

Withholding of Illinois income tax required for Compensation paid to a nonresident for services performed in Illinois.

November 23, 2021

Re: Illinois income tax

Dear NAME:

This is in response to your letter dated May 19, 2021, in which you request information regarding Illinois income tax. 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.

Your letter states as follows:

We hereby request a private letter ruling regarding taxation of a settlement payment to an Employee for back pay.

The Employee was terminated on DATE and was working at the BUSINESS airport location as a COMPANY Employee. Her permanent address at the time of termination was CITY, STATE.

On DATE, she notified COMPANY that her address had changed to CITY, STATE.

On DATE she received a settlement check that included back wages. She was taxed for Illinois State Income Tax since we considered her back wages to be derived from her service in Illinois, as this has been our longstanding policy, interpretation and implementation of state tax regulations. She is claiming that since she was no longer employed or living in Illinois at the time of settlement pay that her back wages should not be subject to Illinois tax.

Please respond with your ruling as to whether her wages were or were not subject to Illinois State Income Tax.

RULING

Regarding the allocation of compensation paid to nonresidents for Illinois income tax purposes, Section 302(a) of the Illinois Income Tax Act ("IITA"; 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.

IITA Section 1501(a)(3) defines the term “compensation” to mean wages, salaries, commissions and any other form of remuneration paid to employees for personal services. The Illinois Administrative Code further describes the statutory definition of compensation in 86 Ill. Adm. Code 100.3100(c):

The name by which remuneration for services is designated is immaterial. Thus, salaries, fees, bonuses, commissions on sales or on insurance premiums, and pensions and retired pay are compensation within the meaning of the statute if paid for services performed by an employee for his employer.

86 Ill. Adm. Code 100.3100(d) states:

Remuneration for personal services constitutes compensation even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services were performed and the individual who performed them, so long as such relationship existed when the services were rendered.

Pursuant to these provisions, back pay must generally be considered “compensation” for purposes of the IITA. As such, back pay is taxable in Illinois if “paid in this State” under IITA Section 302(a).

86 Ill. Adm. Code 100.3120(a)(1) states that compensation is paid in Illinois if:

- A) The individual's service is localized in Illinois because it is performed entirely within Illinois (IITA Section 304(a)(2)(B)(i));
- B) The individual's service is localized in Illinois although it is performed both within and without Illinois, because the service performed without Illinois is incidental to the individual's service performed within Illinois (see IITA Section 304(a)(2)(B)(ii)); or
- C) For taxable years ending prior to December 31, 2020, the individual's service is not localized in any state under subsections (a)(1)(A) and (B), but some of the service is performed within Illinois and either:
 - i) the base of operations, or if there is no base of operations, the place from which the service is directed or controlled is within Illinois; or

- ii) 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 Illinois. (See IITA Section 304(a)(2)(B)(iii).)

- D) The rules in subsections (a)(1)(A) through (C) are to be applied in a manner so that, if they were in effect in other states, an item of compensation would constitute compensation "paid in" only one state. Thus, if an item would, under these rules, constitute compensation paid in a state other than Illinois because the individual's service was localized in that other state under subsection (a)(1)(B), it could not also be compensation paid in Illinois.

- E) For taxable years ending on or after December 31, 2020, the individual's service is not localized in any state under subsection (a)(1)(A) or (B), but some of the individual's service is performed within this State and the individual's service is performed within this State for more than 30 working days during the taxable year, the amount of compensation paid in this State shall include the portion of the individual's total compensation for services performed on behalf of his or her employer during the taxable year that the number of working days spent within this State during the taxable year bears to the total number of working days spent both within and without this State during the taxable year. (IITA Section 304(a)(2)(B)(iii))...

In your letter you state that the former employee "was taxed for Illinois State Income Tax." For the purposes of this GIL, it will be assumed that you mean that COMPANY withheld Illinois state taxes from the back wages. If that assumption is correct, then COMPANY's treatment of the former employee's back wages as derived from her service in Illinois, and withholding appropriate taxes, is consistent with federal case law.

In *United States v. Quality Stores, Inc.*, 134 S. Ct. 1395 (2014), the United States Supreme 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 your former employee are properly designated as wages, even though her employment terminated before the payments were made.

86 Ill. Adm. Code 100.3120(c)(1) states, in pertinent part, as follows:

...For the purpose of determining whether and to what extent compensation paid for past service is "paid in" Illinois and is allocated to Illinois under IITA Section 302(a), that compensation is presumed to have been earned ratably over the employee's last 5 years of service with the employer...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 that year met the tests set forth in [100.3120(a)] applicable to that year...

In this case, the back wages paid to your employee were compensation for services performed during a period in which she was an Illinois based employee and were based on that employer relationship. Accordingly, the back wages are properly characterized as wages to which she was entitled as the result of employee services performed prior to her termination. They are therefore allocable under Section 304(a)(2)(B) of the Illinois Income Tax Act and 86 Ill. Adm. Code 100.3120(a)(1), and subject to Illinois income tax regardless of the former employee's residence at the time of payment.

If your former employee wishes to contest the Department's determination of her liability and preserve her right to a refund of any overpayment, she 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.

Section 911(a) of the Illinois Income Tax Act, 35 ILCS 5/911(a) provides:

(a) In general. Except as otherwise provided in this Act:

(1) A claim for refund shall be filed not later than 3 years after the date the return was filed (in the case of returns required under Article 7 of this Act respecting any amounts withheld as tax, not later than 3 years after the 15th day of the 4th month following the close of the calendar year in which such withholding was made), 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.

Further guidance on when compensation is considered “paid in this State” and subject to withholding, can be found at 86 Ill. Adm. Code Section 100.7010, which can be found at:

<http://www.ilga.gov/commission/jcar/admincode/086/086001000S70100R.html>

and in Publication 130, which can be found at:

<https://www2.illinois.gov/rev/research/publications/pubs/Documents/pub-130.pdf>

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 regarding this letter, you may contact me at (217) 782-2844.

Sincerely,

Michael D. Mankowski
Associate Counsel - Income Tax

cc: Daily File
Correspondence file: