

IT 10-04

Tax Type: Income Tax

Issue: Withholding Tax – Nonqualified Deferred Compensation Plan

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

JOHN & JANE DOE,)	Docket No.	09-IT-0000
)	Tax Years	2004-2005
)		
v.)		
THE DEPARTMENT OF REVENUE)	John E. White,	
OF THE STATE OF ILLINOIS)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: Thomas J. Dwyer, Thomas J. Dwyer & Associates, appeared for John & Jane Doe; Jessica Arong O’Brien, Special Assistant Attorney General, appeared for the Illinois Department of Revenue.

Synopsis:

This matter arose after John & Jane Doe (Taxpayers) filed amended Illinois income tax returns to request a refund of income tax that was withheld and paid over to Illinois regarding calendar years 2004 and 2005. The Illinois Department of Revenue (Department) denied those amended returns, and Taxpayers protested those denials. In a pre-hearing order, the parties agreed that the issue was whether income John Doe received as distributions from a non-qualified deferred compensation plan was subject to taxation under the Illinois Income Tax Act (IITA) for tax years ending December 31, 2004 and December 31, 2005.

The hearing was held at the Department’s offices in Chicago, Illinois. The parties verbally agreed to certain stipulations of fact. The Department also offered into evidence a copy of its denials of Taxpayers’ amended returns, as well as other evidence. Counsel for the parties also made opening statements and closing arguments. After considering

the factual stipulations, evidence, and the parties' arguments, I recommend that the matter be resolved in favor of the Department.

Stipulations & Findings of Fact:

1. During calendar years 2004 and 2005, Taxpayers were non-residents of Illinois. Hearing Transcript (Tr.) pp. 13-15.
2. Prior to 2004, and at least from 1999 through 2003, Taxpayers were Illinois residents. *Id.*
3. The income at issue was distributed to John Doe (Doe) in the form of deferred compensation that was paid out during 2004 and 2005, but which was earned from work Doe performed when he was an Illinois resident. *Id.*; Department Exs. 2-3 (respectively, copies of 2004 and 2005 W-2 forms showing Illinois taxes withheld by the payor regarding distributions to Doe, and showing payments recorded in box 11 of form, under heading "Nonqualified plans").
4. The payor of the income, Bank of America, withheld Illinois income tax from the distributions regarding 2004 and 2005 (Department Exs. 2-3), and Taxpayers' original returns reported the distributions as being allocable to Illinois. *See* Department Ex. 1.
5. Taxpayers' amended returns sought a refund of the tax withheld by the payor, because Illinois income tax was withheld in error. *See* Department Ex. 1.

Conclusions of Law:

When a taxpayer seeks to take advantage of deductions, credits or other tax benefits allowed by statute, the burden of proof is on the taxpayer. Balla v. Department of Revenue, 96 Ill. App. 3d 293, 296, 421 N.E.2d 236, 238 (1st Dist. 1981). Section 909 of

the IITA authorizes the payment of refunds to a taxpayer that has overpaid its Illinois income tax liabilities. 35 ILCS 5/909. Here, Taxpayers claimed a refund of tax previously paid over to the Department, as a result of income tax having been withheld by the payor regarding distributions from a nonqualified deferred compensation plan. Department Exs. 1-3. Therefore, Taxpayers have the burden of proof. Balla, 96 Ill. App. 3d at 296, 421 N.E.2d at 238.

Both parties refer to the applicable Illinois Income Tax Regulation (IITR) for their respective arguments. That IITR, § 100.3120(b), provides, in pertinent part:

b) Compensation paid for past service

1) A federal law, P.L. 104-95 (4 USC 114), which applies to amounts received after December 31, 1995, limits the power of states to impose income taxation on certain nonresident pension income. This limitation also impacts income received by a nonresident in the form of distributions from many deferred compensation plans. The allocation of distributions to nonresidents from deferred compensation plans which are not governed by that law and which are potentially income taxable in this State is governed by this subsection (b)(1). ***

86 Ill. Admin. Code § 100.3120(b)(1).

The beginning of IITR § 100.3120(b)(1) is especially relevant here. Within the express terms of this applicable regulation, the Department acknowledges that 4 U.S.C. § 114 limits the power of states to impose income tax on certain nonresident pension income, and that it also impacts income received by a nonresident in the form of distributions from many deferred compensation plans. *Id.* The Department further recognizes that, whether pension income received by a nonresident constitutes income that Illinois may tax depends on whether the income is governed by 4 U.S.C. § 114. *Id.* If such income is not governed by 4 U.S.C. § 114, the IITR provides that whether Illinois

may tax it is governed by IITR § 100.3120(b)(1). *Id.* The text of the IITR implies, therefore, that Illinois is not permitted to impose upon a nonresident tax on income that is governed by 4 U.S.C. § 114. *Id.*; Carter v. SSC Odin Operating Co., LLC, 237 Ill. 2d 30, 39-40, 927 N.E.2d 1207, 1214 (2010) (“Federal law preempts state laws under the supremacy clause ... where Congress has expressly preempted state action ...”). Thus, the first thing to do here is to ascertain the kind of income that is governed by 4 U.S.C. § 114.

During the years at issue, Title 4, § 114 of the United States Code provided, in pertinent part, as follows:

Limitation on State income taxation of certain pension income

(a) No State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State).

(b) For purposes of this section -

(1) The term “retirement income” means any income from -

(A) a qualified trust under section 401(a) of the Internal Revenue Code of 1986 that is exempt under section 501(a) from taxation;

(B) a simplified employee pension as defined in section 408(k) of such Code;

(C) an annuity plan described in section 403(a) of such Code;

(D) an annuity contract described in section 403(b) of such Code;

(E) an individual retirement plan described in section 7701(a)(37) of such Code;

(F) an eligible deferred compensation plan (as defined in section 457 of such Code);

(G) a governmental plan (as defined in section 414(d) of such Code);

(H) a trust described in section 501(c)(18) of such Code; or

(I) any plan, program, or arrangement described in section 3121(v)(2)(C) of such Code (or any plan, program, or arrangement that is in writing, that provides for retirement payments in recognition of prior service to be made to a retired partner, and that is in effect immediately before retirement begins), if such income -

(i) is part of a series of substantially equal periodic payments (not less frequently than annually which may include income described in subparagraphs (A) through (H)) made for -

(I) the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient), or

(II) a period of not less than 10 years, or

(ii) is a payment received after termination of employment and under a plan, program, or arrangement (to which such employment relates) maintained solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by 1 or more of sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k), or 415 of such Code or any other limitation on contributions or benefits in such Code on plans to which any of such sections apply.

The fact that payments may be adjusted from time to time pursuant to such plan, program, or arrangement to limit total disbursements under a predetermined formula, or to provide cost of living or similar adjustments, will not cause the periodic payments provided under such plan, program, or arrangement to fail the “substantially equal periodic payments” test.

Such term includes any retired or retainer pay of a member or former member of a uniform service computed under chapter 71 of title 10, United States Code.

(2) The term “income tax” has the meaning given such term by section 110(c).

(3) The term “State” includes any political subdivision of a State, the District of Columbia, and the possessions of the United States.

(4) For purposes of this section, the term “retired partner” is an individual who is described as a partner in section 7701(a)(2) of the Internal Revenue Code of 1986 and who is retired under such individual’s partnership agreement.

4 U.S.C. § 114.

The key paragraph, at least regarding this dispute, is (I), which includes within the definition of “retirement income,” income from “any plan, program, or arrangement described in section 3121(v)(2)(C) of such Code” 4 U.S.C. § 114(I). The kind of plans, programs, and arrangements described in § 3121(v)(2)(C) of the Internal Revenue Code (Code) are “Nonqualified deferred compensation plan[s],” which are defined there

as “any plan or other arrangement for deferral of compensation other than a plan described in subsection (a)(5)” 26 U.S.C. § 3121(v)(2)(C). In sum, 4 U.S.C. § 114 governs income from any nonqualified plan or other arrangement for deferral of compensation, so long as that plan is one that is other than one described in Code § 3121(a)(5), and so long as such income:

(i) is part of a series of substantially equal periodic payments (not less frequently than annually which may include income described in subparagraphs (A) through (H)) made for -

(I) the life or life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient), or

(II) a period of not less than 10 years, or

(ii) is a payment received after termination of employment and under a plan, program, or arrangement (to which such employment relates) maintained solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by 1 or more of sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k), or 415 of such Code or any other limitation on contributions or benefits in such Code on plans to which any of such sections apply.

4 U.S.C. § 114.

Although 4 U.S.C. § 114 makes one look beyond its own text to appreciate all of the different types of income Congress intended to include within the term retirement income, the House Report written about the bill that became 4 U.S.C. § 114 makes Congress’ general intent clear. H.R. Rep. No. 389, 104th Cong., 1st Sess. 1995; 1996 U.S.C.C.A.N. 1006 (hereafter, H.R. Rep.); SSC Odin Operating Co., 237 Ill. 2d at 40, 927 N.E.2d at 1214 (“The key inquiry in any preemption analysis is to determine the intent of Congress.”). Specifically, in the purpose and summary section of that House Report, the Judiciary Committee wrote:

The purpose of H.R. 394 is to prohibit State taxation of certain

retirement income of a nonresident of the taxing State. It would protect all income received from pension plans recognized as “qualified” under the Internal Revenue Code. It would also exempt income which is received under deferred compensation plans that are “non-qualified” retirement plans under the tax code, but which meet additional requirements.

H.R. Rep., at 1006-07.¹ Read together, the text of § 114(I) and the text of Code § 3121(v)(2)(C) clearly negate the Department’s fundamental argument at hearing, which was that the only kind of retirement income received by a nonresident that the Department would not tax was income from qualified retirement plans. Tr. pp. 17-20.

The Department’s argument certainly describes the Department’s practice of taxing the income Illinois residents receive from nonqualified deferred compensation plans. *See, e.g.*, 2004 Form 1040 Instructions, p. 7 (“You may not subtract [when calculating Illinois base income] income received as third-party sick pay, nongovernment disability plans, or nongovernment deferred compensation plans, which are not qualified employee benefit plans.”) (instruction form viewable at the Department’s web site at <http://www.revenue.state.il.us/taxforms/incm2004/ind/il1040-inst.pdf>). It is a well-established principle of interstate taxation that a state may tax all the income of its residents. Oklahoma Tax Comm’n v. Chickasaw Nation, 515 U.S. 450, 462-63, 115 S.Ct. 2214, 2222, 132 L.Ed.2d 400 (1995). And by its plain terms, § 114 does nothing to

¹ Congress summarized the “additional requirements” as follows:

To be exempt from State taxation, distributions from non-qualified plans will have to be made in substantially equal installments, not less frequently than annually, over the lifetime of the beneficiary or at least ten years. In addition, the bill protects from State taxation any “excess benefit” plans that are set up because a qualified plan (1) exceeds the \$150,000 in employee compensation that may be considered in qualifying for such a plan, (2) exceeds the present limit on the amount of allowable benefits from a defined benefit plan, or (3) exceeds the present limit on contributions to a defined contribution plan.

H.R. Rep., at 1006-07.

diminish a State's power to tax its own residents. 4 U.S.C. § 114. But, by passing § 114, Congress expressly preempted the states, including Illinois, from imposing an income tax on nonresidents regarding items of retirement income as defined in that section, including income from nonqualified deferred compensation plans having the characteristics described in § 114(I)(i)-(ii). 4 U.S.C. § 114(I); H.R. Rep. at 1006-07.

Having identified the scope of 4 U.S.C. § 114, it is now time to ask whether the income at issue is governed by that federal statute. Unfortunately, the record provides no clue, since there was no evidence offered to show that the income distributed to Doe was paid pursuant to a nonqualified plan that met the conditions described within § 114(I)(i)-(ii). 4 U.S.C. § 114(I)(i)-(ii); 86 Ill. Admin. Code § 100.3120(b)(1). The most that was offered was Taxpayers' counsel's argument that he thought that the nonqualified plan was a SERP, a supplemental employer retirement plan. Tr. p. 15. Argument, however, is not evidence. Simmons v. Garces, 198 Ill. 2d 541, 568, 763 N.E.2d 720, 737 (2002). Nor did the Department make any stipulations regarding whether the distributions to Doe came from a plan having the characteristics described in § 114(I)(i)-(ii). Tr. pp. 13-15; *see also* H.R. Rep., at 1006-07. Specifically, this record does not confirm that the distributions were part of a series of substantially equal periodic payments made for the life or life expectancy of the recipient, or for a period of not less than ten years. 4 U.S.C. § 114(I)(i). Nor was there any evidence offered to show that distributions were payments received after termination of employment. 4 U.S.C. § 114(I)(ii). Finally, § 114's express limitation that retirement income will include income from those nonqualified deferred compensation plans that meet the conditions set forth in § 114(I)(i)-(ii) clearly implies that some nonqualified plans will *not* meet those statutory conditions. 4 U.S.C. §

114(I)(i)-(ii).

In a nutshell, the issue of whether the income was governed by 4 U.S.C. § 114 presented a fact issue regarding which no evidence was offered, and on which Taxpayers bore the burdens of production and persuasion. Under those circumstances, Taxpayers have not shown that the income distributed to Doe was governed by 4 U.S.C. § 114. *See Arts Club of Chicago v. Department of Revenue*, 334 Ill. App. 3d 235, 246, 777 N.E.2d 700, 709 (1st Dist. 2002) (where taxpayer has the burden of proof, absence of evidence regarding a fact issue weighs in the Department's favor). I acknowledge that the income distributed to Doe might well be embraced within Congress' definition of retirement income. But without some type of documentary evidence to corroborate Taxpayers' mere claim that the income met that federal statutory definition, I cannot conclude that Taxpayers have borne their burden of proof on the issue. *Balla*, 96 Ill. App. 3d at 296, 421 N.E.2d at 238.

Since Taxpayers have not shown that the income was governed by 4 U.S.C. § 114, the next task is to determine whether that compensation is allocable to Illinois because it was paid in Illinois. *See* 86 Ill. Admin. Code § 100.3120(b)(1). The remaining text of IITR § 100.3120(b)(1) provides:

*** Where compensation is paid to a nonresident for past service, such compensation will, for the purpose of determining whether and to what extent such compensation is "paid in" Illinois and is allocated to Illinois under IITA Section 302(a), be presumed to have been earned ratably over the employee's last 5 years of service with the employer (or any predecessor or successor of the employer or a parent or subsidiary corporation of the employer), in the absence of clear and convincing evidence that such compensation is properly attributable to a different period of employment or that it was not earned ratably over the appropriate period of employment. Compensation earned in each past year will be deemed compensation paid in Illinois if the individual's service in such year met the tests set forth in subsection

(a) above. Compensation paid for past service includes amounts paid under deferred compensation agreements where the amount of compensation is unrelated to the amount of service being currently rendered. Amounts paid to nonresidents under deferred compensation agreements may be allocated to Illinois under IITA Section 302(a) in accordance with this paragraph notwithstanding the fact that amounts paid to nonresidents under such agreements will be deemed not to be compensation paid in Illinois for purposes of IITA Section 701 and will not be subject to withholding (see Section 100.7010(g)).

2)

86 Ill. Admin. Code § 100.3120(b)(1).

The parties stipulated that the income distributed to Doe was earned from work Doe performed when he was an Illinois resident. Tr. pp. 13-15. They also stipulated that prior to 2004, and at least from 1999 through 2003, Taxpayers were Illinois residents. *Id.* But the parties made no stipulations regarding when or if Doe retired, or regarding whether the compensation deferred was paid in Illinois. *See* Tr., *passim*. This, again, is an issue regarding which Taxpayers bore the burden of production and persuasion. Since there was no evidence offered to show that the income at issue was not paid in Illinois, Taxpayers have not shown that tax was paid in error. Balla, 96 Ill. App. 3d at 296, 421 N.E.2d at 238.

Conclusion:

I recommend that the Director finalize the denials as issued.

August 12, 2010
Date

John E. White, Administrative Law Judge