January 2008 Illinois Department of Revenue Practitioners Meetings
Questions Submitted From Practitioners'

1. **Electronic Filing**
   Can you now file electronically an individual return with a deduction on a k-1-p from a partnership?

   Response:
   Yes, beginning in processing year 2008 for calendar year 2007 IL-1040 Individual Income Tax Returns, Individuals may electronically file if they have a K-1P or K-1T. This includes if they have a deduction.

2. **Informational Bulletin FY2008-5**
   Why has the Department been so negligent in issuing Informational Bulletin FY2008-5? Only one of our clients received it (as of 12/17/07), we did not even receive it at the firm! The contents affect every employer in the state, but few, except for the big payroll companies, even know that the rules have changed.

   Response:
   The department issued Bulletin FY 2008-5 in November and posted it on our website. As part of the transition to the new statutory withholding schedule (which conforms to federal payment dates and is part of a broader attempt to encourage increased electronic filing using the federal/state EFTPS pilot), when the department produced the 2008 withholding booklets it assigned taxpayers to the appropriate payment schedule. FY 2008-5 was mailed to each withholder and timed so that withholders would receive the bulletin before they received their withholding coupon books.

   The department needs to understand why use of the free EFTPS program has not been higher and would like help in understanding what needs to be done to encourage that use. We had presumed larger numbers of taxpayers would take advantage of the convenience and ease of this free service. We would encourage you to contact Kevin Richards with any ideas.

3. **Taxability of Software**
   The Department has chosen to decline to respond to questions surrounding the taxability of software in an Application Service Provider software transaction, most recently in ST 06-0116-GIL. Can you provide the Department's opinion on how these transactions should be treated? Fact Pattern: Company houses software on server located outside Illinois. Users in Illinois access software on Company's server, pursuant to a license agreement, which does not meet the 5 part license test. Users do not download any software from Company onto computers in Illinois.

Response:
The Department is currently reviewing this issue. Until this review process is concluded, the Department is unable to issue any opinion letters on these types of transactions.

4. Informal Review Procedures

It appears that many new procedures are being applied to informal reviews. It appears that the period for the informal review process to be completed is something like three months after the initial meeting before the case is placed into administrative hearings. Only a total of three meetings are allowed during the informal process. Have these rules been summarized into a regulation? If the answer is "yes", were these rules reviewed by JCAR? If the answer is "no", is it the Department's intention to draft regulations on this matter and have them available for public comment before the final draft? I understand the reason for these new procedures is to speed up the informal review process. However, I have concerns that due process may be sacrificed in the name of efficiency.

Response:

86 Admin. Code ch. I, section 200.135 provides the practice and procedure for informal review. The purpose of this procedure, which follows the issuance of a proposed assessment, is to give the taxpayer a less formal forum for the Department to "review the adjustments recommended by the examiner or auditor to determine whether adequate grounds for the assessment of the liability exist given the factual information provided by the taxpayer prior to, and at the time of, the conference… ." Id. at 200.135(d). Taxpayer must request this review within 30 days after its filing of a timely and sufficient protest. Id. at 200.135(a). In addition, "[a] request for informal review shall include a list of all supportive documentation to be presented at the review conference." Id. In short, then, the purpose of the informal review conference is limited to a review of the adjustments made by the Department based upon taxpayer's books and records which are identified at the time of the request and were provided to the auditor during audit or at the conference.

Procedurally, the only status conference in the informal review process that is specifically identified in the regulations is the first one. Id. at 200.135(h). The Department's informal reviewer is to make a written recommendation to the Director, or his designee, regarding the disposition of the matter within 90 days. Id. That period may be extended an additional 90 days upon application to the presiding Administrative Law Judge. Id. There is no prohibition against setting the matter for periodic status conferences during the informal review process.

Within the first 90 days, informal review matters are set for at least one subsequent status conference following the initial one, the purpose being to assure that the taxpayer has provided the books and records that it was required to produce, first at the audit stage, and then identified in the request for informal

review. If the taxpayer produces its documents or gives legitimate reasons why it cannot do so within that time period, then the matter can remain in the informal review process for a total of 180 days, with periodic status conferences during this extended period to assure that the parties are proceeding with diligence. Contrary to the representation in the question, during these periods, the taxpayer can interact with the Department's reviewer as much as the parties agree to between themselves-these meetings are not limited to only those set by order as status conferences in informal review. The status conferences are the only meetings that require the presence of an administrative law judge at some point.

Taxpayer's due process rights are not being threatened by these procedures for a number of reasons. Nor is there any intent to "speed up the informal review process." First, it is recognized the many statutory tax provisions mandate that the taxpayer keep books and records that reflect its business transactions that are affirmatively represented in the various tax returns that it files with the Department. These books and records are to be available to the Department for review or audit when requested. Thus, the taxpayer has full opportunity to gather its documents, which it is required to keep, and present them during the time the Department conducts its audit. At the close of the audit, the taxpayer is advised of the basis of the proposed assessment, which would, necessarily, identify any problems perceived by the Department regarding the adequacy of taxpayer's books and records. There is a period following the close of an audit during which the pertinent Notice of proposed assessment is prepared and issued by the Department, and that is followed by a statutory 60 day period for the taxpayer to protest the assessment and request a hearing. The taxpayer then has an additional 30 days to request a proceeding in informal review. Id. at 200.135(a). These time periods afford the taxpayer additional months following an actual audit to gather its documentation to counter the Department's proposed assessment. As the informal review process is limited in scope to a determination as to "whether adequate grounds for the assessment of the liability exist given the factual information provided by the taxpayer prior to, and at the time of, the conference… ." (id. at 200.135(d)), the status conferences that are held to ascertain compliance with the regulatory requirements are reasonable. If the informal review process is being misused, it will be removed from that forum as it is in violation of purpose and procedure. Thus, the proceedings in informal review are not intended to "speed up the informal review process" as suggested by the question.

The informal review forum is one that the taxpayer elects to utilize and is not mandated. A failure to resolve the matter in informal review does not affect any rights of the taxpayer to have its case heard fully in administrative hearings as mandated by statute. Once the matter is removed from the informal review calendar and placed on the administrative hearings calendar, status conferences are held until such time that the case is set for formal hearing. Id. at 200.101 et seq. With limitatio ns provided by regulation (id.), during the time that the matter

is in either informal review status or on the administrative hearings calendar, settlement offers can be made and books and records can be produced. The difference between the proceedings is that in informal review an attorney, licensed to practice in Illinois, is not required as taxpayer's legal representative, while that is not necessarily the case when the matter is on the regular administrative hearings calendar. Id. at 200.135(a).

5. Tax Rate for Non-retail component of Veterinarian Practice

What is the use tax rate to be applied on purchases of merchandise by veterinarians for their non-retail component of their practice. I have a veterinarian who also has a retail center. He was audited three years ago and paid a substantial amount of tax as a result of confusion regarding the tax rules.

Currently, he is not paying tax at the point of purchase on merchandise. He is self assessing use tax on all purchases used in the non-retail portion of his business. The issue from the audit was the rate he should be remitting on these purchases. We were instructed to remit the local as well as state taxes on these purchases, which in his location is 7.75%. Other accountants tell me he should not be remitting the local rate, only the 6.25% for the state.

I realize the state tax laws for veterinarians have been a hot topic recently and wish to confirm we are in compliance.

Response:

Note: Amendments to regulations governing veterinarians have been proposed at 31 Ill. Reg. 15950 – November 30, 2007

Tax on Service Transactions:

Veterinarians who sell items at retail (as described in the proposed regulation) are not eligible to pay Use Tax to their suppliers on the cost price of tangible personal property that will be transferred to service customers incident to service. Instead, they must pay tax to the Department in the form of Service Occupation Tax, which includes any applicable local taxes, on the tangible personal property that they transfer to service customers incident to service. They should provide their suppliers with Certificates of Resale for the tangible personal property that they transfer to service customers incident to service. Their options for remitting Service Occupation Tax are more fully explained in Sections 140.105, 140.106 and 140.109. These options include paying Service Occupation Tax on either their selling price or their cost price (the latter, only if they are "de minimis").

Tax on Items Used or Consumed by the Veterinarian in Her Practice:

Items which a veterinarian herself uses in her practice and which she does not transfer to service customers – items such as disposable pads, syringes, scalpels, antiseptic cleanser, office supplies and the like – are subject to Use Tax. If the

veterinarian does not pay tax to her supplier for these items, she is required to self-assess and remit tax to the Department at the rate of 6.25% on these items.

6. Parnership Subtraction for Personal Service Income

Can a real estate partnership (20 partners) that has net (rental) income and pays out that income in the form of distributions, deduct that income in line 26 of the IL-1065 as "Personal Service Income or reasonable allowance for compensation of partners"? The net effect being that its Illinois Taxable income is Zero."

Response:

No. Section 203(d)(2)(H) of the Illinois Income Tax Act permits a partnership to subtract:

> Any income of the partnership which constitutes personal service income as defined in Section 1348 (b)(1) of the Internal Revenue Code (as in effect December 31, 1981) or a reasonable allowance for compensation paid or accrued for services rendered by partners to the partnership, whichever is greater.

The income of a real estate rental partnership would not be considered personal service income under former IRC Section 1348(b)(1), so no subtraction would be allowed under the first part of this statute. However, if any of the partners were performing services for the partnership (such as, for example, managing rental property), the partnership would be allowed to subtract a reasonable allowance for compensation for those services.

7. New Illinois Non-Resident Shareholder Requirements

A. Please provide guidance in regard to the new Illinois nonresident shareholder requirements for non-resident shareholders of partnerships, Subchapter S corporations and trusts.

1. Has the department developed regulations, and when will that information be released to practitioners and the taxpayers?

Response:

No regulations have yet been drafted. New Section 709.5 of the Illinois Income Tax Act requires withholding from nonresident partners, Subchapter S corporation shareholders and trust beneficiaries for taxable years ending on or after December 31, 2008. New Section 711(a-5) of the Illinois Income Tax Act provides that payment of the withholding is due no later than the due date (without regard for extensions) of the taxpayer's Illinois income tax return for the taxable year for which the withholding is made. Accordingly, the earliest date on

which withholding payments will be required will be March 15, 2009. We will provide guidance well before that time.

2. Will affected entities be required to withhold on every distribution to the nonresident partner, shareholder or beneficiary that is not covered on a composite return every time there is a periodic distribution - such as monthly or quarterly? Or will this just be an annual withholding requirement?

Response:

No withholding is required from distributions. Withholding is equal to the nonresident partner's, shareholder's or beneficiary's share of the entity's business income apportionable to Illinois for the taxable year, multiplied by the income and replacement tax rates applicable to the partner, shareholder or beneficiary, and must be paid to the Department regardless of when or if any distributions are made to the partner, shareholder or beneficiary.

3. It appears in the statute that distributions will be required to be reported to affected parties on or before January 31 of the following year; however many entities do not have their final tax calculations completed prior to the return due date for that entity. How will the regulations address this issue?

Response:

Withholding payments are due on the unextended return due date.

4. How will entities report and remit this withholding to the Department of Revenue? (What forms or mechanisms will be in place for payment and reporting?)

Response:

New forms will be developed in the course of this year.

5. Please provide any additional guidance regarding this requirement.

Response:

At the time these responses were drafted, SB 783 (which had passed both houses, and which makes some amendments to the new withholding provisions) had not yet been acted upon by the Governor.

8. Employee Classification Act

Please provide additional guidance for practitioners and employers regarding the Employee Classification Act and how employers will identify whether parties employed as independent contractors in the past should now be classified as employees or still retain their status as independent contractors.

Response:

The Employee Classification Act (Public Act 95-0026) is administered by the Department of Labor, not by the Department of Revenue. However, taxpayers and practitioners should note that the provision in Section 10 of that Act, which deems certain individuals to be "employees" even though they could properly be characterized as independent contractors for income tax purposes, expressly applies only "for purposes of this Act." In addition, Section 75 of the Act provides that, if the Department of Labor informs the Department of Revenue or another agency of a suspected violation of the Act, the Department of Revenue must "check such employer or entity's compliance with their laws, utilizing their own definitions, standards, and procedures." Accordingly, the Act does not change the classification of individuals as employees vs. independent contractors for Illinois income tax purposes.