

General Information Letter: For tax years prior to 2006, no credit is allowed for taxes paid to another state on employee compensation “paid in this State” under IITA Section 304(a)(2)(B).

March 23, 2009

Dear:

This is in response to your letter dated February 12, 2009 in which you state the following:

We are writing to request a General Information Letter under 2 Ill. Adm. Code 1200.120 to confirm our understanding of how an Illinois resident individual who has compensation from non-qualified stock options would approach the Illinois tax credit computation for income taxes paid to other states on that same compensation. We have been considering this question in connection with the following facts.

### **Facts**

1. Mr. A has been an employee of Corp B, a publicly traded corporation, since 2001.
2. From 2001 through the end of 2004, the position that Mr. A held with Corp B had its base of operations in California and that position required him to perform services regularly both in California and other states in Corp B’s western region. However, that position with Corp B did not require Mr. A to perform any significant services in Illinois—nothing more than infrequent trips into CITY.
3. For many years up to and including 2004, and in particular for 2001 through 2004, Mr. A was a California resident for income tax purposes.
4. On July 1, 2001, Mr. A had been granted a non-qualified stock option in the common stock of his employer, Corp B. The non-qualified stock option entitled Mr. A to purchase 10,000 shares of the stock of Corp B for \$5 per share. The non-qualified stock option was exercisable on June 30, 2005, four years after the date of the grant.
5. On January 1, 2005, Mr. A moved to Illinois and became an Illinois resident in conjunction with his re-assignment by Corp B to a position in Illinois that had its base of operations in CITY.
6. On June 30, 2005 at the exercise date, the stock of Corp B was trading for \$20 per share. Consequently, Mr. A exercised the option that had been granted to him in 2001 to buy 10,000 shares for \$5 per share. For federal income tax purposes, Mr. A recognized compensation income under IRC Section 83 of \$150,000 as a result of exercising the option.
7. Corp B withheld Illinois income tax in 2005 on all of Mr. A’s compensation, including both his regular salary for 2005 and the \$150,000 of non-qualified stock option compensation. Mr. A included the entire amount of compensation in the base income on his Illinois income tax return for 2005 and paid Illinois income tax on the entire amount.
8. Mr. A did not file non-resident returns for 2005 in California or any of the other western states in which he had worked during 2001 through 2004.
9. California and certain of the states of Corp B’s western region in which Mr. A had worked during 2001 through 2004 have now audited Mr. A for 2005 and asserted an income tax liability on the non-qualified stock option compensation. Each of these states asserted an allocation of that \$150,000 in compensation based on Mr. A’s “working days” in the state for the period from July 1, 2001 through June 30, 2005 as respective fractions of Mr. A’s total working days for that four year period.
10. As a result of the tax audits of Mr. A for 2005 by California and the other states, a very large percentage of Mr. A’s non-qualified stock option compensation has been allocated on a non-

resident basis to these states and the tax has been paid to each. This is the same non-qualified stock option compensation that was included in Mr. A's base income for Illinois income tax purposes.

### **Issue 1**

Was it appropriate for Mr. A to report the non-qualified stock option compensation income under IRC Section 83 in his base income for Illinois income tax purposes for 2005?

### **Conclusion 1**

Yes. Since the non-qualified stock option income is included in Mr. A's adjusted gross income for federal income tax purposes for 2005, and since Mr. A is a resident of Illinois for 2005, the entire \$150,000 is clearly subject to tax for Illinois income tax purposes.

### **Discussion and Analysis 1**

Under IITA 203(a),<sup>1</sup> base income of an individual for Illinois income tax purposes is federal adjusted gross income modified by specifically enumerated additions and subtractions. The non-qualified stock option compensation is in Mr. A's adjusted gross income for 2005 and there is no subtraction modification under IITA 203(a)(2) that would cause it to be removed.

### **Issue 2**

Since Mr. A has paid 2005 income tax on audit to California and other states on a non-resident allocated basis with respect to the non-qualified stock option compensation, can Mr. A recover a portion of his Illinois income tax for 2005 by claiming a credit under IITA 601(b)(3)?

### **Conclusion 2**

Yes. Under IITA 601(b)(3), Mr. A is entitled to a credit against his Illinois income tax liability for 2005 with respect to income taxes paid to California and other states for 2005 on the non-qualified stock option compensation. This credit is available to the extent those other states' income taxes for 2005 related to that portion of the non-qualified stock option compensation that was attributable on a ratable basis to 2001, 2002, 2003, and 2004.

### **Discussion and Analysis 2**

For 2005 and earlier taxable years, IITA 601(b)(3) described the credit available to an Illinois resident taxpayer for income taxes paid in other states as follows. [Note that we have **highlighted** one sentence of this provision in particular in order to identify it for later discussion.]

(3) Foreign tax. The aggregate amount of tax which is imposed upon or measured by income and which is paid by a resident for a taxable year to another state or states on income which is also subject to the tax imposed by subsections 201(a) and (b) of this Act shall be credited against the tax imposed by subsections 201(a) and (b) otherwise due

under this Act for such taxable year. The aggregate credit provided under this paragraph 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 subject to tax both by such other state or states and by this State bears to his total base income subject to tax by this State for the taxable year. **For purposes of this subsection, no compensation received by a resident which qualifies as compensation paid in this State as determined under Section 304(a)(2)(B) shall be considered income subject to tax by another state or states.** The credit provided by this paragraph shall not be allowed if any creditable tax was deducted in determining base income for the taxable year. Any person claiming such credit shall attach a statement in support thereof and shall notify the Director of any refund or reductions in the amount of tax claimed as a credit hereunder all in such manner and at such time as the Department shall by regulations prescribe.<sup>2</sup>

On the facts stated above, the non-qualified stock option compensation, which was part of Mr. A's base income for Illinois income tax purposes in 2005, was also subject to tax in California and other states of Corp B's western region for 2005, and that tax was actually paid by Mr. A after the tax audits by those states. Therefore, as a result of those other states' audits and Mr. A's payments, Mr. A has now satisfied the requirements for the credit against his Illinois income tax liability for 2005. Mr. A should expect that the credit will be allowed if he files a timely claim for refund with the Illinois Department of Revenue in connection with his 2005 tax liability.

In analyzing this question, we would point out affirmatively that the highlighted sentence of IITA 601(b)(3) does not preclude Mr. A from claiming the credit for taxes paid on the non-qualified stock option compensation to California and other states. This is because, under the Department's Reg. Sec. 100.3120(b)(1)<sup>3</sup>, the non-qualified stock option compensation received by Mr. A in 2005, but attributed to 2001 through 2004, does not qualify as compensation "paid in this state under Section 304(a)(2)(B)."

What the highlighted sentence requires is that the double taxed compensation income (in this case, the non-qualified stock option compensation) for which the taxpayer is seeking a foreign tax credit must be analyzed as to how it would have been taxed by Illinois had the taxpayer been a non-resident.<sup>4</sup> To the extent that the double taxed compensation would have been allocated to Illinois by the taxpayer as a non-resident, then the highlighted sentence negates the foreign tax credit, even though the compensation has actually been subjected to tax in another state besides Illinois. If Mr. A in this case had been a non-resident in 2005, when he received and recognized the non-qualified stock option compensation, but otherwise had all of the same facts, no more than one-eighth of the non-qualified stock option compensation would have been allocated to Illinois. This one-eighth solution would have resulted from the application under Reg. Sec. 100.3120(b)(1) of the Illinois "all or nothing" compensation allocation of IITA 304(a)(2)(B) against ratable portions of the nonqualified stock option compensation for a half year in 2001, for full years in 2002, 2003, and 2004, and for a half year in 2005. It would only be in the half year ending June 30, 2005 that Mr. A, as a non-resident would have allocated that year's portion of the non-qualified stock option income to Illinois under the "all or nothing" allocation criteria of IITA 304(a)(3)(B). The ratable portion of the non-qualified stock option compensation attributed to the half year ended December 31, 2001, and to the full years 2002, 2003, and 2004 would all have been allocated away from Illinois by Mr.

A had he been a non-resident in 2005.

According to the Department of Revenue ("Department") regulations, the Department may issue only two types of letter rulings: Private Letter Rulings ("PLR") and General Information Letters ("GIL"). The regulations explaining these two types of rulings issued by the Department can be found in 2 Ill. Adm. Code §1200, or on the website <http://www.tax.illinois.gov/LegalInformation/regs/part1200>. You specifically request a GIL. Please note that GILs are not binding on the Department.

Your letter identifies two issues. The first is whether it was appropriate for the taxpayer, Mr. A, to report the non-qualified stock option compensation income under IRC Section 83 in his base income for Illinois income tax purposes for 2005. The facts provided in your letter indicate that Mr. A exercised the non-qualified stock option granted to him in 2001 to buy 10,000 shares for \$5.00 per share when they were trading at \$20.00 per share on June 20, 2005. As a result, Mr. A recognized compensation income in the amount of \$150,000 on June 30, 2005.

Your letter further states that Mr. A became an Illinois resident on January 1, 2005. Section 201 of the Illinois Income Tax Act ("IITA"), 35 ILCS 5/101 et seq., imposes a tax measured by net income on taxpayers for the privilege of earning or receiving income in this State. Section 203 of the IITA states that in the case of an individual, Illinois begins with federal adjusted gross income to compute the taxpayer's Illinois base income. The \$150,000 non-qualified stock option income is included in his 2005 federal adjusted gross income and would therefore also be included in his Illinois base income. Under Section 301(a) of the IITA, all of an Illinois resident's base income is allocated to Illinois, regardless of source.

The second issue is whether Mr. A may recover a portion of his Illinois income tax for 2005 by claiming a credit under IITA 601(b)(3) for taxes paid to California and other states on a non-resident allocated basis. California and certain of the states of Corp B's western region asserted an allocation of the \$150,000 based on Mr. A's "working days" in their respective states for the period from July 1, 2001 through June 30, 2005 using a fraction of Mr. A's total working days for that four year period. You are correct that this situation is best addressed in the Department Regulations, specifically 86 Ill. Admin. Code Section 100.3120(b)(1), that discusses compensation paid for past service:

1) ... Where compensation is paid to a nonresident 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 ... 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.

The facts as outlined in your letter show that the income from the non-qualified stock option was directly related to the four year period (July 1, 2001 through June 30, 2005), during which Mr. A was actually employed by Corp B prior to the time he exercised the options, so that the proper allocation should be based on the four year period. As a result, Mr. A is entitled to a credit against his Illinois income tax liability for 2005 with respect to the income taxes paid to California and other states for the non-qualified stock option compensation attributable on a ratable basis from July 1, 2001 through December 31, 2004, the period before his employment was relocated to Illinois.

As stated above, this is a general information letter which does not constitute a statement of policy

that either applies, interprets or prescribes tax law. It is not binding on the Department. Should you have additional questions, please do not hesitate to contact our office.

Sincerely,

Heidi Scott  
Staff Attorney -- Income Tax

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<sup>1</sup> The Illinois Income Tax Act which is found at 35 ILCS 5/101 through 35 ILCS 5/1701 is referred to informally throughout this letter simply as "IITA" followed by a section number.

<sup>2</sup> The highlighted sentence was deleted from the statute, effective January 1, 2006, by P.A. 94-247.

<sup>3</sup> The income tax regulations of the Illinois Department of Revenue are found at 86 Ill. Adm. Code 100.2000 through 100.9900. Throughout this letter, these regulations will be referred to simply as "Reg. Sec." followed by a section number.

<sup>4</sup> The basic operation of the highlighted sentence, including cross reference to Reg. Sec. 100.3120, was explained by the Department of Revenue in Reg. Sec. 100.2197.