

Alert 10-157



## New and Improved Illinois Tax Amnesty Law: Creating Pavlov's Taxpayer?

For the second time in seven years, Illinois will ring the dinner bell and entice taxpayers to show up for another helping of tax relief in the form of a tax amnesty program for all taxes collected by the Illinois Department of Revenue ("the Department"). Amendments to the Tax Delinquency Amnesty Act (the "TDAA" and the "New Amnesty Law") made by Senate Bill 377 were sent to the Governor for his signature on June 25, 2010. The New Amnesty Law will become law in 60 days (on August 24) unless the Governor signs or vetoes the bill at an earlier date. The Governor has previously expressed concern about the impact of recurring amnesties on voluntary tax compliance, but, with Illinois having recently been referred to by a New York Times writer as "Greece by the Lake," the State's budget woes may outweigh otherwise valid policy concerns.

Under the New Amnesty Law, the Department will administer an amnesty program from October 1, 2010 through November 8, 2010 (a period a week shorter than the last Illinois amnesty program in 2003) for any taxable period ending after June 30, 2002 but prior to July 1, 2009. As was the case under the 2003 amnesty program, a payment of tax during the amnesty period is rewarded with a full abatement of interest and penalties, but failure to pay the tax amounts owed to the Department during the amnesty program will result in imposition of penalties and interest at 200 % of the otherwise applicable rates.

There are two areas in which we expect that the application of the New Amnesty Law will generate considerable controversy: (i) application of the amnesty to taxpayers with pending state tax audits and administrative appeals; and (ii) application of the amnesty to taxpayers with pending federal audits for amnesty-eligible periods.

### Pending State Tax Audits and Administrative Appeals

The New Amnesty Law renders ineligible for amnesty any taxpayer who is a party to criminal or civil litigation involving a tax year otherwise eligible for amnesty. Thus, such taxpayers will not be exposed to any doubling of interest and penalties. It is important to note that this narrow exclusion does not apply to taxpayers who are under audit or who are in an administrative hearing protesting an audit assessment. Such taxpayers will see their penalties and interest doubled by operation of law if they don't participate in the amnesty program before it ends on November 8.

This presents a dilemma for taxpayers who are being audited or are in the process of protesting an audit assessment in an administrative hearing. If in audit, such taxpayers can participate in the amnesty program if they estimate and pay during amnesty the amount of audit liability they expect at the conclusion of the audit. If in administrative hearings, such taxpayers can participate in the amnesty program if they surrender their due process right to contest the assessed liability and instead pay the assessed tax during the October 1st through November 8th amnesty program. However taxpayers who elect to participate in the amnesty by paying an estimated tax amount will be barred from seeking a refund of any overpayment on the issue generating the amnesty liability, although they may still seek a refund of overpayments on issues for which they did not seek amnesty.

Meanwhile taxpayers with cases in the administrative hearings process and not prepared to surrender their due process rights may seek to fall within the civil litigation exclusion by attempting to have those cases removed to Circuit Court and, thus, avoid doubling of penalties and interest. We expect the Department to vigorously oppose such attempts. We also expect the Department to oppose efforts by taxpayers under audit, who have not yet received a notice of deficiency or notice of tax liability, to short-circuit the audit process by paying the estimated liability for their audit under protest and starting a civil action seeking a refund of the protested payment. One appellate decision involving the 2003 amnesty program allowed a taxpayer, who had received an audit report but had not been issued a notice of tax liability, to pay the anticipated assessment under protest and file an action in circuit court before the Department issued a notice of tax

liability, thus avoiding the administrative hearings process. However, the decision is very narrowly tailored to the facts of that case and may not offer support for similar efforts by differently situated taxpayers.

Taxpayers under audit (including in Informal Conference) or in the administrative hearings process need to promptly consult with knowledgeable Illinois tax counsel and take steps to avoid doubling of penalties and interest by operation of law when the amnesty period closes on November 8, 2010. Reed Smith is advising clients with procedural options specific to their situation.

## Pending Federal Audits

Under the 2003 amnesty program, the Department's position on what constituted taxes "owing" during the amnesty period was much broader than the statutory language authorizing the amnesty might have suggested. The mismatch between the Department's position and the actual statutory language resulted in litigation that is still pending.

The 2003 amnesty legislation offered amnesty for taxes "owing" a tax at the time of the amnesty program. The Department issued emergency regulations implementing the 2003 amnesty program that allowed participation in the program by taxpayers that anticipated an Internal Revenue Service ("IRS") audit adjustment to their federal income tax liability ("federal change") and that preemptively reported and paid tax on their estimate of the Illinois impact of the possible federal change. The resulting pending litigation falls into two basic categories. First, some taxpayers are seeking refunds to the extent that they overestimated the amount of Illinois tax resulting from their federal change. Illinois is contesting such refund claims if they were filed more than one year from the date of the estimated amnesty payment, regardless of when the federal change became final. Second, taxpayers who relied on the statutory language governing the timing for reporting federal changes, and did not treat the additional tax amounts eventually resulting from pending federal audits as "owing" during the amnesty period, have, in several cases, been assessed double interest and and double penalties on the Illinois tax resulting from the federal changes that became final after the close of the 2003 amnesty period.

The New Amnesty Law does not expressly provide for the preemptive reporting of possible future federal changes, but it does say that "[p]articipation in an amnesty program shall not preclude a taxpayer from claiming a refund for an overpayment of tax . . . by taxpayers estimating a non-final tax liability for the amnesty program pursuant to" the provisions of the Illinois Income Tax Act that govern report and payment of additional tax resulting from IRS adjustments to federal returns. See, S.B. 377, amended TDAA § 10, italics added. This language appears to authorize a refund of payments made pursuant to the 2003 amnesty program as well as those made pursuant to the New Amnesty Law.

While it appears that the New Amnesty Law resolves the refund-problem for anticipated federal changes overpaid during the 2003 amnesty, the New Amnesty Law does nothing to help taxpayers who are required by law to report a federal change to Illinois that occurs after November 8, 2010, for the new amnesty-eligible tax period. Unless otherwise provided in emergency regulations the Department of Revenue may issue, these taxpayers will again be subject to 200 % penalties and interest if they follow the statute and timely report the federal change when it becomes final after the New Amnesty period expires. Otherwise, Reed Smith is representing several clients in litigation on this issue with respect to the 2003 amnesty, and a final ruling in one of these pending cases could resolve the issue with respect to the 2010 amnesty as well.

## Emergency Regulations

It is anticipated that the Department will issue emergency regulations to administer the New Amnesty Law as it did for the 2003 amnesty. By issuing emergency regulations, the Department is able to avoid the notice and comment period required for non-emergency regulations. However, this means that there will be little direct taxpayer input into the emergency regulations as they are drafted by the Department. Reed Smith will continue to update clients on the New Amnesty Law developments as they arise.

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For more information on the New Amnesty Law, please contact the author of this Alert, or the Reed Smith attorney with whom you regularly work. For additional information on Reed Smith's State Tax Practice, visit [www.reedsmith.com/ILtax](http://www.reedsmith.com/ILtax).

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