

IT 13-0015 GIL 12/31/13 Credits – Foreign Tax

Illinois resident who had income tax of a reciprocal state withheld from wages in error must file a claim for refund with that state, and cannot claim a foreign tax credit for the taxes.

December 31, 2013

Re: Request for General Information Letter; TAXPAYER

Dear Xxxx:

This is in response to your letter dated November 1, 2013 in which you request a legal tax ruling whether certain correction notices issued by the Department of Revenue (“Department”) were correct. The Department’s regulations require that the Department issue only two types of letter rulings, Private Letter Rulings (“PLRs”) and General Information Letters (“GILs”). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding against the Department, but only as to the taxpayer issued the ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of Department policy that apply, interpret or prescribe the tax laws and are not binding against the Department. See 2 Ill. Adm. Code 100.1200(b) and (c). The nature of your letter and the information provided require that we respond with a General Information Letter.

Your letter states as follows:

We are writing this letter for a legal tax ruling concerning the return correction notice issued by the Illinois Department of Revenue concerning the individual income tax account of TAXPAYER. A copy of this notice is enclosed for your reference.

The income tax issue involves TAXPAYER’s receipt of non-qualified deferred compensation paid by his prior employer, COMPANY A, a STATE company from CITY, STATE. Furthermore, this deferred compensation stems from his employment while the taxpayers were residents of the State of STATE. They moved to Illinois in 20XX.

In 20XX, TAXPAYER has two W-2 tax forms from COMPANY A and the COMPANY B, which total \$XXX,XXX of wages. While there is a reciprocity agreement between Illinois and STATE concerning wages earned by residents of these states, TAXPAYER as a non-resident of STATE was required to declare this non-qualified deferred compensation as STATE source income in 20XX. As evidence, we are enclosing the nonresident STATE tax rules pertaining to this highlighted for your reference. In connection with the out-of-state taxation of wages received by TAXPAYER, we computed a tax credit for tax paid to Other States via Schedule CR on their 20XX Illinois tax return.

Illinois tax regulations also tax their non-residents for deferred compensation that was earned while a taxpayer was a resident of the State of Illinois. This tax regulation was upheld by an Illinois court case, IT 10-04, a copy which is enclosed. The point that we’re making is the opposite of the IT 10-04 case, inasmuch that an Illinois resident should be allowed to declare a tax credit for tax paid to Other States as an exception to the otherwise general tax principles involving reciprocity.

RESPONSE

Section 302(a) of the Illinois Income Tax Act (35 ILCS 5/302) provides that, with respect to nonresidents:

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.

This provision is also relevant to residents who pay income tax to other states and are allowed a credit for such taxes under Section 601(b)(3) of the Illinois Income Tax Act (35 ILCS 5/601), because that paragraph provides, in part:

(t)he credit provided under this paragraph for tax paid to other states shall not exceed that amount which bears the same ratio to the tax imposed by subsections 201(a) and (b) otherwise due under this Act as the amount of the taxpayer's base income that would be allocated or apportioned to other states if all other states had adopted the provisions in Article 3 of this Act bears to the taxpayer's total base income subject to tax by this State for the taxable year.

Under this provision, employee compensation that is "paid in this State" under Section 304(a)(2)(B) of the Illinois Income Tax Act (35 ILCS 5/304) cannot be included in the numerator of the fraction used to compute the limitation on a resident's credit for taxes paid to another states. In the simplest case, a resident whose only income is employee compensation "paid in this State" would not be entitled to a credit for taxes paid to any other state on that compensation.

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

The Director may enter into an agreement with the taxing authorities of any state which imposes a tax on or measured by income to provide that compensation paid in such state to residents of this State shall be exempt from such tax; in such case, any compensation paid in this State to residents of such state shall not be allocated to this State.

Under that authority, the States of Illinois and STATE entered a "reciprocal agreement" effective January 1, 1974, pursuant to which neither state taxes, or requires withholding from, wages earned in the state by a resident of the other state.

The instructions to the Schedule CR expressly provide:

If you earned wages, salaries, tips, or other employee compensation from an employer in Iowa, Kentucky, Michigan, or Wisconsin while you were a resident of Illinois, you are covered by a reciprocal agreement between that state and Illinois and are not taxed by that state on your compensation. However, you may be taxed on other income.

The undersigned spoke with a representative of the STATE Department of Revenue, and they confirmed that if COMPANY A or the COMPANY B withheld taxes or the taxpayers paid tax to STATE based on the deferred compensation, the taxpayers may claim a refund from STATE. Because no STATE tax was due from the taxpayers, they **may not** claim a credit on Schedule CR for that tax. They must file the appropriate forms with STATE to receive a refund of taxes withheld or paid in error. See also the enclosed copy of the STATE Publication XXX and XXX, Tax Information for Part-Year Residents and Nonresidents of STATE.

Accordingly, the taxpayers are not allowed a credit against their Illinois income tax liability for taxes paid to STATE on deferred compensation earned during 2012 because they were Illinois residents for

the entire year. If STATE taxes were withheld from those wages, or they mistakenly filed and paid taxes to STATE, they must file a refund claim with STATE. A credit on Schedule CR is only available for taxes paid to STATE on non-wage income taxable by that State.

However, should STATE make a determination that this income was properly taxed in STATE, then the taxpayers would be allowed a credit in Illinois.

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 the taxpayers are not under audit and they wish to obtain a binding Private Letter Ruling regarding their 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) 524-7580.

Sincerely,

Matthew Crain
Associate Counsel (Income Tax)