

IT 15-0004 GIL 5/27/2015 Compensation

Payments received in settlement of claims brought by former employee against employer are compensation sourced under IITA Section 304(a)(2)(B).

May 27, 2015

Re: TAXPAYER
2011 Illinois Income Tax Liability

Dear Ms. XXXX:

This is in response to your letter dated January 26, 2013, in which you request a refund on behalf of TAXPAYER. The nature of your request and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. *See* 86 Ill. Adm. Code 1200.120(b) and (c), which may be found on the Department's web site at www.tax.illinois.gov.

In your letter you have stated the following:

Taxpayer filed his 2011 Form IL-1040 (attached) requesting a refund of AMOUNT. The State of Illinois has refused to refund this amount and requested a corrected W-2 from the COMPANY. Due to the circumstances detailed below, the Taxpayer is unable to obtain this corrected W-2. On behalf of the above-referenced Taxpayer, we are writing to ask the Department of Revenue to refund the improperly withheld tax of AMOUNT.

Facts

On DATE, TAXPAYER (the "Taxpayer"), a resident of OUT OF STATE, filed a complaint in U.S. District Court of STATE against COMPANY ("COMPANY") and several individuals - case number XX-X-XXXXX-X, alleging violations of Americans With Disabilities Act (the "ADA") and the False Claims Act by: 1) discrimination against him by laying him off based upon a physical disability (Muscular Dystrophy) and 2) committing fraud against the U.S. Government and conducting unlawful retaliation when the Taxpayer reported the existence of such fraudulent practices. Prior to trial, COMPANY and the Taxpayer entered into a settlement agreement whereby COMPANY paid the Taxpayer AMOUNT in consideration of the withdrawal of the lawsuit and violating the ADA. Of this amount AMOUNT was deducted and withheld for Federal taxes and AMOUNT was deducted and withheld, improperly, for Illinois income tax. A

copy of the check stub (attached) indicates that the payment from COMPANY was for a "settlement" and not compensation. COMPANY's withholding of income tax was improper because the Taxpayer was, and continues to be, a resident of OUT OF STATE at the time the complaint was filed as well as when the settlement agreement was executed. Due to the acrimony of the lawsuit, COMPANY has refused to issue a new W-2.

Relief Sought

The Taxpayer respectfully requests a refund of the overpaid Illinois income tax which COMPANY improperly withheld and remitted to the Illinois Department of Revenue on his behalf. As demonstrated herein, the settlement proceeds are not Illinois source income that is taxable to a nonresident of the state. In sum, a nonresident can only have Illinois source income if such income is derived from compensation in an employer-employee relationship, business income apportioned to Illinois, or nonbusiness income allocated to the state. The settlement proceeds received from COMPANY were paid in consideration of the Taxpayer's withdrawal of a lawsuit filed against COMPANY and several identified individuals. Accordingly, the settlement proceeds do not fall within the aforementioned categories of Illinois source income of a nonresident and, therefore, the amount of Illinois income tax attributed to the settlement proceeds, an amount improperly withheld and remitted to the state, must be refunded to the Taxpayer.

Discussion

Illinois personal income tax is imposed on a person's net income, which is their federal adjusted gross income that is allocated to Illinois in accordance with the provisions of Illinois law.¹ Such allocation provisions are set forth in Article 3 of the Illinois Income Tax Act. For individuals who are not residents of Illinois, all income items are excluded from the computation of the individual's personal income tax base unless it is specifically allocated to Illinois under the provisions of 35 ILCS Sections 5/302, 5/303, or 5/304.²

35 ILCS SECTION 5/302 - COMPENSATION PAID TO NONRESIDENTS

Under this section, all items of compensation that are paid in Illinois to a nonresident at the time of such payment are specifically allocated to Illinois.³ Compensation is paid in Illinois if it meets one of the following three criteria:

- The individual's service is performed entirely within Illinois;
- The individual's service is performed both inside and outside of Illinois but the service performed outside of Illinois is incidental to the individual's service performed within the state; or
- The individual performs some service in Illinois and the individual's base of

¹ 35 ILCS §§ 5/201, 5/202, 5/203

² 35 ILCS § 5/301(c)(2)(A), 86 Ill. Admin Code § 100 3300(b)(2)

³ 35 ILCS § 5/302(a)

operations is Illinois, or, barring no base of operations, then the place the individual was directed and controlled from was Illinois.⁴

"Compensation" means wages, salaries, commissions, and any other form of remuneration paid to an employee for personal services.⁵ Absent an employer-employee relationship, the individual cannot receive "compensation."⁶ The nominal designation given to a form of remuneration has no bearing as to whether the item of income is "compensation" for Illinois tax purposes.⁷ Rather, salaries, fees, bonuses, commissions, pensions and retirement pay are compensation if paid for services performed by an employee for his employer.⁸ But compensation can be paid to someone who is no longer an employee,⁹ provided an employer-employee relationship existed when the services were rendered for which the compensation is paid.

With respect to compensation paid for past service, certain allocation rules apply. Specifically, when compensation is paid to a non-resident for a past service, such compensation is presumed to be earned ratably over the employee's last five years of service with the employer for purposes of allocating compensation to the state.¹⁰ The exception from this five-year rule exists if the individual can demonstrate the compensation is properly attributable to a different period of employment or was not earned ratably of the appropriate period of employment.¹¹ Application of the five-year rule is provided in the example below:

Individual A is a resident of State X but works in Illinois from 2005 through 2008. In 2009, A transferred to his employer's facility in State X and worked the entire year in that facility. In 2010, the individual receives \$10,000 cash in lieu of a retroactive wage increase. Unless individual A can provide evidence the compensation is properly allocable to a different period, \$8,000 of the \$10,000 in compensation will be deemed earned by the service localized in Illinois during the 2005-2008 period. The remaining \$2,000 is allocated outside of Illinois based on the employee's services being localized outside the state

⁴ Id 35 ILCS § 5/304(a)(2)(B), 86 Ill Admin Code § 100.3120(a)(1) The term "base of operations" refers to the place or fixed center from where the individual works which can be their business office (which can include the individual's home office) and is generally the place where he receives his business mail, supplies, or maintains his business records. See 86 Ill Admin Code § 100 7010(d)(2) The place of "direction or control" is the looks to the permanent place from which the employee's service is directed and controlled from. See 86 Ill Admin Code § 100 7010(c)(1)

⁵ 86 Ill Admin Code § 100.3100(a)

⁶ See 86 Ill Admin Code § 100.3100(b)

⁷ 86 Ill Admin Code § 100.3100(c)

⁸ *See id*

⁹ 86 Ill Admin Code § 100.3100(d)

¹⁰ 86 Ill Admin Code § 100.3120(b)(1)

¹¹ *Id*

In contrast, if the cash payment mentioned above constituted a wage increase retroactive to 2009, then none of the \$10,000 of compensation would be allocated to Illinois since it was earned by services localized outside the state.

Compensation can include income amounts taken into account by a non-resident employee under the provisions of IRC Sections 401-425, such as 401(k) contributions or withdrawals, or amounts received as a beneficiary of an employees' trust under IRC Section 402. While such amounts can represent remuneration for past services provided by an individual in his capacity as employee, such amounts are specifically excluded from the Illinois personal income tax base of a non-resident individual.¹²

Analysis

The settlement proceeds the Taxpayer received from COMPANY were in consideration of his withdrawal of the legal complaint against COMPANY and several of its employees. These proceeds do not represent compensation for services rendered by the Taxpayer as an employee or former employee of COMPANY. As such, the settlement amount cannot represent compensation paid to an employee as the term is defined under Illinois law.

35 ILCS SECTION 5/303 –NONBUSINESS INCOME EARNED BY A NONRESIDENT

Law

The second class of possible income earned by a nonresident than can be allocated to Illinois is nonbusiness income sourced to the state. To the extent a nonresident individual earns certain specified items of nonbusiness income, such items are allocated to Illinois if sourced to the state under the state's allocation rules. There are five general categories of non business income an nonresident individual can earn that can be allocated to Illinois: capital gains and losses, rents and royalties, patent and copyright royalties, Illinois lottery prizes, and unemployment benefits. The sourcing rules with respect to each category are described below:

Capital Gains & Losses

Capital gains and losses from the sale or exchange of real property are allocated to Illinois if the property being disposed of is located in the state.¹³ Similarly capital gains and losses from tangible property are sourced to Illinois if the property is located in the state.¹⁴ However, capital gains and losses associated with the disposition of intangible property are sourced to the Illinois only if the taxpayer is commercially domiciled in Illinois at the time of the sale or exchange.¹⁵

¹² See 35 ILCS § 5/301(c)(2), 86 Ill. Admin Code § 100.3120(c)(1)

¹³ 35 ILCS § 5/303(b)(1), 86 Ill Admin Code § 100.3220(b)

¹⁴ 35 ILCS § 5/303(b)(2)

¹⁵ 35 ILCS § 5/303(b)(3) A "commercial domicile" is the principal place from which the trade or business of the taxpayer is directed or managed See 86 Ill. Admin Code § 100.321 0(a)

Rents & Royalties

The sourcing rules with respect to rent and royalty income are similar to the rules regarding capital gains and losses. Namely, rents and royalties derived from real and tangible property are sourced to Illinois if the property is located or, with respect to tangible property, utilized in the state.¹⁶

Patent & Copyright Royalties

Patent and copyright royalties are allocated to Illinois to the extent the patent or copyright is utilized by the payor in the state.¹⁷ A patent is deemed utilized in Illinois to the extent that it is employed in production, fabrication, manufacturing, or other processing in Illinois or to the extent a patented product is produced in the state.¹⁸ Similarly, a copyright is utilized in Illinois to the extent that printing or other publication originates in the state.¹⁹ With respect to both patent and copyright royalties, if the basis of receipts from such royalties does not permit allocation, or if the accounting procedures do not reflect the sourcing of utilization, then the royalties from both patents and copyrights are sourced to Illinois if the taxpayer is commercially domiciled in Illinois.

Lottery Prizes & Unemployment Benefits

Items of income that are awarded under the Illinois Lottery Law or paid by the Illinois Department of Employment Security are allocated to Illinois.²⁰

Analysis

An item of nonbusiness income that is allocated to Illinois can only include an item of income that represents one of the five categories of income described above. The settlement proceeds the Taxpayer received from COMPANY were consideration of my withdrawal of a lawsuit filed against COMPANY and several of its employees and do not fall into any of the categories of specifically allocable nonbusiness income mentioned above. Accordingly, the settlement proceeds received from COMPANY are not allocable to Illinois under 35 ILCS Section 5/304.

35 ILCS SECTION 5/304 – BUSINESS INCOME EARNED BY A NONRESIDENT

Law

The final class of possible income earned by a nonresident that can be sourced to Illinois is business income. Business income is income earned or received from any activity

¹⁶ See 35 ILCS § 5/303(c)(1) & (2), 86 Ill. Admin Code § 1003220(c)

¹⁷ 35 ILCS § 5/303(d)(1), 86 Ill. Admin Code § 100.3220(d)

¹⁸ 35 ILCS § 5/303(d)(2)(A)

¹⁹ 35 ILCS § 5/303(d)(2)(B)

²⁰ 35 ILCS § 5/303(c) & (e-5)

conducted by the taxpayer during the regular course of the taxpayer's trade or business, but does not include wages or compensation received by an employee.²¹ To the extent an individual derives business income solely within Illinois, such business income is allocated to Illinois. But if the business income is derived from Illinois as well as at least one other state, then the business income is apportioned to Illinois by multiplying the business income by a fraction, the numerator of which is the taxpayer's total sales in Illinois during the tax year and the denominator being the taxpayer's total sales everywhere during the same period.²²

Analysis

An individual can only generate business income that would be sourced to Illinois if they operate a trade or business that derives income - in whole or in part - from Illinois sources. The Taxpayer does not operate a trade or business, either in my own right or through a flow-through entity, which has physical contacts with Illinois or otherwise derives income from Illinois sources. Moreover, the settlement proceeds the Taxpayer received do not relate to any trade or business but rather were properly characterized as consideration for withdrawal of the Taxpayer's lawsuit against COMPANY and several of its employees. Consequently, the settlement proceeds received from COMPANY cannot be allocated to Illinois under 35 ILCS Section 5/304.

Conclusion

The taxpayer is a nonresident of Illinois. As a nonresident of the state, the Taxpayer can only be subject to Illinois income tax the portion of net income that is specifically allocated to the state under the sourcing rules contained within 35 ILCS Sections 5/302 (compensation), 5/303 (nonbusiness income), 5/304 (business income). If a nonresident receives income that is not sourced to Illinois pursuant to one of these three statutory provisions, such income is not subject to Illinois income tax. The Taxpayer has demonstrated the settlement proceeds received in consideration for the withdrawal of his lawsuit filed against COMPANY and several of its employees is not "compensation paid to a nonresident" as the term is defined in 35 ILCS Section 5/302. Nor do the settlement proceeds amount to nonbusiness income allocated to Illinois under 35 ILCS Section 5/303 or business income apportioned to the state pursuant to 35 ILCS Section 5/304. As a nonresident can only be subject to Illinois income tax on income that falls into one of these three statutory definitions, the settlement proceeds do not represent Illinois source income to a nonresident.

Accordingly, we respectfully request the Illinois Department of Revenue to refund the overpaid Illinois income tax of AMOUNT, including interest that COMPANY improperly withheld and remitted to the state on the Taxpayer's behalf.

In the complaint TAXPAYER filed in his lawsuit against COMPANY, which you enclosed with your letter, TAXPAYER states that he was an employee of COMPANY from YEAR until

²¹ 35 ILCS § 5/1502

²² 35 ILCS 5/304(a), 5/304(h)(3), 5/304(a)(3)(A)

DATE. He was based in OUT OF STATE, in COMPANY DIVISION, until DATE, and thereafter was based in Illinois, in COMPANY DEPARTMENT.

In the complaint, TAXPAYER alleges violations by COMPANY of the [STATE] Law Against Discrimination, the STATE Family Leave Act, the anti-retaliation provisions of the Illinois Whistleblower Act, the federal Family and Medical Leave Act of 1993, and the anti-retaliation provisions of the federal False Claims Act.

TAXPAYER also states in the complaint that he had been diagnosed with CONDITION prior to being hired by COMPANY, but that he demonstrated no outward signs of the disease at the time he was hired. In YEAR, the disease flared, requiring workplace and travel accommodations by COMPANY, which were made at the time. His claims under the STATE Law Against Discrimination, the STATE Family Leave Act, and the federal Family and Medical Leave Act of 1993 arose from failure to make accommodations subsequent to that time.

TAXPAYER also states in the complaint that the events that gave rise to his claims under the Illinois Whistleblower Act and the anti-retaliation provisions of the federal False Claims Act began in YEAR.

The lawsuit was settled in YEAR. In settlement of the lawsuit, COMPANY agreed to pay to TAXPAYER AMOUNT, “less applicable withholdings,” and to pay AMOUNT as “reasonable attorneys fees” to TAXPAYER’s attorneys. COMPANY treated the AMOUNT as wages, from which it withheld AMOUNT in federal income tax, AMOUNT in Medicare tax and AMOUNT in FICA tax, and AMOUNT in Illinois income tax. TAXPAYER filed an Illinois income tax return for YEAR as a nonresident, and reported the AMOUNT received in the settlement as wages sourced to Illinois on the Schedule NR, Nonresident and Part-Year Resident Computation of Illinois Tax, attached to his return. He also claimed a subtraction for the AMOUNT, reducing his Illinois net income to zero, and requested a refund of the entire AMOUNT in Illinois income tax withheld by COMPANY.

The Department of Revenue issued a Taxpayer Notification Response to TAXPAYER, dated XX-XX-XX, stating that his Illinois income tax liability was AMOUNT, and that he was entitled to a refund of AMOUNT.

Response

Section 302(a) of the Illinois Income Tax Act (35 ILCS 5/302) provides:

All items of compensation paid in this State (as determined under Section 304(a)(2)(B)) to an individual who is a nonresident at the time of such payment and all items of deduction directly allocable thereto, shall be allocated to this State.

Section 304(a)(2)(B) of the Illinois Income Tax Act (35 ILCS 5/304) provides:

Compensation is paid in this State if:

(i) The individual's service is performed entirely within this State;

(ii) The individual's service is performed both within and without this State, but the service performed without this State is incidental to the individual's service performed within this State; or

(iii) Some of the service is performed within this State and either the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is within this State, or the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this State.

As shown in the pay statement attached to your letter, COMPANY withheld federal and Illinois income tax from the settlement payment, as well as Medicare and FICA taxes. This treatment of the settlement payment as wages subject to withholding is consistent with federal case law.

The most recent Supreme Court case on this matter is *United States v. Quality Stores, Inc.*, 134 S.Ct. 1395 (2014), in which the court held that severance pay made to employees who were terminated as the result of the employer's bankruptcy constituted wages subject to Social Security taxation. The Court noted that Section 3121(a) of the Internal Revenue Code defines wages as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash" and that Section 3121(b) of the Internal Revenue Code provides that "employment" encompasses "any service, of whatever nature, performed by an employee for the person employing him.". The Court stated that the term "service," used with respect to Social Security, "means not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer." This principle goes back to the decision in *Social Security Bd. v. Nierotko*, 327 U. S. 358 (1946), which held that "wages" in the Social Security context to apply to damages paid by a business to a former employee, who had been wrongfully terminated.

In *Noel v. New York State Office of Mental Health Central New York Psychiatric Center*, 697 F.3d 209 (2d Cir. 2012), the court held that a jury award to a former employee constituted wages subject to withholding. In that case, Noel had been terminated from his job at the Central New York Psychiatric Center. Prior to his termination, he had cooperated in a formal investigation of race discrimination by his supervisors, and he brought a retaliation claim arising from this episode. The jury awarded him \$210,000 in back pay and \$70,000 in front pay, plus damages for emotional distress, which were disallowed on appeal. The Second Circuit court held that the back pay and front pay were wages subject to federal and state withholding.

In all of these cases, the courts found it irrelevant that the employee was no longer employed by the former employer at the time the payments were made, and that the employee actually performed no services for the employer in direct exchange for the payments. Under this case law, the amounts received by Sicilia are properly designated as wages, even though his employment terminated before he filed suit.

Under 86 Ill. Adm. Code Section 100.3120(b)(1):

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.

In this case, TAXPAYER's complaint against COMPANY arose entirely from acts of COMPANY during a period in which he was an employee and was based in Illinois, and the complaint is based on rights arising out of that employment relationship. Accordingly, the settlement is properly characterized as wages to which he was entitled as the result of employee services performed prior to his termination. The payment is therefore allocable to Illinois under Section 304(a)(2)(B) of the Illinois Income Tax Act, and is subject to Illinois income tax regardless of TAXPAYER's residence at the time of payment. There is no basis in the facts you assert in your letter for allocating the income to any other state.

If TAXPAYER wishes to contest the Department's determination of his liability and preserve his right to a refund of any overpayment, he must timely file a refund claim and, if the claim is denied, protest the denial in the manner that will be explained in the denial.

Neither TAXPAYER's return nor your letter constituted a claim for refund. 86 Ill. Adm. Code Section 100.9400(f)(1) provides:

A claim for refund of an overpayment of income tax may be filed with the Department only if a return for the taxable year for which the refund is claimed has been filed. An original return does not constitute a claim for refund under IITA Section 909(d) and (e) of the Act calling for consideration, but may qualify as an extension of the limitations period for filing a claim for refund under Section 100.9410(c)(2) of this Part. A separate claim shall be filed for each taxable year for which an income tax overpayment was made. Every claim for refund shall be in writing, shall be on the appropriate form prescribed by the Department, and (using attachments if necessary) shall state the specific grounds upon which it is founded.

86 Ill. Adm. Code Section 100.9400(f)(2) provides that the proper form for TAXPAYER to use is the Form IL-1040-X,

Section 911(a) of the Illinois Income Tax Act provides:

(1) A claim for refund shall be filed not later than 3 years after the date the return was filed . . . , or one year after the date the tax was paid, whichever is the later; and

(2) No credit or refund shall be allowed or made with respect to the year for which the claim was filed unless such claim is filed within such period.

As stated above, this is a general information letter which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b). If you have any further questions, you may contact me at (217) 782-7055.

Sincerely,

Paul S. Caselton
Deputy General Counsel – Income Tax