How to Repeal Illinois' Tax Preference for Retirement Income Without Taxing Retirees

*Brian L. Stocker**

In the midst of perhaps the most severe fiscal crisis the State of Illinois has ever faced, legislators are being forced to consider new laws that increase state tax revenues. One of the more contentious proposals is to repeal the state exemption for retirement income. Because repealing that exemption would mean raising retirees' taxes, the proposal is particularly unpopular. This Article analyzes Illinois' exemption for retirement income, identifies its true nature, and demonstrates that it is possible to repeal the exemption for retirement income without raising taxes on retirees.

INTRODUCTION

While Illinois politicians continue to battle over the budget and long-term solutions to the State of Illinois' fiscal ills, it appears that both Democrats and Republicans agree that additional revenues will be necessary to achieve a truly balanced budget.[1] Aside from simply raising

* Associate Counsel (Income Tax) with the Illinois Department of Revenue. The views and opinions expressed in this Article are the Author's own and do not reflect the views or opinions of the Illinois Department of Revenue.

1. *See, e.g.*, Kim Geiger, *Madigan: Raise Income Tax Rate Back to 5 Percent, for Starters*, CHI.

existing income tax rates, various legislative proposals urge the state to repeal certain tax preference items to generate additional revenue by broadening the tax base.[2] One of the preference items mentioned for repeal, albeit quietly, is the tax preference afforded to retirement income under the Illinois Income Tax Act ("IITA").[3] In contrast to federal income tax law, Illinois does not tax any part of a distribution from a qualified retirement plan.[4] Because taxing distributions from qualified plans generally requires taxing a primary source of retired persons' income, the decision to repeal the tax preference in this manner would be politically unpopular.

But it is possible to repeal the Illinois preference for retirement income without taxing distributions from qualified retirement plans. This Article describes how this may be accomplished. Part I begins with a very brief overview of the federal tax treatment of qualified retirement plans, and identifies the nature of the federal tax preference afforded such plans and their participants. Part II then provides an overview of the Illinois tax treatment of qualified plans, and discusses how Illinois provides an additional tax preference to such plans beyond that provided under federal law—in effect, Illinois provides a double tax benefit for retirement income. By identifying the nature of the additional Illinois tax preference, this Article demonstrates in Part III that a repeal is possible without taxing distributions from qualified plans. Instead, Illinois can accomplish a repeal by disallowing the deduction or exclusion for contributions to qualified plans. Part IV discusses several disadvantages

---

TRIB. (Dec. 10, 2015, 7:06 AM), http://www.chicagotribune.com/news/ct-mike-madigan-city-club-met-20151209-story.html (reporting that Illinois Speaker of the House Michael Madigan calls for raising the income tax rate applicable to individuals from 3.75 to 5 percent); Gov. Bruce Rauner, *Gov. Bruce Rauner: It's Time to Work Together to End Illinois' Budget Impasse*, ST. J.-REG. (Apr. 16, 2016), http://www.sj-r.com/opinion/20160406/gov-bruce-rauner-its-time-to-work-together-to-end-illinois-budget-impasse (calling for a mix of reforms, cost reductions, and revenue).

2. *See, e.g.*, H.B. 4300, 99th Gen. Assemb., 2015–2016 Sess. (Ill. 2015) (proposing to disallow the deductions under Internal Revenue Code ("IRC") sections 179 and 199); H.B. 295, 99th Gen. Assemb., 2015–2016 Sess. (Ill. 2015) (proposing to repeal the exemption for dividends received from foreign and domestic corporations).

3. *See* Mike Riopell, *AARP: Don't Tax Illinois Retirement Income*, DAILY HERALD (Dec. 17, 2015, 5:21 PM), http://www.dailyherald.com/article/20151217/news/151218997/ (reporting that the idea of ending the exemption for retirement income has been floated privately by some politicians and publicly by other interest groups).

4. *See* Illinois Income Tax Act, 35 ILL. COMP. STAT. 5/203(a)(2)(F) (2012) (reducing a taxpayer's adjusted gross income ("AGI") by distributions included under sections 402(a), 402(c), 403(a), 403(b), 406(a), 407(a), and 408 of the IRC). The same subtraction modification is provided to trusts and estates under section 5/203(c)(2)(H) of the Illinois Compiled Statutes. *Id.* at 5/203(c)(2)(H).

to repealing the preference by disallowing the deduction or exclusion for plan contributions. This Article concludes by noting in Part V certain advantages to repealing the preference in this manner, including not taxing retired persons.

I. FEDERAL TAXATION OF QUALIFIED PLANS

For most people, the retirement nest egg is comprised of two sources of income: the personal service income (i.e., wages or salary) that the individual saved throughout the duration of his or her working life and the investment income (i.e., interest, dividends, capital gains, etc.) generated by those savings. Under federal income tax law, wages and salary income, as well as interest, dividends, and capital gains, must ordinarily be included in "gross income," and thus are taxable, at the time the individual earns or receives the income.[5] In other words, the income is taxed currently in the year it is generated. Therefore, if an individual's retirement savings consists of a savings account at the local bank, the wage or salary income the individual contributes to the account is taxable in the year the income is received. A taxpayer is not allowed to exclude or deduct from gross income money that is deposited into a standard savings account at the local bank. The income deposited into the savings account is thus tax-paid investment. In addition, the savings account itself is not entitled to any special tax treatment; therefore, a taxpayer must include in gross income the interest income derived from the account balance at the time the bank credits the taxpayer's account. Again, the tax is applied currently for the tax year in which the interest is received. As both sources of income within the account—personal services income and interest income—are taxed currently in the year earned or received, no additional tax is imposed when the taxpayer withdraws money from the account upon retirement. The withdrawal consists entirely of previously taxed income.

The same pattern of current taxation would follow if, instead of a savings account, the taxpayer opened a brokerage account to invest in stocks and bonds. The taxpayer must include the income used to fund the account in his or her gross income and must include any interest income, dividends, or capital gains generated from securities held within the account in his or her gross income each year in which such income is

5. Section 61(a) of the IRC defines gross income to mean, "all income from whatever source derived, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, fringe benefits, and similar items; . . . (3) Gains derived from dealings in property; (4) Interest; . . . (7) Dividends." I.R.C. § 61(a) (1994). Under section 451(a) of the IRC, most individual taxpayers are required to include in gross income any item of income that is actually, or constructively received, during the year. I.R.C. § 451(a) (2015).

realized. Once again, as the two sources of income that comprise the account are taxed currently, a taxpayer does not include withdrawals from the account in gross income.

The money deposited in a savings account or a brokerage account is thus subject to arguably overly burdensome taxation, which may hinder an individual's ability to adequately save for retirement. Therefore, to facilitate and encourage retirement savings, Congress provided tax-preferred alternatives to the savings account or brokerage account.[6] Alternatives are provided both in the form of employer-sponsored deferred compensation plans as well as individual retirement accounts.[7] In each case, the tax benefit to the individual participant is an exception from the general rule of current taxation discussed above. When a taxpayer saves for retirement through a tax-preferred plan, the wage or salary income that he or she contributes to the plan is not taxed in the year such income is earned. In addition, interest, dividends, capital gains, and other investment income that those contributions generate is not taxable in the year such income is realized. Rather, taxation is deferred until these moneys are distributed to the participant upon retirement. As will be discussed and illustrated below, deferred taxation provides substantial tax benefits to the participant.

Employer-sponsored plans achieve the benefit of tax deferral when the plan satisfies all of the requirements of section 401 of the Internal Revenue Code ("IRC").[8] When a plan satisfies all of these requirements, the plan is referred to as a "qualified" plan.[9] Section 401(a) of the IRC imposes many requirements for a plan to obtain the status of a "qualified" plan, including requirements relating to participation, vesting, benefit accrual, alienation, and antidiscrimination.[10] Individuals who are not covered by an employer-sponsored plan may also save for retirement on a tax-deferred basis, as section 408 of the IRC allows for retirement savings through an "individual retirement account" ("IRA").[11] One can take advantage of the tax benefits of an IRA by establishing an account

---

6. Stanley N. Bergman & David L. Reynolds, *Plan Selection—Pension and Profit-Sharing Plans*, 350 TAX MGMT. PORTFOLIOS A-1, A-1 (2014).

7. I.R.C. §§ 401, 408 (2014).

8. *Id.* §§ 401(a), 402(a), 404(a).

9. *Id.* § 401(a); 26 C.F.R. § 1.401-1 (2015); Bergman & Reynolds, *supra* note 6, at A-9. The particular requirements for qualification under section 401(a) of the IRC are beyond the scope of this Article.

10. *See* Felicia A. Finston, *Plan Qualification—Pension and Profit-Sharing Plans*, 351-6th TAX MGMT. PORTFOLIOS A-1, A-9–A-13 (2015) (outlining the numerous requirements of a qualified retirement plan pursuant to section 401(a) of the IRC).

11. I.R.C. § 408 (2014).

that meets all of the requirements set forth in section 408 of the IRC.[12] One alternative to the conventional IRA under section 408 of the IRC is the Roth IRA that section 408A of the IRC permits an individual to establish.[13] As will be discussed in Part I.B, taxation of a Roth IRA follows a different pattern, but can be seen to provide the same tax benefit as the conventional IRA.

A. Employer-Sponsored Qualified Plans

There are two general categories of employer-sponsored qualified plans: defined contribution plans and defined benefit plans.[14] Under a defined contribution plan, an employer provides each employee with an individual account to which employer contributions are made. The defined contribution plan yields benefits for the employee based solely on the account balance at retirement.[15] The balance available for distribution upon an employee's retirement consists of the employer's contributions to the plan on the employee's behalf and the amount of investment income that those contributions generated while held in the plan.[16] Perhaps the most well-known defined contribution plan is the qualified cash or deferred arrangement, or "401k plan," as defined in section 401(k)(2) of the IRC.[17] Under a "401k plan," the participating employee elects to either have the employer make an annual contribution to his or her plan account or receive the same amount as current cash compensation.[18] Contributions to the 401k account are invested in stocks, bonds, or other securities, and the balance that exists in the account when the employee retires constitutes his or her "retirement benefit." The balance in the 401k account thus consists of the same two sources of income that comprise the balance of the savings account at the local bank or the brokerage account (i.e., the salary income that the taxpayer elects to have contributed to his or her plan account and any interest, dividends, capital gains, or other investment income generated by those contributions).[19]

12. Kathryn J. Kennedy, *IRAs*, 367-2nd TAX MGMT. PORTFOLIOS A-1, A-2 (2013).

13. I.R.C. § 408A (2014).

14. *Id.* § 414(i). *See generally* Barbara A. Butrica et al., *The Disappearing Defined Benefit Pension and Its Potential Impact on the Retirement Incomes of Baby Boomers*, 69 SOC. SEC. BULL. 1 (2009) (discussing the more traditional defined benefit pension plans and the defined contribution pension plan, which have grown in popularity).

15. Bergman & Reynolds, *supra* note 6, at A-3.

16. Butrica et al., *supra* note 14.

17. I.R.C. § 401(k)(2) (2014).

18. Bergman & Reynolds, *supra* note 6, at A-3.

19. Butrica et al., *supra* note 14.

The second category of employer-sponsored qualified plan is the defined benefit plan. A defined benefit plan does not generally provide for individual accounts, but rather consists of the employer's promise to provide a certain benefit at retirement.[20] The employer periodically contributes to the plan amounts based on the actuarially determined present value of the promised benefit (i.e., the amount that must be invested today in order to provide the promised future benefit).[21] A defined benefit plan provides for benefits based on either a fixed formula, which may be a flat dollar amount, or a specified percentage of compensation.[22] The key distinction between a defined contribution plan and a defined benefit plan is who bears the investment risk.[23] In the case of a defined contribution plan, the employee bears the investment risk because at retirement, the employee is entitled to only the account balance, whatever it may be. In the case of a defined benefit plan, the employer bears the investment risk. With a defined benefit plan, at retirement, the employee is entitled to the promised benefit. Therefore, if the investment returns are insufficient to generate an account balance necessary to satisfy the promised benefit, the employer must make additional contributions to the plan.[24]

Employee participants of employer-sponsored qualified plans, whether defined contribution or defined benefit plans, are taxed on the benefit on a deferred basis.[25] That is, employer contributions on behalf of the employee in any employer-sponsored qualified plan are generally not included in the employee's gross income for the taxable year in which they are earned.[26] Consequently, the wage or salary income that is contributed to the plan on the employee's behalf—unlike wages or salary that are currently paid to the employee in cash—is not taxable for the year it is contributed to the plan.[27] In addition, while funds are held in the

20. *Id.*

21. *Id.*

22. Bergman & Reynolds, *supra* note 6, at A-9.

23. *Id.*

24. *Id.*

25. *See supra* note 8 and accompanying text (discussing sections 401(a), 402(a), and 404(a) of the IRC and how employer-sponsored plans allow for tax deferral when the plan satisfies all the requirements promulgated in section 401). *See also infra* note 31 (discussing the timing of the employer's deduction for contributions to qualified plans).

26. I.R.C. § 402(a) (2014); Bergman & Reynolds, *supra* note 6, at A-1.

27. Note that an exclusion from gross income is the equivalent to a deduction from gross income. In other words, excluding an item of gross income from the tax base is the same as first including the item in gross income, but then allowing a deduction of the item in determining the tax base. For example, the exclusion from an employee's gross income of an employer's $5,000 contribution to a qualified plan produces the same result as allowing an individual to deduct $5,000

employer-sponsored qualified plan (i.e., during the time before an employee's retirement), the income generated from investing the contributions is likewise not included in the employee's gross income.[28] The employee-participant does not include in gross income—and therefore does not currently pay tax on—either the portion of his or her salary contributed to the account or any interest, dividends, or capital gains realized by the plan. But when the employee retires, he or she must include the distributions from the plan in his or her gross income for that year.[29] The tax on plan benefits is thus "deferred" until the taxpayer begins taking withdrawals from the account at retirement.[30] Tax deferral is the primary tax preference that Congress provided for retirement savings accomplished through qualified plans.[31]

B. Individual Retirement Accounts

The IRC permits individuals not covered by an employer-sponsored plan to establish an individual retirement account ("IRA").[32] An IRA is an account that an individual establishes with a bank or other financial institution acting as trustee.[33] To save for retirement, individuals are permitted to make contributions to an IRA up to a certain annual amount.[34] The conventional IRA, under section 408(a) of the IRC, and the Roth IRA, under section 408A of the IRC, are the two most common types of IRAs provided under the IRC.[35] The taxation of conventional IRAs follows the same basic pattern as the taxation of qualified employer-sponsored plans. A taxpayer may claim a deduction from gross income on his or her annual income tax return for contributions to a

---

contributed to an individual retirement account ("IRA"). In either case, the plan or account is funded on a "pre-tax" basis. The employee has no "tax-paid" investment in the account.

28. I.R.C. § 501(a) (2015); Bergman & Reynolds, *supra* note 6, at A-1.

29. I.R.C. § 402(a) (2014).

30. *Id.* Periodic distributions from a qualified trust are taxable to the participant under the annuity rules of section 72 of the IRC. *Id.* § 72.

31. Note that a participant in a nonqualified deferred compensation plan can also achieve deferral of tax on plan benefits, but in the case of nonqualified deferred compensation plans the employer's deduction for contributions to the plan is likewise deferred until amounts attributable to those contributions are included in the participant's gross income. *Id.* § 404(a)(5). In the case of a qualified plan, deferral is achieved because the employer may generally deduct contributions to the plan in the year made even though the employee is not currently taxed on those contributions. *Id.* § 404(a).

32. Kennedy, *supra* note 12, at A-1–A-2.

33. I.R.C. § 408 (2015).

34. *Id.* § 219. For 2017, taxpayers may contribute up to $5,500 to an IRA. In addition, taxpayers age fifty and over may make "catch-up" contributions up to $1,000. *Id.* § 219(b)(5)(B).

35. *Id.* § 408; Kennedy, *supra* note 12, at A-2.

conventional IRA.[36] As a result, contributions to an individual's conventional IRA, like employer contributions to an employer-sponsored plan, are made on a "pre-tax" basis. In addition, investment income accrued within an IRA is not included in the individual's gross income each year that income is generated.[37] But distributions from a conventional IRA must be included in gross income when they occur.[38] Accordingly, as in the case of the employer-sponsored plan, the primary tax preference provided to conventional IRAs is tax deferral.

Contrary to the taxation of conventional IRAs, the taxation of Roth IRAs follows a different pattern. First, unlike a conventional IRA, a taxpayer cannot deduct contributions to a Roth IRA from his or her gross income.[39] As contributions to a Roth IRA are not deductible from gross income, a taxpayer must fund his or her Roth IRA on a "tax-paid" basis. Second, unlike a conventional IRA, distributions from a Roth IRA are excluded from gross income. Therefore, although tax is applied up front on the income that is contributed to the Roth IRA, the funds in a Roth IRA are not subjected to further taxation thereafter. It can be seen, then, that the tax benefit provided under a Roth IRA is an exclusion from gross income, and thus from taxation, for the investment income generated within the Roth IRA account. Any interest, dividends, capital gains or other investment income generated by contributions to a Roth IRA is not taxable because distributions from a Roth IRA are excluded from gross income.

While the taxation of conventional IRAs appears very different from taxation of Roth IRAs, the two accounts enjoy the very same tax preference.[40] In fact, the tax deferral afforded to the conventional IRA produces a result that is identical to the exclusion for investment income afforded under the Roth IRA.[41] Professors Chirelstein and Zelenak illustrate this identity with an example: assume a taxpayer in the 30 percent marginal tax bracket has $5,000 of pre-tax earnings to save for retirement.[42] The taxpayer decides to use the $5,000 to (i) pay any income tax due on the year's earnings, and (ii) to use the remainder to

---

36. *See* note 26 and accompanying text (discussing how an employer's contribution on behalf of its employees in an employer-sponsored qualified plan is not taxable to the employees in that tax year). *See also supra* note 27 (discussing how an exclusion from gross income is equivalent to a deduction from gross income).

37. I.R.C. § 408(e) (2015).

38. *Id.* § 408(d).

39. *Id.* § 408A; Kennedy, *supra* note 12, at A-111.

40. MARVIN A. CHIRELSTEIN & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION 102–06 (Foundation Press, 12th ed. 2012).

41. *Id.* at 102.

42. *Id.* at 103–04.

make an IRA contribution. The annual rate of return generated by contributions to the account is assumed to be 7 percent, so that after ten years, the account balance approximately doubles. The taxpayer withdraws the entire account balance at the end of year ten. The illustration demonstrates that the taxpayer receives the same amount of money whether the earnings are contributed to a conventional IRA or a Roth IRA:

	After-Tax Contributions	**Tax Due (Years 1–9)**	**Account Balance (Year 10)**	**Tax Due (Year 10)**	**Net Balance After-Tax**
Conventional IRA	$5,000	$0	$10,000	$3,000	$7,000
Roth IRA	$3,500	$0	$7,000	$0	$7,000

Professors Chirelstein and Zelenak explain the results:

> As to [the conventional] IRA, the government and the taxpayer "own," respectively, a 30% and a 70% share in the account from the beginning. Both shares increase in value over the 10-year period. The government's claim is fully satisfied when it receives its 30% share, which has grown from $1,500 to $3,000, in year 10. The value of the taxpayer's 70% share has then grown from $3,500 to $7,000, which growth represents the investment income earned on the taxpayer's share over the 10-year period. But since the government, having received its own 30% share, makes no further claim, such investment income is entirely tax-free. As to [the Roth] IRA, the government actually takes its 30% share—$1,500— in year 0. That satisfies the government's claim, however, and it takes nothing further when the account is withdrawn. While the original value of the taxpayer's share, $3,500, increases to $7,000 by year 10, such increase is never taxed. As with [the conventional] IRA, therefore, the income earned on the taxpayer's net investment is finally received by him tax-free.[43]

As Professors Chirelstein and Zelenak illustrate—provided that the taxpayer is in the same marginal tax bracket at the time the government "takes its share" of the account (the taxable year of contribution or taxable year of withdrawal)—the taxpayer is left with the same after-tax balance accumulated for retirement.[44] In the case of the Roth IRA, the

43. *Id.* at 104.

44. *Id.* at 104–06. This can also be seen mathematically. Alicia H. Munnell, *Just the Facts on Retirement Issues: A Primer on IRAs*, CTR. FOR RETIREMENT RES. BOS. C. 1, 2 (Mar. 2003). Munnell illustrates that where "r" is the rate of return on plan assets, "t" is the individual's marginal

government collects the present value of the tax on the wage or salary income used to fund the account, whereas in the case of the conventional IRA, the government collects the future value of the tax on the income contributed to the account. In either case, the taxpayer receives the investment income that the contribution subsequently generates tax free. Consequently, the federal tax preference afforded to employer-sponsored qualified plans and IRAs provides a complete exemption from tax for investment income generated by assets held within those qualified plans or IRAs.[45]

The value of the federal preference afforded to qualified plans can be seen by comparing the after-tax return derived when the same amount is deposited into a savings account at the local bank. Using the same facts included in the table above, the amount of money received when a taxpayer deposits earnings into a savings account is significantly less:

	After-Tax Contributions	Tax Due (Years 1–9)	Account Balance (Year 10)	Tax Due (Year 10)	Net Balance After-Tax
Savings account	$3,500	$807	$5,383	$113	$5,647

The amount deposited into a savings account may not be deducted from the taxpayer's gross income. In addition, the interest income that the bank credits to the account is currently taxed each year. As a result, the after-tax balance available at the end of year ten is only $5,647, compared to $7,000 when the same amount is contributed to either a conventional or Roth IRA.

II. ILLINOIS TAXATION OF QUALIFIED PLANS

In Illinois, the tax base for income tax purposes is first determined by

tax rate, and "n" is the number of years, $1,000 invested in a conventional IRA yields an after-tax value of: (1-t) $1,000 $(1+r)^n$. *Id.* The same $1,000 invested in a Roth IRA yields an after-tax value of: $(1+r)^n$ (1-t) $1,000. *Id.* Because multiplication is commutative, the equations are identical. Thus, assuming the same tax rate applies at the time of contribution and the time of withdrawal, the after-tax results are identical. As Munnell discussed, several legal differences exist between the regular IRA and Roth IRA. *Id.* at 2–3. The primary differences relate to the eligibility criteria and contribution limits. Regarding contribution limits, because the Roth IRA provides for after-tax contributions, the limitation on amounts that may be contributed to a Roth IRA is effectively higher than the limitation that applies to a regular IRA. *Id.*

45. The IRC now allows for nondeductible contributions to employer-sponsored deferred compensation plans. For plan years after 2005, section 402A of the IRC permits 401(k) and 403(b) plans to include a "qualified Roth contribution program." I.R.C. § 402A (2014).

an individual's adjusted gross income ("AGI"), as reported for federal income tax purposes under the IRC.[46] Various statutorily prescribed addition and subtraction modifications then modify the AGI.[47] Generally, addition modifications apply to items of income that are excluded or deducted from the taxpayer's AGI, but which the Illinois legislature has determined should be taxable for Illinois purposes, or to items of deduction that are allowed in computing federal AGI, but for which the Illinois legislature has determined should not be allowed for Illinois purposes. In either case, addition modifications increase the Illinois income tax base. For example, interest income derived from state and local government bonds that is excluded from federal AGI pursuant to section 103 of the IRC must be added to Illinois base income as an addition modification.[48] Subtraction modifications apply to items of income that are included in federal AGI, but for which the Illinois legislature has determined should be excluded from Illinois income, or to items of deduction that are disallowed in computing federal AGI, but for which the legislature has determined should be deductible for Illinois purposes. In either case, subtraction modifications reduce the Illinois tax base. For example, social security benefits that must be included in federal AGI pursuant to section 86 of the IRC are subtracted from AGI for purposes of computing Illinois income as a subtraction modification.[49] The application of these modifications to AGI yields the taxpayer's "base income." In the case of an Illinois resident, base income—after the reduction for personal and dependency exemptions—is the base upon which the current tax rate of 3.75 percent is applied to determine the taxpayer's liability.[50] The 3.75 percent rate is a flat rate, as the Illinois Constitution mandates that any tax upon income must be at a nongraduated rate (i.e., the rate of tax may not increase for higher levels

46. 35 ILL. COMP. STAT. 5/203(e) (2012).

47. *Id.* at 5/203(a).

48. *Id.* at 5/203(a)(2)(A). As another example, section 203(a)(2)(D-15) of the Illinois Income Tax Act ("IITA") requires an individual to make an additional modification for the amount of the bonus depreciation allowed to the taxpayer under section 168(k) of the IRC. *Id.* at 5/203(a)(2)(D-15).

49. *Id.* at 5/203(a)(2)(L). As another example, section 203(a)(2)(M) of the IITA allows a subtraction modification for amounts disallowed as a deduction for federal income tax purposes under sections 171(a)(2), 265, 280C, 832(b)(5)(B)(i), and 45G(e)(3) of the IRC. *Id.* at 5/203(a)(2)(M).

50. *Id.* at 5/202. In addition, certain credits are allowed that may reduce the liability otherwise determined. For example, section 208 of the IITA allows a credit against the income tax equal to 5 percent of the real property taxes paid by the taxpayer during the taxable year on his or her principal residence. *Id.* at 5/208.

of income).[51]

Therefore, absent a modification, any federal income tax preference that applies in determining a taxpayer's AGI applies automatically in determining the taxpayer's Illinois base income. Consequently, like federal law, Illinois does not tax investment income earned within qualified plans and IRAs. This preference is attained simply by incorporating federal AGI as the starting point in computing Illinois base income, and by not modifying the federal treatment. Therefore, the federal tax benefits that individuals retrieve from employer-sponsored qualified plans and IRAs are similarly accomplished in Illinois.

But Illinois does not stop there: the Illinois Income Tax Act ("IITA") extends an *additional* tax preference to retirement income. This preference is a subtraction modification that applies to distributions from qualified employer-sponsored plans and conventional IRAs.[52] For purposes of computing Illinois base income, section 203(a)(2)(F) of the IITA allows taxpayers to subtract from federal AGI distributions from qualified plans and conventional IRAs. Accordingly, while federal income tax law provides for only *tax deferral*, under the IITA, tax is *entirely forgiven*. That is, federal law allows for pre-tax contributions and investment income to accrue tax free, but a taxpayer must include in gross income the plan distributions when they are received upon retirement. In Illinois, however, nothing is ever included in base income. By using federal AGI as the starting point, Illinois allows for the same pre-tax contributions and tax-free investment income as under federal law, while the subtraction modification under section 203(a)(2)(F) of the IITA allows taxpayers to avoid tax at the time of distribution as well.

Interestingly, the legislative intent underlying the enactment of the subtraction modification for qualified plan distributions appears to have

---

51. ILL. CONST. of 1970, art. IX, § 3(a).

52. Section 203(a)(2)(F) of the IITA allows a taxpayer to subtract, to the extent included in AGI, the following:

> An amount equal to all amounts included in [AGI] pursuant to the provisions of sections 402(a), 402(c), 403(a), 403(b), 406(a), 407(a), and 408 of the [IRC], or included in [AGI] as distributions under the provisions of any retirement or disability plan for employees of any governmental agency or unit, or retirement payments to retired partners, which payments are excluded in computing net earnings from self-employment by Section 1402 of the Internal Revenue Code and regulations adopted pursuant thereto.

35 ILL. COMP. STAT. 5/203(a)(2)(F) (2012). The list of IRC citations contained in section 203(a)(2)(F), other than the citation to section 1402 of the IRC, are to subchapter D of the IRC, entitled "Deferred Compensation, etc.," which, as discussed above, generally requires that distributions from a qualified plan or IRA be included in gross income. Note that the IITA does not extend an additional tax preference to Roth IRAs. *See infra* notes 65–68 and accompanying text (explaining why the subtraction modification does not apply to Roth IRAs).

had nothing to do with the idea of extending an additional tax preference to retirement income. The subtraction modification for distributions from qualified plans was originally enacted under Public Act 77-669, effective for tax years beginning after December 31, 1970. This legislation was in response to the 1969 Illinois Supreme Court's decision in *Thorpe v. Mahin*.[53]

The taxpayer in *Thorpe* sought a declaratory judgment that the IITA, as originally adopted under Public Act 76-261, violated various provisions of the Illinois and federal constitutions rendering the tax invalid.[54] Public Act 76-261, as originally approved on July 1, 1969, expressly provided that the income tax shall operate prospectively, beginning August 1, 1969.[55] One of the arguments the taxpayer made against the tax was that if the IITA applied "to the realization of increased value of capital assets accruing prior to August 1, 1969, [the taxpayer] would be deprived of due process of law and be denied equal protection of the law."[56] In other words, the taxpayer argued that it was unconstitutional for Public Act 77-261 to include, in base income, gain from the sale of property attributable to appreciation in value that accrued economically prior to the August 1, 1969 effective date of the tax law.

For both federal and Illinois—given that AGI is the starting point for Illinois base income—income tax purposes, mere appreciation in the value of a capital asset does not become "gross income" for tax purposes until that appreciation in value is "realized" by means of a sale or other disposition of the asset.[57] Accordingly, the taxpayer argued that a sale or other disposition of a capital asset occurring after the effective date of the IITA may not result in taxable income to the extent the taxpayer's gain on that sale may be traced to appreciation in value that occurred prior to August 1, 1969. The court never actually addressed the merits of this argument, because it determined that, though not clearly stated, the legislature did not intend the IITA to apply to appreciation in value occurring prior to August 1, 1969. More precisely, the court found that the IITA did not intend to have a taxpayer's Illinois base income increase

53. *See generally* Thorpe v. Mahin, 250 N.E.2d 633 (Ill. 1969) (holding that by enacting IITA, the Illinois legislature did not intend to increase an Illinois taxpayer's base income as a result from appreciation value accruing prior to August 1, 1969).

54. *Id.* at 634.

55. *Id.* at 640.

56. *Id.*

57. I.R.C. § 1001 (1993). There are exceptions to this rule. For example, under section 475 of the IRC, a dealer in securities must "mark to market" (i.e., value on the last day of the taxable year) certain securities it owns, including shares of stock in a corporation. *Id.* § 475. Accordingly, a securities dealer must include in gross income any appreciation in the value of those securities. *Id.*

due to appreciation in value accruing prior to August 1, 1969.[58]

Following the *Thorpe* decision, the Illinois General Assembly clarified its position in Public Act 77-669 by enacting two similarly purposed subtraction modifications.[59] First, it enacted a subtraction modification that allowed taxpayers to subtract "pre-August 1, 1969 appreciation amounts" in computing Illinois base income.[60] Second, the General Assembly enacted the subtraction modification for distributions from qualified retirement plans.[61] In its original form, the subtraction applied to qualified plan distributions, but only to the extent the distribution was attributable to benefits accrued during plans years beginning prior to the August 1, 1969 effective date of the IITA.[62]

The statute also instructed the Illinois Department of Revenue to promulgate regulations to identify that portion of a distribution that may be traced to benefits accrued to the participant for plan years beginning prior to August 1, 1969, and that portion of a distribution attributable to benefits accrued to the participant for plan years beginning on and after August 1, 1969. The former qualified for the subtraction modification, and the latter was taxable. Similar to the valuation limitation, the

---

58. *Thorpe*, 250 N.E.2d at 642 ("In holding the legislative intent to be that the August 1, 1969, value of property acquired before August 1, 1969, should be used in the computation of gains or losses on the subsequent disposition of that property, we simply mean that the value on that date should be used as a limitation upon the amount of gain or loss that would be computed under the [IRC]. Thus, the August 1, 1969, value cannot be used to increase either the taxable gain or the deductible loss, but it can be used to decrease the taxable gain or deductible loss, on the property acquired before that date as computed under the [IRC] upon subsequent sale or exchange of the property.").

59. 1971 Ill. Pub. Act 77-669 (codified in 35 ILL. COMP. STAT. 5/203 (1971)) (articulating that Illinois Public Act 77-669 also enacted a subtraction modification for any amounts that are exempt from taxation by reason of the Illinois Constitution, or by reason of the United States Constitution, statutes, and treaties).

60. 35 ILL. COMP. STAT. 5/203(f) (1971). The "valuation limitation amount" is defined under the IITA as the sum of (i) the pre-August 1, 1969 appreciation amounts (to the extent consisting of gain reportable under sections 1245 and 1250 of the IRC) for all property for which such gain was reported for federal income tax purposes for the taxable year, plus (ii) the lesser of the total pre-August 1, 1969 appreciation amounts for all property in which capital gain was reported for the taxable year for federal income tax purposes or the net capital gain for the taxable year. *Id.* 5/203(f)(1).

61. 1971 Ill. Pub. Act 77-669 (codified in 35 ILL. COMP. STAT. 5/203 (1971)).

62. *Id.* In its original form, the IITA provided a subtraction modification for:

> an amount equal to all amounts included in [federal AGI] pursuant to the provisions of sections 402(a), 402(c), 402(d), 403(a), 403(b), 405(d), 406(a), and 407(a) of the Internal Revenue Code, but only to the extent such amount is determined, under regulations prescribed by the Department, to be attributable to benefits accrued (whether or not vested) during plan years beginning before August 1, 1969 by or on behalf of the employee with respect to whom such amounts are received.

Id.

legislature intended to exempt from tax any retirement income that was earned or accrued prior to August 1, 1969, but that was not included in gross income for tax purposes until realized as a distribution occurring on or after August 1, 1969. But Public Act 77-2062 quickly repealed this limiting language.[63] The Illinois Senate debates on the measure indicate that the legislature was concerned with the costs to employers that would result if the portion of any given distribution must be traced to benefits accrued for plan years beginning prior to August 1, 1969.[64] An easy way out of this problem was to simply exempt from tax the entire distribution. As a result, currently under section 203(a)(2)(F) of the IITA, all distributions from qualified plans, regardless of when the benefits were earned, qualify for the subtraction.

Nearly forty-eight years after the effective date of the IITA, the subtraction modification under section 203(a)(2)(F) of the IITA has arguably outlived its original purpose. But even if the subtraction modification remains necessary to avoid taxing benefits accrued pre-August 1, 1969, the mere passage of time should have greatly diminished the tracing problem that caused the legislature to simply exempt from tax all qualified plan distributions. It seems likely that today only a small number of taxpayer claims for benefits accrued during pre-August 1, 1969 plan years would exist, thereby allowing for an administrable subtraction modification exempting only those benefits, but not benefits earned for plan years after August 1, 1969. For example, the Illinois General Assembly could amend the subtraction modification to apply only to distributions from a plan in which the taxpayer first became a participant prior to August 1, 1969. While overly broad, a subtraction along these lines would easily take care of the original concern regarding benefits earned prior to the effective date of the IITA. At the same time, however, changing the subtraction modification in this manner would be politically unpopular as it would subject many retirees to additional tax burdens.[65]

63. *See* Pub. Act 77-2062, 77th Gen. Assemb., Reg. Sess. (Ill. 1972) (removing the language "but only to the extent such amount is determined, under regulations prescribed by the Department, to be attributable to benefits accrued (whether or not vested) during plan years beginning before August 1, 1969 by or on behalf of the employee with respect to whom such amounts are received" from the statute).

64. *See* Transcript of Ill. Senate Debates at 56–59 (June 19, 1972) (offering the statements of Sen. Clarke).

65. Of course, other variations are possible to avoid impacting those individuals currently retired or nearing retirement. For example, the subtraction modification could be phased out based on the age of the taxpayer as of January 1, 2017. To illustrate, consider the following schedule:

Before further considering the subtraction modification under section 203(a)(2)(F), it is important to recognize that the subtraction does not apply to distributions from a Roth IRA. The subtraction modification under section 203(a)(2)(F), by its terms, applies *only* to the extent distributions are included in federal AGI.[66] Distributions from a Roth IRA are excluded from federal AGI under section 408A of the IRC.[67] Consequently, the subtraction does not apply to distributions from a Roth IRA. In addition, the IITA does not provide a subtraction modification for contributions to a Roth IRA.[68] As discussed above, contributions to a Roth IRA are made on a tax-paid basis, and Illinois does not modify that treatment. Therefore, the IITA simply couples onto the federal treatment by virtue of using AGI as the starting point in the computation

---

Age of Taxpayer as of January 1, 2017	% Allowable Subtraction
65 and over	100
60–64	90
55–59	80
50–54	70
45–49	55
40–44	40
35–39	30
30–34	20
25–29	10
Under 25	0

The idea here would be to base a phase out of the subtraction according to a very rough approximation of the amount of time remaining in a taxpayer's working career. This would mitigate the effect of repeal on those taxpayers who are retired or nearing retirement, as those taxpayers do not have sufficient time to increase their savings to account for the change in the tax law. Taxpayers age sixty-five or over are deemed "retired" and thus allowed the full subtraction modification. Taxpayers under age twenty-five are just entering the workforce and thus allowed no subtraction modification.

66. *But see* 35 ILL. COMP. STAT. 5/203(a)(2)(W) (2012) (allowing a subtraction modification for amounts converted from a regular IRA to a Roth IRA).

67. I.R.C. § 408A.

68. *But see* 35 ILL. COMP. STAT. 5/203(a)(2)(Y) (2012) (allowing a subtraction modification for up to $10,000 per taxable year for contributions made to certain qualified tuition programs under section 529 of the IRC). For federal income tax purposes, the tax pattern applicable to section 529 plans follows the pattern applicable to Roth IRAs: contributions are not deductible, but investment income is allowed to accrue tax-free and distributions are excluded from gross income to the extent used to pay education expenses. I.R.C § 529 (2015).

of base income. No related modifications apply.[69]

It is therefore apparent that while one may view the federal tax treatment of conventional and Roth IRAs as providing the same tax benefit (i.e., a tax exemption for investment income), the Illinois tax treatment of the two accounts differs. Illinois provides an additional tax preference to conventional IRAs beyond the tax deferral afforded under federal law. As to the conventional IRA, the combination of using AGI as the starting point in computing Illinois base income, and the subtraction modification afforded distributions under section 203(a)(2)(F) of the IITA, results in a complete exemption from tax for all income that makes up a distribution from the account—both the income that is contributed to the account and investment earnings generated from contributions.

But in the case of a Roth IRA, Illinois merely follows the federal treatment. Because there is no deduction for contributions to a Roth IRA for federal income tax purposes, and no subtraction modification for Illinois purposes, the income contributed to a Roth IRA is currently taxed in Illinois. Without repealing section 203(a)(2)(F), equalizing the treatment of the two accounts would require either an addition modification for contributions to a conventional IRA or a subtraction modification for contributions to a Roth IRA.

III. ALTERNATIVE MEANS TO REPEAL

The public discussion concerning repeal of the Illinois tax preference for retirement income has focused on repeal of the subtraction modification under section 203(a)(2)(F) of the IITA. Repeal of the subtraction would align the IITA with federal law regarding taxation of qualified plans and conventional IRAs. As discussed above, federal law already provides a tax preference for retirement savings through qualified plans.[70] Therefore, repeal of Illinois' subtraction modification would merely limit the tax preference for retirement savings to that provided under the IRC (i.e., the same treatment that Illinois law currently extends to Roth IRAs). With respect to Roth IRAs, Illinois extends only the same benefit that the IRC provides, and does not provide an additional tax preference.

Comparing Illinois' differing treatment of conventional and Roth IRAs demonstrates the true nature of the tax preference provided under section

69. *But see* 35 ILL. COMP. STAT. 5/203(a)(2)(W) (2012) (allowing a subtraction modification for amounts converted from a regular IRA to a Roth IRA).

70. *See* text accompanying notes 33–46 (discussing the details of the two most common types of individual retirement accounts: the conventional IRA and the Roth IRA).

203(a)(2)(F) of the IITA. Illinois law allows investment income generated within a qualified plan or IRA to be tax free, pursuant to its following of federal AGI, and Illinois also provides an additional tax preference under section 203(a)(2)(F) that exempts from taxation the income contributed to a qualified plan or conventional IRA. The additional preference under Illinois law is thus a tax exemption for the wages, salaries, and other personal service income with which taxpayers fund their plans. The combination of coupling onto federal AGI as the starting point in computing Illinois base income and the subtraction modification under section 203(a)(2)(F) produces a double tax benefit for qualified plans and conventional IRAs in that a taxpayer receives both sources of income that are ultimately distributed to the taxpayer upon retirement (i.e., the income contributed to the plan and the investment income that those contributions generate) tax free. Repeal of section 203(a)(2)(F) would extend Illinois' tax to the wage and salary income used to fund qualified plans and IRAs. Like the federal government, Illinois would collect the future value of the tax on such income.[71]

By identifying the precise nature of the additional Illinois preference, the Illinois legislature can now develop a way to eliminate the preference without repealing section 203(a)(2)(F). Rather than repealing section 203(a)(2)(F) to tax distributions from qualified plans, the Illinois legislature could amend the IITA to tax contributions to qualified plans and IRAs. In particular, the Illinois legislature could amend the IITA to impose an addition modification for contributions to qualified plans and IRAs that are either excluded or deducted from the taxpayer's AGI for federal income tax purposes. An addition modification for contributions to qualified plans and conventional IRAs would tax the income contributed to the plan (i.e., the same result that would be achieved by repeal of section 203(a)(2)(F)). The difference is that an addition modification would impose the tax at the time of contribution rather than at the time of distribution. Illinois would collect the present value of the tax on the wage and salary income used to fund the plan. Section 203(a)(2)(F) would remain law, thereby allowing Illinois to continue to follow the federal exemption for investment earnings on qualified plan assets. Repeal of the Illinois preference for retirement income by means of an addition modification for contributions to a qualified plan or conventional IRA would transform Illinois into a "Roth state," in which Illinois would tax all qualified plans the same as Roth IRAs.

71. It is also possible to phase out section 203(a)(2)(F) in a manner to tax the income contributed to the plan on and after a certain date. *See supra* note 65 (suggesting a phase out of the subtraction based on the age of the taxpayer as of January 1, 2017).

IV. DISADVANTAGES TO TAXING PLAN CONTRIBUTIONS

An addition modification for contributions to qualified plans and conventional IRAs presents numerous disadvantages. First, an addition modification would constitute a departure from the way plan contributions are treated for federal income tax purposes.[72] State modifications to federal AGI always impose additional administrative costs, as taxpayers must make computations and otherwise ensure compliance with state law where similar computations and compliance efforts are not required either for federal income tax purposes or in other states where the taxpayer may also be conducting business.[73]

Second, it is not clear whether an addition modification for plan contributions would be appropriate in the case of a participant of a defined benefit plan. As mentioned above, unlike a defined contribution plan, a defined benefit plan does not provide individual accounts for plan participants.[74] Moreover, as the employer bears the investment risk with respect to plan assets, investment gains and losses that those assets generate belong to the employer.[75] Even assuming it is appropriate to require an addition modification in the context of a defined benefit plan, there may be significant administrative costs incurred to determine the amount of the modification for a participant of a defined benefit plan.[76]

Finally, requiring an addition modification for plan contributions

---

72. *See supra* text accompanying notes 14–24 (discussing the two types of employer-sponsored qualified plans: defined contribution plans and defined benefit plans).

73. In addition, the enactment of one modification may necessitate the enactment of a related modification. For example, the addition modification for federal bonus depreciation under section 203(a)(2)(D-15) of the IITA necessitates the subtraction modification under section 203(a)(2)(Z) of the IITA in order to allow taxpayers a cost-recovery deduction for the bonus depreciation previously added back. This Article's proposed addition modification would likely also necessitate related subtraction modifications. For example, a subtraction modification would be necessary for amounts forfeited where the employee fails to meet the plan's vesting requirements. Despite the additional complexity that attends modifications, the Illinois legislature appears quite fond of them. In the case of an individual taxpayer, the IITA currently mandates roughly forty-three separate modifications to federal AGI to calculate Illinois base income. 35 ILL. COMP. STAT. 5/203(a)(2) (2012).

74. *See supra* text accompanying note 20 (remarking that defined benefit plans do not usually provide for individual accounts, but they consist of the employer's promise to provide a certain benefit at retirement).

75. *See supra* text accompanying notes 23–24 (noting that the difference between a defined contribution plan and a defined benefit plan is that, in the former, the employee bears the risk of investment, and, in the latter, the employer bears the risk of investment).

76. It is also possible that such treatment triggers the Employee Retirement Income Security Act of 1974 ("ERISA") and its preemption concerns. *See generally* Mark F. Sommer et al., *O Preemption, Where Art Thou? ERISA's Lost State and Local Tax Preemption*, 64 TAX LAW. 783 (Summer 2011) (discussing the application of section 514(a) of ERISA, 29 U.S.C § 1144(a) (2006), to state and local tax laws).

deprives plan participants of the flexibility to choose between the Roth-type tax pattern and the pattern under conventional IRAs, a flexibility that appears to be expanding under federal income tax law. For plan years after 2005, section 402A of the IRC permits section 401(k) plans and certain other plans to include an elective "qualified Roth contribution program."[77] An addition modification for plan contributions would force plan participants into the Roth structure for Illinois purposes. In light of these concerns, it may be the case that eliminating the Illinois tax preference for retirement income is best accomplished through repeal, in whole or in part, of the subtraction modification under section 203(a)(2)(F) of the IITA.[78]

V. ADVANTAGES TO TAXING PLAN CONTRIBUTIONS

To repeal the tax preference for retirement income, the Illinois legislature may prefer to amend the IITA to impose an addition modification rather than eliminating the subtraction modification under section 203(a)(2)(F) of the IITA for several reasons. First, it would operate only prospectively. Current retirees would be generally unaffected because section 203(a)(2)(F) would remain law. Second, this approach could generate substantial revenue while simultaneously maintaining a valuable tax preference for retirement income because Illinois would remain coupled onto the federal exemption for investment income generated by plan assets. In this regard, recall that the Illinois Constitution mandates a nongraduated rate structure.[79] One of the principal considerations for taxpayers choosing between a Roth IRA and a conventional IRA is the taxpayer's expected marginal tax rate at retirement.[80] This would generally not be a factor under the IITA because, although tax rates may be adjusted in the future, a nongraduated rate structure eliminates the possibility of a taxpayer being in a different marginal rate bracket at retirement. Because the tax rate in Illinois must be nongraduated, the same after-tax results should follow whether Illinois

77. I.R.C. § 402A (2014). *But see* Stephanie Cumings, *Republicans Discussing Going 'Fully Roth,' Practitioners Say*, TAX NOTES TODAY (May 16, 2017) (noting that congressional Republicans are discussing the possibility of removing pretax benefits from qualified plans). Interestingly, if Congress were to impose the Roth pattern of taxation, then federal law would repeal the Illinois tax preference for retirement income. *Id.* Therefore, an amendment to the IITA would no longer be necessary. *Id.*

78. *See supra* note 65 (suggesting a phase out of the subtraction based on the age of the taxpayer as of January 1, 2017).

79. *Supra* note 51.

80. *See* CHIRELSTEIN & ZELENAK, *supra* note 40 (explaining the mathematical differences between IRAs).

taxes contributions or distributions.[81] Finally, an addition modification for plan contributions would ensure that compensation earned in Illinois is taxed in Illinois. At retirement, many taxpayers are effectively taxed at 0 percent in Illinois because they have relocated to the warmer climates of other states. Federal law precludes states from taxing nonresidents on distributions from qualified plans (and certain nonqualified plans), even if the income used to fund the plan was earned within the state.[82] An addition modification for plan contributions would ensure that Illinois tax is owed on income earned in Illinois.

CONCLUSION

As the budget crisis in Illinois continues, both sides of the aisle appear willing to consider additional tax revenues in combination with reforms intended to improve the business climate and the operation of state government. Besides simply raising tax rates, legislators may also consider measures that broaden the tax base. Illinois' tax treatment of retirement income should be a prime candidate for reconsideration. This Article demonstrates that Illinois allows a double tax benefit for retirement savings by exempting not only investment earnings generated within qualified plans, but also the income with which taxpayers fund their plans. A repeal of the Illinois tax preference for retirement income by taxing contributions to qualified plans and IRAs would eliminate only one of those benefits. In the midst of perhaps the most challenging fiscal crisis in the State's history, Illinois legislators must note that merely reducing one tax-preference item without entirely eliminating it may be something worth considering. Illinois can change its tax preference for retirement income from complete exemption to partial exemption, thereby creating additional tax revenues without eliminating the tax incentives intended to facilitate retirement savings.

81. *But see supra* note 44 (illustrating mathematically how a taxpayer is left with the same balance, if in the same marginal tax bracket, whether the employer's money was invested in a conventional IRA or a Roth IRA).

82. Act of Jan. 10, 1986, Pub. L. No. 104-95, 109 Stat. 979 (codified as amended at 4 U.S.C. § 114 (1996)).