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Illinois' Taxation and Apportionment of Partnership Income Earned by Corporate Partners

Partnerships are not subject to the Illinois Income Tax. Instead, partners are taxed individually on their distributive shares from a partnership.[1] For nonresident individual partners, only their pro rata share of the partnership's income apportioned to Illinois is taxable.[2] Corporate partners may be required to combine the partnership income and factors in their combined business income and factors if they are unitary with the partnership.[3] However, it is always important to keep in mind that Illinois also imposes a Replacement Tax which is generally imposed at the entity level.[4]

Apportionment and Allocation of Income for Corporate Partners

Generally speaking, two primary issues arise in the context of partnership distributions to corporate partners. In general, corporate partners must know whether the distributions should be treated as unitary income and, if the distributions constitute business income, the manner in which the income should be apportioned. This first question can be split into two parts: (1) is the partnership income apportionable business income and (2) is the partnership unitary with the corporate partner?

While a number of states have not provided guidance as to when a unitary decision regarding the characterization of income should be made, Illinois' regulations specifically provide that the "determination of whether an item of base income is business income or nonbusiness income shall be based on the facts and circumstances of the partnership itself. Trade or business activities of a partner or of any related party are irrelevant."[5] To the extent partnership income is characterized as nonbusiness income, the respective shares of a non-resident partner shall be taken into account by such partners pro rata according to their distributive shares of the partnership, and the income will be allocated to Illinois.[6]

Business income of the partnership is apportioned to Illinois pursuant to 35 ILCS 5/304 in the same manner as it is allocated or apportioned for any other nonresident.[7] We have previously addressed the general apportionment rules for corporate income taxpayers here. However, whether a partnership's income should be apportioned on a combined basis with a non-resident corporate partner will depend on whether the partner is engaged in a unitary business with the partnership.[8] Once a unitary determination has been made, transactions between the unitary partner and the partnership are eliminated for purposes of calculating the apportionment factor.[9]

In order to determine whether a partner is unitary with a partnership, the partner and partnership must be related through common ownership and be integrated with, dependent upon, and contribute to each other.[10] The Department of Revenue has explained that in the context of a partnership, a "general partnership interest gives the partner the authority to act on behalf of the partnership and bind the partnership, regardless of actual ownership share? Accordingly, a general partner in any partnership has an interest in the partnership sufficient to establish common ownership."[11] Where a partnership has

80% or more of its business activity conducted outside the United States, it will not be included in the corporation's combined Illinois return.[12]

Taxation of Investment Partnerships

Investment partnerships are those entities treated as partnerships for federal income tax purposes that meet three requirements: (1) no less than 90% of the partnership's cost of its total assets consists of qualifying investment securities, deposits at banks or financial institutions, and office space and equipment necessary to carry on its activities as an investment partnership; (2) no less than 90% of its gross income consists of interest, dividends, and gains from the sale or exchange of qualifying investment securities; and (3) the partnership is not a dealer in qualifying investment securities.[13] Generally speaking, all taxable income of investment partnerships distributed to nonresident partners must be treated as nonbusiness income, and is allocable to the partner's state of residence (for individuals) or commercial domicile (in the case of other persons).[14] Under certain circumstances, nonresident partners may elect to treat distributions from an investment partnership as apportionable income.[15]

A Multistate Perspective

Few states provide as much guidance as Illinois regarding partnership distributions to corporate partners. However, there is a very notable split between states regarding whether a corporate partner's distributions should be apportioned at the partner level versus the partnership level. By my count, approximately 36 states apportion a partnership's distribution at the partner level. Of these states, approximately 12 impose the same unitary rule adopted by Illinois; the income is only apportioned at the partner level if the corporate partner is unitary with the partnership.[16] Otherwise, the income should be apportioned at the partnership level. Five states and DC, however, apportion income at the partnership level. A handful of states simply have no guidance or do not impose a tax.

Importantly, while most states have provided guidance describing whether apportionment should occur at the partnership or partner level, they have not provided the level of guidance Illinois provides regarding the nonbusiness income determination. Whether income earned by a partnership constitutes business income will often depend on whether the income is assessed at the partnership or partner level.[17] Whereas a gain may clearly constitute business income when viewing a partnership in isolation, it is very possible that the same gain would be nonbusiness income when viewing the corporate partner's business activities. For taxpayers looking for a uniform approach to states that do not have explicit guidance as to when the nonbusiness determination should be made, Illinois may be a good starting place.

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[1] Illinois follows federal treatment of limited liability companies, so if an LLC is taxed as a partnership for federal purposes, it is taxed as a partnership for Illinois purposes. 35 ILCS 5/1501(a)(16). For purposes of this discussion, partnerships and LLC's taxed as partnerships are treated the same. Note, however, that this is not uniformly true in Illinois. For instance, franchise tax obligations may differ between LLC's and partnerships.

[2] 35 ILCS 5/305(a); 86 Ill. Admin. Code 100.3500(b).

[3] 86 Ill. Admin. Code 100.3310; 86 Ill. Admin. Code 100.9700.

[4] 35 ILCS 5/205(b). For a discussion on the Replacement Tax and its history, see here.

[5] 86 Ill. Admin. Code 100.3500(b)(1).

[6] 86 Ill. Admin. Code 100.3500(c).

[7] 86 Ill. Admin. Code 100.3500.

[8] 876 Ill. Admin. Code 100.3380(d)(1).

[9] 86 Ill. Admin. Code 100.3380(d)(2)(A).

[10] 35 ILCS 5/1501(a)(27).

[11] 86 Ill. Admin. Code 100.9700(e).

[12] 35 ILCS 5/1501(a)(27); 86 Ill. Admin. Code 100.9700(c).

[13] 35 ILCS 5/1501(11.5)(A).

[14] 35 ILCS 5/305(c-5).

[15] 35 ILCS 5/1501(a)(1);35 ILCS 5/305(c-5).

[16] Notable states in this category include California, Massachusetts, and New Jersey.

[17] Note, for instance, Pennsylvania law states that the "determination of whether a taxpayer's distributive share of partnership income is business or nonbusiness income shall be made" by considering whether the income arose in the regular course of the corporate partner's trade or business." Pa. Code 153.29 (c); (e).