

The Illinois 2010 Amnesty Law: "Say hello to my little friend!"

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Reading the 2010 Illinois Tax Delinquency Amnesty Act (the "2010 Illinois Amnesty Law") brings to mind two memorable lines from 1983 movie, "Scarface." The first is the instruction about the drug business that dealer Frank Lopez gives to Tony Montana: "Don't underestimate the other guy's greed." The other is Tony Montana's pre-mayhem gun-toting taunt: "Say hello to my little friend!" But first, some background.

Background - The 2010 Illinois Amnesty Law and Emergency Regulations -Good Karma vs. Bad Karma

The 2010 Illinois Amnesty Law and the Illinois Department of Revenue's Amnesty Emergency Regulations provide guidance on how the tax amnesty, which runs from October 1, 2010 through November 8, 2010, will apply in various situations. Some of the results are counterintuitive.

The 2010 Illinois Amnesty Law and the Emergency Regulations essentially divide taxpayer actions into two categories: those that, if taken during the amnesty, will allow the taxpayer to avoid penalty and interest on taxes administered by the Illinois Department of Revenue (other than motor fuel taxes) that are owed to Illinois for periods ending after June 30, 2002 and before July 1, 2009 (actions resulting in "Good Karma"); and those that will result in a doubling of otherwise applicable penalties and interest (actions resulting in "Bad Karma").

- Taxpayers with tax appeals pending for amnesty-eligible periods (periods ending after June 30, 2002 and before July 1, 2009) in civil litigation (not administrative protests) or in criminal investigation will not experience Bad Karma, but they are also not eligible for Good Karma.
- Taxpayers with tax appeals pending for amnesty-eligible periods in bankruptcy court can experience Good Karma, if participation in the Illinois tax amnesty is allowed by the bankruptcy court. However, such taxpayers are not exposed to the risk of incurring Bad Karma.
- Taxpayers with ongoing audit disputes involving an amnesty-eligible period can make a payment under the Illinois tax amnesty and receive Good Karma. If the amnesty payment is insufficient to cover the taxpayer's ultimate liability, at the end of the audit, they will suffer Bad Karma only with respect to the amount of tax due in excess of what they paid in amnesty. Such taxpayers will have

the option of paying the remaining balance due within 30 days of notice by the Department (thus, preserving the Good Karma associated with the initial amnesty payment). However, if they protest the liability, and that protest is not successful (or if they reach a settlement with the Department after they protest), then they will lose all Good Karma previously conferred as a result of the initial payment, and will experience Bad Karma with respect to the full amount of the final tax assessment. (Yes, shamefully, Illinois will be penalizing taxpayers that exercise their statutory due process rights.)

- Taxpayers who expect to report a federal change to Illinois for an amnesty-eligible period, but do not expect that the federal change will become final until after November 8, 2010, can make a Good Karma deposit on or before November 8, 2010. However, if a taxpayer chooses not to make such a deposit and, instead, reports the federal change and pays the resulting Illinois tax when the federal change becomes final, then the taxpayer will not experience any Bad Karma on the amounts timely reported and paid. (This is different from the treatment of federal changes under the 2003 Illinois tax amnesty).

"Don't underestimate the other guy's greed."

Suppose that Conservative Corp. substantially overpaid its Illinois taxes for 2009, but expects losses in the years ahead. As a consequence, on its original 2009 Illinois return Conservative Corp. indicated that the overpayment should be refunded rather than carried as a credit to the following tax year. Conservative Corp. has prior-year Illinois tax positions that, although reasonable, have been questioned in a pending audit. The Tax Director of Conservative Corp. is intrigued by the possibility of using its 2009 overpayment to mitigate its exposure through the new amnesty program, until reading this passage from Section 520.105(c)(2) of the Emergency Regulations: ?

". . . if a taxpayer has reported an income tax overpayment for a taxable year that has not been paid or denied as of the beginning of the Amnesty Program Period, and wishes to report an Eligible Liability for the same taxable year, the taxpayer must file an amended return . . . *and pay the increase in tax reported on the amended return, as if it had already received a refund of the previously reported overpayment.*"

Thus, to participate in the 2010 Illinois tax amnesty, Conservative Corp. will need to make a payment to Illinois to cover its amnesty-eligible liabilities, notwithstanding the fact that Illinois has not refunded Conservative Corp.'s 2009 overpayment. Conservative Corp.'s Tax Director is incredulous.

The new accounting regime in Illinois appears to be single-entry accounting - entries that benefit the State are made immediately, while any offsetting entries that benefit the taxpayer are deferred until a formal claim is filed, processed and approved. Illinois' current unpaid balance of tax refunds is approximately \$800 million, and will likely reach \$1 billion by year-end, so one would think reducing that balance would be a useful feature of an amnesty program, but the State is proposing other ways to do that.

The Proposed Regulation on Overpayments

The Tax Director of Conservative Corp. does some additional research and finds a pending proposed amendment to the Department of Revenue's regulation on Credits and Refunds.¹ Under the proposed amendment, the Department will not consider the 2009 return filed by Conservative Corp. as a request for a refund of the 2009 overpayment.

Under the proposed amendment, the language in the Credits and Refunds regulations stating that "a timely return may have the effect of a claim for refund of a tax overpayment" is replaced with: "An original return . . . may qualify as an extension of the limitations period for filing a claim for refund under Section 100.9410(c)(2)." Further, Section 100.9410(c)(2) of the proposed amendment provides that "an original return is not a refund claim that preserves a taxpayer's right to a refund or credit of an overpayment of tax after the statute of limitations for filing a refund claim has otherwise expired." Instead, under the proposed amendment, the original return's direction that the overpayment be refunded is only "an extension of time for the filing of the claim for refund of that overpayment through a date which is 6 months after the date on which the Department issues a refund of a portion of the reported overpayment, notifies the taxpayer that it has allowed a credit for a portion of the reported overpayment, or notifies the taxpayer that no refund or credit of the reported overpayment will be allowed." However, since the Emergency Regulations provide that only a "verified" overpayment can be applied as an amnesty payment, that means that, under the proposed amendment to the Credits and Refunds regulations, filing a claim does nothing to free up an overpayment to be applied towards amnesty- it is only approved claim amounts that can be used to make an amnesty payment.

The implications for Conservative Corp. are clear. Illinois will ignore overpayments reported on an original return unless, and until, Conservative Corp. files an amended return claiming the refund, and the refund is approved by the Department. In the long term, this means that Conservative Corp. will take more aggressive positions for Illinois tax purposes, and pay less tax to Illinois, in order to avoid being in a

position of a creditor to the State of Illinois. In the short-term, however, an amnesty decision must be made.

The Amnesty Decision -- "Say hello to my little friend!"

After November 8, when Illinois auditors start firing off proposed deficiencies that include double penalties and interest, taxpayers may well be envisioning their auditor in the role of Tony Montana, brandishing the Amnesty Law in the air, announcing, "Say hello to my little friend!"

After November 8, the bigger the tax bullet, the bigger the hit from doubling penalties and interest. The likely result will be a more compliant taxpayer. Like the proverbial indigent defendant that may plea to an offense he or she may not have committed rather than face a more serious charge and sentence, every taxpayer currently in an audit will feel the pressure to concede issues (and pay the resulting tax) by November 8, rather than run the risk that he or she will face the Bad Karma of double penalties and interest when the audit closes.

However, like many other taxpayers, our hypothetical Conservative Corp. will decide that the only leverage it retains after November 8 is by not making a payment. The amnesty payment gains the taxpayer no leverage, since all Good Karma is forfeited, and Bad Karma is unleashed if the taxpayer does not agree to what could well be an unrealistic or unreasonable audit position when the audit closes after November 8. The calculus for Conservative Corp. might be different if Illinois would give Conservative Corp. timely credit for the overpayment made with Conservative Corp.'s original 2009 return.

Thus, the coercive approach that Illinois has taken with its 2010 amnesty program will, in some cases, actually encourage taxpayers to defer the payment of some taxes. This is hardly the result one would consider desirable for an amnesty program. But, then again, the Illinois program seems more akin to a protection racket than a true amnesty.

When an Illinois audit closes after November 8, 2010, taxpayers will end up getting clobbered with double penalties and interest on tax liabilities that they had hoped they would be able to pay with existing overpayment balances. Instead, these taxpayers will discover that Illinois has instead reduced or eliminated their overpayment balances by offsetting the overpayment against the tax liability, newly inflated with double interest and penalties. These taxpayers may be reminded of another crime movie scene and feel like Illinois left the gun but took the cannoli.²



For more information on the 2010 Illinois amnesty program, contact the author of this Alert or another member of the Reed Smith State Tax Group. For more information on Reed Smith's Illinois tax practice, visit www.reedsmith.com/iltax.

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1. *See, 34 Ill. Reg. 12658 Issue 36, proposed amendments to 86 Ill. Admin. Code § 100.9400 and § 100.9410.*
 2. *"Leave the gun. Take the cannoli.", says Clemenza to his fellow-hitman, Rocco, as they stand by their victim's car and spot cannoli he was taking to his family resting on the dashboard, in the 1972 movie, "The Godfather."*

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