

Illinois Legislature Moves to Capture Tax Revenues

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GR Review

Withholding by Illinois Partnerships, Subchapter S Corporations and Trusts

The net income derived by business entities from their Illinois based activities is generally subject to tax in Illinois. Where the business is conducted by a "pass-through entity" such as a partnership, limited liability company or subchapter S corporation, the income tax is not imposed on the entity but is borne proportionately by the owners of the equity interests in the entity.

However, where the owners are non-residents of the State of Illinois who would not otherwise be required to file in the State, the Department of Revenue finds itself in a position of having to pursue out of state persons to collect the many small fractions of the tax base due to noncompliance. To solve this problem, the Illinois legislature has introduced legislation to cause the collection of the full amount of the tax revenues generated by the profits of nonresidents at the source by requiring the Illinois based business to withhold and remit the tax on behalf of its out of state owners.

The FY2008 Budget Implementation Act (the "Act")¹ imposes withholding requirements on every partnership (other than a publicly traded partnership), Subchapter S corporation, and trust ("Pass Through Entities") for each taxable year ending on or after December 31, 2008. Pass Through Entities must withhold from each nonresident partner, shareholder, or beneficiary an amount equal to the distributable share of the business income of the partnership, Subchapter S corporation, or trust apportionable to Illinois of that partner, shareholder, or beneficiary (whether or not distributed), multiplied by the applicable rates of tax for that partner, shareholder or beneficiary.

All Pass Through Entities required to withhold tax will be required to report the amounts withheld and the names and tax ID numbers of the indirect owners from whom the amounts were withheld. Each Pass Through Entity will be required to pay over the amount withheld, no later than the due date (without regard to extensions) of the tax return for the Pass Through Entity.

REIT Distribution

For federal income tax purposes, a real estate investment trust ("REIT") is taxed as a corporation with one major caveat; a REIT is permitted a deduction for its dividends paid to shareholders, thereby approximating the pass-through income tax characteristics of partnerships and other "pass-through" type tax entities. For

state tax purposes, the Illinois Department of Revenue generally starts with the taxpayer's federal income tax return and makes certain additions and subtractions ("adjustments") in arriving at the taxpayer's Illinois sourced income. This means that, under present law, if a REIT earns profits on its Illinois based real estate activities and distributes those profits to owners, the REIT generates no state income tax liability on those revenues in Illinois.

Moreover, the taxable distributions to owners being in the nature of dividend distributions are traditionally thought of as "portfolio" income items and, as such, are taxable for state income tax purposes only where the shareholder is a resident.

Therefore, without a legislative fix, the earnings generated by a REIT in connection with operating its Illinois real estate business, if distributed to non-resident shareholders, could completely escape Illinois income tax.

The Act partially closes this loophole. Under the Act, for taxable years beginning after December 31, 2008, the Illinois base income of a REIT would be increased by any federal deduction for dividends paid to a corporation if the REIT is a Captive Real Estate Investment Trust ("CREIT").

A CREIT is a REIT that is not regularly traded on an established securities market; and of which more than 50% of its voting power or value is owned, directly or indirectly, by a single entity that is taxed as a C corporation. A REIT is not a CREIT if the C corporation that owns more than 50% of the voting power or value the REIT is (i) a REIT, other than a CREIT; (ii) a federally tax exempt entity; or (iii) a REIT that is intended to become regularly traded on an established securities market.

In this way, the State of Illinois will collect state income tax on the Illinois based revenue of a closely held corporate owned REIT at the operating entity level.

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¹At present the Act has been passed by both houses of the Illinois legislature and is awaiting the governor's signature.