

Illinois Department of Revenue
J. Thomas Johnson, Director
101 West Jefferson Street
Springfield, Illinois 62708

INFORMATIONAL BULLETIN FY87-25 (Revised 1/88)

TO: Illinois Tax Practitioners and Taxpayers
SUBJECT: Income Exempt From Tax

This bulletin is intended to update the information in Income Tax Informational Bulletin FY87-25 (5/87).

Under Section 203 of the Illinois Income Tax Act, taxpayers are entitled to deduct in the computation of "base income" amounts which would otherwise be taxable but "which are exempt from taxation by this State either by reason of its Constitution or by reason of the Constitution, treaties or statutes of the United States"

I. INTEREST ON OBLIGATIONS OF THE UNITED STATES

A federal statute, 31 U.S.C.A. Section 3124(a), exempts from state income taxation "stocks and obligations of the United States Government", as well as "the interest on the obligation(s)."

"Obligations of the United States" are those obligations issued "to secure credit to carry on the necessary functions of government." *Smith v. Davis* (1944) 323 U.S. 111, 119, 89L. ed. 107, 113, 65 S. Ct. 157, 160. The exemption is aimed at protecting the "Borrowing" and "Supremacy" clauses of the Constitution. *Society for Savings v. Bowers* (1955) 349 U.S. 143, 144, 99 L. Ed. 2d 950, 955, 75S. Ct. 607, 608. *Hibernia v. City and County of San Francisco* (1906) 200 U.S. 310, 313, 50 L. Ed. 495, 496, 26 S. Ct. 265, 266. A governmental obligation which is secondary, indirect, or contingent, such as a guaranty of a nongovernmental obligor's primary obligation to pay the principal amount of and interest on a note, is not an obligation of the type exempted under 31 U.S.C.A. Section 312(a). *Rockford Life Ins. Co. v. Department of Revenue*, 112 Ill. 2d 174, 492 N.E. 2d 1278(1986). reh. den. June 2, 1986; U.S. App. pdng.

Tax exempt credit instruments possess the following characteristics: they (1) are written documents, (2) bear interest, (3) are binding promises by the United States to pay specified sums at specified sums at specified dates and (4) have Congressional authorization which also pledges the faith and credit of the United States in support of the promise to pay. *Smith v. Davis*, supra.

Based on the above, the following types of income are exempt under 31 U.S.C.A. Section 312(a):

- a. Interest on U.S. Treasury bonds, notes, bills, certificates, and savings bonds.

- b. Income from GSA Public Building Trust Participation Certificates: First Series, Series A through E; Second Series, Series F; Third Series, Series G; Fourth Series, Series H and I.
- c. Income from Participation Certificates in the Federal Assets Financing Trust, Series A through D, due in 1987 and 1988, and income from Participation Certificates in the Federal Assets Liquidation Trust, Series B, due in 1987, issued by the Federal National Mortgage Association as trustee (the Government National Mortgage Association is the current trustee) under 12 U.S.C.A. Section 1717(c).

Note: For more information on securities issued by the Government National Mortgage Association, see Section V.a. of this bulletin.

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II. OTHER INCOME EXEMPTED BY REASON OF OTHER FEDERAL STATUTES

Other federal statutes provide exemption from state taxation with respect to various specifically named types of income. Following is a list (intended to be exhaustive) of exempt income and the specific statutes to which each item relates:

- a. Banks for Cooperatives - Income from notes, debentures, and other obligations issued by Banks for Cooperatives (12 U.S.C.A. Section 2134).
- b. Commodity Credit Corporation - Interest derived from bonds, notes, debentures and other similar obligations issued by Commodity Credit Corporation (15 U.S.C.A. Section 713a-5).
- c. Federal Deposit Insurance Corporation - Interest derived from notes, debentures, bonds, or other such obligations issued by Federal Deposit Insurance Corporation (12 U.S.C.A. Section 1825).
- d. Federal Farm Credit Banks - Income from consolidated system-wide notes, bonds, debentures, and other obligations issued jointly, and severally under 12 U.S.C.A. Section 2153 by Banks of the Federal Farm Credit System (12 U.S.C.A. Section 2055; 12 U.S.C.A. Section 2079; 12 U.S.C.A. Section 2098; and 12 U.S.C.A. Section 2134).
- e. Federal Home Loan Banks - Interest derived from notes, debentures, bonds, and other obligations issued by Federal Home Loan Banks and from consolidated Federal Home Loan bonds and debentures (12 U.S.C.A. Section 1433).
- f. Federal Intermediate Credit Banks - Income from notes, bonds, debentures, and other obligations issued by Federal Intermediate Credit Banks (12 U.S.C.A. Section 2079).
- g. Federal Land Banks and Federal Land Bank Association - Income from notes, bonds, debentures, and other obligations issued by Federal Land Banks and Federal Land Bank Associations (12 U.S.C.A. Section 2055).
- h. Federal Savings and Loan Insurance Corporation - Interest derived from notes, bonds, debentures, and other such obligations issued by Federal Savings and Loan Insurance Corporation (12 U.S.C.A. Section 1725(e)).

- i. General Insurance Fund -
 - 1. Interest derived from debentures issued by General Insurance Fund under the War Housing Insurance Law (12 U.S.C.A. Section 1739(d));
 - 2. Interest derived from debentures issued by the General Insurance Fund to acquire rental housing projects (12 U.S.C.A. Section 1747g(g));
 - 3. Interest derived from Armed Services Housing Mortgage Insurance Debentures issued by the General Insurance Fund (12 U.S.C.A. Section 1768b(f)).
- j. Production Credit Association - Income from notes, debentures, and other obligations issued by Production Credit Associations (12 U.S.C.A. Section 2098).
- k. Puerto Rico - Interest derived from bonds issued by Government of Puerto Rico (48 U.S.C.A. Section 745).

Note: This income is not presently included in federal taxable income and therefore, is not an allowable subtraction on an Illinois income tax return.

- l. Railroad Retirement Act - Annuity and supplemental annuity payments as qualified under the Railroad Retirement Act of 1974 (45 U.S.C.A. Section 231m).

Note: Under the Railroad Retirement Act, annuity payments are not presently includible in the federal adjusted gross income of the recipient and, therefore, are not allowable subtractions on an Illinois income tax return. However, supplemental annuity payments are presently includible in the recipient's federal adjusted gross income and, therefore, are allowable subtractions.

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- m. Special Food Service Program - Assistance to children under the Special Food Service Program (42 U.S.C.A. Section 1760(e)).
- n. Student Loan Marketing Association - Interest derived from obligations issued by the Student Loan Marketing Association (20 U.S.C.A. Section 1087-2(1)).
- o. Tennessee Valley Authority - Interest derived from bonds issued by the Tennessee Valley Authority (16 U.S.C.A. Section 831n-4(d)).
- p. United States Postal Service - Interest derived from obligations issued by the United States Postal Service (39 U.S.C.A. Section 2005(d)(4)).
- q. Virgin Islands - Interest derived from bonds issued by the Government of the Virgin Islands (48 U.S.C.A. Section 1574(b)(ii)(A)).

Note: Income from Virgin Islands bonds is not presently included in federal taxable income and, therefore, is not an allowable subtraction on an Illinois income tax return.

III. ENTITIES EXEMPT FROM STATE INCOME TAX BY REASON OF FEDERAL STATUTE

The following entries are exempt from state income taxation by reason of the following federal statutes.

- a. Banks for Cooperatives (12 U.S.C.A. Section 2134);
- b. Commodity Credit Corporation (15 U.S.C.A. Section 713(a)(5));
- c. Farmers Home Administration (12 U.S.C.A. Section 1717(c)(2)(B));
- d. Federal Credit Unions (12 U.S.C.A. Section 1768);
- e. Federal Deposit Insurance Corporation (12 U.S.C.A. Section 1825);
- f. Federal Financing Bank (12 U.S.C.A. Section 2290(a));
- g. Federal Home Loan Banks (12 U.S.C.A. Section 1433);
- h. Federal Intermediate Credit Banks (12 U.S.C.A. Section 2079);
- i. Federal Land Banks and Federal Land Bank Associations (12 U.S.C.A. Section 2055);
- j. Federal National Mortgage Association (12 U.S.C.A. Section 1723(c)(2));
- k. Federal Reserve Banks (12 U.S.C.A. Section 531);
- l. Federal Savings and Loan Insurance Corporation (12 U.S.C.A. Section 1725(e));
- m. Government National Mortgage Association (12 U.S.C.A. Section 1723a(c)(1));
- n. Production Credit Associations for any year or part thereof in which stock in the Association is held by the Governor of the Farm Credit Administration (12 U.S.C.A. Section 2098);
- o. Student Loan Marketing Association (20 U.S.C.A. 1087-2(b)(2)).

IV. INTEREST ON OBLIGATIONS OF STATE AND LOCAL GOVERNMENTS

Income from state and local obligations is not exempt from Illinois income tax except where authorizing legislation adopted after August 1, 1969 specifically provides for an exemption. To date, authorizing legislation provides exemption for the income from the following securities.

- a. Illinois Housing Development Authority bonds and notes (Ill. Rev. Stat., 1979, Ch. 67 1/2, Par. 331).
- b. Illinois Development Finance Authority bonds, notes, and other evidence of obligation (Ill. Rev. Stat., 1984, Ch. 48, Par. 850.07.z17).

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- c. Quad Cities Regional Economic Development Authority bonds and notes (P.A. 85-713, effective September 22, 1987).
- d. "College Savings Bond", general obligation bonds issued by the Baccalaureate Trust Authority (P.A. 85-939, effective December 2, 1987).

V. INCOME NOT EXEMPT FROM ILLINOIS TAXATION

The following types of income are not exempt from Illinois income taxation:

- a. Income from securities commonly known as GNMA "Pass-Through Securities" and also known as "GNMA "Mortgage-Backed Securities" issued by approved issuers under 12 U.S.C.A. Section 1721(g) and guaranteed by GNMA under 12 U.S.C.A. 1721(g). *Rockford Life Insurance Co. v. Department of Revenue*, 112 Ill. 2d 174, 492 N.E. 2d 1278 (1986), reh. den. June 2, 1986; and income from debentures, notes, and bonds issued by the Federal National Mortgage Association including mortgage-backed bonds issued under authority of 12 U.S.C.A. Section 1719(d) and guaranteed by GNMA under 12 U.S.C.A. Section 1721(g).
- b. Accumulated interest on Internal Revenue Service tax refunds. Illinois Department of Revenue Letter Ruling No. 86-0640, dated July 11, 1986, citing *Gidden Co. v. Glander*, 151 Ohio St. 344, 86 N.E. 2d 1, 9 A.L.R. 2d 515 (1949).
- c. Distributions from regulated investment companies (mutual funds), even those that invest exclusively in U.S. securities. Numerous Illinois Department of Revenue Letter Rulings including No. 86-0735, dated September 30, 1986, citing *Andras v. Department of Revenue*, Kane County Circuit Court, Gen. No. 85-TX-381, decided May 22, 1986.

Note: On March 31, 1987, the Second District Appellate Court (No.86-535) reversed the decision of the Kane County Circuit Court in *Andras* regarding taxation of distributions from mutual funds investing exclusively in U.S. securities. The Illinois Supreme Court denied the Department's petition for leave to appeal on October 5, 1987. The Department is appealing the case to the United States Supreme Court.

- d. Income from U.S. securities acquired by a taxpayer under a repurchase agreement ("repo") with a bank or similar financial organization. The Department takes the position that, for income tax purposes, such agreements are generally to be treated as loans. That is, the taxpayer "loans" money to the bank and receives interest in return. The securities subject to repurchase by the bank serve as collateral for the loan. The bank remains legally entitled to receive the interest payments from the issuing authority and remains the actual owner of the securities. Therefore, any tax benefit attributable to the "exempt" income paid by the issuing authority accrues to the bank and not to the investor."

VI. LIMITATION ON THE SUBTRACTION OF EXEMPT INCOME

The Department emphasizes that Section 203 of the Act permits the subtraction of items of exempt income only to the extent those items would otherwise be included in base income. For example, a railroad retirement pension (or in most cases a social security pension) would not be included in an individual's federal adjusted gross income. It would, therefore, not be included in base income. Consequently, the amount of the pension should not be subtracted from base income. On the other hand, interest on U.S. Treasury notes would be included in an individual's federal adjusted gross income and thus would be part of base income. This should then be subtracted to eliminate it from the Illinois tax base.

VII. INQUIRIES/LETTER RULINGS

Any inquiries or letters regarding income exempt from tax should be

directed to:

Income Tax Legal Division
Illinois Department of Revenue
101 West Jefferson Street
Springfield, Illinois 62794
Phone: 1 217 785-8256

Roger D. Sweet,
Director of Revenue

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