- Railroad retirement income
- Social security benefits
- IRC §401(k) deferred compensation plans
- IRA distributions, including amounts rolled over to Roth IRAs or SEPs
- Government retirement plans, including IRC §457 deferred compensation plans
- Capital gains on employer securities received in a lump-sum distribution, to the extent the gains are due to the securities' net unrealized appreciation at the time of distribution and included on U.S. Form 1040, line 13 (see Form IL-4644 section in this chapter)
- Payments from partnerships to retired partners
- Group term life insurance premiums paid by qualified private or government retirement plans for the benefit of retired employees and included as wages as a taxable fringe benefit on U.S. Form 1040, line 7
- Interest income realized on the redemption of U.S. retirement bonds

**Observation.** Despite the fact the federal government penalizes **early distributions** from qualified retirement plans, Illinois allows income from early withdrawals to be excluded from state taxable income. In effect, this reduces the taxpayer's early withdrawal penalty by 3%, from 10% to 7%. This loophole allows voluntary contributions to qualified salary deferral plans to escape Illinois tax, since contributions are excluded from federal AGI when they are contributed and subtracted from state taxable income when they are withdrawn.

10. Illinois Income Tax Act, 35 ILCS §203(a)(2)(F)

> **Tax Planning Tip.** Taxpayers who are qualified to make salary deferral contributions and who are also eligible to withdraw penalty-free from their retirement accounts (e.g., working taxpayers over the age of $59^1/_2$) can avoid Illinois tax without sacrificing current income by making contributions and withdrawing them in the same tax year. However, the taxpayer should analyze any charges imposed by the retirement plan before engaging in this tax-savings strategy. This tactic currently would result in a 3% state tax savings.

## RETIREMENT INCOME INELIGIBLE FOR EXCLUSION

Income from the following retirement sources is not exempt from state tax and cannot be subtracted from Illinois taxable income:

- Nonqualified employee benefit plans
- Qualified retirement plan distributions elected to receive "special 10-year averaging" treatment on U.S. Form 4972, *Tax on Lump Sum Distributions*

## DISABILITY PENSIONS

Taxable income from disability pensions generally is treated as wages until the taxpayer reaches "minimum retirement age." Minimum retirement age may vary from plan to plan, but generally it is the age at which an employee who is not disabled could first begin receiving pension benefits. Benefits beginning the day after the taxpayer reaches minimum retirement age are treated as pension income.

### Nongovernment Disability Pensions

Nongovernment disability pensions are subject to federal income tax, unless the employee paid for the plan's disability insurance premiums with taxable income. Disability payments treated as wages cannot be subtracted from Illinois taxable income; neither can proceeds from third-party sick pay. Disability payments treated as pension income, i.e., payments made after the disabled employee reaches minimum retirement age, can be excluded from Illinois taxable income.

Disabled taxpayers receiving employer-provided disability payments the year they reach minimum retirement age should receive two Form 1099-Rs — one coded "3" for disability and the other coded "7" for normal retirement. However, this is not always the case. As a precaution, preparers are advised to make inquiries into the minimum retirement age for the taxpayer's plan so the proper state tax treatment can be ascertained.

### Government Disability Pensions

Federal and state government disability pension payments are eligible for exclusion from Illinois tax, regardless of the employee's age at the time the payments are received. This exception applies to military plans as well. Because the IRS treats proceeds from taxable, preretirement age governmental disability pensions as wages (U.S. Form 1040, line 7), these payments are considered earned income and may qualify the disabled individual for the earned income tax credit. However, Illinois taxpayers subtract government disability pensions as retirement income on Form IL-1040, regardless of federal tax treatment.

> **Note.** Retired taxpayers sometimes receive W-2s from their former employers, reporting the amount of group term life insurance premiums paid by qualified retirement plans. Many retired Caterpillar employees receive these W-2s. These payments may be excluded from state income tax as retirement income on the appropriate line of Form IL-1040.

## FORM IL-4644, *GAINS FROM SALES OF EMPLOYER'S SECURITIES RECEIVED FROM A QUALIFIED EMPLOYEE BENEFIT PLAN*

Employee retirement plans can distribute stock certificates in lieu of cash distributions. If these shares are liquidated (i.e., the employee sells the shares) and a capital gain is realized, a portion of the gain represents appreciation from shares distributed from the employee's retirement plan. Because Illinois does not tax income from qualified retirement plans, these situations require special handling on the Illinois return.

### CALCULATING THE NET UNREALIZED APPRECIATION

Form IL-4644, *Gains from Sales of Employer's Securities Received from a Qualified Employee Benefit Plan*, is used to apportion the taxpayer's capital gain between Illinois taxable and nontaxable income from these types of sales. This form is used to report gains resulting from **employee retirement plans only**. Taxpayers should **not** file Form IL-4644 to report gains resulting from the exercise of a stock option under an employee stock purchase plan.

#### Determining Market Values

A key figure used to calculate the taxpayer's net unrealized appreciation is the market value of the shares on the date they were distributed from the retirement plan to the taxpayer. The employer generally informs the employee of the market value at the time the shares are distributed. If the employer does not provide the market value, the taxpayer must determine the value based on whether the shares:

- Traded on a national exchange, use the closing price on the date of distribution.
- Did not trade on the date of distribution, use the closing price on the last trading date preceding the date of distribution.
- Were traded in the over-the-counter market, average the bid and ask prices on the date of distribution.
- Were not traded on a national exchange or in the over-the-counter market, use the valuation method specified in the employer's written plan.

### Adjusting for Stock Splits

The value of shares received through stock dividends and stock splits should be calculated in the same manner as basis is calculated for federal tax purposes. The original cost of the shares should be apportioned among the new shares received.

**Example 1.** Jo Blough's retirement was invested in her employer's pharmaceutical company's stock, E.D. Labs. Jo's daughter was engaged and Jo decided to take a distribution from her retirement plan to pay for the wedding. Since her company was about to announce a new product line, Jo opted to receive her distribution in shares of stock in case the value went up before she had to pay the caterer. Jo withdrew 1,000 shares on February 19, 2007. The shares closed at $10 the day she took her distribution. Jo's market value was $10,000 (1,000 × $10).

According to her plan administrator, Jo had a basis of $6 per share in the 1,000 shares distributed. Jo included the $6,000 (1,000 shares × $6) as a retirement income distribution in her 2007 federal adjusted income and took the corresponding qualified retirement plan subtraction on her 2007 IL-1040. Jo does not report any appreciation in the shares until she realizes the gain.

One month after Jo took her distribution, her company unveiled its new wonder drug. The value of the company's stock soared and the shares soon split two for one. Jo decided to sell in October 2007, when the stock was trading at $12. Her gross sales price was $24,000 (2,000 shares × $12 per share). Since her company offered to buy back the stock with no commission charges, Jo reported a capital gain of $18,000 ($24,000 sales price – $6,000 basis) on her federal tax return.

Jo's completed Form IL-4644 calculates the amount of this capital gain that Jo may deduct as retirement income from her 2007 Illinois taxable income. As shown on the following page, Jo lists a description of the shares sold, the month and date the shares were distributed and sold, and the $18,000 federal gain realized on the disposition in Form IL-4644, Step 2.

Jo then lists the $10,000 market value of her shares on the date of distribution on Form IL-4644, Step 3, Column E. In Column F, Jo records the $6,000 federal tax basis of the stock on the date of distribution and shows the $4,000 difference between the market value (Column E) and the tax basis (Column F) in Column G. In Column H, she lists the lesser of the federal gain on the distribution (Column D) or the amount of the shares' net unrealized appreciation on the date of distribution (Column G).

In Jo's case, the $4,000 net unrealized appreciation was less than her $18,000 federal gain. Jo adds this $4,000 to the $6,000 of retirement income she can subtract (resulting from the February share distribution) and deducts a total of $10,000 on her 2007 Form IL-1040, line 5.

**Note.** Form IL-4644 is used to compute the unrealized appreciation from capital gains only. Capital losses resulting from the distribution of retirement plan shares are already included in the taxpayer's federal AGI and do not require further adjustment on the Illinois return.

**For Example 1**

Illinois Department of Revenue

**IL-4644 Gains from Sales of Employer's Securities Received from a Qualified Employee Benefit Plan**

Attach this form and a copy of your Federal Schedule D to your Form IL-1040 or Form IL-1041. IL Attachment No. 20

**Step 1: Provide the following information**

1 This form is for calendar year 2007 (Year) or other taxable year beginning ______ (Month) ______ (Year) and ending ______ (Month) ______ (Year).

2 Write your name as shown on your Form IL-1040 or Form IL-1041. Jo Blough

3 Write your Social Security number or federal employer identification number. 312-34-5678

4 Check one ☑ Individual ☐ Estate or trust

**Step 2: Provide general security information**

| | Column A<br>Description of security<br>(List each sale separately) | Column B<br>Date distributed<br>(month, year) | Column C<br>Date sold<br>(month, year) | Column D<br>Federal gain<br>on disposition |
|---|---|---|---|---|
| 5 | 2000 shares E.D. Labs | 2/07 | 10/07 | 18,000.00 |
| 6 | | | | |
| 7 | | | | |
| 8 | | | | |

**Step 3: Calculate net unrealized appreciation**

| | Column E<br>Market value of stock<br>on date of distribution<br>(See instructions.) | Column F<br>Federal tax basis of stock<br>on date of distribution<br>(See instructions.) | Column G<br>Excess of Column E over Column F<br>(if any) | Column H<br>Lesser of Columns G or D |
|---|---|---|---|---|
| 9 | 10,000.00 | 6,000.00 | 4,000.00 | 4,000.00 |
| 10 | | | | |
| 11 | | | | |
| 12 | | | | |

13 Write the total here and on Form IL-1040, Line 5 or Form IL-1041, Part I, Line 4b. 13 4,000.00

...file a Schedule F (because Line 18 below is a gain), also write this amount on Form IL-1040 ... F, Line 1...

## SECURITIES RECEIVED BEFORE AUGUST 1, 1969

Illinois did not impose an income tax prior to August 1, 1969. Therefore, gains from any securities purchased before that date are not subject to tax. The Form IL-4644 instructions detail the additional steps that must be taken to exempt these pretax gains from being taxed at the time of sale.

## ENTERPRISE ZONE/RIVER EDGE REDEVELOPMENT ZONE AND HIGH IMPACT BUSINESS DIVIDEND SUBTRACTIONS

Illinois offers tax incentives to encourage businesses to locate and stay in Illinois. In addition to the incentives offered to qualified businesses, Illinois encourages taxpayers to invest in certain corporations by exempting dividends paid by qualified businesses from state tax.

### OVERVIEW OF SELECTED BUSINESS TAX INCENTIVES

Among the tax incentives Illinois offers are the **Illinois Enterprise Zone Program**, the **River Edge Redevelopment Initiative**, and incentives for designated **high impact businesses** (HIBs). Brief overviews of these programs appear below.

#### Illinois Enterprise Zone Act

Launched in 1982, this program designates certain areas within the state as “enterprise zones” in order to revitalize economically depressed areas and stimulate investment activity. The state conducts the Enterprise Zone program in partnership with municipal governments around the state, seeking contributions from local businesses, labor, and community groups. Businesses located within these enterprise zones receive state and local tax breaks, regulatory relief, and enhanced governmental services.

The Department of Commerce and Economic Opportunity (DCEO) administers the Enterprise Zone program. There are 95 zones now operational throughout Illinois, ranging in size from a half square mile to 15 square miles. Schedule 1299-S, *Enterprise Zones, Foreign Trade Zones, and Sub-Zones*, provides a listing of Illinois Enterprise Zones, arranged in chronological order according to the date the DCEO designated each zone eligible. There is no official listing of individual businesses located within Illinois enterprise zones.

**Enterprise Zone Benefits.** The following incentives are extended to businesses located within enterprise zones:

1. **Illinois Sales and Utility Tax Exemptions**

   - A 6.25% state sales tax exemption on building materials
   - A 6.25% state sales tax exemption, available only to **qualified** businesses, on the purchase of certain machinery and equipment used or consumed in the:
     - Manufacturing or assembly process, or
     - Operation of a pollution control facility
   - A state utility tax exemption, available only to qualified businesses, on gas and electricity, the Illinois Commerce Commission’s administrative charge and telecommunication excise tax

   Eligibility for the sales tax exemption on machinery and equipment and the utility tax exemption is contingent upon a business making a minimum $5 million investment and creating 200 full-time equivalent jobs primarily within a designated enterprise zone. Alternate dollar/job configurations are offered, but all offers center on creating or retaining Illinois jobs while pouring large sums of money into an enterprise zone. Businesses must apply and be certified by the DCEO to qualify for these exemptions.

2. **Illinois Income Tax Credits**

   - **Enterprise zone investment tax credit**. A 0.5% investment tax credit is available for taxpayers who invest in qualified machinery, equipment, and buildings within designated enterprise zones. This credit may be carried forward for five years and is in addition to the regular 0.5% investment credit and the 0.5% credit on qualified property for new companies or company’s whose Illinois base employment increased by 1% or more over the preceding year.[11]

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[11] Available only to Illinois taxpayers filing the following returns: Form IL-1120, IL-1120-ST, IL-1065, IL-1041, or IL-990-T. See Form IL-477, *Replacement Tax Investment Credits*, for additional information.

- **Enterprise zone jobs tax credit.** Businesses may claim a $500 credit for each qualified job created in the enterprise zone. To qualify, the employer must hire a **minimum** of five eligible employees who are certified as dislocated workers or economically disadvantaged individuals. This credit may be carried forward for five years.

3. **Illinois Income Tax Deductions**

   - **Dividend income deduction.** Investors, whether individual taxpayers, corporations, trusts, or estates, can subtract dividends paid by corporations conducting **substantially all** of their business in an Illinois enterprise zone.

   - **Interest deduction.** Financial institutions may exempt the interest received on loans for development within an enterprise zone.

   - **Contribution deduction**. Businesses can deduct an amount double the value of cash or in-kind contributions made to approved enterprise zone projects.

4. **Local Government Incentives.** Many Illinois municipal governments offer enterprise zone incentives on a local level to encourage investment within their communities. The following list details some of the more common municipal perks offered:

   - Property tax abatements on new improvements
   - Homesteading and shopsteading property tax relief
   - Business licensing and permit fee waivers
   - Streamlined building code and zoning regulations
   - Special financing programs

## River Edge Redevelopment Zone Act

Public Act 94-1022, enacted July 12, 2006, created the River Edge Redevelopment Zone Act to encourage communities, developers, and businesses to clean-up, remediate and redevelop rundown Illinois riverfront areas. The Act authorized three pilot zones throughout the state, in the cities of Aurora, East St. Louis, and Rockford. The program is administered jointly by the DCEO and the Illinois Environmental Protection Agency (IEPA). The Aurora zone, certified in April 2007, was the first zone to be approved.

The legislature authorized this act to stimulate redevelopment of underused and abandoned properties along Illinois' rivers and to provide funds to encourage environmental remediation of brownfields. The River Edge Redevelopment Zone Act uses tax incentives similar to the Enterprise Zone Act as well as an environmental remediation tax credit to attract businesses and developers to these riverfront areas. Also, the state is offering grants to fund clean-up, remediation, and redevelopment activities.

## High Impact Business Program

The High Impact Business (HIB) program provides enterprise zone-like tax incentives to Illinois companies making substantial capital investments in the state in order to create or retain jobs on a large scale. Companies must invest a minimum of $12 million causing the creation of 500 full-time jobs, or invest $30 million causing the retention of 1,500 full-time jobs. These investments must take place at a designated Illinois location **outside** of an enterprise zone.

The program has been expanded to include coal/energy HIBs, such as qualified new electric generating facilities, production operations at a new coal mine, new or upgraded transmission facilities that support the creation of 150 Illinois coal-mining jobs, and newly constructed gasification facilities. Both general and coal/energy HIBs receive tax incentives, although the types of incentives vary slightly. Designated HIBs located in foreign trade zones or sub-zones qualify for additional tax incentives.

**Foreign Trade Zones.** A foreign or ‘‘free’’ trade zone or subzone is a specially designated area in or adjacent to a U.S. customs’ port of entry, which is considered to be outside of U.S. customs. Goods held in these zones are exempt from customs’ duties and other ad valorem taxes. This allows U.S.-based companies engaged in international trade to lower costs, which in turn allows them to create and retain jobs and increase capital investments in the U.S.

Illinois foreign trade zones are located in portions of Chicago; Granite City; Peoria; Rock Island; Moline; Rockford; Decatur; and Lawrence, Jo Daviess, and Carroll counties. The following chart, updated May 2007, shows designated Illinois foreign trade zones and subzones arranged by port of entry.[12] This list provides the address and phone number of a contact person for each zone. If the contact person is not an employee of the grantee, the name of the grantee organization is also given.

12. This list is provided by the U.S. Department of Commerce, Import Administration, and can be accessed at http://ia.ita.doc.gov/ftzpage/letters/ftzlist.html.

| CBP Port of Entry | Zone | Subzones |
|---|---|---|
| Chicago | FTZ No. 22 Chicago<br>Grantee: Illinois International Port District<br>3600 East 95th Street<br>Chicago, IL 60617-5193<br>Anthony Ianello (773) 646-4400<br>Fax (773) 221-7678 | 22B Ford<br>22F Abbott Laboratories<br>22G sanofi-aventis U.S. LLC<br>22H BP Pipeline North America<br>22I Citgo Petroleum Corp.<br>22J EXXON Mobil<br>22K Henkel Corporation<br>22L Premcor Refining Group<br>22M Northrop Grumman Corporation<br>22N Michelin North America, Inc. |
| St. Louis | FTZ No. 31 Granite City<br>Grantee/Operator: Tri-City Regional Port District, 1635 West First Street<br>Granite City, IL 62040<br>Robert Wydra (618) 452-3337<br>Fax (618) 452-3402 | 31A DaimlerChrysler<br>31B ConocoPhillips<br>31C Premcor Refining Group |
| Peoria | FTZ No. 114 Peoria<br>Grantee: Economic Development Council Inc<br>124 S.W. Adams, Suite 300, Peoria, IL 61602<br>Greg Truninger (309) 495-5952<br>Fax (309) 676-7534<br>gtruninger@edc.h-p.org<br>**www.edc.centralillinois.org** | 114A Caterpillar<br>114C Mitsubishi Motor Mfg of America<br>114D E.I. du Pont de Nemours & Co.<br>114E Rockwell Automation |
| Quad-Cities | FTZ No. 133 Quad-Cities, Iowa/Illinois<br>Grantee: Quad-City Foreign-Trade Zone, Inc.<br>1830 Second Avenue, Suite 200<br>Rock Island, IL 61201-8038<br>Thomas Hart (309) 788-7436<br>Fax (309) 788-4964 | 133B Maytag<br>133C Maytag<br>133D Deere & Company |
| Evansville | FTZ No. 146 Lawrence County<br>Grantee: Bi-State Authority<br>Lawrence County Industrial Development Council, 718 11th Street, Suite 2<br>Lawrenceville, IL 62439<br>Terry L. Denison (618) 943-5219<br>Fax (618) 943-5910 | 146A North American Lighting & Hella Electronics<br>146C Fedders<br>146D Marathon Petroleum Company LLC |
| Rockford | FTZ No. 176 Rockford<br>Grantee: Greater Rockford Airport Authority<br>60 Airport Drive, Rockford, IL 61109-2902<br>Marge Bevers (815) 969-4427<br>Fax (815) 969-4001<br>mbevers@flyrfd.com | 176A Milk Specialties<br>176C DaimlerChrysler<br>176D Nissan Industrial Engine<br>176E Nissan Forklift Corporation |
| Peoria | FTZ No. 245 Decatur<br>Grantee: Board of Park Commissions<br>Decatur Park District<br>620 East Riverside Drive, Decatur, IL 62521<br>William Clevenger (217) 422-5911 | 245A Archer Daniels Midland |
| Davenport, IA/ Moline & Rock Island, IL | FTZ No. 271 Jo-Daviess & Carroll Counties<br>Grantee: Jo-Carroll Foreign Trade Zone Board<br>18933 A Street, Savanna, IL 61074<br>Don Crawford (815) 273-4371 | |

### INCOME TAX SUBTRACTIONS AND CREDITS FOR INVESTORS

Illinois offers investors two similar, but distinct, state income tax exemptions for dividends paid by qualified corporations. One exemption applies to dividends paid by companies that conduct **substantially all** of their operations in an Illinois **Enterprise Zone or River Edge Redevelopment Zone**.[13] The state does not maintain any listing of corporations whose dividends qualify for these subtractions. Instead, the Illinois Department of Revenue relies on corporations to determine whether their dividends qualify and then to inform their shareholders of any allowable deduction.[14]

The other exemption applies to dividends paid by **HIBs** that conduct **some of their operations** in a **foreign trade zone**.[15] Caterpillar, Abbott Laboratories, and Takeda Pharmaceuticals are among the companies whose dividends qualify for this exemption.[16] Preparers can use the contacts in the list provided in this section to determine whether an Illinois corporation is located within a foreign trade zone. Further investigation may be needed to determine if the DCEO has designated the particular business as an HIB.

Individual taxpayers who receive qualified dividends claim the Enterprise Zone and River Edge Redevelopment Zone subtractions on Illinois Schedule 1299-C, *Income Tax Subtractions and Credits for Individuals*, lines 1 through 3. The High Impact Business Dividend Subtraction (within a Foreign Trade Zone or sub-zone) is deducted on Schedule 1299-C, lines 4 and 5. These amounts are combined and flow through Illinois Schedule M before being deducted on the taxpayer's Illinois return. Other Illinois taxpayers claim their qualified dividend deductions on Illinois Schedule 1299-B, *Enterprise Zone or Foreign Trade Zone/Sub-Zone Subtractions*.

## SPECIAL TAXPAYERS

This section discusses special taxpayer issues of importance to Illinois taxpayers filing individual tax returns.

### RAILROAD EMPLOYEES

Illinois taxable income is based on the taxpayer's federal adjusted gross income (AGI) as modified by certain statutorily-authorized additions, subtractions, and exemptions. The majority of these modifications are authorized by the state; however, certain items of federally-taxed income are exempt from state tax by federal statute. Two such statutes affecting railroad workers are the **Railroad Retirement Act** and the **Railroad Unemployment Insurance Act**.

Pursuant to federal statute, qualified annuity and supplemental annuity income received under the Railroad Retirement Act of 1974 is exempt from state tax.[17] These amounts generally are deducted as retirement income on Form IL-1040, line 5. Unemployment benefits paid under the Railroad Unemployment Insurance Act are similarly exempt from state tax.[18]

Although railroad unemployment benefits are specifically mentioned in Illinois Pub. 101, *Income Exempt from Tax*, there are no line instructions detailing where these amounts should be subtracted on Form IL-1040. Presumably, they would be included on IL-1040, line 9, "Other Subtractions to Your Income." However, directions for this line indicate Schedule M, *Other Additions and Subtractions*, must be attached in order to substantiate a line 9 entry.

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13. 35 ILCS §§203(a)(2)(J), (b)(2)(K), (c)(2)(M) and (d)(2)(K)
14. IDOR provides guidance for corporations at 86 Ill. Admin. Code 100.2480.
15. 35 ILCS §§203(a)(2)(K), (b)(2)(L), (c)(2)(O) and (d)(2)(M)
16. Information on Caterpillar and Abbott Labs provided by Paul Caselton, IDOR's Deputy General Counsel, Income Tax, in a personal communication dated May 31, 2007; information on Takeda Pharmaceuticals was obtained from a June 2005 article found on *Business Facilities* online magazine at www.businessfacilities.com/bf_05_06_move.asp.
17. 45 USC §231
18. 45 USC §352(e)

Because there is no line corresponding to railroad unemployment benefit subtractions on Schedule M, preparers must "force" the entry either on Form IL-1040, line 9, or somewhere on Schedule M in order to properly modify a taxpayer's Illinois taxable income. However, this presents a software dilemma for the preparer and a processing problem for the Illinois Department of Revenue.

The University of Illinois Tax School has alerted the state regarding this oversight and IDOR is working to correct forms in time for the 2007 filing season. In the meantime, Paul Caselton, IDOR's Deputy General Counsel of Income Tax, suggests preparers write the amount of the deduction in wherever feasible on the subtraction section of Form IL-1040 and/or Schedule M and attach a short letter of explanation to the taxpayer's return. This letter should detail the type and amount of the deduction and direct the state's processing center to **contact Paul Caselton directly** before disallowing the subtraction.

## EDUCATION EXPENSE CREDIT FOR HOME-SCHOOLED CHILDREN

Illinois taxpayers are allowed a nonrefundable credit for qualified educational expenses paid in excess of $250 for tuition, book rental, and lab fees for students in kindergarten through 12th grade. Certain expenses incurred for home schooling elementary and secondary school students qualify for this credit. To be eligible for the credit, private schools providing educational instruction in the home must satisfy the truancy law requirements in Section 26-1 of the Illinois School Code.[19]

Preparers often have experienced difficulty determining which educational expenses qualify for the credit when it comes to home-schooled students. To clarify this issue, in August 2005, the Illinois Department of Revenue produced Pub. 119, *Education Expense Credit General Rules and Requirements for Home Schools*. This publication details the types of expenses that qualify — and those that don't qualify — in addition to listing the substantiation requirements for expenses incurred for home schooling.

### Qualified Expenses

The following list itemizes expenses incurred to home school students that are **qualified** for the Illinois education expense credit:

- **Tuition.** This includes fees paid to facilities, such as private health clubs or public recreation centers, in order to satisfy state physical education requirements.
- **Books.** Only books which are substantially consumed during class activities (i.e., books that have no value remaining after use), may be calculated in the cost of qualified educational expenses. This includes items such as student workbooks and teacher grade books. Fees paid to **rent** books required for the student's educational program are also eligible for the credit as long as the books are returned after use.
- **Curriculum fees.** This includes fees paid to rent lesson plans, lectures, or other curriculum development items such as DVDs or tapes.
- **Lab expenses.** This includes the cost of supplies, equipment, materials, or instruments required for participation in a lab course for which the student will receive credit toward graduation. According to Pub. 119, to qualify, lab courses must provide "an environment for organized activity involving observation, experimentation, or practice, i.e., science, music, art, or language." However, qualifying lab items cannot become the student's personal property. (See the following section, "Nonqualified Expenses.")

**Sales and use taxes** and **shipping fees** paid to purchase or receive any of the above-mentioned items may be included when calculating the amount of the credit.

19. 105 ILCS 5/26-1

### Nonqualified Expenses

The following list details items that **do not qualify** for the Illinois education expense credit:

- **Nonconsumable educational items.** This includes items such as flashcards, wall maps, calculators, and nonconsumable textbooks.
- **Educational items converted to personal use.** This includes items used for bona fide educational purposes, but that will convert to the student's personal property at the end of the school year. Examples include band instruments, and athletic equipment.
- **Expenses for tutoring or enrichment classes.** Only the cost of education required to satisfy graduation requirements for grades K–12 is eligible for the education expense credit.

> **Observation.** Computers are frequently used in the education of home-schooled students. Although Pub. 119 does not specifically list computers as examples of items not qualified for the educational expense credit, it seems clear that the cost of computer hardware and software would be ineligible for the credit. Although they grow obsolete quickly, both computer hardware and software are nonconsumable and presumably remain the personal property of the student and/or family at the end of the school year.

### Documentation Requirements

Unlike other taxpayers who file Schedule ED, *Credit for K–12 Education Expenses*, parents or guardians of home-schooled students **must attach receipts** for qualifying expenses claimed during the calendar year. To qualify, receipts must show:

- The type and amount of educational expense for **each** qualifying student,
- The calendar year in which the expenses where paid,
- The name and address of the business to whom the expenses were paid, and
- The name of the parent or guardian who paid the expense.

> **Note**. IDOR will **not** accept cancelled checks in lieu of receipts.

## RESIDENCY ISSUES FOR MARRIED COUPLES WHEN ONLY ONE SPOUSE IS A FULL-YEAR RESIDENT

Illinois allows married taxpayers who file jointly on their federal income tax return to file separately on their Illinois tax return(s). Because Illinois offers injured spouse relief and taxes all individual taxpayer income at a flat 3% as opposed to a graduated tax rate, there is no advantage or disadvantage for full-year residents to file jointly or separately.

However, when one spouse is a full-year Illinois resident and the other is a part-year resident or a nonresident, they can choose to file "**married filing separately**" on their Illinois return(s). When this option is selected, each spouse determines individual income and exemptions as if each had filed separate federal returns. Federal tax law governs the treatment of income from community property sources when spouses who are residents of different states file separate returns.

Taxpayers with differing residency statuses may elect to file jointly on their Illinois return by checking the appropriate filing status box on the first page of their IL-1040, *Illinois Individual Income Tax Return*. If this option is selected, both spouses are treated as Illinois residents. Once chosen, this election is irrevocable for the tax year in question. If a joint return is filed, both spouses are treated as Illinois residents and all of their income is treated as Illinois income. However, taxpayers may receive a credit for any out-of-state income that is taxed by both Illinois and another taxing entity. Taxpayers with dually-taxed income may file for an Illinois credit on Schedule CR, *Credit for Tax Paid to Other States*.

## INJURED AND INNOCENT SPOUSE RELIEF

In September 2006, IDOR released Pub. 125, *Injured and Innocent Spouse Relief*, to address the state's treatment of tax issues arising from either of these two situations. Because the terms are so similar, they are often confused. The following recap details the differences between an injured spouse and an innocent spouse:

- **Injured spouse.** An injured spouse is a married taxpayer filing a joint return with a spouse who owes a balance on a debt that can be offset by federal and state tax refunds. Tax refunds may be seized to pay past due federal and state taxes, child support, spousal support, and certain federal debts such as unpaid student loans. To be eligible for injured spouse relief, the **injured spouse must not be legally obligated to pay the debt.**
- **Innocent spouse.** An innocent spouse is a taxpayer who filed a joint return without knowing that the other spouse fraudulently underreported income or overstated deductions or credits. To be eligible for innocent spouse relief, **the innocent spouse must have signed a jointly-filed return unaware that the return was fraudulent, and consider the other spouse solely responsible for any additional tax liability arising from the fraud.**

### Injured Spouse Relief

Illinois does not provide a special form for claiming injured spouse relief. An injured spouse filing a **joint** Illinois return simply **writes "Injured Spouse" in red ink** across the top of Form IL-1040, page 1, **and attaches a copy of IRS Form 8379,** ***Injured Spouse Allocation***, to the jointly-filed state tax return. An injured spouse filing a **separate** Illinois return does not need to apply for injured spouse relief.

If a joint Illinois return was filed without requesting injured spouse relief, and the taxpayers receive notice that all or a portion of the Illinois refund is being used to offset an IDOR tax liability, the injured spouse may file an IL-1040X, *Amended Individual Tax Return*, to request the portion of the refund due the injured spouse. The IL-1040X should show only the injured spouse's income, modifications, exemptions, credits, and tax withholding. The words "Injured Spouse" should be written in red ink across the top of IL-1040X, page 1, and the following supporting documents should be attached:

- A copy of the couple's jointly-filed federal tax return
- The injured spouse's Forms W-2 and 1099 (if applicable)
- IRS Form 8379, if filed

The injured spouse should only file an IL-1040X if the Illinois Department of Revenue is applying all or a portion of the taxpayers' joint refund to satisfy the noninjured spouse's prior state income tax debt. If another agency has a lien against the taxpayers' Illinois tax refund, the taxpayers must contact that agency for information on obtaining the injured spouse's portion of the offset refund. The notice of offset should contain information on how to contact the specific agency for a refund. IDOR does not issue refunds of overpayments offset to other agencies.

### Innocent Spouse Relief

An innocent spouse should request relief by filing a separate Form IL-8857, *Request for Innocent Spouse Relief*, for each year of requested relief. This form should be accompanied by copies of the originally-filed state and federal tax returns for the appropriate year, copies of any amended returns filed, a copy of U.S. Form 8857, *Request for Innocent Spouse Relief*, if filed, and a copy of any final determination issued by the IRS, IDOR, or a court of law regarding any grant or denial of innocent spouse relief. Any other documentation in support of the innocent spouse claim may also be attached.

There is no time limit for making an innocent spouse claim, but **refunds will only be issued for timely filed requests**. To be considered timely filed, the innocent spouse must submit Form IL-8857 by the latest of the following periods:

- Three years after the taxpayer's extended due date of the original Form IL-1040,
- Three years after the taxpayer filed his or her original Form IL-1040, or
- One year after the Illinois tax was paid.

**Example 2.** Wilbur Milktoast and his wife Bertha Burnt-Milktoast have filed joint federal and state tax returns since they were first married in 1980. Wilbur works as a greeter at a local discount center and Bertha is a housewife. Bertha has always been in charge of the family's finances, including preparation of their federal and state tax returns. Wilbur's check goes into their joint account through direct deposit. He has never written a check on or made a withdrawal from this account or any other account since they have been married. Bertha gives him a $10 allowance every Saturday and that is all the money Wilbur ever sees.

One day, two IRS criminal investigation agents showed up at Wilbur's work with badges and guns. They asked Wilbur about the earned income tax credit and about his sons, Rusty and Lucky. Wilbur explained that he didn't have any children but, coincidentally, he had two dogs with the same names. The IRS agents did not look happy, but for the life of him, Wilbur did not know why. Then one of the agents told Wilbur he better get a lawyer. Wilbur hoped he could find one for less than $10.

The following IL-8857 shows the first page of Wilbur's request for innocent spouse relief for 2005. The form's other three pages (not shown) break down the allocation of liability for each item on the Milktoast's return and detail each erroneous item of income and deduction on their 2005 return.

**For Example 2**

Illinois Department of Revenue

# IL-8857 Request for Innocent Spouse Relief

## Read this information first

Innocent spouse relief may be available under Illinois law. To request innocent spouse relief, you must file this form even if you filed a federal Form 8857, Request for Innocent Spouse Relief, with the Internal Revenue Service (IRS) and that request was either granted or denied.

## Step 1: Provide the following information

1 Wilbur Milktoast
Your name

2 PO Box 1
Your street address

3 Boody, Illinois 62514
Your city, state, ZIP

4 321-12-3321
Your Social Security number

5 What tax year are you requesting tax liability relief? 12/2005

*Attach a copy of your Illinois and federal income tax returns, W-2s, and attachments for the year identified above.*

*You must complete and file a separate Form IL-8857 and an Allocation of Liability Worksheet for each year you are seeking innocent spouse relief.*

## Step 2: Provide the following information about the person to whom who you were married

6 Bertha Butte-Milktoast
Name

7 PO Box 1
Street address

8 Boody, Illinois 62514
City, state, ZIP

9 333-44-5556
Social Security number

10 Housewife
Place of employment/address

11 (217) 865-9999
Work phone number

(217) 865-9999
Home phone number

## Step 3: Answer the following questions

| | | Yes | No |
|---|---|---|---|
| 12 | Have you filed a federal Form 8857, Request for Innocent Spouse Relief, with the IRS for the tax year identified on Line 5 prior to filing this request with us? *If you answered **"yes,"** you must attach a copy of that form, all pertinent documentation, and any IRS determination.* | ☑ | ☐ |
| 13 | Since the tax liability arose, did you or your spouse transfer any assets for which you did not receive full value in payment? See instructions. | ☐ | ☑ |
| 14 | **a** Is this request for tax relief for a tax year ending before August 13, 1999? | ☐ | ☑ |
| | **b** Did you pay the entire tax liability for that tax year ending before August 13, 1999? See instructions. *If you answered **"yes"** to both 14 a and b, answer questions 15 and 16. Otherwise, skip to Step 4.* | ☐ | ☐ |
| 15 | For the tax year that you are requesting, is there a difference between the total amount of tax that should have been shown on the return and the amount of tax that was actually shown. | ☐ | ☐ |
| 16 | Did you know that the tax was understated at the time you signed the joint return(s)? | ☐ | ☐ |

## Step 4: Explain your request

17 Explain why you are not responsible for the tax liability for the tax year identified on Line 5. *Attach an additional sheet if needed.*

My wife always prepared our tax returns. I never saw the actual forms, I just signed where she told me to sign, when she told me to sign, and how she told me to sign. I was afraid to cross her. I did not know she was claiming our dogs as dependents and receiving the earned income tax credit until the revenue agents showed up at our door.

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