Taxation of Illinois nonresident taxpayers / Illinois 'sourcing' not based on workdays

This document is to clarify nonresident individual income tax filing positions in Illinois.

Summary - The Illinois Department of Revenue has explained that a non-resident employee whose base of operations is outside of Illinois will not be subject to tax in Illinois for incidental workdays in Illinois. Conversely, wages paid to an employee with a base of operations in Illinois are 100% allocable to Illinois even if the individual performs services inside and outside of Illinois. This item is discussed in further detail in IT 09-0001-GIL, a General Information Letter written by the Illinois Department of Revenue.

As a result, many taxpayers who are not resident of Illinois but who have workdays in Illinois (e.g., due to business trips) do not have an Illinois filing requirement. Please become familiar with these rules before preparing/signing any Illinois income tax returns. The Q&A below are intended to guide you through the rules and implications.

In addition, we have included a summary of new legislation enacted for the 2009 tax year pertaining to claiming other state tax credits.

Taxation of Illinois nonresident taxpayers

1) Who is a non-resident of Illinois?

First, let's review who is a resident. You are an Illinois resident if you were domiciled in Illinois, but are absent from the state for a temporary or transitory purpose for a period of less than one year. An individual is also a resident if he or she is in the state for other than a temporary or transitory purpose during the taxable year. You are a nonresident of Illinois if you are not a resident. You are a part-year resident if you became a resident during the tax year or ceased to be a resident during the tax year.

Residence ceases with the establishment of domicile in another state, which includes a foreign country.

Illinois Regulations 86 Ill. Adm. Code Section 100.3020(f) provides:

"Presumption of residence and nonresidence. If an individual spends in the aggregate more than nine months of any taxable year in Illinois, it will be presumed that he is a resident of Illinois. An individual who is absent from Illinois for one year or more will be presumed to be a nonresident of Illinois. These presumptions are not conclusive, and
may by overcome by other satisfactory evidence to the contrary."

The nine month rule is just a presumption of residency. The fact that a taxpayer does not come within the strict terms of the rule does not create a presumption of nonresidency. A dispute over residency will be resolved on the facts of the case whether or not the presumption applies. The taxpayer may submit any relevant evidence to the Department for its consideration. Such evidence may include, but is not limited to, affidavits, evidence of: voter registration, automobile or drivers license registration, filing an income tax return as a resident of another state, home ownership or rental agreements, club and/or organizational memberships and participation, telephone and/or other utility usage over a duration of time. In appropriate instances, the Department may request any relevant evidence which may assist it in determining the taxpayer's place of residence.

In practice, we suggest using the following general guidelines. Individuals who previously resided outside of Illinois (including foreign nationals) and came to Illinois for an assignment of one year or less, are typically non-residents of Illinois. For assignments expected to last more than one year, the individual usually becomes a resident of Illinois. In this case, individuals would typically start Illinois residency on the date the individual arrived in Illinois (for their assignment) and stop Illinois residency on the date the individual permanently leaves the state.

2) When is a non-resident required to file an Illinois tax return?

Non-residents are required to file an Illinois tax return if they either a) are entitled to, and wish to apply for, a refund of any Illinois income tax withheld, or b) had Illinois base income greater than the taxpayer's prorated Illinois exemption allowance. Illinois base income includes income from Illinois sources such as an Illinois rental property.

_It is important to understand the points outlined below in 3 and 4 as they are integral in understanding the allocation of compensation in point 5._

3) What is a base of operations?

In regard to an employee's base of operations, Ill. Adm. Code Section 100.7010(d)(2) states:

"The term "base of operations" refers to the place or fixed center from which the individual works. An individual's base of operations may be his business office (which may be maintained in his home), or his contract of employment may specify a place at which the employee is to receive his directions and instructions. In the absence of more controlling factors, an individual's base of operations may be the place to which he has his business mail, supplies, and equipment sent or the place where he maintains his business records.

The determination of the location of the “base of operations” is not really dependent on the number of days spent at a particular site during a tax year. Some employees are almost constantly travelling for particular projects, and may spend fewer days during a year at their home office than they spend at one or more temporary work sites. Generally, every employee who is not constantly on the move has some place that can be called his or her base of operations.

4) What is the place of direction or control?
In regard to the place of direction or control, Regulations §100.7010(e)(1) states:

The permanent place from which the employee's service is directed or controlled is relevant in determining whether wages are subject to withholding if the localization tests are not applicable and it is impossible to determine the base of operation for such individual. In such a case, if both the place from which the individual's service is directed or controlled is within this State, and some of the service is performed within this State, then his entire compensation will be taxable, but if not, none of his compensation will be taxable. For example, a salesman's territory may be so indefinite and so widespread that he will not retain any fixed business office or address but will receive his orders or instructions by mail or wire wherever he may happen to be. In such case, the location of the permanent place from which direction and control is exercised must be determined.

5) How is a non-resident of Illinois taxed on compensation?

A) Wages earned in the current year

Summary - The Illinois Department of Revenue has explained that a non-resident employee whose base of operations is outside of Illinois will not be subject to tax in Illinois for incidental workdays in Illinois. Conversely, wages paid to an employee with a base of operations in Illinois are 100% allocable to Illinois even if the individual performs services inside and outside of Illinois. This item is discussed in further detail in IT 09-0001-GIL, a General Information Letter written by the Illinois Department of Revenue.

Under these provisions, an employee with a base of operations outside Illinois (including a foreign country) would not allocate wages earned in the current year to Illinois, even if he or she spent considerable time working in Illinois during the year, provided the service performed in Illinois is incidental to the services performed outside Illinois. Note that the Illinois Regulations do not specify a time period regarding what is deemed "considerable time".

Detail - Under Section 302(a) of the Illinois Income Tax Act (35 ILCS 5/302), wages are allocated to Illinois if considered 'paid' in Illinois. Section 304(a)(2)(B) of the Illinois Income Tax Act (35 ILCS 5/304) is used for this determination, which states (in part):

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.

For a more detailed application of these rules, see page 5 of Publication 130, Who is Required to Withhold Illinois Income Tax, which can be found at
Example

For this example, the fact pattern below is utilized to illustrate how compensation income would be allocated for a non-resident taxpayer.

- All compensation was earned in the current year
- Taxpayer was a non-resident of Illinois for the entire current year
- Taxpayer's base of operations was outside of Illinois (for example, a foreign country or another US state) for the entire current year
- Taxpayer worked in Illinois for 35 days and outside of Illinois for 205 days in the current year

None of the taxpayer’s compensation income is attributable to Illinois since the taxpayer was a non-resident at the time of payment and all of the compensation relates to when the taxpayer’s base of operations was outside of Illinois. Note that it does not matter that the taxpayer had a significant portion of Illinois workdays in the current year.

In the above example, it is important to note that the employer should not be reporting the income related to Illinois workdays as Illinois wages in a Form W-2. If they do, the employer can either issue a W-2c to report the Illinois wages as zero and refund the withholding or the tax preparer/employee can prepare an Illinois non-resident tax return and attach a letter from the employer on company letterhead explaining that the Illinois wages were reported in error and that the taxpayer’s base of operations was outside of Illinois for the entire year. The letter approach is based on standard practice and procedure as provided by the Illinois authorities in the past.

B) Wages earned in a prior year

Summary - 86 Ill. Admin. Code 100.3120(b) discusses compensation for past services. The presumption is that deferred compensation is earned over employee's last 5 years of service with the employer. As an alternative method, the actual period the compensation was earned can be utilized, if known and supported by clear and convincing evidence, instead of utilizing the aforementioned 5 year period. When reading the regulation, it is important to understand that compensation considered "paid in" Illinois under section 302(a) is not based on working days (which is the rule in most states), but uses the same rule as the payroll factor in 304(a)(2)(B) as discussed above.

If compensation that was earned in a prior year was properly taken into account by such individual under the provisions of IRC Sections 401 through 424, then it will not be allocated to Illinois in the current year. Please see details below under iii).

Detail - The Regulation that speaks directly to this is Reg 86 Ill. Admin. Code 100.3120(b)(1) which states:

*Compensation paid for past service:* 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 non-resident pension income. This limitation also impacts income received by a non-resident in the form of distributions from many
deferred compensation plans. The allocation of distributions to non-residents from
delayed 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). Where
compensation is paid to a non-resident 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). 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 non-residents 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 non-residents 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)).

i) **Bonus earned in a prior year**

Based on the above, if an individual is paid a bonus in the current year and it was earned in the
prior year, then you would allocate the income to Illinois based on where the individual’s base of
operations was during the time period that the income was earned.

*Example*

For this example, the fact pattern below is utilized to illustrate how a prior year bonus would be
allocated for a non-resident taxpayer.

- Bonus paid in 2008 and based on performance in 2007
- The taxpayer performed services within and without Illinois throughout 2007
- Assume that the individual's base of operations was inside Illinois until 7/31/2007, the
date that he/she left Illinois as a result of an overseas long-term assignment. At that
time, the base of operations moved to outside Illinois.

The portion of income attributable to the time period that the taxpayer had a base of operations
within Illinois (1/15/07 to 7/31/07) should be 100% taxable in Illinois on the 2008 non-resident
return and the remainder of income (8/1/07-12/31/07) is not attributable to Illinois on the 2008
non-resident return (regardless of the number of Illinois workdays during this period) as the
taxpayer’s base of operations was outside of Illinois during the period.

ii) **Non Qualified Stock Options (NQSO)**

In short, Illinois has not ruled on whether grant to vest, grant to exercise or some other method
should be used to determine when NQSO income was earned.

The Illinois Department of Revenue does say that you have to allocate the income over the past
5 years from date of exercise (or last date of employment, if earlier). However, Illinois allows an exception to this allocation when there is clear and convincing evidence to the contrary (similar to the discussion above for other multi-year compensation).

As federal law provides, under Regulation Section 1.861-4(b)(2)(ii)(F), that the proper sourcing of NQSO income is generally based on the workdays between grant date and vest date and since Illinois often follows federal regulations, it may be reasonable at this time to use grant to vest for Illinois sourcing of NQSO income.

**Example**

For this example, the fact pattern below is utilized to illustrate how NQSO income might be allocated for a non-resident taxpayer.

- Grant date 1/15/2005
- Vest date 1/15/2008
- Exercised in 2008; therefore, income is included in the 2008 W-2
- Individual was a resident of Illinois until 7/15/2005 when he/she broke residency in Illinois as a result of an overseas long-term assignment
- Assume that the individual's base of operations was inside Illinois up until the date he/she broke residency with Illinois. At that time, the base of operations was outside Illinois.

The portion of income attributable to the time period that the taxpayer had a base of operations within Illinois (1/15/05 to 7/15/05) should be 100 % taxable in Illinois on the 2008 non-resident return and the remainder of income (7/16/05-1/15/08) is not attributable to Illinois on the 2008 non-resident return (regardless of the number of Illinois workdays during this period) as the taxpayer's base of operations was outside of Illinois during the period.

**iii) Income taken into account under IRC Section 401 through 424 (e.g., qualified plans, qualified stock options (ISOs))**

Note that 86 Ill. Adm. Code Section 100.3120(c) sets forth exceptions to the general allocation rules for non-resident compensation, including compensation for past services. Section 100.3120(c)(1) provides:

While "compensation" may include items of income taken into account by a nonresident employee under the provisions of 26 USC 401 through 424, such as, for example, amounts received by a beneficiary of an employees' trust (taxable to the employee under 26 USC 402, whether the trust is exempt or nonexempt from federal income tax), or income resulting from a disqualifying disposition of stock acquired pursuant to the exercise of a qualified stock option (taxable to the employee under 26 USC 421(b above), such compensation is not allocated under IITA Section 302(a). Instead such compensation is allocated under the rules of IITA Section 301(b)(2)(A), (i.e. is not allocated to Illinois), whereas compensation which is allocated pursuant to IITA Section 302(a) is allocated to Illinois, if "paid" in this State (see subsections (a) and (b) above). Consequently, a nonresident claiming that compensation which would otherwise constitute compensation paid in Illinois should not be allocated to Illinois under IITA Section 301(b)(2)(A) must establish that such compensation was properly taken into account by such individual under the provisions of 26 USC 401 through 424.

Illinois Department of Revenue Regulations Section 100.7010(g)(1) states:

Under certain contractual unfunded deferred compensation agreements, payments are made by an employer to an employee for service rendered at an earlier date. In many such agreements, the employee receiving deferred compensation payments is not required to render any current service whatsoever, whereas in others he may be required to hold himself available to render advisory and consultative service, if called upon to do so, and to refrain from competition, but in either case, the amount of compensation is unrelated to any service being currently rendered. Payments made under any such deferred compensation agreement will be deemed to meet the tests set forth in subsection (a) for compensation paid in Illinois if paid to the individual while a resident of this State. Conversely, payments made under such an agreement will be deemed not to be compensation paid in this State and will not be subject to withholding if paid to the individual while a nonresident. Amounts paid to nonresidents under deferred compensation agreements may be allocated to Illinois under IITA Section 302(a) in accordance with Section 100.3120(b)(1) notwithstanding the fact that such amounts will be deemed not to be compensation paid in Illinois for purposes of IITA Section 701 and will not be subject to withholding.

Based on the above, deferred compensation paid from an unfunded plan to a nonresident of Illinois is not subject to withholding but is still allocated to Illinois using the same rules as compensation for past services described above.

Note that funded plans tend to be qualified under IRC Section 401 and are discussed in iii) above.

6. Is an amended return possible?

Yes, if you have a scenario where a prior year Illinois non-resident tax return has been filed to report income to Illinois based on workdays (when the individual's base of operations was outside of Illinois), you can file an amended return to request a refund of the taxes paid on that portion of income. Note that if the employer reported wages as "Illinois wages" on the W-2, you will need a letter on company letterhead explaining that the W-2 reported Illinois wages in error as the taxpayer's base of operations was outside of Illinois during the period of nonresidence.

The amended returns are subject to the same statute of limitations as federal tax returns (e.g., 3 years from the last extended due date for filed returns). Illinois accepts the federal extension. As such, if the taxpayer had a valid 2006 Form 4868 and filed by the extended deadline of October 15, 2007, they will have until October 15, 2010 to file a 2006 Amended Illinois Tax Return. Taxpayers who filed by April 15, 2007 would be prudent to file their refund claims by April 15, 2010 but if they fail to do so, they should still file the Illinois amended return by October 15, 2010. This is on the basis that Illinois typically recognizes an 'automatic' 6-month extension that does not require a written request. No guarantees.

New sourcing rules for other state tax credit legislation, effective with tax year 2009-applicable to Illinois resident returns
For taxable years ending on or after December 31, 2009, the other state tax credit was changed to limit the credit to the amount of Illinois tax that would be computed using the Illinois sourcing rules. Previously, many taxpayers figured their Illinois credit for tax paid to other states by completing Illinois Schedule CR and entering base income and tax from their other states' income tax returns. However, many taxpayers did not take into account that the base income and tax from the other states' returns were not comparable to the base income and tax on their Illinois return.

As outlined above, with regard to compensation, Illinois generally does not tax non-residents on compensation unless the person's base of operations is in Illinois during the time period that the compensation was earned. Most states tax compensation of nonresidents based on days worked in the state. Illinois has indicated that, for 2009 and later tax years, it will determine other state-source income using the same sourcing rules it applies to determine Illinois source income. In other words, Illinois will not generally allow credits for taxes paid in other states on compensation, unless the employee's base of operations was the other state and Illinois will only allow credit for one state.

The preparer may need to explore whether the state that the individual worked in will allow a "reverse credit" to minimize the instance of double taxation.

Note that for tax years 2009 and later, it is no longer required to attach a copy of the other state's return to the Illinois return to document the taxes paid. You will only provide this information if later requested by the Illinois Department of Revenue.

Please see www.iltax.com/Publications/Pubs/Pub-111.pdf for a copy of Illinois Publication 111, issued December 1, 2009, that describes the proper treatment of claiming credits for tax year 2009 and later as well as a detailed description of claiming credits for tax year 2008 and earlier.

If you have any questions regarding the items above, you should contact either Dave Austin at 312-298-2153 or Rebecca Kiser at 312-298-2141 of our Chicago IAS practice. They should be provided with a WBS code for any assistance.

Clarissa Cole
Director- International Assignment Services (Tax)
350 S. Grand
Los Angeles, CA 90071
Telephone 213-217-3164
Facsimile (813) 639-3729
http://www.pwc.com/us/hrs

This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding U.S. federal, state or local tax penalties.