2009 Illinois Update

Corrections were made to this workbook through January of 2010. No subsequent modifications were made.

OVERVIEW

The Illinois Department of Revenue (IDOR) is under the immediate direction of the Illinois Director of Revenue, who has general administrative responsibility for the assessment and collection of state taxes. Brian Hamer is the agency's current director, overseeing approximately 2,100 employees.

IDOR is headquartered at 101 West Jefferson Street in Springfield, Illinois. Regional offices are maintained in Chicago, Des Plaines, Fairview Heights, Marion, and Rockford in Illinois and also in Paramus, New Jersey.

By administering over 75 tax laws, the revenue department primarily serves as the tax collection agency for Illinois' state and local governments. IDOR collects nearly all of Illinois' own source revenue, money that provides funding for public health, safety, human services, and education in the state.

As the parent agency for the Illinois Gaming Board, the Illinois Racing Board, the Illinois Lottery, and the Illinois Liquor Control Commission, IDOR also regulates riverboat gaming and the state's horse racing industry, administers the state's lottery, and regulates the manufacture, distribution, and sale of alcoholic beverages. IDOR also oversees local property tax assessments and functions as the funding agent for the Illinois Housing Development Authority.

DEPARTMENTAL ORGANIZATION

IDOR's tax operation is organized into six divisions:

1. Account Processing
2. Taxpayer Services
3. Tax Enforcement
4. Bureau of Audits
5. Information Services
6. Administrative Services

Each year, the department processes approximately six million individual income tax returns and 500,000 business tax returns. Approximately 60% of returns claim a refund.

REVENUE COLLECTIONS

According to the Illinois Comptroller's state budget report for fiscal year 2008,[1] Illinois' annual general fund revenues totaled $33.838 billion. Personal income tax accounted for the largest source of general fund revenue, with receipts totaling $10.32 billion (30.5%). Sales taxes were the second largest source of revenue with $7.215 billion (21.3%).

Federal revenues totaled $4.815 billion (14.2%), corporate income taxes totaled $1.86 billion (5.5%), gaming sources totaled $1.236 billion (3.7%), and public utility taxes totaled $1.157 billion (3.4%). All other sources accounted for 21.4% of revenue and included cigarettes, liquor, insurance, inheritances, short-term borrowing, and other miscellaneous sources totaling $7.235 billion.

General Fund Revenues by Source[2]

Source	Percentage
Individual income taxes	30.5%
Sales taxes	21.3%
Federal sources	14.2%
Corporate income taxes	5.5%
Gaming sources	3.7%
Public utility taxes	3.4%
All other	21.4%

State Income Tax Collections FY2006–FY2008[3]

Income Taxes	FY2006	FY2007	FY2008
Corporate income tax	$ 1,809,397,506	$ 2,189,612,609	$ 2,221,686,464
Individual income tax	9,573,955,481	10,469,796,531	11,169,401,414
Personal property replacement income tax	1,229,138,670	1,473,415,461	1,497,403,730
Total income taxes	$12,612,491,657	$14,132,824,601	$14,888,491,608

In a September 23, 2008 press release, IDOR indicated the state may experience a $200 million revenue shortfall in fiscal year 2009.[4] Stagnant wages and high unemployment are contributing to a decrease in individual income tax collections. Corporate tax collections also are expected to be affected because 10% of Illinois' corporate income tax revenue comes from the financial services sector.

Tax professionals calculate a good portion of Illinois' tax revenue, which makes accurate state return preparation very important.

1. [www.revenue.state.il.us/AboutIdor/TaxStats/2008-IL-1040-ComptrollerReport.pdf] Accessed on May 20, 2009.
2. Ibid.
3. IDOR 2008 Annual Report, *Annual Report of Collections and Distributions 2008.*
4. *National Economy Weighs Heavily on Illinois Revenue Collections*, Illinois Department of Revenue (Sep. 23, 2008).

COMPUTER SYSTEM MIGRATION AND E-FILING

COMPUTER SYSTEM UPDATE

IDOR began consolidating the administration of more than 200 state tax and fee programs into a single, integrated computer system in 2007.[5] The department is halfway through its 4-year plan to merge and update the various computer systems, some of which were 30 years old. The computer system overhaul is estimated to cost $45 million.[6]

The new system will enhance the department's processing of tax returns and its ability to provide information to taxpayers and practitioners. It will also improve IDOR's billing and collection procedures, as well as IDOR's ability to enforce Illinois tax laws. Due to increased efficiency, the state projected in 2006 that revenue collections will increase by $250 million.[7]

The first phase of improvements, which began at the end of 2007, included the following taxes and forms:

1. Sales tax (ST-1, *Sales and Use Tax Return*)
2. Income tax withholding (IL-941, *Illinois Quarterly Withholding Income Tax Return*)
3. Business income and replacement taxes, including:
    - IL-1120, *Corporation Income and Replacement Tax Return,*
    - IL-1120-ST, *Small Business Corporation Replacement Tax Return,*
    - IL-1065, *Partnership Replacement Tax Return,*
    - IL-1041, *Illinois Fiduciary and Replacement Tax Return,*
    - IL-1023-C, *Composite Income and Replacement Tax Return*, and
    - IL-990-T, *Exempt Organization Income and Replacement Tax Return.*

Starting in January 2009, all individual income tax returns and payments were processed through the new system. As a result, line numbers on the 2008 IL-1040, *Individual Income Tax Return*, were rearranged, some new lines were added, and some items were shifted from the IL-1040 to other schedules.

Additionally, IDOR introduced two new schedules:

1. **Schedule ICR, *Illinois Credits***, is used to calculate the taxpayer's property tax credit, K–12 education expense credit, and earned income credit. The total of these credits is carried to the taxpayer's Form IL-1040. Schedule ED, *Credit for K–12 Education*, was eliminated since this credit is now reported on the new schedule.
2. **Schedule G, *Voluntary Charitable Donations***, contains a list of all the eligible funds that taxpayers may elect to contribute to through their Illinois tax return. It also contains a description of each fund.

Two new lines were added to the IL-1040. One is for recapture of investment tax credits. The second is for pass-through entity payments. This is discussed later in the section on "Pass-Through Entity Payments."

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5. *Illinois Begins Implementation of New Tax Computer System,* IDOR Informational Bulletin FY 2008-10 (Dec. 2007).
6. *State to launch modernization project that will improve services for taxpayers.* IDOR/Gov. Rod Blagojevich Press Release. (Sep. 1, 2006).
7. Ibid.

E-FILING UPDATE

Over three million taxpayers electronically file their Illinois individual income tax returns. IDOR reports receiving "numerous positive comments" about the ease of use of its e-filing programs. To encourage additional use of the program, IDOR is adding new forms and payments to its e-file catalog.

On October 15, 2008, the department opened its WebFile and WebPay programs to accept payroll returns and deposits. Employers, payroll providers, and withholding agents can electronically file Form IL-941, *Illinois Quarterly Withholding Income Tax Return*, or Form IL-941-A, *Illinois Yearly Withholding Income Tax Return,* and pay any tax due, without a service fee.

Businesses can also use WebPay to make Illinois estimated tax payments and to pay extension payments or balances due on annual returns.

E-Filing Illinois Corporate Returns

Beginning July 1, 2009, taxpayers who electronically file their federal Form 1120, *U.S. Corporation Income Tax Return*, may also file their Form IL-1120, *Corporation Income and Replacement Tax Return*, and accompanying schedules. This is part of the federal-state electronic filing program.

New Mailing Address for Paper Returns

Paper IL-1040 returns with no payments enclosed are now mailed to:

Illinois Department of Revenue
PO Box 1040
Galesburg, Illinois 61402-1040

RECENT LEGISLATION

PARTNERSHIP REPLACEMENT TAX CHANGE

Governor Pat Quinn signed into law the Emergency Budget Implementation Act of Fiscal Year 2010 on July 15, 2009. Although this bill did not include an anticipated income tax increase, it did make changes in an attempt to address the state's fiscal crisis.

One of the provisions in the bill modifies the definition of partnership taxable income by **terminating the deduction for the greater of personal service income or a reasonable allowance for partner's compensation.**[8] This change is effective for taxable years ending on or after December 31, 2009.

The original intent of the deduction for reasonable compensation was to put partnerships on equal footing with S corporations. S corporations are allowed to deduct salaries paid to shareholders for personal services rendered as employees of the S corporation from their Illinois taxable income. However, partnerships do not pay salaries per se to their partners for personal services rendered, and Illinois did not enact specific guidelines for determining what constitutes "a reasonable allowance." Consequently, there was a concern that the vague nature of the terminology led to abuse which could only be determined by auditing the partnership.

The impact of this change is mitigated for some partnerships by another provision in the bill which **ends the requirement to add back into Illinois taxable income, guaranteed payments to partners** which are federally deductible.

8. Public Act 096-0045 (SB1912).

Example 1. Abby, Blabby, and Crabby (ABC) is an Illinois partnership. For the taxable year ending December 31, 2008, it had taxable income of $200,000 before its $180,000 allowance for reasonable compensation to partners. ABC did not make any guaranteed payments to its partners. Following is a calculation of ABC's Illinois income tax for the 2008 taxable year:

Unmodified base income	$200,000
Subtraction for personal service income or reasonable allowance for partners' compensation	(180,000)
Base income	$ 20,000
Replacement tax rate	× 1.5%
Total tax	$ 300

Example 2. Use the same facts as in **Example 1,** except ABC's taxable year ends December 31, 2009. The partnership's Illinois income tax is calculated as follows:

Unmodified base income	$200,000
Subtraction for personal service income or reasonable allowance for partners' compensation	(0)
Base income	$200,000
Replacement tax rate	× 1.5%
Total tax	$ 3,000

Note. "H.B. 2239, which repeals the partnership replacement tax changes described in this section, was passed by the Illinois House and Senate in late October. The bill is currently awaiting the governor's signature.

ILLINOIS ESTATE TAX

Illinois taxes estates of residents and nonresidents who own real property in Illinois. Prior to 2009, the amount of the Illinois estate tax exemption matched the federal estate tax exemption. However, the federal estate tax exemption for 2009 is $3.5 million, while the Illinois exemption is limited to $2 million. Accordingly, taxpayers with large estates should consult with estate planning professionals in order to minimize the tax burden.

RESEARCHING ILLINOIS TAX LAW

Illinois tax law is enacted by the Illinois General Assembly. The Illinois Income Tax Act (IITA) is located in the Illinois Compiled Statutes, Chapter 35, Subchapter 5 (35 ILCS 5/et.seq.). It can be found on the Illinois General Assembly website at **www.ilga.gov/legislation/ilcs/ilcs.asp.**

IDOR REGULATIONS

IDOR is the government agency charged with promulgating rules for the administration of the Illinois Income Tax Act. IDOR regulations are contained in the Illinois Administrative Code, Title 86, *Revenue*, Part 100, *Income Tax*, Section 100 (86 Ill. Adm. Code 100). These regulations are available on the IDOR website at **tax.illinois.gov/LegalInformation/regs/Part100/.**

THE RULEMAKING PROCESS[9]

IDOR's rulemaking is a multi-stepped process. First, the agency publishes a regulatory agenda twice yearly (January and July) indicating the scope of rulemaking activities it expects to engage in during the following six months.

Next, IDOR publishes a Notice of Rulemaking in the *Illinois Register* (Register), the official periodical where all Illinois governmental agencies publish notices of their rulemaking activities. Rulemaking activities consist of proposed or adopted new rules, amendments to or repeals of existing rules, and rules promulgated by emergency or peremptory action. The Register also publishes the governor's executive orders and proclamations, statutorily-required notices of public information, and Joint Committee on Administrative Rules (JCAR) activities.

The Register's table of contents is arranged categorically by rulemaking activity and alphabetically by agency within each category. It is published by the Illinois Secretary of State every Friday and can be accessed though the Illinois General Assembly website at **www.ilga.gov.**

The Register provides a weekly update of the Illinois Administrative Code (a compilation of the rules adopted by state agencies). The most recent editions of the Code and the Register comprise the most current accounting of rulemakings by Illinois agencies.[10]

JCAR also publishes *The Flinn Report: Illinois Regulation*, a 4- to 6-page weekly bulletin summarizing the week's rulemaking activities. *The Flinn Report* can be accessed on the Illinois General Assembly website at **www.ilga.gov.** Interested parties can also request that JCAR mail copies of *The Flinn Report* to them.

First-Notice Period

IDOR initiates the first-notice phase of rulemaking when it publishes a notice of proposed rulemaking in the Register. This phase must last a **minimum** of 45 days and terminates when IDOR files with JCAR. During this first-notice period, the Illinois Department of Commerce and Economic Opportunity (DCEO) reviews each proposed rule for its impact on small businesses.

Public comment is invited during the first-notice period. IDOR may voluntarily hold a public hearing or a hearing may become mandatory if requested by one of the following parties:

- The governor
- JCAR
- An association representing over 100 persons
- At least 25 individuals
- A local government

Hearing requests must be filed within 14 days after publication of the first notice.

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9. *Illinois Rulemaking Process.* Joint Committee on Administrative Rules. [www.ilga.gov/commission/jcar/] Accessed on Aug. 7, 2009.

10. Introductory section. (2009). *Illinois Register.*

Second-Notice Period

At the conclusion of the first-notice period, IDOR files with JCAR to initiate the second-notice period, which lasts for a **maximum** of 45 days. Through mutual agreement between IDOR and JCAR, this period may be extended another 45 days.

Proposed rules are subject to legislative and JCAR review during the second-notice period. Rules can be modified at this point by agreement of IDOR and JCAR. Alternatively, JCAR can take one of the following actions:

- Adopt the rule by filing a Certificate of No Objection,
- Issue a recommendation to IDOR,
- Object, or
- File for prohibition/suspension (3/5 vote required).

Public Input on the Regulatory Process

Public comment is essential to the JCAR review process. In order for the committee to fully recognize a rule's effect, it must understand the burden the rule places on individuals, businesses, or local governments.

Any interested person may contact IDOR during the first-notice period to record a position on a proposed rule. Additionally, IDOR may consult with identified interest groups while drafting the rule prior to the first-notice period.

Once a proposed rule goes to second notice, JCAR receives a copy or summary of all written comments submitted to IDOR. The public may contact JCAR directly if IDOR refused to make modifications in response to public comment or if the existence of the proposal was discovered too late for the first-notice public-comment period.

Complaints about existing rules may also be filed with IDOR. IDOR is required to allow the public to suggest rule revisions. Additionally, JCAR may open an investigation into an existing rule on its own initiative or in response to a public complaint.

ILLINOIS SCHEDULE M

Illinois bases its taxable income on modifications to the taxpayer's federal adjusted gross income (AGI). The taxpayer's federal AGI is modified with statutorily-authorized additions or subtractions to arrive at Illinois base income, which is then reduced by any allowable exemption amounts to determine net taxable income.

Individual taxpayers entering additional income on Form IL-1040, line 3, or subtraction amounts on Form IL-1040, line 7, must attach Illinois Schedule M, *Other Additions and Subtractions for Individuals*, and any other required documentation to their Illinois income tax returns.

RECENT SCHEDULE M FORM CHANGES

As noted elsewhere in this chapter, the 2008 Form IL-1040 underwent changes to coordinate with IDOR's computer system upgrade. Schedule M now includes subtraction lines for the following items, which were previously located on Form IL-1040:

- Military pay included in federal AGI
- U.S. treasury bonds, bills, notes, savings bonds, and U.S. agency interest

Previous modifications to Schedule M include the addition of a subtraction line for railroad unemployment income and an additional line for recapture of deductions for contributions to in-state college savings plans when funds are transferred to an out-of-state plan.

Earnings from out-of-state college savings plans that meet certain disclosure requirements no longer have to be added back on Schedule M. (See the subsection "Addition for Certain IRC §529 College Savings Plan Earnings" in this section.)

ADDITION MODIFICATIONS

The following items must be added back to the taxpayer's federal AGI to compute Illinois' base income. The line numbers listed correspond to the line numbers in Schedule M, Step 2.

***Line items noted with an asterisk** require the attachment of additional documentation, as listed in brackets.

Line 1. Taxpayer's child's federally tax-exempt interest and dividend income from U.S. Form 8814, *Parents' Election to Report Child's Interest and Dividends*

***Line 2.** Distributive share of additions from partnerships, S corporations, estates, and trusts [Illinois Schedule K-1-P, *Partner's or Shareholder's Share of Income Deductions, Credits, and Recapture*, and/or Illinois Schedule K-1-T, *Beneficiary's Share of Income and Deductions*]

Line 3. Medical care savings account (MCSA) withdrawals that are included in the taxpayer's federal AGI but were not used for purposes allowed under the MCSA Act (MCSAs are accounts established under Illinois law and are not to be confused with federal health savings accounts). The Illinois Medical Care Savings Account Act sunsets January 1, 2010.[11]

Line 4. Lloyd's plan of operations[12] loss, if reported on Form IL-1023-C, *Composite Income and Replacement Tax Return*, on the taxpayer's behalf and included in the taxpayer's federal AGI

Line 5. Certain IRC §529 college savings plan distributed earnings (See next section.)

***Line 6.** Special depreciation addition [Form IL-4562] (Distributive additions from partnerships, S corporations, trusts and estates should be reported on Schedule M, line 2.)

Line 7. Business expense recapture (nonresidents only)

Line 8. Recapture of deductions for contributions to Illinois tax-advantaged college savings plans transferred to an out-of-state plan (smaller of amount previously deducted or amount transferred during the year)

***Line 9.** Other income [Include a description or attach a statement describing any other required additions.]

These addition items are totaled and carried to the taxpayer's Form IL-1040, line 3.

Addition for Certain IRC §529 College Savings Plan Earnings

Earnings from §529 college savings plan distributions, other than the exceptions listed below, must be added back to Illinois income if the earnings were **not** included in the taxpayer's federal AGI.

The exceptions are:

1. Bright Start College Savings Pool;
2. Bright Directions College Savings Pool;
3. College Illinois Prepaid Tuition Program;
4. Qualified §529 tuition programs that:
   - Comply with the College Savings Plans Network's disclosure principles,[13] and
   - Annually inform Illinois residents and program distributors that in-state programs exist; and
5. Earnings that were rolled over tax-free into another §529 college savings plan.

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11. 820 ILCS 153.

12. 86 Ill. Admin. Code 100/5170.

13. A copy of the College Savings Plans Network's disclosure principles statement can be found at www.collegesavings.org/includes/pdfs/CSPN.Disclosure.Principles.statement2.7.26.05.pdf.

SUBTRACTION MODIFICATIONS

The following items may be subtracted from the taxpayer's federal AGI to compute Illinois' base income (listed by the Schedule M, Step 3, corresponding line number).

***Line items noted with an asterisk** require the attachment of additional documentation, as listed in brackets.

Line 11. Contributions to Illinois tax-favored college-savings plans (Bright Start, Bright Directions, and College Illinois plans only; limited to a total of $10,000 per individual return or $20,000 per joint return)

***Line 12.** Distributive share of subtractions from partnerships, S corporations, estates, and trusts [Illinois Schedules K-1-P and/or K-1-T or a copy of the notification specifically detailing the subtraction; include the entity's federal employer identification number (FEIN), or, if a grantor trust, a statement identifying the trust]. (Include distributive portions of Enterprise or River Edge Redevelopment Zones and High Impact Business dividends on Schedule M, line 23. Include valuation limitations from Illinois Schedule F, *Gains from Sales or Exchanges of Property Acquired Before 8/1/69*, on Schedule M, line 22.)

Line 13. Restoration of amounts held under a claim of right described in IRC §1341 (e.g., repayment of unemployment benefits taxed in a previous year)

Line 14. Contributions to a job-training project under the Tax Increment Allocation Redevelopment Act (For more information, refer to IDOR Informational Bulletin FY 90-40.)

Line 15. Expenses related to federal credits or federally tax-exempt income disallowed under IRC §§171(a)(2), 265, or 280C

Line 16. Home Ownership Made Easy (HOME) program interest

***Line 17.** Special depreciation subtraction [Form IL-4562] (Distributive subtractions from partnerships, S corporations, trusts, and estates should be reported on Schedule M, line 12.)

***Line 20.** Military pay received from the U.S. Armed Forces or any state's National Guard. Do not include federally-nontaxable combat pay or any pay received as a voluntary-separation incentive, as a civilian, under the Ready Reserve Mobilization Income Insurance Program, or as a Public Health Service officer. [Form W-2 showing military pay]

***Line 21.** Income from federally-taxable U.S. treasury bonds, bills, notes, savings bonds, and U.S. agency interest (See Illinois Publication 101, *Income Exempt from Tax*). [U.S. Form 1040, Schedule B, *Interest and Ordinary Dividends*, or U.S. Form 1040A, Schedule 1, *Interest and Ordinary Dividends for Form 1040A Filers;* a copy of any applicable mutual fund statement; and any worksheets clearly identifying the taxpayer's interest from U.S. obligations]

> **Note.** Returns may not be e-filed if subtractions are claimed on Schedule M, Lines 22 or 23.

***Line 22.** August 1, 1969, valuation limitation [Illinois Schedule F and any required federal forms]

***Line 23.** Enterprise and River Edge Redevelopment Zone and High Impact Business dividend subtractions from Illinois Schedule 1299-C, *Income Tax Subtractions and Credits*, Step 2, line 7 [Illinois Schedule 1299-C]

***Line 24.** Recovery of items previously deducted on U.S. Form 1040, Schedule A, *Itemized Deductions*, but included in Illinois taxable income for the current year (e.g., state tax refunds from states other than Illinois). [U.S. Form 1040, page 1, and any federal schedule or attachment that shows the nature and source of this deduction]

Line 25. Ridesharing money and other benefits included in federal AGI, but not including any salary received by the driver

Line 26. Prepayment of life insurance, endowment, or annuity benefits received as an indemnity for a terminal illness, if the amount is included in federal AGI

Line 27. Employer contributions and interest earned under an account established for the taxpayer under the state's Medical Care Savings Account Act (MCSAs are accounts established under Illinois law and are not to be confused with federal health savings accounts. The Illinois Medical Care Savings Account Act sunsets January 1, 2010.)

Line 28. Lloyd's plan of operations income if already reported on a composite return filed on the taxpayer's behalf

Line 29. Illinois Pre-Need Cemetery Sales Act trust income, if this amount is included in income on the taxpayer's Form IL-1040, lines 1 or 3

Line 30. Education loan repayments for primary care physicians who comply with requirements to practice in certain shortage areas for a set period of time, if this amount is included in income on the taxpayer's Form IL-1040, lines 1 or 3

Line 31. Reparations or other amounts received as a victim of racial or religious persecution by any Axis regime, or an heir of a victim, if these amounts are included in the taxpayer's federal AGI

Line 32. As detailed on lines 32 a–m, interest on tax-exempt obligations of Illinois state and local governments specifically exempt by Illinois statute,[14] if the taxpayer has included the income on IL Form 1040, lines 1, 2, or 3. Taxpayers may not deduct this interest if they own the underlying bonds indirectly through mutual funds. (See later in this section for a discussion on double-exempt interest entries.)

Line 33. Interest on mutual mortgage insurance fund bonds and tax-exempt obligations of non-U.S. governments, including the governments of Guam, Puerto Rico, the Virgin Islands, American Samoa, and the Northern Mariana Islands, if the taxpayer has included the income on IL Form 1040, lines 1, 2, or 3

Line 34. Taxpayer's child's interest reported on U.S. Form 8814, if this amount is included in income on the taxpayer's Form IL-1040, lines 1 or 3

Line 35. Railroad unemployment compensation

These subtraction items are totaled and carried to the taxpayer's Form IL-1040, line 7.

Taxpayers may not subtract any out-of-state income on Schedule M, with the exception of state tax refunds included on Schedule M, line 24. Items subtracted from Illinois income must first be included in Illinois income. (See section titled "Double-Exempt Interest Entries.")

Special Subtractions

Not all subtraction modifications are calculated on Schedule M. Social security income and income from certain qualified retirement plans is still subtracted on the front page of the Form IL-1040, as is the subtraction for Illinois income tax refunds that are included in the taxpayer's federal AGI.

IDOR no longer provides a "fill-in-the-blank" section for miscellaneous subtractions, meaning that all subtraction modifications to Illinois income must be categorized as either a Schedule M line item or a front-page deduction. However, not all modifications fit neatly into these categories. Take, for example, government disability plan income.

Disability income paid to state workers is reported on Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc.*, with a distribution code of "3," indicating disability income. The IRS directs taxpayers to include this income as wages. For taxpayers filing a U.S. Form 1040, the amount of disability income from the taxpayer's Form 1099-R is entered on line 7.

Illinois allows taxpayers to subtract income received from government disability plans from Illinois taxable income. But the question is "How?" Schedule M contains no line item for disability income, and the income doesn't seem to fit the description of retirement income because it is classified by the federal government as wages.

14. Refer to Illinois Publication 101, *Income Exempt from Tax*, or 86 Ill. Reg. 100.2470 for more detailed information.

So how does government disability income get deducted from state taxable income? The fine print in the instructions for Form IL-1040 reveals that government disability payments can be subtracted on Form IL-1040, line 5, as retirement income.

Since it is doubtful that software packages will automatically pick up on this nuance, preparers must be alert for situations in which their clients receive income from government disability plans and be prepared to override the assumption that the income is deemed wages on the state return.

> **Note.** Group term-life insurance premiums paid to retirees but reported federally as wages are also qualified for deduction as retirement income on the Illinois return.

DOUBLE-EXEMPT INTEREST ENTRIES

Some interest income may be statutorily exempt from both state and federal income tax. An example of such income is interest from a qualified Illinois Housing Development Authority bond that the taxpayer owns outright (i.e., not indirectly through a mutual fund). The federal government exempts this income as municipal interest, and Illinois specifically exempts it by statute.

A double entry is required to correctly exclude double-exempt interest income from a taxpayer's return. That is, the taxpayer must first modify his Illinois base income by adding the amount of federally tax-exempt interest income to his federal AGI on Form IL-1040, Step 2, line 2. Then, the taxpayer subtracts the amount of qualified interest on the appropriate line of his Illinois Schedule M, lines 32a–m.

Example 3. Billy Goat owned an Illinois Sports Facility Authority bond that earned $500 interest in 2009. This interest was excluded from Billy's 2009 federal AGI.

To exclude this $500 from state income tax, Billy modifies his Illinois income as follows:

- Increases his base income by adding $500 on Form IL-1040, line 2
- Decreases his base income by subtracting $500 on Schedule M, line 32f, and carrying the total of all of his Schedule M subtractions to Form IL-1040, line 7

The net result is that Billy does not pay either federal or Illinois tax on this municipal bond interest income.

PASS-THROUGH ENTITY PAYMENTS

IDOR began a compliance initiative in 2006 to determine how many nonresident partners and shareholders were filing Illinois income tax returns to report and pay tax on their distributive portions of Illinois income.

After manually reviewing information reported on Illinois entity income tax returns and cross-checking to see if corresponding returns were filed by nonresident partners and shareholders, IDOR uncovered "widespread ignorance and deliberate disregard of Illinois law."[15]

The first 300 entities examined revealed over 5,000 noncompliant partners and shareholders.[16] As a result of this project, IDOR recovered **$22.5 million in unpaid income tax**.[17]

15. *Tax Talk: Pass-Through Entity Payments*. Nov. 18, 2008. Illinois Revenue. [www.revenue.state.il.us/AboutIdor/TaxTalk.htm] Accessed on May 22, 2009.

16. IDOR Compliance Alert (CA-2007-01), December 2006.

17. *Tax Talk: Pass-Through Entity Payments*. Nov. 18, 2008. Illinois Revenue. [www.revenue.state.il.us/AboutIdor/TaxTalk.htm] Accessed on May 22, 2009.

To counteract the tendency of nonresidents to ignore their obligation to pay Illinois taxes, the Illinois General Assembly enacted laws requiring certain pass-through entities to remit payments to IDOR on behalf of most nonresident partners, shareholders and beneficiaries.[18] These laws went into effect for tax years ending on or after December 31, 2008.

The new pass-through entity laws provide an easier and more taxpayer-friendly way for entities to report and pay Illinois tax for their nonresident stakeholders than by filing composite returns. In fact, an IDOR spokesperson hinted that the department hopes to phase out Form IL-1023-C, *Composite Income and Replacement Tax Return*, over the next few years.

THE MECHANICS OF PASS-THROUGH ENTITY PAYMENTS

Note. For a discussion of composite returns and a completed Form IL-1023-C, see the 2008 *University of Illinois Federal Tax Workbook,* IDOR Chapter.

Pass-through entity payment laws require targeted entities to compute and remit any Illinois tax due on apportioned Illinois business income on behalf of their nonresident partners, shareholders, and beneficiaries. Nonresident taxpayers receive an Illinois income tax credit for the amount remitted on their behalf.[19]

However, if the amount of the tax remitted on behalf of the partner, shareholder, or beneficiary is sufficient to cover their tax liability, the nonresident **individual** taxpayer does not have to file an Illinois tax return.[20] This creates a win-win-win situation. Individual taxpayers are relieved of the burden to file out-of-state tax returns, IDOR is relieved of administrative costs, and Illinois collects more tax.

Note. Nonindividual partners and shareholders must still file Illinois tax returns. That is, if a nonresident entity owner is also a pass-through entity, it is not relieved of the responsibility to file an Illinois tax return to report its Illinois income. These situations may be referred to as tiered partnerships and distributions. (See **Examples 2** and **3.**)

Business Income versus Nonbusiness Income

Only Illinois-apportioned business income is subject to the pass-through entity tax payment rules.[21] Nonbusiness income, such as interest and dividends, is not subject to these rules. The definition of business income is set forth in Section 1501(a)(1) of the Illinois Income Tax Act,[22] which defines it as “all income that may be treated as apportionable business income under the Constitution of the United States.”

The Illinois Administrative Code[23] provides that all income is business income “unless clearly classifiable as nonbusiness income.”

These definitions are not enlightening. In at least one public pronouncement, IDOR stated that income from operating rental real estate is “likely business income.”[24]

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18. 35 ILCS 5/709.5 as enacted by Public Act 95-0233 (Senate Bill 1544), effective Aug. 16, 2007, and Public Act 95-0707 (Senate Bill 783), effective Jan. 11, 2008.

19. 35 ILCS 5/709.5(b).

20. 35 ILCS 5/502(a).

21. 35 ILCS 5/709.5.

22. 35 ILCS 5/1501.

23. 86 ILCS 100.3010(a)(3)(c)

24. *Tax Talk: Pass-Through Entity Payments*. Nov. 18, 2008. Illinois Revenue. [www.revenue.state.il.us/AboutIdor/TaxTalk.htm] Accessed on May 22, 2009.

Affected Entities

The following pass-through entities with Illinois-apportioned business income are required to remit payments on behalf of their respective nonresident partners, shareholders, and beneficiaries **(nonresident owners):**

- Partnerships, other than publicly-traded partnerships under IRC §7704 and investment partnerships[25]
- Subchapter S corporations
- Trusts

> **Note.** This does not include estates.[26] Trusts that do not have business income are also not included.

Affected Owners

Payments must be remitted on behalf of all nonresident partners, shareholders, and beneficiaries, **except:**

- Individuals included on composite income and replacement tax returns, or
- **Nonindividual owners** who certify that they will file an Illinois tax return and pay any tax due by completing Form IL-1000-E, *Certificate of Exemption for Pass-through Entity Payments*, and submitting it to the pass-through entity.

> **Note.** Pass-through entities should keep Form IL-1000-E on file. This form is not submitted to IDOR unless requested.

Pass-Through Entity Obligations

Affected pass-through entities with nonexempt, nonresident owners must do the following:

- File Form IL-1000, *Pass-through Entity Payment Income Tax Return*
- Calculate and remit required payments on behalf of nonresident owners
- Notify affected nonresident owners of the amount of pass-through entity payments made on their behalf via Illinois Schedule K-1-P, *Partner's or Shareholder's Share of Income Deductions, Credits, and Recapture*, or Illinois Schedule K-1-T, *Beneficiary's Share of Income and Deductions*

Nonresident Owner Obligations

Individual taxpayers for whom pass-through entity payments have been made are not required to file an Illinois income tax return if the payments made on their behalf cover their entire Illinois individual income tax liability.

Nonresident pass-through entities and individuals who are otherwise required to file an Illinois tax return must report income derived from the pass-through entity on their Illinois income tax returns and claim a credit for payments made on their behalf by the pass-through entity. If the nonresident owner is also a pass-though entity, it can claim the credit either on its Illinois income tax return or Form IL-1000.

Taxpayers must attach any Schedules K-1-P or K-1-T received from pass-through entities to their Illinois tax returns to support any claims for the credit.

25. For taxable years ending on or after Dec. 31, 2004, an "investment partnership" is exempt from Illinois income taxation. (35 ILCS 5/205(b)).

26. IL-1023-C.

Calculating the Payment

The amount pass-through entities are required to remit to the state equals the sum of each nonexempt, nonresident owner's Illinois-apportioned income multiplied by the Illinois tax rate applicable to each nonresident owner.

> **Note.** See the previous section, "Business Income versus Nonbusiness Income," for more information.

Form and Due Date. Payments are remitted to the state along with Form IL-1000, *Pass-Through Entity Payment Income Tax Return.* Form IL-1000 and payments are due no later than the **unextended** due date of the pass-through entity's Illinois income tax return.

Compliance Problems. The due date for a pass-through entity's Form IL-1000 can fall on the same date or later than the due date for the nonresident owner's return. This may present a compliance problem when there are tiered partnerships and distributions or when the pass-through entity has filed an extension and cannot compute the amount of the nonresident shareholders' tax liability.

IDOR addressed these concerns with Proposed Regulation §100.7035(f)(2). This regulation exempts a **nonresident owner** from penalty and interest if the pass-through entity fails to pay the owner's tax on time, but only if the nonresident owner did not cause the pass-through entity payment to be late.

When the pass-through entity has filed an extension for time to complete the entity's income tax return, the entity is advised to use a best-guess estimate in calculating the amount of the pass-through entity payment on behalf of nonresident owners.

Amended Payments. Underpayments can be corrected by filing Form IL-1000-X, *Amended Pass-Through Entity Payment Income Tax Return*. **Pass-through entities cannot claim a refund for any overpayments**. Amounts overpaid in error can only be recovered by the nonresident owner on whose behalf the payment was made.

Example 4. Eight 'R from Decatur (Eight 'R) is a calendar-year partnership conducting business in Decatur, Illinois, and Decatur, Texas. The partnership has eight equal partners, shown as follows:

Partner	Residency	Taxpayer Status
1. Earl Jones	Decatur, IL	Individual
2. Merle Jones	Decatur, IL	Individual
3. Pearl Jones	Decatur, GA	Individual
4. Burle Jones	Decatur, GA	Individual
5. Girl Jones	Decatur, AL	Individual
6. Chuck Finklestein	Decatur, AL	Individual
7. Jones Brothers	Decatur, TX	Partnership
8. Jones Sisters	Decatur, TX	Partnership

Eight 'R's 2009 net profit was \$80,000. Twenty-five percent of this profit was derived from business in Texas and the rest from Illinois. Each Eight 'R partner's share of Illinois-apportioned income in 2009 is \$7,500 [(\$80,000 ÷ 8) × 75%].

The Jones Sisters' partnership conducts a separate business in Illinois. Since the Jones Sisters' partnership may have an additional Illinois income tax liability, the partnership submitted Form IL-1000-E to Eight 'R to request exemption from pass-through entity payments.

Eight ’R’s 2009 pass-through entity payment is calculated as follows:

Partner	Residency/Status	IL Income	Rate	Payment
1. Earl Jones	Resident/Individual	$7,500	N/A	$ 0
2. Merle Jones	Resident/Individual	7,500	N/A	0
3. Pearl Jones	NonRes/Individual	7,500	3.0%	225
4. Burl Jones	NonRes/Individual	7,500	3.0%	225
5. Girl Jones	NonRes/Individual	7,500	3.0%	225
6. Chuck Finklestein	NonRes/Individual	7,500	3.0%	225
7. Jones Brothers	NonRes/Partnership	7,500	1.5%	113
8. Jones Sisters	NonRes/Exempt	7,500	N/A	0
Eight ’R’s 2009 pass-through entity payment				$1,013

Eight ’R must remit $1,013 to IDOR along with Form IL-1000 no later than April 15, 2010. (See completed Form IL-1000 for Eight ’R on the following page.)

Eight ’R must also inform each of its partners of the amount of Illinois income tax remitted on the partner’s behalf via separate Schedules K-1-P.

Jones Sisters must report the $7,500 income derived from Eight ’R on its 2009 Illinois partnership return. As a pass-through partnership, Jones Sisters may also have to file a Form IL-1000 and remit pass-through entity payments if it has any nonresident, nonexempt partners. (**Example 5** illustrates the filing liability of a tiered partnership.)

For Example 4

Illinois Department of Revenue
Form IL-1000
Pass-through Entity Payment Income Tax Return

If this return is not for calendar year 2008, write your fiscal tax year here.
Tax year beginning ____/____, 2008, ending ____/____/ 20__ __

Write the amount you are paying. $ **1,013.00**

Read this information first:

You must file Form IL-1000 if the following apply to you:

- you are a subchapter S corporation, partnership, or a fiduciary with an Illinois filing obligation, and
- you have business income distributable to Illinois nonresident partners, shareholders, or beneficiaries who are not included on Form IL-1023-C, Illinois Composite Income and Replacement Tax Return, or
- you have business income distributable to Illinois nonresident partners, shareholders, or beneficiaries who have not provided you with Form 1000-E, Certificate of Exemption for Pass-through Entity Payments.

If you are an investment partnership as defined in the Illinois Income Tax Act, Section 1501(a)(11.5), you should not file Form IL-1000.

Note **Do not file Form IL-1000 if all of your nonresident partners, shareholders, and beneficiaries:**

- are included on a Form IL-1023-C,
- provided you with Form 1000-E, or
- are exempt organizations.

Step 1: Identify your partnership, S corporation, or trust

A Write your business name and mailing address.
If your address has changed or is different than the mailing address on your Form IL-1120-ST or IL-1065, check the box. ☐

Eight 'R from Decatur
Name of organization

1234 West Eldorado Street
Mailing address

Decatur | **IL** | **62522**
City | State | ZIP

B Write your federal employer identification number (FEIN).
37 - 1234567 5 5 5

C Check your entity type:
☒ Partnership ☐ S corporation ☐ Trust

Step 2: Figure your payment amount

1 Write your total amount of business income apportioned to Illinois (cannot be less than zero). **1** **60,000.00**

Lines 2 through 5, write the percentage of business income that is distributable to partners, shareholders, or beneficiaries subject to Illinois Income Tax. (See instructions.)

2	Nonresident individuals and estates	**.500**	x amount on Line 1 =	**30,000.00**	x .03 =	2	**900.00**
3	Partnerships/S corporations	**.125**	x amount on Line 1 =	**7,500.00**	x .015 =	3	**113.00**
4	Nonresident trusts	.	x amount on Line 1 =		x .045 =	4	
5	Corporations	.	x amount on Line 1 =		x .073 =	5	

6 Add Lines 2 through 5. **6** **1,013.00**

7 Write any pass-through entity payment reported to you on Schedule K-1-P or K-1-T that you choose to apply toward your pass-through entity payment obligations. See instructions. **7** **0.00**

8 Subtract Line 7 from Line 6. This is your pass-through entity payment amount. **8** **1,013.00**

Under penalties of perjury, I state that I have examined this return and, to the best of my knowledge, it is true, correct, and complete.

________ Signature of partner, authorized officer, or fiduciary | **04 / 15 / 2010** Date | **Partner** Title | **(217) 555-0000** Phone

________ Signature of preparer | ___ / ___ / ___ Date | Preparer's Social Security number or firm's FEIN

________ Preparer firm's name (or yours, if self-employed) | Address | (____)______ Phone

Attach your payment here.

▶ **Mail this return to: Illinois Department of Revenue, P.O. Box 19017, Springfield, IL 62794-9017** ◀

NS **DR**________
IL-1000 front (R-3/09)

This form is authorized as outlined by the Illinois Income Tax Act. Disclosure of this information is REQUIRED. Failure to provide information could result in a penalty. This form has been approved by the Forms Management Center. IL-492-0067

Example 5. Use the same facts as **Example 4** with the following additional facts. The Jones Brothers' partnership has two partners, Roy Jones and Ray Jones. Both partners are residents of Texas.

Because the Jones Brothers' partnership has Illinois-apportioned income and nonresident owners, it also must file Form IL-1000 and remit a pass-through entity payment on behalf of its partners. Assuming the partnership has no other Illinois income, the Jones Brothers' pass-through entity payment is calculated as follows:

	IL Income	Rate	Required Payment
Roy Jones	$3,750	3%	$113
Ray Jones	3,750	3%	113
Jones Bros. 2009 pass-through entity payment			$226

The Jones Brothers' partnership can claim a credit for the $113 paid on its behalf by Eight 'R on the Jones Brothers' Form IL-1000, line 7 or on the Jones Brothers' Form IL-1065, *Illinois Partnership Tax Return.* It must attach the Schedule K-1-P received from Eight 'R to the appropriate return.

FORM ACCOMMODATIONS FOR PASS-THROUGH PAYMENTS

To accommodate pass-through entity payments on nonresident owners' income tax returns, IDOR has revised all Illinois income and replacement tax returns with the exception of Forms IL-990-T, *Illinois Exempt Organization Income and Replacement Tax Return,* and IL-1023-C.

Forms IL-1065 and IL-1120-ST, *Illinois Small Business Corporation Replacement Tax Return;* Schedule B, *Partners' or Shareholders' Identification;* and Form IL-1041, *Fiduciary Income and Replacement Tax Return,* Schedule D, *Beneficiary Information,* now include columns to record pass-through payment information for each partner, shareholder, or beneficiary.

Caution. An IDOR spokesperson warns practitioners to monitor their software programs when preparing both the pass-through entity's income tax return and Form IL-1000. The department reports that some software programs have been crediting the entity's pass-through payments to the entity's Forms IL-1065 or IL-1120ST.

MISCELLANEOUS PASS-THROUGH ENTITY PAYMENT ISSUES

Since the pass-through entity payment laws went into effect last year, practitioners have raised a lot of questions. IDOR has published a 9-page *Tax Talk* in question and answer format on the topic of pass-through entity payments.[27] This publication is available on IDOR's website at **www.revenue.state.il.us.**

Highlights from this *Tax Talk* publication follow:

- Pass-through payments do **not** have to be made on income that is not allocable to Illinois (i.e., nonbusiness income, such as interest and dividends, that is properly allocated to the owner's state of residency). Refer to this *Tax Talk* for a discussion on the classification of rental income and other business versus nonbusiness income issues.
- There is no exception from pass-through entity payments for cash-strapped entities.
- Pass-through entities are assessed a **10% penalty** if they fail to submit pass-through payments, and late-filing penalties may also apply (to the pass-through entities, not to the nonresident owners).
- IDOR cannot respond to federal tax issues on the topic of disproportionate distributions for subchapter S corporation shareholders arising from state-mandated payments on behalf of certain shareholders.

Observation. The requirement for pass-through entities to remit Illinois tax payments on behalf of nonresident partners, shareholders, and beneficiaries may complicate preparation of the pass-through entity's federal tax return.

SALES TAX ISSUES

Illinois does not impose a sales tax, per se. What people often refer to as the state's sales tax is actually a combination of the transactional-based taxes described in the Illinois statutes as "occupation" and "use" taxes. **Occupation taxes** are imposed on sellers based on certain retail sales. **Use taxes** are imposed on buyers based on certain retail purchases.

However, IDOR uses the term "sales tax" to describe the combination of all state, local, mass transit, water commission, home rule occupation and use, nonhome rule occupation and use, park district, and county public safety taxes.

ILLINOIS SALES TAX RATES

Illinois has three "sales tax" rate structures: one for qualifying food, drugs, and medical appliances; one for items required to be titled or registered (vehicles); and another for all other general merchandise. In addition to the state rates quoted below, local governmental units may impose additional taxes.

Qualifying food, drugs, and medical appliances are taxed at the state rate of **1%**. This category of items includes:

- Food that has not been prepared for immediate consumption, such as most food sold at grocery stores, but **not** including grocery sales of hot foods, alcoholic beverages, and soft drinks;
- Prescription medicines and nonprescription items claimed to have medicinal value, such as aspirin, cough medicine, and medicated hand lotion; and
- Prescription and nonprescription medical appliances that directly replace a malfunctioning part of the human body, such as corrective eyewear, contact lenses, prostheses, insulin syringes, and dentures.

27. *Tax Talk: Pass-Through Entity Payments*. Nov. 18, 2008. Illinois Revenue. [www.revenue.state.il.us/AboutIdor/TaxTalk.htm] Accessed on May 22, 2009.

Vehicles are taxed at the state rate of **6.25%**. This category of items includes:

- Motor vehicles, ATVs, watercraft, aircraft, trailers, and mobile homes; and
- Motor vehicles, aircraft, and vessels owned by a business when that business moves into or relocates to Illinois.

Other general merchandise is taxed at the state rate of **6.25%** and includes sales of most tangible personal property, such as:

- Soft drinks,[28]
- Prepared food,
- Photo processing (picture development),
- Prewritten and "canned" computer software,
- Prepaid telephone calling cards and other prepaid telephone calling arrangements, and
- Repair parts and other items transferred or sold in conjunction with providing a service under certain circumstances based on the actual selling price.

SALES AND USE TAX CHANGES[29]

As of September 1, 2009, the tax bases of three merchandise classes have changed. The items taxed differently are candy, personal grooming and hygiene products, and soft drinks. Prior to September 1, 2009, these items were taxed as food and medicine (low rate). Now they are taxed as general merchandise (high rate). The sales and use taxes are reported as follows:

- For sales tax, the items are reported on Form ST-1, *Sales and Use Tax Return*, step 3, line 4a; and Form ST-2, *Multiple Site Form*, line 4a.
- For use tax, these items are reported on Form ST-1, line 6a.

Definitions of Items Affected by Tax Change

Candy. For Illinois tax purposes, candy is defined as "a preparation of sugar, honey, or other natural or artificial sweeteners, in combination with chocolate, fruits, nuts or other ingredients, or flavorings in the form of bars, drops, or pieces." Examples include, but are not limited to, the following:

- Chocolate bars,
- Yogurt or chocolate-covered fruit or nuts,
- Honey-coated nuts,
- Caramel popcorn,
- Lollipops,
- Snack mixes containing yogurt or chocolate,
- Breath mints, and
- Gum.

28. The tax rate for soft drinks has changed effective Sep. 1, 2009. See following section.

29. Illinois Department of Revenue Informational Bulletin FY 2010-01 (July 2009).

Items that contain flour or that require refrigeration are **not** considered candy; they remain taxed as food. Examples include, but are not limited to, the following:

- Chocolate-covered cookies,
- Yogurt-covered pretzels,
- "Candy" that contains flour,
- Plain dried fruits, and
- Nuts with no added sweeteners.

Ingredient lists on packaging can be used to determine whether the item is classified as a food or as candy.

Personal Grooming and Hygiene Products. Personal grooming and hygiene products for humans are taxed as general merchandise, whether or not they make a medicinal claim, unless sold as a result of a prescription. Products affected by this change include, but are not limited to, the following:

- Body soap and cleansers,
- Shampoo,
- Toothpaste,
- Mouthwash,
- Antiperspirant, and
- Suntan lotion and sunscreens.

Soft Drinks. For Illinois tax purposes, a soft drink is defined as "any non-alcoholic beverage containing natural or artificial sweeteners." This includes, but is not limited to, the following:

- Soda,
- Sport or energy drinks,
- Sweetened tea,
- Waters containing natural or artificial sweeteners,
- Beverages containing 50% or less fruit or vegetable juice, and
- All other preparations commonly known as soft drinks.

This definition **excludes** any beverage containing milk or milk products, soy, rice or similar milk substitutes; unsweetened teas; drinks with greater than 50% of vegetable or fruit juice by volume; and carbonated or uncarbonated water that contains no natural or artificial sweeteners. These continue to be taxed as food and are reported on Form ST-1, step 3, line 5a.

If, according to the ingredients label or package, an item contains milk or milk products or does not contain natural or artificial sweeteners, it is not considered a soft drink and remains taxed as food.

All beverages sold at a restaurant remain taxed as general merchandise.

The Chicago Soft Drink Tax

The broader definition of "soft drink" also applies to the Chicago Soft Drink Tax. The soft drinks previously identified as moving from low-rate to high-rate taxation are now subject to the Chicago Soft Drink Tax. The rate for the tax remains at 3% and is reported on Form ST-14, *Chicago Soft Drink Tax Return.*

See IDOR Publication 116, *Chicago Soft Drink Tax,* for more information regarding this local tax.

USE TAX AND INTERNET SALES

Many Internet retailers charge sales tax only to residents of the seller's state. However, this does not mean sales tax is not due. Illinois buyers are responsible for remitting sales tax directly to IDOR if the seller does not collect Illinois sales tax on the transaction.

The tax is called a "use" tax. Illinois imposes a tax for the privilege of **using** tangible personal property in Illinois if that property has been purchased at retail from any retailer anywhere.[30] (Certain exceptions apply; see the section titled "Use Tax Filing Requirements.")

The imposition of use tax is designed to encourage fair competition between in-state and out-of-state businesses. However, a 1992 U.S. Supreme Court decision did not balance the competition. In *Quill Corp. v. North Dakota*,[31] the court ruled that states cannot make retailers collect state sales tax unless the retailer's company has a physical presence in that state.

Nexus Test for Internet Retailers

Determining which virtual retailers are required to collect sales tax on Internet transactions can be difficult. IDOR issued a General Information Letter in 2000 in response to a question regarding nexus in relation to Internet sales. An excerpt of the Department's answer follows (emphasis added):

> *The Supreme Court has set out a 2-prong test for nexus. The first prong is whether the Due Process Clause is satisfied. Due process will be satisfied if the person or entity purposely avails itself or himself of the benefits of an economic market in a forum state.*[32]
>
> *The second prong of the Supreme Court's nexus test requires that, if due process requirements have been satisfied, the person or entity must have physical presence in the forum state to satisfy the Commerce Clause.* ***A physical presence is not limited to an office or other physical building.***
>
> ***Under Illinois law, it also includes the presence of any agent or representative of the seller.*** *The final type of retailer is the out-of-State retailer that does not have sufficient nexus with Illinois to be required to submit to Illinois tax laws. A retailer in this situation does not incur Retailers' Occupation Tax on sales into Illinois and is not required to collect Use Tax on behalf of its Illinois customers.*
>
> *However, the retailer's* ***Illinois customers will still incur Use Tax*** *on the purchase of the out-of-State goods* ***and have a duty to self-assess their Use Tax liability and remit the amount directly to the State.***[33]

As a result of the *Quill* decision, an online retailer is only required to collect sales tax from customers who live in the state in which the company has a "brick and mortar" facility. Online retailers like Old Navy, which has stores located in Illinois, are required to collect and remit Illinois sales tax on sales made to customers living in Illinois.

Companies not otherwise required to collect Illinois sales tax can voluntarily collect and remit the tax to the state if they so choose. An estimated 1,100 online retailers now do so.[34] eBay is not one of those companies. Out of concern that collecting, reporting, and remitting sales tax to multiple states would be burdensome to their sellers, eBay remains emphatically opposed to the idea of requiring sellers to collect sales tax on out-of-state transactions.

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30. 35 ILCS 105/3.
31. *Quill Corp. v. North Dakota,* 112 S.Ct. 1904 (May 26, 1992).
32. Ibid.
33. ST 00-0153-GIL 07/24/2000.
34. *The Tech Beat: The State of the Internet Sales Tax*. [www.businessweek.com] Accessed on Apr. 20, 2009.

Pending Internet Sales Tax Legislation

As of this writing, U.S. Congress is considering legislation that would require the majority of online retailers to collect tax in the 23 states participating in the Streamlined Sales Tax Project.[35] Illinois is not currently a member of this coalition, but it is considering National Conference of State Legislatures-supported legislation that would eliminate the physical presence requirement and open the door to requiring out-of-state retailers to collect state tax on all Internet sales.

A recent IDOR study estimates **the state of Illinois has lost $153 million in tax revenue from online sales** for the current fiscal year.[36] While this is lower than previous estimates of up to $800 million, it is still a significant financial loss for a cash-strapped state.

To close this gap, IDOR has implemented educational programs to inform residents of their duty to pay the use tax. The department is also strengthening efforts to collect the tax by auditing online retailers that have "brick and mortar" stores located within Illinois. IDOR estimates 68% of the 100 largest online merchants currently remit sales tax to the state.

IDOR is also focusing on Illinois companies that file corporate income tax and payroll tax returns in the state but have not filed sales or use tax returns. The department's Use Tax Voluntary Compliance outreach is part educational and part "inspirational" — encouraging companies to confess to delinquent use taxes on their own. The state is waiving penalties for businesses that "voluntarily disclose and pay use tax for the past four years," as long as the businesses agree to continue paying use taxes on applicable future purchases.[37]

To quote IDOR, "Illinois is aggressively focusing upon collecting [use] tax."[38] To this end, Illinois shares sales information with other states. IDOR then estimates liability and bills Illinois residents for any unpaid tax, penalty, and interest. Taxpayers have the right to challenge any estimate made by the department.

IDOR also uses U.S. Customs Service records to gather use tax data.

USE TAX FILING REQUIREMENTS

Illinois imposes use tax on retail purchases made for use or consumption within the state. The use tax applies whether items are purchased from Illinois retailers within the state or whether purchased from out-of-state businesses and delivered to an Illinois address or brought back to Illinois for use.

However, certain sales are **exempt** from Illinois sales tax. Illinois Pub. 104, *Common Sales Tax Exemptions*, lists typical types of exempt transactions, such as sales to exempt organizations, sales of items purchased for resale, and sales of certain farm machinery and equipment. A complete list of exemptions can be found at Illinois Administrative Code §130.120.

Most in-state retailers collect Illinois sales tax at the point of purchase. Buyers who purchase goods from out-of-state retailers must voluntarily remit the required use tax to IDOR if the retailer did not charge Illinois sales tax or if the sales tax charged was lower than the state use tax rate, assuming the item purchased is not exempt from Illinois sales tax.

35. Streamlined Sales Tax Governing Board, Inc. [www.streamlinedsalestax.org] Accessed on May 22, 2009.

36. *Revenue study estimates up to $153 million in on-line sales tax remains uncollected.* IDOR News Release. Feb. 16, 2009.

37. Ibid.

38. *Use Tax for Individual Taxpayers.* Illinois Revenue. [www.revenue.state.il.us/Businesses/TaxInformation/Income/usetaxindividualsl.htm] Accessed on May 22, 2009.

IDOR's website lists the following examples of transactions that would elicit the need for filing an Illinois use tax return:

- Catalog purchases made from an out-of-state retailer who does not charge Illinois sales tax
- Purchases made through home shopping channels or via the Internet when the seller has not charged Illinois sales tax
- Items purchased by an Illinois resident while:
  - In another state, from a retailer who charged sales tax at a lower rate than the Illinois rate; or
  - In a foreign country.

> **Note.** The payment of duty tax does not exclude an item from Illinois use tax.

Form ST-44, *Illinois Use Tax Return*

Taxpayers file **Form ST-44, *Illinois Use Tax Return***, to report and pay use tax to the state. The form's due date depends on the amount of use tax owed.

- If the total use tax due is **$600 or less** for the entire calendar year, the filing deadline is on or before **April 15** of the following year.
- If the amount of tax due **exceeds $600**, the taxpayer must file Form ST-44 and pay the full amount due by the **last day of the month** following the month in which the purchase(s) were made.

Taxpayers who fail to file and pay any use tax due in a timely manner will be assessed a late-filing penalty and a late-payment penalty.

Credit may be claimed for any sales tax properly paid to another state. Taxpayers must pay Illinois the difference if the tax paid to the other state is less than the tax due at the Illinois rate. **Credit cannot be claimed for any taxes paid to foreign governments.** These nondomestic purchases are taxed at the full Illinois use tax rate.

Other Sales and Use Tax Forms

The following forms may be required in lieu of Form ST-44 to report and pay use tax:

- **Form ST-1, *Sales and Use Tax Return*:** Registered Illinois retailers or servicepersons report use tax on Form ST-1 if they are otherwise required to file this form.
- **Form RC-44, *Illinois Cigarette Use Tax Return*:** Illinois residents use Form RC-44 to report any cigarette purchases made outside of the state.
- **Form RUT-25, *Vehicle Use Tax Transaction Return*:** Taxpayers use Form RUT-25 to report purchases of motor vehicles, watercraft, aircraft, or trailers purchased from any out-of-state dealers, lending institutions, leasing companies or retailers, or from any unregistered Illinois lending institutions or leasing companies.
- **Form RUT-50, *Private Party Vehicle Tax Transaction Return*:** Illinois residents must file Form RUT-50 to report transfer of a motor vehicle from a private party, whether by gift or by purchase.
- **Form RUT-75, *Aircraft/Watercraft Use Tax Transaction Return*:** Illinois residents must file RUT-75 to report acquisition of an aircraft or watercraft, whether by gift, donation, transfer, or nonretail purchase.

AUDIT ISSUES FOR BUSINESS TAX RETURNS

Since Illinois requires taxpayers to self-assess their various tax liabilities, it is easy to imagine that some taxpayers might underestimate the amount of tax they owe. IDOR is willing to help these taxpayers improve their self-assessment skills.

IDOR conducts audits to verify the procedures taxpayers use to compute taxable income, the legitimacy of any exemptions or deductions claimed, and the overall accuracy of tax returns filed.

IDOR views these audits as more than a way to deter tax evasion and collect deficient and delinquent taxes. The department also looks at audits as a way to promote voluntary compliance by educating taxpayers about Illinois tax laws.

IDOR strives to be fair and equitable with taxpayers during audits. The department's goal is to determine the correct amount of tax due under Illinois law. Auditors are expected not only to uncover underpayments, but also to acknowledge taxpayer overpayments and errors made by the department.[39]

AUDIT METHODS AND PROCEDURES

Because needs vary from tax issue to tax issue and from business to business, there is no standard methodology for conducting a business tax audit. In IDOR's words, ". . . the methods used in a sales tax audit for a flower shop would be different from the methods used in a sales tax audit of a manufacturer."[40]

However, there are some commonalities. Auditors generally follow these steps when examining returns:

- Review source documents and general ledger accounts in detail.
- Test source documents.
- Compare federal or consolidated returns and associated schedules with Illinois returns.

> **Note.** Taxpayers with sales tax/use tax exposure are encouraged to timely file periodic tax returns to maintain a statute of limitations for an audit timeframe by the state of Illinois. Without a statute period set by filing of tax returns, IDOR auditors could audit and solicit delinquent sales tax returns back to 1981.

Selection, Notice, and Location

IDOR uses a variety of methods to select taxpayers for audit. Some taxpayers are selected due to the nature of their business or their relationship to a targeted tax issue. Others invite inspection based on their past audit history or by virtue of an outside referral. Some are selected purely at random.

Taxpayers are notified that they are subject to an audit via phone or mail, or IDOR may appear unannounced. IDOR has the right to inspect and audit retailers' tax information at any time the taxpayer's business is open.[41]

Audits generally are conducted at the location where the business maintains its books and records. A taxpayer can elect to have the audit conducted elsewhere, such as in the office of a designated representative. Occasionally, audits are conducted at an IDOR office.

39. Brochure PIO-60, *Audit Information for Business Taxpayers.*

40. Ibid.

41. 86 Ill. Admin. Code §130.801(c).

Timeline

Audits vary in length. Some last one day, while others take many months to complete. The length of an audit depends on several factors, including the:

- Type of business,
- Size of business,
- Condition and availability of the taxpayer's records, and
- Level of the taxpayer's cooperation with the auditor.

Representation

Taxpayers may represent themselves during an IDOR audit or may opt to be represented by an accountant, attorney, or any other authorized person who has knowledge of the taxpayer's day-to-day operations, recordkeeping, and tax reporting requirements. IDOR must be informed of the taxpayer's selection of an authorized representative via a signed Form IL-2848, *Power of Attorney.*

Burden of Proof

All sales of tangible personal property in Illinois are presumed subject to sales tax unless proof is established to the contrary. The **burden of proof falls to the taxpayer** who is required to remit any necessary tax.

If a taxpayer cannot provide evidence to refute the taxability of an item during an audit, IDOR is authorized to give the taxpayer written notice to produce documentation within 60 days. The auditor may extend this period either for just cause or on the auditor's own motion. If proof of exemption is not provided in a timely fashion, the transaction is presumed to be taxable.[42]

RECORDKEEPING REQUIREMENTS FOR SALES TAX AUDITS

Taxpayers must maintain records with a sufficient level of detail to support the information they report to IDOR. Auditors may request copies of all of the taxpayer's records or only sufficient records to obtain an adequate sample of the accuracy of information filed.

To support entries on sales tax returns, IDOR requires Illinois retailers to maintain records of all sales and purchases of tangible personal property in **English.**[43]

At **minimum**, a business that is exclusively retail must keep the following records:

- Cash register tapes or other types of daily records documenting gross sales
- A record of merchandise purchased, including copies of all vendor invoices and purchase orders, maintained in serial order and sequence as to date
- A true and complete annual inventory[44]

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42. 86 Ill. Admin. Code §130.801(g).

43. 86 Ill. Admin. Code §130.801(e).

44. 86 Ill. Admin. Code §130.805(a).

Additionally, a business is advised to maintain the following records for inspection:

- Credit memos, debit memos, bills of lading, shipping records, and all other records pertaining to any and all purchases and sales of goods, whether or not the retailer believes them to be subject to sales tax
- Summaries; recapitulations; totals; journal entries; ledger accounts; accounts receivable records; accounts payable records; statements; tax returns with all schedules or pertinent working papers used in connection with the preparation of such returns; and other documents listing, summarizing or pertaining to such sales, purchases, inventory changes, shipments or other transactions[45]
- Books that distinguish taxable from nontaxable receipts[46]

All books and records are required to be kept in Illinois, unless a business has multiple branches and is headquartered in another state. However, after a reasonable notice, businesses headquartered outside Illinois must produce all required documents to IDOR at a location within the state of Illinois.[47]

ELECTRONIC ACCOUNTING SYSTEM AUDIT ISSUES

IDOR Pub. 107, *Electronic Records and Computer-Assisted Auditing*, contains guidance for businesses selected for audit that use electronic methods to document and store their tax information. This publication also describes IDOR's computer-assisted auditing techniques.

Special Procedures for Electronic Records' Audits

During a traditional audit, IDOR examiners typically interact with representatives of a company's taxation, accounting, and legal departments. In an audit of electronic records, the auditor also may need to work with representatives of areas such as internal audit, data processing, management information systems, and records management.

IDOR generally holds an opening conference with the taxpayer prior to conducting a computer-assisted audit (CAA). Discussions at this conference include an overview of the audit plan, a review of the taxpayer's computer system, an outline of the agreements to be reached, and a summary of the IDOR's sampling guidelines and projection techniques.

In a CAA, the auditor likely will ask questions such as the following:[48]

- What are the origins of the taxpayer's electronic records?
- What is the record retention policy of the business?
- What controls are in place to safeguard the records?
- Is detailed transaction level information available to sample and determine whether the tax treatment is correct? (Summary reports may not be sufficient to satisfy the auditor's needs.)
- How are tax accrual system changes developed and implemented?
- Do undocumented system changes exist?

IDOR auditors examine the taxpayer's internal controls for the electronic collection and storage of tax-related data to determine to what extent the auditor can rely on the data provided. The auditor will look for mechanisms and procedures that prevent the alteration, forgery, and falsification of electronic tax records. However, IDOR Pub. 107 states, "This evaluation does not indicate any change in the degree of trust between the auditor and the taxpayer."

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45. 86 Ill. Admin. Code §130.801(a).
46. 86 Ill. Admin. Code §130.801(b).
47. 86 Ill. Admin. Code §130.801(f).
48. See IDOR Publication 107, *Electronic Records and Computer-Assisted Auditing*, for a more comprehensive list of potential audit questions.

Software Compatibility

In the event the taxpayer's hardware and software are not compatible with IDOR's, the department will work with the taxpayer to arrive at a solution. To aid in this endeavor, taxpayers must provide IDOR with access to their electronic records in ASCII, EBCDIC, or flat file formats, if so requested.

IDOR may download taxpayers' records and complete the CAA examination off-site.

APPEAL OPTIONS[49]

If a business is dissatisfied with the outcome of its audit, Illinois provides several opportunities for resolution. These appeal protocols are outlined below.

Informal Conference Board

The first avenue of appeal is the state's Informal Conference Board (ICB). The ICB was created on April 2, 2001 to replace the Informal Conference Unit, a panel which had no real power. The ICB is empowered to resolve disputes with taxpayers concerning their tax liability at the earliest possible opportunity in the administrative process by liberally exercising its discretion in all areas.[50]

The ICB is a separate and distinct division of IDOR, but it is not part of IDOR's Audit Bureau. It is statutorily composed of the following members:[51]

1. IDOR's General Counsel
2. The chairman of the Board of Appeals
3. The manager of the Audit Bureau
4. At least three IDOR employees, other than the ICB administrator, who are designated by the director of revenue and have experience in state and local tax and procedure

Taxpayers may request an informal review before the ICB after IDOR has proposed a liability or denied a taxpayer's claim. The ICB review allows taxpayers the potential to settle any disagreements with IDOR before the formal appeal and administrative hearing process begins.

Filing Written Request. Taxpayers must file a written request for an ICB review within 60 days after receiving a *Notice of Proposed Liability, Notice of Proposed Deficiency,* or *Notice of Proposed Claim Denial*. This written request is filed by either the taxpayer or an authorized representative using Form ICB-1, *Request for Informal Conference Board Review.* The request must state **specific** reasons why the taxpayer disagrees with IDOR's finding, cite evidence of the department's error, and list all references on which the taxpayer relies.

In-Person Conferences. A taxpayer may wish to plead his case via an in-person conference with the ICB. This request is indicated on Form ICB-1, Step 4. Likewise, the ICB can request an in-person conference with a taxpayer. If the taxpayer refuses the ICB's request, the ICB may deny the taxpayer a review due to a lack of sufficient information on which to render a decision.

Whenever possible, in-person conferences are scheduled within 45 days of receipt of the request. The time for the conference is established by mutual consent. The ICB confirms the conference via written notice. Taxpayers who fail to attend the conference without good cause waive their right to reschedule an in-person conference.

49. PIO-60, *Audit Information for Taxpayers.*

50. 86 Ill. Admin. Code §215.100.

51. 86 Ill. Admin. Code §215.105(a).

Board Action. The ICB operates in panels of three members. After considering all available information, the ICB issues an Action Decision within 90 days of receipt of the taxpayer's request (extensions of time may apply). The decision must be approved by at least two of the three deciding board members. The ICB's Action Decision is **binding** on IDOR.

The audit is concluded after the ICB issues its decision. Taxpayers have 30 days from the issuance of the department's Audit Report to take action before the audit is finalized.

Administrative Hearings

If the ICB denies the taxpayer's request[52] or fails to successfully resolve the issue at hand, taxpayers may request an administrative hearing. Administrative hearings are quasi-judicial proceedings under the direction of an administrative law judge (ALJ) and handled similar to matters in a circuit court. Following the hearing, the ALJ submits a recommendation to the director of revenue. Taxpayers then receive written notice of the decision.

Circuit Court

If the taxpayer is dissatisfied with the ALJ's decision or did not undergo an administrative hearing, the taxpayer has the option of paying the full amount of the deficiency under formal appeal and then filing suit in circuit court. To preserve the taxpayer's right to receive a refund, the written appeal must be filed within 30 days of making the appealed payment and it must state the taxpayer's intention to file a circuit court complaint.

Board of Appeals

The Board of Appeals has the authority to waive penalties and interest upon a finding of just cause. The Board of Appeals also may reduce a taxpayer's tax liability if it appears doubtful that the full amount can be collected.

A taxpayer may not request a Board of Appeals' review until all other forms of appeal are exhausted, unless the time for taking alternative actions (i.e., requesting an administrative hearing and/or bringing suit in circuit court), has expired. However, upon the taxpayer's and IDOR's request, the board can review controversies pending in administrative hearings or court.

TAX ASSISTANCE FOR STATE INCOME TAX ISSUES

Continuing the spirit of educating taxpayers on their rights and duties under Illinois tax laws, IDOR's Office of Legal Services responds in writing to a taxpayer's written questions on specific tax issues. The department's responses are issued in two forms: general information letters and private letter rulings.

General Information Letters[53]

A general information letter (GIL) deals with general tax principles or applications. GIL requests do not require a specific format and generally do not require copious detail. However, IDOR may request additional information from the inquirer in order to provide the most accurate answer to the question posed.

GILs basically provide background information. They do not constitute statements of agency policy that apply, interpret, or prescribe Illinois tax law. GILs are **not legally binding and may not be relied upon** by taxpayers in taking positions with reference to tax issues. They also create no rights for the taxpayer under the Taxpayer's Bill of Rights Act.

52. The taxpayer must have received a *Notice of Proposed Liability, Notice of Proposed Deficiency*, or *Notice of Proposed Claim Denial*, before an administrative hearing can be requested.

53. 2 Ill. Admin. Code §1200.120.

Private Letter Rulings[54]

A private letter ruling (PLR) has a much more specific focus than a GIL. Taxpayers or their authorized representatives may request a PLR regarding one specific issue within a single tax type. IDOR will not issue a PLR on any issue under audit or pending litigation, on proposed transactions, or on hypothetical situations.

The department will not respond to PLR requests from anonymous or unidentified taxpayers. Also, IDOR will not issue PLRs to business, trade, or industrial associations or similar groups concerning the application of tax laws to group members.

Unlike GILs, PLRs are legally binding on IDOR, but only as to the taxpayer who is the subject of the request for ruling. Changes in the law, case law, rules, or material facts could alter this binding application.

IDOR responds to all requests for private letter rulings either by issuance of a ruling or by a letter explaining that the request for ruling will not be honored. If so warranted, IDOR reserves the right to issue a GIL in place of a PLR.

The format for filing a PLR is quite specific. The following information must be included with the request:[55]

1. A complete statement of all material facts and other information pertinent to the request, including:
   - Identification of all interested parties,
   - A statement of the business reasons for the transaction,
   - A detailed transaction description, and
   - An analysis of the relation of the material facts to the issue;
2. All contracts, licenses, agreements, instruments or other documents relevant to the request
3. An identification of the tax period at issue and disclosure of whether an IDOR audit or litigation is pending
4. A statement that, to the best of the knowledge of both the taxpayer and the taxpayer's representative, IDOR has not previously ruled on the same or a similar issue for the taxpayer or a predecessor, and, if applicable, a statement as to whether the taxpayer or any authorized representative has previously submitted the same or a similar issue to IDOR but withdrew it before a letter ruling was issued
5. A statement of authority supporting the taxpayer's views, an explanation of the grounds for that conclusion, and citation of the relevant authority supporting the taxpayer's conclusion
6. A statement of any authorities contrary to the taxpayer's views (Each taxpayer is under an affirmative duty to identify any and all authorities contrary to the taxpayer's views; if the taxpayer determines that there are no authorities contrary to her views, or the taxpayer is unable to locate such authority, the request must contain a statement to that effect.)
7. An identification of any specific trade secret information the taxpayer wishes to be deleted before the PLR is disseminated to the public
8. The signature of the taxpayer or the taxpayer's representative (accompanied by a properly executed power of attorney)

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54. 2 Ill. Admin. Code §1200.110.

55. 2 Ill. Admin. Code §1200.110(b).

Mailing Address

Requests for GILs and PLRs should be sent to:

Illinois Department of Revenue
Office of Legal Services 5-500
101 West Jefferson Street
Springfield, IL 62702

PROPERTY TAX RELIEF

Illinois law provides for a variety of programs that offer property tax relief. Some programs, like the General Homestead Exemption, are available to a wide population base. Other programs, like the Returning Veterans' Homestead Exemption, apply only to a narrow segment of homeowners.

This section provides an overview of the various types of property tax relief offered in Illinois and reviews details of the property tax credit for individual income tax filers.[56]

GENERAL HOMESTEAD EXEMPTION[57]

Eligibility

The General Homestead Exemption (GHE) applies only to **residential** property **occupied** as a **principal dwelling**. This exemption is available to:

1. Homeowners, or
2. Lessees of single-family residences that:
   - Have a legal or equitable interest in the property, and
   - Are liable for paying the home's property tax.

The exemption is available to all qualified residents in Illinois, **except** those living in Cook County who are covered under one of two alternate programs specific to that county.

Exemption Amount

The GHE is equal to the difference between the home's current year equalized assessed value (EAV) and the home's 1977 EAV, up to a **maximum of $5,500** for tax year 2008 (property taxes payable in 2009).

The Illinois legislature increased the GHE from the former $5,000 maximum in 2007.[58] The GHE is scheduled to increase again to a maximum of $6,000 in 2009 (property taxes payable in 2010).

Application Process

Eligible residents may apply for the GHE at the chief county assessment office in the county in which they live. There is no prescribed application form. Some counties grant the GHE automatically.

56. Property tax relief information is available at [http://tax.illinois.gov/localgovernment/propertytax/taxrelief.htm] Accessed on Aug. 12, 2009.
57. 35 ILCS 200/15-175.
58. P.A. 95-644, Oct. 17, 2007.

ALTERNATIVE GENERAL HOMESTEAD EXEMPTION FOR COOK COUNTY (AGHE)[59]

Eligibility

The Alternative General Homestead Exemption (AGHE), also called the 7% expanded homeowner exemption, is available to homeowners in Cook County, Illinois **only**. Applied as an expansion of the GHE, the AGHE limits the increase of a residence's EAV to 7% each year.

However, provisions of the AGHE **expire** according to the following time table:

- 2008: City of Chicago
- 2009: North Suburbs
- 2010: South Suburbs

Homeowners may apply for the GHE after expiration of the AGHE.

Exemption Amount

The AGHE exemption amount varies each year. The minimum exemption amount is equal to the GHE. The maximum exemption amount is based on the property's annual increase in EAV and its general assessment year. For properties that receive the Senior Citizen Assessment Freeze Homestead Exemption (Senior Freeze, covered later in this section), the AGHE is limited to the amount of the annual GHE.

Application Process

The Cook County Assessor's Office handles AGHE applications. The application form is simply an affidavit establishing that the applicant owns and occupies the home as a primary residence.

LONG-TIME OCCUPANT HOMESTEAD EXEMPTION FOR COOK COUNTY (LOHE)[60]

Eligibility

This exemption applies to Cook County residential property beginning with tax year 2007. To be eligible for the LOHE, the property must be **occupied** as a **primary residence** by a qualified taxpayer. Qualified taxpayers must:

1. Have total household income of $100,000 or less; **and**
2. Live in the home:
   - 10 continuous years, **or**
   - 5 continuous years if receiving government or nonprofit assistance to acquire the home.

Exemption Amount

The minimum amount for the LOHE is equal to the GHE. The LOHE limits annual EAV increases to specified percentages based on the total household income of the property's occupants, shown as follows:

Total Household Income	Maximum EAV Increase
$75,000 or less	7%
75,001–100,000	10%

A property may not receive both the LOHE and the AGHE, GHE, or Senior Freeze. Properties eligible for the Senior Freeze receive an exemption equal to the GHE.

59. 35 ILCS 200/15-176.

60. 35 ILCS 200/15-177, P.A. 95-644, Oct. 17, 2007.

Application Process

The Cook County assessor's office handles LOHE applications.

HOMESTEAD IMPROVEMENT EXEMPTION[61]

Eligibility

The Homestead Improvement Exemption is available for new improvements to existing structures on homestead property or the rebuilding of residential structures following a catastrophic event.

Exemption Amount

The Homestead Improvement Exemption is limited to the fair cash value of the improvement or the difference in an increase in assessed value between the prior homestead structure and the rebuilt homestead structure, up to a maximum annual exemption of $75,000. The exemption applies for four years after the improvement is completed and the dwelling is occupied.

Application Process

Counties may grant the Homestead Improvement Exemption automatically. Alternatively, they may require applicants to file Form PTAX-323, *Application for Homestead Improvement Exemption*. Cook County applications must be filed with the County Assessor's Office and accompanied by a valuation complaint. Applicants in all other counties should contact their county's chief assessment office.

DISABLED PERSONS' HOMESTEAD EXEMPTION (DPHE)[62]

Eligibility

The Illinois General Assembly created the Disabled Persons' Homestead Exemption beginning with 2007 property taxes payable in 2008. To be eligible for this relatively new exemption, a property must serve as the principal residence of a disabled person who is liable for payment of the residence's property tax. The criteria for determining disability are the same as the Social Security Administration's criteria. Alcoholism and drug abuse are not considered disabilities for this purpose.

Exemption Amount

The DPHE reduces a property's EAV by $2,000 per eligible year. A property cannot receive both the DPHE and any disabled veterans' homestead exemption.

Application Process

Disabled persons may apply for this exemption by filing Form PTAX-343, *Application for Disabled Persons' Homestead Exemption*, with their chief county assessment office. This initial application must be accompanied by proof of disability such as Form PTAX-343-A, *Physician's Statement for Disabled Persons' Homestead Exemption*. Renewal applications must be filed each year on Form PTAX-343-R, *Annual Verification of Eligibility for Disabled Persons' Homestead Exemption*.

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61. 35 ILCS 200/15-180.

62. 35 ILCS 200/15-168, P.A. 95-644, Oct. 17, 2007.

DISABLED VETERANS' STANDARD HOMESTEAD EXEMPTION[63]

Eligibility

The Disabled Veterans' Standard Homestead Exemption applies to single-family dwellings occupied as the primary residence of a disabled veteran who is responsible for payment of the property's taxes. This exemption begins with 2007 property taxes payable in 2008.

For this exemption, "veteran" means an Illinois resident who has served as a member of the U.S. Armed Forces on active duty or State active duty, a member of the Illinois National Guard, or a member of the U.S. Reserve Forces, and who has received an honorable discharge.

Exemption Amount

The amount of this exemption is tied to the level of the veteran's service-connected disability, as established by the U.S. Department of Veterans' Affairs. The annual reduction in EAV for the property is shown as follows:

Percentage of Service-Related Disability	Reduction in EAV
Less than 50%	N/A
At least 50% but less than 75%	$2,500
75% or more	5,000

A property cannot receive more than one disability-related homestead exemption.

Application Process

Disabled veterans may apply for this exemption by filing Form PTAX-342, *Application for Disabled Veterans' Standard Homestead Exemption*, with their chief county assessment office. Renewal applications must be filed each year on Form PTAX-342-R, *Annual Verification of Eligibility for Disabled Veterans' Standard Homestead Exemption*.

DISABLED VETERANS' HOMESTEAD EXEMPTION[64]

Eligibility

The Disabled Veterans' Homestead Exemption is distinct from the Disabled Veterans' Standard Homestead Exemption. For purposes of the Disabled Veteran's Homestead Exemption, a "disabled veteran" means a person who has served in the U.S. Armed Forces and for whom the federal government authorized payment for the purchase or construction of specially-adapted housing to accommodate the veteran's disability.

Eligibility for this homestead exemption is determined by the Illinois Department of Veterans' Affairs and must be reestablished annually. The exemption applies to property owned and used by a disabled veteran **or his or her unmarried surviving spouse**. It also applies to mobile homes occupied by qualifying individuals.

Exemption Amount

The Disabled Veterans' Homestead Exemption can reduce the property's assessed value by a **maximum of $70,000**. It cannot be applied simultaneously with the Disabled Persons' Homestead Exemption or the Disabled Veterans' Standard Homestead Exemption.

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63. 35 ILCS 200/15-169, P.A. 95-644, Oct. 17, 2007.

64. 35 ILCS 200/15-165, P.A. 95-644, Oct. 17, 2007.

Application Process

Application for the Disabled Veterans' Homestead Exemption must be made through the Illinois Department of Veterans' Affairs.

RETURNING VETERANS' HOMESTEAD EXEMPTION[65]

Eligibility

The Illinois General Assembly created the Returning Veterans' Homestead Exemption beginning with 2007 property taxes payable in 2008. To be eligible for this exemption, a property must serve as the principal residence of a veteran returning from active duty in an armed conflict involving the U.S. Armed Forces.

Exemption Amount

The Returning Veterans' Homestead Exemption reduces a qualified property's EAV by $5,000. Unlike the GHE, this exemption applies only for a single year. However, the exemption applies each time a qualified veteran returns home from an active duty tour.

Application Process

Returning veterans may apply for this exemption by filing Form PTAX-341, *Application for Returning Veterans' Homestead Exemption*, with their chief county assessment office.

SENIOR CITIZENS ASSESSMENT FREEZE HOMESTEAD EXEMPTION (SENIOR FREEZE)[66]

Eligibility

The Senior Citizens Assessment Freeze Homestead Exemption, commonly referred to as the "senior freeze," applies to single-family dwellings **occupied** as the **primary residence** of **qualified** senior citizens. To be qualified, an occupant must:

- Be age 65 or older,
- Have household income less than the maximum limitation for the tax year,
- Be liable for payment of the property tax, and
- Own the property or have written evidence of legal or equitable interest in the property.

For 2009 property taxes, payable in 2010, the maximum **household** income limitation is **$55,000**.

Exemption Amount

The senior freeze exemption maintains the EAV of qualified property at a level equal to the EAV for the property's "frozen" base year, thus reducing the effect of inflation. The "frozen" base year refers to the year an occupant first qualified for the senior freeze.

> **Observation.** Since the frozen base year remains the same, seniors are not irreparably harmed if they become temporarily disqualified due to uncharacteristically high income, such as in a year that they cash in savings bonds, sell stock, or pull large sums from their retirement funds.
>
> However, in light of today's declining property values, their property's base year assessment may be higher than their home's current value.

65. 35 ILCS 200/15-167, P.A. 95-644, Oct. 17, 2007.

66. 35 ILCS 200/15-172.

Application Process

Applicants for the senior freeze exemption must apply annually to their chief county assessment office via Form PTAX-340, *Senior Citizens Assessment Freeze Homestead Exemption Application and Affidavit.*

SENIOR CITIZENS HOMESTEAD EXEMPTION[67]

Eligibility

Occupants age 65 or older, who are liable for the taxes owed on the Illinois single-family dwelling they primarily reside in and own or in which they have a legal and equitable interest, are eligible for a senior homestead exemption in addition to their general homestead exemption.

Exemption Amount

The Illinois General Assembly raised the Senior Citizens Homestead Exemption to **$4,000** starting with 2008 property taxes payable in 2009 and continuing for years thereafter.[68] This exemption was previously $3,500.

Application Process

Application procedures vary by county. Some counties require only an affidavit on record with the chief county assessment officer stating that the applicant is age 65 and resides in a qualified residence. However, some counties require seniors to file Form PTAX-324, *Application for Senior Citizens Homestead Exemption*, to receive the exemption and then to file Form PTAX-329, *Certificate of Status — Senior Citizens Homestead Exemption*, annually thereafter.

SENIOR CITIZENS REAL ESTATE TAX DEFERRAL PROGRAM

The Senior Citizens Real Estate Tax Deferral Program is distinct from the senior homestead exemption and senior freeze exemption. The deferral program may allow qualified senior residents to defer paying all property taxes and special assessments on their Illinois principal residence until their property is sold or transferred.

This deferral is similar to a loan against the property, and a lien is filed to ensure the state recovers its money. The amount deferred, plus 6% annual interest and lien fees, cannot exceed 80% of the taxpayer's equity in the property. The loan must be repaid within 90 days after the property ceases to qualify for the deferral or within one year after the taxpayer's death.

To be qualified, a resident must be age 65 or older and have total household income under $50,000. Applications are available through the taxpayer's local County Treasurer's Office.

PROPERTY TAX EXTENSION LIMITATION LAW (PTELL)[69]

The Property Tax Extension Limitation Law (PTELL) limits increases in property tax extensions for non-home rule taxing districts in Illinois. PTELL is often mistakenly referred to as a "tax cap." However, the PTELL law does not cap taxes but rather allows a taxing district to receive a limited inflationary increase in tax extensions. These limits protect property owners from escalating real estate taxes when property values rise dramatically.

Voters are allowed to rescind or reinstate PTELL by referendum if the county's board of commissioners places the question on the ballot.

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67. 35 ILCS 200/15-170.

68. P.A. 95-644, Oct. 17, 2007.

69. 35 ILCS 200/18-185.

EXEMPT PROPERTIES[70]

Certain Illinois properties are exempt from real estate tax. Exempt properties include those owned by religious, charitable, and educational organizations and used **exclusively** for nonprofit activities. Some civic and fraternal organizations that perform charitable work, but are not primarily organized and operated for charitable purposes, do not qualify. Examples of these types of organizations are American Legion halls, Chambers of Commerce, and Rotary Clubs.

Property owned by units of federal, state, and local governments are also exempt from Illinois property taxes. Many other types of exempt properties are outlined in the Illinois statutes.

An organization that wishes to apply for exemption should contact the County Board of Review for its locality.

ILLINOIS PROPERTY TAX CREDIT[71]

Illinois allows a **nonrefundable** credit against an individual's income tax equal to 5% of the taxpayer's qualified property or village tax. Starting with tax year 2008, this credit is computed on Schedule ICR, *Illinois Credits.*

Generally, the property tax credit is based on tax paid by Illinois residents for property that they owned and occupied as a principal residence. The tax must actually be paid before it is considered eligible for the credit.

Regarding lots, property tax paid on a lot or lots that adjoin the taxpayer's principal residence may be included in the computation of the credit because these lots are considered an extension of the taxpayer's principal residence. However, tax paid on a building lot upon which a taxpayer's principal residence is being constructed cannot be included in computation of the credit because it is not yet part of the taxpayer's principal residence.

Property tax paid on **multi-unit property** may also be included, but only if the taxpayer resides in one of the units. The tax attributed to the portion of the dwelling in which the taxpayer does not live must be excluded from the credit. Property tax attributed to the **business-use portion** of a residence or **farm property** also must be excluded from the credit.

Additionally, the following amounts may **not** be included in the credit computation:

- Tax assessed on property that is not the taxpayer's principal residence
- Tax assessed on the taxpayer's principal residence but the taxpayer does not own the property (even if the taxpayer pays the tax)
- Tax assessed on mobile homes (euphemistically referred to as the "mobile home privilege tax")
- Interest and penalties assessed on late payments of property tax
- Tax due but not paid during the year
- Professional fees paid in association with property tax
- Homeowner's association dues or fees
- Tax paid on an out-of-state residence

In Illinois, property taxes are paid a year in arrears. That is, the taxes payable during the income tax year are based on property that the taxpayer lived in during the preceding year. The computation gets tricky when a taxpayer switches residences mid-year.

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70. 35 ILCS 200/15-10-160.

71. IDOR Pub. 108, *Illinois Property Tax Credit.*

Example 6. Ted purchased a home in Mt. Vernon, Illinois, in January 2000 and lived there until October 2009 when he was transferred to Chicago. He purchased a Chicago condo in November 2009. Ted did not sell his Mt. Vernon home during 2009.

During 2009, Ted paid $800 to Jefferson County. This amount represented $600 for the 2008 property tax assessed on his Mt. Vernon home and $200 for lots he owned across the street from his house. Ted also paid $1,000 into his escrow account for 2009 property taxes on his condo.

Question 6A. How much is Ted's 2009 Illinois property tax credit?

Answer 6A. $30 ($600 × .05). Ted may claim the credit on only the $600 tax he paid to Jefferson County in 2009 for his personal residence, since this tax was paid for a 2008 assessment and he lived in the property all of 2008. He cannot include the $200 property tax he paid for the lots in the credit computation, because the lots did not adjoin his residential property.

Ted will claim a portion of the 2009 tax he paid on his Chicago condo in 2010, the year this tax is due and disbursed by his escrow agent.

Because Illinois property taxes become due in the calendar year following the tax year, the seller's property tax bill is prorated when a property changes hands. The closing agent generally divides the property tax due (or estimated tax due) by the number of days in the year and then multiplies this daily amount by the number of days the seller owned the property for the given year. The seller then credits the buyer with this amount so that the buyer can pay the tax when it is due.

A taxpayer may include the amount of prorated taxes paid at closing in the computation of the Illinois property tax credit. However, the taxpayer must have occupied the house as a principal residence for the prorated period. A taxpayer may also include back taxes paid in the credit computation but not interest or penalties.

Example 7. Greg sold his Illinois principal residence on May 31, 2009. His 2008 property taxes, payable in 2009, are $12,000. The projected 2009 taxes for the property, payable in 2010, are also $12,000. Greg's 2009 Illinois income tax is $1,000.

Question 7A. How much is Greg's 2009 prorated property tax?

Answer 7A. The 2009 prorated tax is computed as follows:

$12,000 estimated 2009 tax ÷ 365 days = $32.88 daily tax rate

The number of days Greg owned and occupied the property in 2009 is as follows:

January	31
February	28
March	31
April	30
May	31
	151

$32.88 daily tax rate × 151 days = $4,964.88 (rounded to $4,965)

Question 7B. How much is Greg's 2009 Illinois property tax credit?

Answer 7B. $848 [($12,000 + $4,965) × .05] Greg is allowed to compute his property tax credit on the total amount of qualified principal residence tax he paid in 2009. In this case, Greg paid $12,000 for his 2008 property tax payable in 2009. And, since Greg paid his 2009 prorated tax of $4,965 at the time of closing in May 2009, he can also use this amount to compute his 2009 tax credit.

Example 8. Use the same facts as **Example 7,** except Greg's 2009 Illinois income tax is $800 and he has no other Illinois tax credits.

Question 8A. What is Greg's 2009 Illinois property tax credit?

Answer 8A. $800. The Illinois property tax credit is nonrefundable (i.e. it cannot exceed the taxpayer's Illinois tax liability). There is no carryover provision.

Example 9. Use the same facts as in **Example 7,** except Greg also closed on his new Illinois principal residence on May 31, 2009. At the time of closing, the seller credited Greg with $10,000 of 2008 tax and $4,137 of 2009 tax payable in 2010. Greg disbursed the 2008 tax of $10,000 to the county in which he lived during the summer of 2009.

Question 9A. What is Greg's 2009 Illinois property tax credit for his new home?

Answer 9A. $0. Even though Greg paid the 2008 taxes of $10,000 that were due on the property in 2009, he did not occupy his new home in 2008, the year for which the tax liability was assessed. Therefore, Greg is not eligible to claim an Illinois property tax credit on his new home for 2008 taxes.

Note. Greg should reduce the amount of his property taxes paid in 2010 by the $4,137 he was credited by the buyer. This amount represents the buyer's portion of the 2009 property tax payable in 2010.