

General Information. Apportionment of income of Subchapter S corporations and shareholders to Illinois.

November 17, 1998

Dear:

This is in response to your letter dated October 5, 1998 in which you request a letter ruling. The nature of your letter and the information you have provided require that we respond with a General Information Letter (GIL) which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), enclosed.

In your letter you have stated as follows:

I have a client who formed an S-Corporation in Indiana in 1998 and would like to clarify whether their services constitute Illinois income in a formal written ruling.

The client is a catastrophic insurance claims adjuster. They are hired and paid by an insurance company based in Illinois to go to various locations in the United States to adjust claims. Sometimes they are in the states a few days and sometimes they are in the states a few weeks. Do you consider any of the payment from the insurance company to be Illinois revenue.

I would like an official written ruling on this matter. In addition, could you specify the exact Illinois tax forms my client needs to file?

In addition to the letter, you have represented that the Indiana S-corporation contracts to adjust claims arising in various states with a single Illinois insurance company. The S-corporation then employs its agents to perform the contracts, certain of which require adjusting claims that have arisen in Illinois. The S-corporation has three nonresident individual shareholders. A letter ruling is requested regarding the Illinois income tax consequences to the S-corporation and its shareholders respecting payments received by the corporation under the contracts.

#### **RULING**

Section 201(a) of the Illinois Income Tax Act ("the IITA"; 35 ILCS 5/101 *et seq.*) imposes a tax measured by net income on every individual, corporation, trust, and estate on the privilege of earning or receiving income in Illinois. In addition, section 201(c) of the IITA imposes the Personal Property Tax Replacement Income Tax ("RIT") measured by net income on every corporation (including Subchapter S corporation), partnership, and trust. Section 205(c) of the IITA exempts a Subchapter S corporation from the income tax imposed by section 201(a), but not the RIT imposed by section 201(c). In the case of an individual, the tax is imposed at the rate of 3% of the taxpayer's net income. In the case of a Subchapter S corporation, the RIT is imposed at the rate of 1.5% of the taxpayer's net income. Section 202 of the IITA defines the term "net income" to mean that portion of the taxpayer's base income which is allocable to Illinois.

#### **1. Subchapter S corporation**

As indicated above, a Subchapter S corporation is subject to RIT on that portion of its base income allocable to Illinois. Section 203(e)(2)(G) of the IITA defines the base income of a Subchapter S corporation as its federal taxable income determined in accordance with section 1363(a) of the Internal Revenue Code ("IRC"), but to include the items required by IRC section 1363(b)(1) to be separately stated. Section 304(a) of the IITA sets forth the general manner by which a Subchapter S corporation must allocate its business income to Illinois. That section provides that where the taxpayer derives business income from Illinois and one or more other states, the portion thereof allocable to Illinois is determined under a three-factor apportionment formula that compares the taxpayer's Illinois property, payroll, and sales to its total everywhere of such items. Specifically, section 304(a) provides:

If a person other than a resident derives business income from this State and one or more other states, then, except as otherwise provided by this Section, such person's business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the sum of the property factor (if any), the payroll factor (if any) and 200% of the sales factor (if any), and the denominator of which is 4 reduced by the number of factors other than the sales factor which have a denominator of zero and by an additional 2 if the sales factor has a denominator of zero.

Generally, the property factor is a fraction, the numerator of which consists of the average value of the taxpayer's real and tangible personal property owned or rented and used in the business in Illinois, and the denominator of which is the average value of all such property of the taxpayer (IITA §304(a)(1)). Similarly, the payroll factor is the fraction of the total amount paid as compensation by the taxpayer in Illinois to the total of such amount paid by the taxpayer (IITA §304(a)(2)). Finally, the sales factor is defined as the fraction of the taxpayer's total sales in Illinois over its total sales everywhere (IITA §304(a)(3)).

Regarding the sales factor, Illinois income tax regulations state, in the case of a person engaged in providing services, that the sales factor includes all gross receipts from the performance of services, including fees, commissions, and similar items (86 Ill. Adm. Code §100.3370(a)(1)(C)). Thus, the denominator of the sales factor includes the taxpayer's entire gross receipts. The regulations also provide that gross receipts from the sale of services are attributable to Illinois if the income producing activity which gave rise to the receipts is performed in Illinois (86 Ill. Adm. Code §100.3370(c)(3)). The term "income producing activity" applies to each separate item of income and includes "the rendering of personal services by employees" (Id.). Thus, the numerator of the sales factor includes that portion of the gross receipts generated by the taxpayer's employees performing services in Illinois.

Applying the foregoing to the Subchapter S corporation described in your letter, the corporation must apply the three-factor apportionment formula under IITA section 304(a) to determine that portion of its base income allocable to Illinois. For that purpose, amounts paid or accrued the corporation in respect of claims adjusted within Illinois would be apportioned to Illinois and thus included in the numerator of the sales factor. Accordingly, the Subchapter S corporation will be subject to RIT as a result of its adjusting claims within Illinois. The corporation must report its RIT on Form IL-1120-ST (copy enclosed).

## **2. Subchapter S shareholders**

Individuals are subject to Illinois income tax on the portion of their base income allocable to Illinois. Generally, an individual's base income equals his or her federal adjusted gross income, modified in accordance with specific statutory addition and subtraction provisions (See IITA §203(a)). Where the individual is a non-resident shareholder in a Subchapter S corporation, IITA section 308 provides the manner by which such individual's pro rata share of the tax items of the corporation must be allocated to Illinois. That section states as follows:

The respective shares of shareholders other than residents in so much of the business income of the Subchapter S corporation as is allocated or apportioned to this State in the hands of the Subchapter S corporation shall be taken into account by such shareholder pro rata in accordance with the requirements of Section 1366 of the Internal Revenue Code for the Subchapter S corporation's taxable year and allocated to this state

Accordingly, each shareholder referred to in your letter would be subject to Illinois income tax on his pro rata share of the business income of the Subchapter S corporation allocated to Illinois. Individuals generally report their Illinois income on Form IL-1040 (copy enclosed). However, pursuant to IITA section 502(f) the Department has promulgated regulations that permit nonresident Subchapter S corporation shareholders of the same Subchapter S corporation to file composite individual income tax returns reflecting the composite income of such individuals allocable to Illinois, and to make composite individual income tax payments. A copy of these regulations and Form IL-1023-C, Illinois Composite Income and Replacement Tax Return have been enclosed.

As stated above, this is a GIL which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding upon the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Illinois Income Tax Regulations 1200.110(b).

Sincerely,

Brian L. Stocker