

Illinois finalizes investment partnership regulations

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In brief

What happened?

On July 11, the Illinois Department of Revenue (Department) finalized proposed regulations related to the legislative changes affecting Illinois qualified investment partnerships (QIPs) enacted in 2023. ([Section 100.9730 Investment Partnerships](#) and [Section 100.7034 Investment Partnership Withholding](#)). Since the first Notice of Proposed Rulemaking was published in December 2023, the Department has sought public comments to address this complex issue.

Why is it important?

Due to these legislative changes, which are effective for tax years ending on or after December 31, 2023, the definition of which partnerships qualify as Illinois QIPs was expanded to capture most non-operating partnerships that are treated as securities under 15 U.S.C. 77b(a)(1); however, this expanded QIP definition comes with a great deal of added complexity. The final regulations provide additional guidance and several examples to assist taxpayers in navigating these changes.

Actions to consider

Taxpayers who may be affected by these changes should examine the potential impact of the new QIP withholding tax regime, including the impact of it being considered an entity-level tax. In addition, there are new considerations for the reporting of income and the filing requirements for the partnership and its partners.

In detail

In 2023, Illinois enacted [S.B. 1963](#), which made several changes that affect investment partnerships, effective for tax years ending on or after December 31, 2023. S.B. 1963 amended the definitions of “investment partnership” and “qualifying investment securities,” thereby expanding both the asset and income tests. The 90% asset test now

includes partnerships as a qualifying security, and the 90% income test now includes partnership income from lower-tier partnership interests as qualifying income. The legislation also now requires QIPs to report and withhold Illinois-sourced income on nonresidents, including at an increased 4.95% (up from 1.5% for non-QIP withholding) QIP withholding tax rate on the QIP's partnership partners. See our [prior Insight](#) for additional details relating to this legislative enactment.

Over the past several months, the Department released filing instructions detailing the impact of the changes as well as proposed regulations with commentary, providing additional guidance relating to these legislative changes.

On July 11, the Department adopted as final the draft regulations in whole, including the addition of Example 8 that had been added in April after the original release of the draft regulations. The final regulations in general provide guidance on the complex filing requirements of QIPs and tiered partnership structures, although questions remain about certain scenarios.

The following highlights a few of the areas that may warrant additional consideration given the changes and clarifications made by the final regulations:

- **Dealers under IRC Section 475 still have limitations:** The initial legislation removed the dealer limitations for those partnerships that were subject to the IRC Section 475 mark-to-market accounting method for dealers in securities. The finalized Section 100.9730(d)(3) adds in a limitation of securities subject to IRC Section 475 accounting rules as nonqualifying assets towards the 90% qualifying assets requirement. The change still allows for entities with a mix of strategies or investments to qualify as an investment partnership by only disqualifying assets subject to IRC Section 475 versus the entire entity.
- **Withholding tax rates:** There are disparate withholding tax rates for partnership partners of non-QIPs (1.5%) and QIPs (4.95%).
- **Entity level deduction:** The state has commented that the QIP withholding is considered an entity-level tax, and thus deductible on the federal return. However, the deductibility may have additional accounting and partner impacts, such as how the QIP withholding tax is booked for the partner's capital accounts, considerations for financial statement accounting, the federal deduction for the tax paid, and associated addback modification.
- **Filing considerations:** The federal income of the QIP now will be classified and reported as nonbusiness income on the IL K-1-Ps given to the QIP's partners. Therefore, partners of a QIP are not required to file in the state if they have no other sources of non-QIP Illinois-sourced income. Additionally, if a QIP does not have withholding tax due on lower-tier income, there is no filing requirement for the QIP, similar to the prior QIP guidance for Illinois. This likely will reduce the number of returns filed by many taxpayers, but there are circumstances where a filing still may be recommended.
- **Withholding credit:** Nonresident partners are not able to claim the QIP withholding tax credits and do not have a filing obligation if they have no other sources of non-QIP Illinois-sourced income. Illinois resident partners and Illinois domiciled entities can claim QIP withholding tax credits on their Illinois state returns. This will limit the filing in Illinois for nonresidents, but also can impact offsetting losses and income from lower-tier investments, resulting in potentially more taxes paid by the partner. The regulations provide eight examples to address various scenarios for claiming withholding credits, in addition to the commentary from the second notice outlining examples of where refunds and additional tax may be owed in tiered partnership structures with a mix of entity types.

- **Residents' credit for taxes paid to other states:** Given the entity-level classification of the payment, the income related to QIPs cannot be included in the Illinois resident calculation for credit for taxes paid to other states, which will limit the credit allowed and may result in additional tax owed.
- **Pass-through entity election impact:** Since the QIP withholding is still required, even if the pass-through entity tax is elected, affected taxpayers should examine the overall impact of these changes and possible planning opportunities. Additionally, since an upper-tier partnership will receive all income from QIPs as nonbusiness, there are planning opportunities for Illinois-domiciled partnerships to consider.

Let's talk

If you have questions relating to the changes affecting QIPs in Illinois, please contact:

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