

Withholding is not required when deferred compensation is paid while employee is a non-resident.

August 18, 2023

NAME
ADDRESS

RE: When withholding is required for non-qualified stock options

Dear NAME:

This is in response to your letter dated August 30, 2021, in which you requested information about when the company is required to withhold Illinois income tax on non-qualified stock options. We have no record of providing a previous response. We regret the delay and any inconvenience it may have caused. The nature of your letter and the information provided require that we respond with a General Information Letter (GIL). A GIL is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 2 Ill. Admin. Code 1200.120(b) and (c), which may be accessed from the Department's web site at www.tax.illinois.gov.

Your letter states as follows:

I had previously requested information via email on two occasions. After a month, I finally received a response. However, my questions were not addressed with no clear answer. When I responded to the comments provided, I was advised that I would have to send a letter. This is now my third request for clarification as the information within the state website is not straight forward.

This is my revised request below, similar to the original requests.

I am updating our domestic procedures for holders of Stock Options within each state. I have gone through your website and have obtained limited information on the topic. I am trying to determine your policy when state withholding taxes would apply on Non-Qualified Stock Options and what triggers them. Is it based on the date of the grant, vesting or when they exercise?

As an example, X Team Member is granted Stock Options while living in Illinois, however, only 2 of the 5 tranches are vested. X Team Member relocates to another state where the remaining 3 vestings occur, which are then exercised while residing in the new domicile.

Would X Team Member be subject to your state withholding taxes on all vested and unvested shares because the Stock Options were granted in your state? Would X Team Member only be subject to the shares that were vested in

your state? Or since they were exercised after relocation would X Team Member not be required to pay withholding taxes to Illinois.

Of course, I understand that while residing in your state withholding taxes do apply. My concern is if/when a Team Member relocates in or out of Illinois.

Thank you in advance for your guidance.

RULING

Section 701 of the Illinois Income Tax Act (IITA) requires tax to be withheld upon payment of compensation in Illinois. The Department's rules on allocating compensation paid to nonresidents, 86 Ill. Admin. Code 100.3120(a), provide as follows:

In order for items of compensation paid to an individual who is a nonresident of Illinois at the time of payment to be allocated to Illinois, the compensation must constitute "compensation paid in this State". If the test is met, then all items of the compensation, and all items of deduction directly allocable thereto, are allocated to Illinois under IITA Section 302(a) (except items allocated under IITA Section 301(c)(2), as to which see subsection (d)). Compensation paid to a nonresident, which is allocated to Illinois, enters into the computation of the individual's net income under IITA Section 202 and is generally subject to withholding under IITA Section 701 (see Sections 100.7000, 100.7010 and 100.7020). The tests for determining whether compensation is paid in Illinois appear in IITA Section 304(a)(2)(B)

86 Ill. Admin. Code 100.3120(c) further provides:

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 (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 the 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 that year met the tests set forth in subsection (a) applicable to that year. 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.

Under IITA section 203, in the case of an individual, Illinois begins with federal adjusted gross income to compute the taxpayer's Illinois base income. The non-qualified stock option income is included in the Team Member's federal adjusted gross income when it is exercised and would, therefore, also be included in Illinois base income. If the Team Member is no longer an Illinois resident at the time the non-qualified stock option is exercised, the income is deemed earned ratably over the last five years of employment and allocated to Illinois accordingly. Even though the employee may have Illinois source income, the employer would not be required to withhold income tax under 86 Ill. Admin. Code 100.7010(c) if the deferred compensation was paid to the employee while a nonresident.

We hope this information is helpful. As stated above, this is a GIL. A GIL does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department.

Very truly yours,

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