

IT 11-05
Tax Type: Income Tax
Issue: Claim For Refund On Retirement Income

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

JOHN AND JANE DOE,)	Docket No.	XXXXXX
Taxpayers)	Tax Years	XXXXXX
v.)		
THE DEPARTMENT OF REVENUE)	John E. White,	
OF THE STATE OF ILLINOIS)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION FOLLOWING REHEARING

Appearances: Thomas J. Dwyer, Thomas J. Dwyer & Associates, appeared for John and Jane Doe; Jessica Arong O'Brien, Special Assistant Attorney General, appeared for the Illinois Department of Revenue.

Synopsis:

This matter involves the Illinois Department of Revenue's (Department) denials of amended returns/claims for refund that John and Jane Doe (Taxpayers) filed for tax years ending December 31, 2004 (TYE 2004) and December 31, 2005 (TYE 2005). On the amended returns, Taxpayers reported that Illinois income tax had been withheld in error by the payor of income to John Doe (John Doe), in the form of distributions from non-qualified deferred compensation plans. A hearing was held in 2010, after which the Director adopted and issued a recommendation, dated August 12, 2010 (Recommendation) upholding the Department's denials. Following receipt of that agency decision, Taxpayers filed a request for rehearing. They attached to their request copies of deferred compensation plans pursuant to which, they asserted, the income paid to John Doe was distributed, and asked for the opportunity to offer those documents into evidence at the requested rehearing, if necessary.

After the Department had the opportunity to review the copies of the plans submitted by Taxpayers, the second hearing was held at the Department's offices in Chicago, Illinois. Both

parties offered additional documentary evidence, and Taxpayers offered the testimony of an employee of the person that prepared Taxpayers' tax returns. I am incorporating into this recommendation following rehearing the findings of fact previously set forth in the Recommendation, as well as those based on the evidence offered at the rehearing. This recommendation following rehearing is intended to supplement the Recommendation by taking into account the additional evidence admitted. Based on that additional evidence, I recommend that the Director cancel the denials previously issued, and grant the refunds Taxpayers requested for TYE 2004 and 2005.

Findings of Fact:

1. I adopt here each of the findings of fact set forth in ¶¶ 1-5 of the Recommendation.
6. The payments BOA made to John Doe during tax years ending (TYE) December 31, 2004 (TYE 2004) and December 31, 2005 (TYE 2005) were paid pursuant to two pension plans titled, respectively, the BOA Pension Restoration Plan (as amended and restated effective July 1, 1998) (1998 Plan), and the BOA 401(k) Restoration Plan (as amended and restated effective July 1, 2000) (2000 Plan). Taxpayer Exs. 1-2 (respectively, copies of the 1998 and 2000 Plans); Rehearing Transcript (Tr.2), pp. 14-16 (testimony of Jack Black, a C.P.A. and employee of Taxpayers' tax return preparer).
7. The income at issue was paid to John Doe after the termination of his employment with BOA, or a bank taken over by BOA. Tr.2 pp. 16, 32 (Jack Black); Taxpayer Exs.1-2.
8. The 1998 Plan's Statement of Purpose provides:

Prior to July 1, 1998, the Corporation and certain of its affiliates (collectively with the Corporation, the "Participating Employers") maintained the NationsBank Corporation and Designated Subsidiaries Supplemental Retirement Plan (the "Restoration Plan"). *The Restoration Plan provided benefits which would have accrued to participants in the NationsBank Pension Plan (the "Pension Plan") but for certain benefit limitations imposed by the Internal Revenue Code.*

Effective July 1, 1998, the Pension Plan was amended to convert it to a defined benefit cash balance plan, and the Participating Employers desire to amend and restate the Restoration Plan in its entirety effective as of that date to reflect the amendments to the Pension Plan and to meet other current plans.

In addition, effective July 1, 2000, a number of changes were made to the Corporation's employee benefit plans in connection with the combination of the former NationsBank and BankAmerica benefit programs. The Participating Employers desire to further provide herein for a number of design changes to the Restoration Plan in connection with those benefit program changes, as well as to rename the Restoration Plan as the "Bank of America Pension Restoration Plan".

The Participating Employers have reserved the right to amend the Plan at any time and have delegated to the Corporation the right to amend the Plan on behalf of the all Participating Employers.

NOW THEREFORE, for the purposes aforesaid, the Corporation, on behalf of the Participating Employers, hereby amends and restates the Restoration Plan effective July 1, 1998 to consist of the following Articles I through V:

Taxpayer Ex. 1 (Statement of Purpose) (emphasis added).

9. The 2000 Plan's Statement of Purpose provides:

The Corporation sponsors The NationsBank Corporation 401(k) Restoration Plan (the "Restoration Plan"). *The purpose of the Restoration Plan is to provide benefits, on a non-qualified and unfunded basis, to certain associates whose benefits under The NationsBank 401(k) Plan (the "401(k) Plan") are adversely affected by the limitations of Sections 401(a)(17), 401(k)(3), 401(m), 402(g) and 415 of the Internal Revenue Code, as well as certain limits placed on the contribution rates of highly compensated participants established by the administrative committee under The NationsBank 401(k) Plan.*

In addition, effective July 1, 2000, a number of changes were made to the Corporation's employee benefit plans in connection with the combination of the former NationsBank and BankAmerica benefit programs. By this Instrument, the Corporation is amending and restating the Restoration Plan effective July 1, 2000 to (i) make a number of design changes to the Restoration Plan in connection with those benefit program changes, (ii) rename the Restoration Plan as the "Bank of America 401(k) Restoration Plan", and (iii) otherwise meet current needs.

NOW THEREFORE, for the purposes aforesaid, the Corporation hereby amends and restates the Restoration Plan effective July 1, 2000 to consist of the following Articles I through V:

Taxpayer Ex. 2 (Statement of Purpose) (emphasis added).

10. Within the definitions section of both of the 1998 and 2000 Plans, the terms “Code” and “Code Limitations” are defined as follows:

Code means the Internal Revenue Code of 1986. References to the Code shall include the valid and binding governmental regulations, court decisions and other regulatory and judicial authority issued or rendered thereunder.

Code Limitations means any one or more of the limitations and restrictions that Sections 401(a)(17) and 415 of the Code place on the accrual of benefits under the Pension Plan.

Taxpayer Exs. 1-2 (§ 1.1 of each exhibit).

11. Section 5.1 and 5.8 of both the 1998 and 2000 Plans provides:

Section 5.1 Nature of Plan and Rights. The Restoration Plan is unfunded and intended to constitute an incentive and deferred compensation plan for a select group of officers and key management employees of the Participating Employers. If necessary to preserve the above intended plan status, the Committee, in its sole discretion, reserves the right to limit or reduce the number of actual Participants and otherwise to take any remedial or curative action that the Committee deems necessary or advisable. The Restoration Accounts established or maintained under the Restoration Plan by a Participating Employer are for accounting purposes only and shall not be deemed or construed to create a trust fund or any kind or to grant a property interest of any kind to any Participant, designated beneficiary or estate. The amounts credited by a Participating Employer to such Restoration Accounts are and for all purposes shall continue to be a part of the general assets of such Participating Employer, and to the extent that a Participant, beneficiary or estate acquires a right to receive payments from such Participating Employer pursuant to the Restoration Plan, such right shall be no greater than the right of any unsecured general creditor of such Participating Employer.

Section 5.8 Status Under the Act. The Restoration Plan is maintained for purposes of providing deferred compensation for a select group of management or highly compensated employees. *In addition, to the extent that the Restoration Plan makes up benefits limited under the Pension Plan as a result of Section 415 of the Code, the Restoration Plan shall be considered an “excess benefit plan” within the meaning of the Act.*

Taxpayer Exs. 1-2 (§§ 5.1, 5.8) (emphasis added).

12. Taxpayers have continued to file Illinois income tax returns, as nonresidents, after the tax years at issue. Taxpayer Ex. 3 (copy of schedule Jack Black prepared based on W-2 forms

issued to John Doe regarding distributions during tax years at issue through TYE 2010, and copies of those W-2 forms); Tr.2 pp. 21-22, 32-34, 54-57 (Jack Black).

13. After the years at issue, BOA stopped withholding Illinois income tax from the distributions made to John Doe, pursuant to the 1998 or 2000 Plans. Regarding those later years, the Department has not issued an NOD to Taxpayers, to claim that Illinois income tax was due regarding their receipt of such income. Tr.2 pp. 71-72 (Jack Black).
14. Effective sometime in tax year ending 2007, BOA began to identify, on the W-2 forms issued to Taxpayers, the source of the plans from which the distributions were made. Taxpayer Ex. 3. Prior to that tax year, the W-2 forms BOA issued, or caused to have issued, did not specify which particular plan formed the source of the pension payments to John Doe. *Id.*

Statutes & Regulations Involved

15. During the years at issue, Title 4, § 114 of the United States Code provided, in pertinent part, as follows:

Limitation on State income taxation of certain pension income

(a) No State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State).

(b) For purposes of this section -

(1) The term “retirement income” means any income from -

(I) any plan, program, or arrangement described in section 3121(v)(2)(C) of such Code (or any plan, program, or arrangement that is in writing, that provides for retirement payments in recognition of prior service to be made to a retired partner, and that is in effect immediately before retirement begins), if such income -

(ii) is a payment received after termination of employment and under a plan, program, or arrangement (to which such employment relates) maintained solely for the purpose of providing retirement benefits for employees in excess of the limitations imposed by 1 or more of sections 401(a)(17), 401(k), 401(m), 402(g), 403(b), 408(k), or 415 of such Code or any other limitation on contributions or benefits in such Code on plans to which any of such sections apply.

Such term includes any retired or retainer pay of a member or former member of a uniform service computed under chapter 71 of title 10, United States Code.

4 U.S.C. § 114.

16. During the years at issue, § 100.3120 of the Department's income tax regulations applied to items of compensation paid to nonresidents of Illinois, and it provided, in pertinent part:

Section 100.3120 Allocation of Compensation Paid to Nonresidents (IITA Section 302)

b) Compensation paid for past service

1) 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 nonresident pension income. This limitation also impacts income received by a nonresident in the form of distributions from many deferred compensation plans. The allocation of distributions to nonresidents from deferred 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). ***

86 Ill. Admin. Code § 100.3120(b)(1).

Conclusions of Law:

Before addressing the evidence offered at rehearing, a brief review of the facts and context of this dispute is in order. During TYE 2004 and 2005, BOA made certain distributions of income to John Doe. Department Exs. 2-3. BOA also withheld from those distributions certain amounts of Illinois income tax, and paid over such amounts to the Department. Department Exs. 2-3. Taxpayer filed their original Illinois income tax returns as nonresidents, and they reported the income that BOA paid to John Doe as being allocable to Illinois. *See* Department Ex. 1. Later, Taxpayers filed amended Illinois income tax returns to report that they made an error on their original Illinois income tax returns for TYE 2004 and 2005. The factual and legal errors that Taxpayers reported within their amended returns included the payor's mistake in withholding Illinois income tax from non-qualified deferred compensation income

BOA paid to John Doe, a non-resident of Illinois. Taxpayers also reported that they erred by reporting the non-qualified deferred compensation income BOA paid to John Doe as being allocable to Illinois. At the first hearing, the parties stipulated that Taxpayers were non-residents of Illinois during the years at issue. Tr.1, pp. 13-15.

The issue at the first hearing was whether “Taxpayer’s distributions from a non-qualified deferred compensation plan [were] subject to the Illinois Income Tax Act (IITA) for tax years ending 12/31/2004 and 12/31/2005[.]” Pre-Hearing Order. On this point, the Department had argued that the only kind of retirement income received by a nonresident that the Department would not tax was income from qualified retirement plans. Tr.1 pp. 17-20. That argument was rejected in the Recommendation, since the text and context of § 114(I) of the federal statute provides that income from certain non-qualified plans is also included within § 114(b)(1)’s definition of retirement income. 4 U.S.C. § 114; 26 U.S.C. § 3121(v)(2)(C). What Taxpayers did not do at the original hearing, however, was to offer documentary evidence to show that the non-qualified deferred compensation plan income John Doe received from BOA was included within § 114(b)(1)’s definition of retirement income.

At the second hearing, Taxpayers identified and offered into evidence copies of two pension plans they claim were the source of the distributions BOA paid to John Doe during the years at issue. They also offered the testimony of Jack Black, an employee of Taxpayers’ tax return preparer. Jack Black laid the foundation for the pension plans and other documents Taxpayers offered, and which were admitted into evidence. He testified that he had personal knowledge of the items reported on Taxpayers federal and Illinois returns, including the original and amended Illinois returns for the years at issue, and the bases for the entries made on those returns. He testified that the income distributed to John Doe during the years at issue, and before and after such years, came from the two pension plans he identified as Taxpayer Exhibits 1 and

2. He also identified, and testified about making, a schedule which showed the amounts John Doe received from such plans during the years at issue and after, which included copies of W-2 forms documenting such distributions. Tr.2 pp. 21-22, 32-34, 54-57 (Jack Black); Taxpayer Ex.

3. Jack Black pointed out that, after the years at issue, the W-2's issued to Taxpayers began to specify which particular pension plan was the source of the payments, but that the forms issued for the years at issue did were not as specific. Tr.2 pp. 54-57 (Jack Black). I had the opportunity to observe Jack Black while he testified, and he was calm, clear and measured when responding to questions during direct and cross-examination. He was a credible witness, and his testimony was closely associated with the documentary evidence Taxpayers offered into evidence. Department Exs. 2-3; Taxpayer Exs. 1-3.

Both the 1998 and 2000 Plans state that they are excess benefit plans. Taxpayer Exs. 1-2 (§§ 5.1, 5.8). Note 1 of the Judicial Committee's Report that was published regarding the passage of 4 U.S.C § 114 provided, "[i]n addition, the bill protects from State taxation any 'excess benefit' plans that are set up because a qualified plan (1) exceeds the \$150,000 in employee compensation that may be considered in qualifying for such a plan, (2) exceeds the present limit on the amount of allowable benefits from a defined benefit plan, or (3) exceeds the present limit on contributions to a defined contribution plan." H.R. Rep. No. 389, 104th Cong., 1st Sess. 1995; 1996 U.S.C.C.A.N. 1006-07 & n.1. The 2000 Plan amended and renamed a plan whose "purpose ... [was] to provide benefits, on a non-qualified and unfunded basis, to certain associates whose benefits under The NationsBank 401(k) Plan (the "401(k) Plan") are adversely affected by the limitations of Sections 401(a)(17), 401(k)(3), 401(m), 402(g) and 415 of the Internal Revenue Code, as well as certain limits placed on the contribution rates of highly compensated participants established by the administrative committee under The NationsBank 401(k) Plan." Taxpayer Ex. 2. Further, the Plans' definitions of the term Code Limitation, and

the manner in which that term is used in Article III of each Plan, show that each Plan provides benefits that are in excess of the limitations placed by §§ 401(a)(17) and 415 of the Internal Revenue Code. Taxpayer Exs. 1-2 (§§ 1.1, 3.1-3.2); 4 U.S.C. § 114(1)(b)(I)(ii). Finally, the evidence, including the Plans, the W-2 forms issued regarding the years at issue, and Jack Black's testimony, reflect that John Doe had terminated his employment prior to the years at issue. Taxpayer Exs. 1-2; Department Exs. 2-3; Tr.2 p. 16 (Jack Black).

In sum, Taxpayers have offered documentary evidence, and clear and credible testimony that is closely identified with such documentary evidence, showing that the income at issue was retirement income, as that term is defined in 4 U.S.C. § 114(1)(b)(I)(ii). That evidence is sufficient to rebut the statutory presumption of correctness accorded to the Department's initial determination. Congress has preempted Illinois from imposing income tax on nonresidents regarding the retirement income at issue. 4 U.S.C. § 114(1)(b)(I)(ii); 86 Ill. Admin Code § 100.3120(b). Thus, it is clear that the Illinois income tax BOA withheld and paid to the Department was paid in error.

Once a taxpayer offers documentary evidence that overcomes the Department's prima facie case, the burden shifts to the Department to prove its case by a preponderance of the competent evidence. John Doe v. Department of Revenue, 408 Ill 574, 581-82, 97 N.E.2d 788, 792 (1951). The Department did not do so here. What it did, instead, was to suggest that the since the W-2 forms issued to Taxpayers reported the distributions as "wages," the income must be considered to be wages that were allocable to Illinois, and not retirement income. Tr.2 pp. 88-91. Given Congress' express preemption, this argument is not well taken. Moreover, the argument ignores that, for W-2 reporting purposes, "wages" include distributions from non-qualified deferred compensation plans. 2005 Instructions for Forms W-2 and W-3 (available to view online at <http://www.irs.gov/pub/irs-prior/iw2w3--2005.pdf>) (last viewed on

July 8, 2011). Specifically, the instructions the Internal Revenue Service published regarding 2005 W-2 forms provides, in pertinent part:

Box 1—Wages, tips, other compensation. Show the total wages, tips, and other compensation, before any payroll deductions, that you paid to your employee during the year. Do not include elective deferrals, except section 501(c)(18) contributions. **Include the following:**

14. **Distributions** to an employee or former employee from a nonqualified deferred compensation plan (including a rabbi trust) or a **nongovernmental** section 457(b) plan.

Box 11—Nonqualified plans. The purpose of box 11 is for the SSA to determine if any part of the amount reported in box 1 or boxes 3 and/or 5 was earned in a prior year. The SSA uses this information to verify that they have properly applied the social security earnings test and paid the correct amount of benefits.

Show **distributions** to an employee from a nonqualified plan or a **nongovernmental** section 457(b) plan. Also report these distributions in box 1. **Make only one entry in this box.** Distributions from governmental section 457(b) plans must be reported on Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., not in box 1 of Form W-2.

Report distributions from nonqualified or section 457 plans to beneficiaries of deceased employees on Form 1099-R, not on Form W-2.

W-2 Instructions, pp. 9-11 (emphases original).

The Department also argued that Taxpayers should have obtained from BOA a statement correcting the original W-2 forms. Tr.2 pp. 89-93. But the facts reported on those W-2 forms are, in all material respects, correct. Illinois income tax *was* withheld from the amounts BOA distributed to John Doe; the income BOA distributed to John Doe *was* from a non-qualified deferred compensation plan; and BOA's distribution of such income *was* attributable to wages, tips, or other compensation. Department Exs. 2-3; Taxpayer Ex. 3; W-2 Instructions.

More importantly, BOA cannot "correct" the fact that it withheld Illinois income tax from its distributions to John Doe regarding the years at issue, and paid such tax over to the

Department. Department Exs. 2-3. BOA is not the entity that adjudicates whether the tax it withheld and paid over to the Department was paid in error. 35 ILCS 5/910. Nor has the Department explained why Taxpayers must first seek some action or remedy from BOA before they can obtain a refund — from the Department — for any amounts of Illinois income tax that BOA withheld and paid over to the Department. 35 ILCS 5/712 (“No payee shall have any right of action against his payor in respect of any money deducted and withheld and paid over to the Department in compliance or in intended compliance with Section 710 ...”); 35 ILCS 5/909(d). Taxpayers exercised the statutory rights the IITA afforded them, by timely filing amended returns/claims for refund. 35 ILCS 5/909-910. They also offered documentary and other credible evidence showing that the tax BOA withheld and paid over to the Department was paid in error. Taxpayer Exs. 1-3; 4 U.S.C. § 114(1)(b)(I)(ii). They do not need to do more.

Conclusion:

I recommend that the Director cancel the denials previously issued, and refund the tax paid in error.

July 13, 2011

John E. White
Administrative Law Judge