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ILLINOIS INCOME TAXATION OF QUALIFIED PLAN DISTRIBUTIONS

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Mr. Daleiden presents a chronological analysis of the Illinois Income Tax Act from its enactment to its present status as it treats distributions from tax-qualified employee benefit plans. As a result of the "piecemeal" treatment of these distributions by both statute and case law, he reveals that only 1971-plan distributions, representing benefits attributable to post 1969-plan years, are subject to income taxation. Consequently, the author urges that the Illinois legislature reconsider the previously rejected proposed amendatory legislation which would eliminate this discriminatory result.

INTRODUCTION

HISTORICALLY, the treatment of distributions from tax-qualified employee benefit plans¹ under the Illinois Income Tax Act² has been relatively chaotic. Although the Illinois Act became effective on August 1, 1969, only recently has a fairly comprehensive analysis of the tax status of qualified plan distributions under the Act become possible. This article presents a history of the tax status of such distributions under Illinois law, investigates current developments, and concludes with a chronological summary of the Illinois income tax status of plan distributions.

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1. The term "tax-qualified employee benefit plans" generally refers to those plans that meet the requirements of section 401 of the Internal Revenue Code of 1954, the most important of which, perhaps, is the requirement relating to nondiscrimination in coverage and contributions or benefits. INT. REV. CODE of 1954, § 401. Distributions under tax-qualified employee benefit plans normally are governed by INT. REV. CODE of 1954, §§ 402(a) and 403(a). It should be noted that the Illinois income tax rules discussed in this article also are generally applicable in connection with certain types of other employee benefit plan distributions. For instance, the rules apply in connection with distributions from tax-sheltered annuity plans governed by INT. REV. CODE of 1954, § 403(b).

2. ILL. REV. STAT. ch. 120, §§ 1-101 to 17-1701 (1971).

1969 and 1970 Developments

The Illinois Department of Revenue, which has general rule-making power under the Act,³ initially determined that the entire amount distributed under a qualified employee benefit plan after July 31, 1969 would be subject to Illinois income tax to the extent it exceeded an employee's own contributions.⁴ The Department of Revenue took this position with respect to all types of plan distributions, including total or lump sum distributions which are "deemed capital assets" under sections 402(a)(2) and 403(a)(2) of the Internal Revenue Code of 1954. It is interesting that the Department maintained its position even after the Illinois Supreme Court, in *Thorpe v. Mahin*,⁵ decided that, in computing the "Illinois gain" on property acquired prior to August 1, 1969, the "Illinois basis" of the property would be its value on the date of acquisition or August 1, 1969, whichever was greater. The concept of an "August 1, 1969 valuation limitation" is generally applicable to taxpayers when computing the "Illinois gain" resulting from the disposition of certain types of property acquired before that date.⁶

The Department of Revenue's position was originally contested before the Circuit Court of Cook County in *Mitchell v. Mahin*.⁷ In *Mitchell*, the plaintiffs argued that an amount equal to the July 31, 1969 value of an employee's interest in a benefit plan should be recoverable free of Illinois income tax when the

3. ILL. REV. STAT. ch. 120, § 14-1401 (1971).

4. The Department, for instance, advocated this position in *Mitchell v. Mahin*, 51 Ill.2d 452, 283 N.E.2d 465 (1972), cert. denied, 409 U.S. 982 (1972).

5. 43 Ill. 2d 36, 250 N.E.2d 633 (1969). The taxpayers brought an action for declaratory judgment that the Illinois Income Tax Act approved July 1, 1969, was constitutionally invalid. They further sought an injunction to restrain state revenue authorities from collecting any tax under the act and from expending any monies for that purpose. The Supreme Court held, *inter alia*, that the Illinois General Assembly had the power to impose the income tax and that the tax was not a property tax, which would be subject to the limitations imposed by article IX of the Illinois Constitution.

6. ILL. REV. STAT. ch. 120, § 2-203 (Supp. 1972), amending ILL. REV. STAT. ch. 120, § 2-203 (1971).

7. Civil No. 69 L 17526 (Cir. Ct. Cook County, Dec. 31, 1970). Five taxpayers brought suit for declaratory judgment that the Illinois Department of Revenue had incorrectly construed the *Thorpe* opinion in limiting the applicability of the "August 1, 1969 valuation limitation" to capital assets, as defined in section 1221 of the Internal Revenue Code.

employee later receives a plan distribution or distributions. On December 31, 1970, the circuit court decided in favor of the plaintiffs. However, in entering its final order on January 19, 1971, it limited the application of its decision to the specific plaintiffs involved in *Mitchell* until the Illinois Supreme Court finally determined the matter.

Because the circuit court limited its decision in *Mitchell* to the plaintiffs in that case while authorizing the Department of Revenue to enforce its determination pending ultimate disposition of the case, an employee who received a distribution in 1970 generally had three options in reporting his Illinois income tax liability:

- (a) He could have reported his entire distribution as being taxable under Illinois law as though *Mitchell* had not been decided. If, as later happened, *Mitchell* were affirmed by the Illinois Supreme Court, he then would become entitled to a refund of the Illinois tax he paid on the distribution plus statutory interest.
- (b) He could have reported his distribution as though *Mitchell* would be affirmed on appeal. If, however, *Mitchell* were reversed by the Illinois Supreme Court, he then would owe additional tax plus statutory interest. In such an instance, it also was conceivable that the Department of Revenue might impose a penalty tax.
- (c) He could have requested the Department of Revenue to grant him an extension of time for filing his 1970 Illinois income tax return.⁸ The *Mitchell* litigation, however, did not end until November 6, 1972 when the United States Supreme Court denied *certiorari*.⁹ If an Illinois taxpayer availed himself of this option, his Illinois tax status for 1970, and possibly 1971, would have remained uncertain for sometime.

Obviously, because of the uncertainty existing at the time Illinois taxpayers were preparing their 1970 returns, none of these options was entirely satisfactory.

8. The Department of Revenue permitted certain taxpayers who would be affected by the outcome of *Mitchell* to request extensions of time for filing their Illinois income tax returns. 1 CCH STATE TAX REP., ILL. ¶ 16-055 (1971).

9. 409 U.S. 982 (1972).

1971 Developments

Effective for taxable years beginning after 1970, the Illinois Income Tax Act was amended to provide, in general, that plan distributions would be taxable only to the extent they included benefits accrued during plan years beginning on or after August 1, 1969 (the effective date of the Act).¹⁰ Toward the end of 1971, the Illinois Department of Revenue promulgated proposed, and somewhat complex, regulations in order to explain the provisions of the amendment.¹¹ The theory of the regulations, as applied to a specific plan distribution, was to establish a certain dollar amount that would escape Illinois income taxation and tax only amounts received in excess of such amount.

The proposed regulations focused on distributions made during taxable years beginning after 1970 from plans that were in effect prior to August 1, 1969. Except with respect to plan distributions that included employer securities, retirement bonds, and annuity contracts, these regulations generally did not apply to distributions made between July 31, 1969 and January 1, 1970, nor to distributions made during taxable years that began in 1970. The Illinois Supreme Court's decision in *Mitchell*, discussed below, determined the tax status of those distributions that were not covered by the regulations.

Under the regulations, plan distributions made during taxable years beginning after 1970 because of an employee's termination of employment on or before the last day of the last plan year beginning *before* August 1, 1969 (such day was termed the "valuation date"), were not subject to Illinois income taxation. If plan benefits were distributed during taxable years beginning after 1970 because of an employee's termination of employment after the valuation date, the amount of such benefits that represented an employee's own contributions and those benefits in excess of an employee's contributions that were accrued through the valuation date (regardless of the extent to which they were then vested) were excluded from income for purposes of the Illinois Act.

10. ILL. REV. STAT. ch. 120, § 2-203 (Supp. 1972), amending ILL. REV. STAT. ch. 120, § 2-203 (1971).

11. The proposed regulations are reprinted and discussed in PRENTICE-HALL, INC., TAXING ILLINOIS PENSION AND PROFIT SHARING PAYOUTS (1972).

The proposed regulations also contained formulae for allocating a portion of the excludable amount to employer securities, retirement bonds, and annuity contracts included in a qualified plan distribution. If any such security or bond was disposed of by a distributee, a portion of any taxable gain (*i.e.*, the part of any such gain in excess of the amount allocated to the asset) would escape Illinois income taxation. Likewise, with respect to amounts received under an annuity contract included in a plan distribution, a certain dollar amount of payments would be recoverable under the contract before any Illinois income tax would be payable.

1972 Developments

During 1972, two significant simplifying developments occurred relating to the Illinois income taxation of qualified plan distributions. On April 17, 1972, the Illinois Supreme Court affirmed the decision of the Circuit Court of Cook County in *Mitchell v. Machin*;¹² on July 17, 1972, the Illinois legislature amended the Illinois Income Tax Act so that qualified plan distributions made during 1972 and later tax years would be excluded from income for purposes of the Illinois Income Tax Act.¹³

Although the Illinois Supreme Court's decision in *Mitchell* could have been interpreted by the Department of Revenue merely to permit a distributee to recover his July 31, 1969 plan interest free of Illinois tax, the Department, by Information Bulletin dated November 27, 1972,¹⁴ extended the *Mitchell* decision so that *no portion of any plan distribution* made during the 1969 and 1970 tax years would be subject to the Illinois income tax. Furthermore, the Information Bulletin permitted Illinois taxpayers to file refund claims on Form IL-843 with respect to 1969 and 1970 distributions. It should be noted that refund claims for 1969 must have been filed no later than April 16, 1973 and refund claims for 1970 must be filed no later than April 15, 1974.¹⁵ The In-

12. 51 Ill.2d 452, 283 N.E.2d 465 (1972), *cert. denied*, 409 U.S. 982 (1972).

13. ILL. REV. STAT. ch. 120, § 2-203 (Supp. 1972).

14. Bulletin No. ITIB 1972-4, 1 CCH STATE TAX REP., ILL. ¶ 16-019 (1972).

15. Under the Illinois Income Tax Act, a refund claim for a particular year generally may not be filed later than three years after the due date of the income tax return for such year. ILL. REV. STAT. ch. 120, § 9-911 (1971).

formation Bulletin did *not* make any provisions for refunds with respect to 1971 distributions inasmuch as the taxability of such distributions is governed by the 1971 Illinois Income Tax amendment and regulations discussed above.

As previously stated, the Illinois Income Tax Act was further amended in 1972 to completely exclude plan distributions made during 1972 and later tax years from Illinois income taxation. With respect to plan distributions of employer securities, the Department of Revenue has interpreted the 1972 amendment as follows:

- (a) If, in connection with the distribution of employer securities, the distributee is informed as to the market value of the securities distributed as of the distribution date, the distributee should consider such market value as his "Illinois basis" in the securities when computing his "Illinois gain" upon their disposition.
- (b) If the distributee is not informed as to the market value of the securities as of the distribution date and if the securities are traded on a national exchange, the distributee should consider his "Illinois basis" in the securities distributed as their closing price on the date of distribution. Special rules apply if the securities are not traded on a national exchange.
- (c) If, after distribution, additional securities are received as a result of stock splits or dividends, the distributee's "Illinois basis" in the original securities distributed should be apportioned among the original and additional securities.¹⁶

The Department also has indicated that, under the 1972 amendment, no amounts received pursuant to an annuity contract distributed in 1972 or later tax years are subject to Illinois income tax.

The proposed regulations issued under the 1971 Illinois income tax amendment referred to above required an employer maintaining a qualified plan to communicate (or cause to be communicated), in writing, to each Illinois resident receiving a plan distribution after the "valuation date", as well as to the Illinois Department of Revenue, certain information describing the elements of the distribution. As a concomitant to the 1972 developments discussed above, employers were relieved of these burdensome reporting requirements with which they had to comply for 1971

16. This interpretation is found on the reverse side of 1972 Illinois Income Tax Form IL-4644.

distributions. Beginning with 1972 tax years, the Illinois income tax forms (in particular, Form IL-1040, Schedule F thereto, and Form IL-4644) place the burden of accurately reporting plan payments on distributees. In this regard, it is noted that the Illinois forms appear to be relatively complete and easy to follow.

1973 Developments

During the first six months of 1973, the Illinois legislature considered House Bill 655,¹⁷ introduced by Representative John Porter of the First District of Cook County. The purpose of House Bill 655 was to eliminate 1971 qualified plan distributions from Illinois income taxation and thereby permit refund claims to be filed with respect to such distributions.

Under the *Mitchell* decision, as interpreted by the Illinois Department of Revenue, distributions made from qualified plans during 1969 and 1970 tax years are not subject to Illinois income tax.¹⁸ Furthermore, the 1972 amendment to the Illinois Income Tax Act generally excludes 1972 and later distributions from Illinois income taxation. Therefore, *only* 1971 distributions remain subject to tax. House Bill 655, which was not passed by the Illinois legislature, would have eliminated this discriminatory result.

In general, the Illinois Income Tax Act, as in effect for 1971 and as interpreted by the Illinois Department of Revenue, subjects 1971-plan distributions to Illinois income taxation to the extent that they represent benefits attributable to post-1969 plan years. Thus, if a distribution were made in 1971, 1970 and 1971 plan benefit accruals would be subject to tax. However, as discussed above, a 1970 benefit accrual would not have been subject to tax if it were paid in 1970. Also, neither 1970 nor 1971 benefit accruals would be subject to tax if they were included in a plan distribution made after 1971. The "accident" of imposing a tax on 1970 and 1971 benefit accruals included in 1971 plan distributions seems to be somewhat unreasonable.

The Illinois Department of Revenue, in its November 27, 1972 Information Bulletin, extended the *Mitchell* decision further than

17. H.B. 655, 78th Ill. Gen. Assembly (1973).

18. Bulletin No. ITIB 1972-4, 1 CCH STATE TAX REP., ILL. ¶ 16-019 (1972).

absolutely required and, therefore, permitted refund claims in instances where such claims would not otherwise have been allowed. In view of this, and considering that probably relatively few 1971-plan distributions are involved, it is submitted that only a small administrative burden would have been placed upon the Department of Revenue if House Bill 655 had been enacted into law and if refund claims based upon it had been allowed.

The Illinois income tax laws would permit refund claims for 1971 to be filed no later than April 15, 1975. No further amendment of the Illinois Income Tax Act, therefore, would have been necessary in order to permit the filing of refund claims based upon House Bill 655 if that legislation had been enacted.

SUMMARY AND CONCLUSION

If it is assumed that a plan is maintained on a calendar year basis and plan distributees report their income on the same basis, the status of qualified plan distributions under the Illinois Income Tax Act generally may be summarized as follows:

- (a) Distributions made during the period beginning on August 1, 1969 and ending on December 31, 1970 are governed by *Mitchell*, as interpreted by the Illinois Department of Revenue. In this connection, it should be noted that if a person received a distribution during 1970 and paid an Illinois income tax with respect to such distribution, he still may be permitted to file a claim for a refund of such tax.
- (b) Distributions made in 1971 will be subject to Illinois income taxation to the extent they represent benefits accrued during plan years beginning after July 31, 1969, reduced, of course, by employee contributions.
- (c) Distributions made in 1972 and later years will not be taxed under the Illinois Act.

It is submitted that the Illinois legislature should reconsider amendatory legislation along the lines of House Bill 655 so that the discriminatory result still in effect will respect to 1971 distributions may be eliminated.