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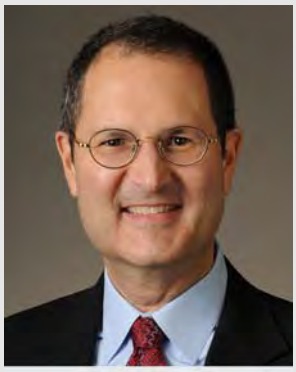

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In this installment of Prairie State Perspectives, the authors analyze the Local Government Revenue Recapture Act, which was enacted this year and allows an Illinois county or municipality to hire third-party auditors to review taxpayer data from the Department of Revenue to confirm that the locality has received the correct tax disbursement from the DOR.

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An Overview of the Act

What Is It?

The Local Government Revenue Recapture Act, signed into law on January 24, 2020, allows local governments in Illinois to hire third-party auditors on a contingency fee basis to review sales tax information "for the purpose of ensuring that the municipality or county receives the correct disbursement from the Department [of Revenue] and monitoring disbursements."[1] The auditor will be charged with ensuring that no tax is "paid by the taxpayer and allocated to one unit of local government that should have been allocated to a different unit of local government."[2] The act became effective June 1.

How Does It Work?

The act authorizes local taxing authorities and third-party auditors to access and examine otherwise confidential sales tax data provided to the department.[3] If a third-party auditor discovers that local sales taxes may have been misallocated or underpaid, the auditor is permitted to send a taxpayer audit referral to the department for further review.[4] The department will then review the audit referral to determine "whether it is sufficient to warrant further action."[5] If the department determines the referral is not actionable, no further action is taken. If it determines that the referral is actionable, however, it will then determine if the taxpayer is under audit or scheduled for audit. If not, and the department decides to schedule an audit, it will

[1] P.A. 101-0628, article 5, section 5-10.

[2] P.A. 101-0628, article 5, section 5-5.

[3] P.A. 101-0628, article 5, section 5-10 (d)(3).

[4] P.A. 101-0628, article 5, section 5-50.

[5] P.A. 101-0628, article 10, section 10-30(c)(1).

notify the taxpayer that its local government referred it for audit and either commence the audit or allow the taxpayer to hire a certified auditor (discussed below) to conduct the audit of the taxpayer and its sales tax payments — at the taxpayer's cost.

Municipality and Third-Party Auditor Restrictions

Unlike the previous iteration of this bill (H.B. 2717), which was highly contentious, the revenue recapture act passed with relative ease. The department and the business community — concerned about legislation that would have allowed the sharing of taxpayer information — worked with legislators to ensure restrictions on and repercussions for improper sharing of taxpayer information by municipalities and third-party auditors.

The act imposes several restrictions on localities and their third-party auditors. They are prohibited from contacting the department or communicating, directly or indirectly, with taxpayers about any matters directly or indirectly related to the audit. They cannot "access, review, or compel the production of taxpayers' actual tax returns or . . . books and records."[6] The local governments and third-party auditors are each further restricted from engaging in audits of, assessing tax against, or engaging in collection actions against taxpayers related to taxes administered by the department.[7] The auditors are further required to sign confidentiality agreements and permanently destroy any financial information received through the audit process within 30 days after receipt of information if not referred to the department or within 30 days after the department receives the taxpayer audit referral.[8]

Pilot Certified Audit Program

Finally, the act creates a pilot certified audit program to further enhance tax compliance and the associated review process. The certified audit program establishes a partnership among taxpayers, Illinois CPAs, and the department to provide guidance to taxpayers, enhance voluntary compliance, and lessen the burden on the department to audit all referred taxpayers.[9]

As part of the certified audit program, after an audit referral the department will issue a notice to the taxpayer that its local government contracted with a third party to review its sales and use tax payments and referred the taxpayer for a certified audit under the act. The notice further explains that the department is required to disclose the taxpayer's confidential financial information to these local governments and third-party auditors and refers all questions regarding the referral to the local government authority.

As an alternative to the audit by the municipality's third-party contingent fee auditor, taxpayers referred for audit under the Act are encouraged to hire qualified practitioners at their own expense (although not on a contingency fee basis) to review and report on their tax compliance. The reviews are limited to "factors that impact the department's allocation of sales and use tax revenues to the jurisdiction in which the taxpayer reports sales or use tax."[10] As an incentive to use qualified practitioners, the department will abate penalties due on any tax liabilities revealed by the certified audit.[11]

The Backdrop That Created the 'Perfect Storm'

Overview

Suffice to say, Illinois has one of the most complex sales and use tax regimes in the United States. The Retailers' Occupation Tax Act (Illinois's sales tax) imposes tax on persons engaged in the business of selling tangible personal property at retail rather than being a pure excise tax imposed on the sale of tangible personal property.[12] The Use Tax Act imposes a use tax for the privilege of using in Illinois tangible personal property purchased at retail from a retailer.[13]

[6] P.A. 101-0628, article 5, section 5-50(c).

[7] P.A. 101-0628, article 5, section 5-50(d).

[8] P.A. 101-0628, article 5, section 5-20.

[9] P.A. 101-0628, article 10, section 10-5.

[10] P.A. 101-0628, article 10, section 10-20(a).

[11] This authority to abate penalties does not apply to any tax liability collected but not remitted to the department or fraud penalties. *See* P.A. 101-0628, article 10, section 10-20(b).

[12] *See* 35 ILCS 120/1.

[13] *See* 35 ILCS 105/3.

The state sales and use tax rates are both 6.25 percent, with 5 percent allocated to the state and 1.25 percent allocated among local governments. The state allows local jurisdictions to impose an additional add-on sales tax, effectively raising the sales tax to more than 6.25 percent in those jurisdictions. Local governments are not, however, permitted to impose local use taxes (except for a 1 percent use tax imposed and administered by Chicago).

The local government portion of the sales tax is allocated to municipalities and counties in which the sale occurred based on the retailer's activities in making the sale, and not the point of delivery. The use tax is deposited into a fund administered by the department and disbursed to local governments as follows: 20 percent to Chicago, 10 percent to the Regional Transportation Authority (RTA), 0.6 percent to Metro-East Mass Transit District, $3.15 million to the Build Illinois Fund, and the remainder to municipalities (other than Chicago) based on population.

Kankakee Cases and New Sourcing Regulations

The proper sourcing of Illinois sales tax has been a contentious and heavily litigated issue that has left municipal, county, and other local government units with overblown concerns about the department's review of local sales tax allocations. For decades, the department used an order acceptance rule in which the sole factor for sourcing the sale was where a retailer accepted a purchase order. This rule encouraged retailers to source their sales to lower-taxing jurisdictions by having an authorized representative in the jurisdiction to accept sales orders on behalf of the seller. Some retailers even entered tax-sharing arrangements with municipalities under which a portion of the resulting local tax was rebated to the retailer. Not surprisingly, this led other municipalities and units of local government to pursue claims against these low-taxing jurisdictions for improperly sourced sales.

No litigation was more extensive than the *Kankakee* lawsuits. The RTA, Cook County, and Chicago all filed lawsuits against Kankakee and other municipalities, alleging they entered into agreements with retailers to improperly source sales to those municipalities or improperly pay sales tax instead of use tax, a portion of which was rebated to the retailer. In *City of Chicago v. City of Kankakee*, Chicago also sought declaratory judgment against internet retailers for improperly reporting the sourcing of their sales to avoid being subject to the use tax.[14] However, the plaintiffs' claims eventually failed, in part because of *Hartney Fuel Oil Co. v. Hamer*.[15]

In *Hartney*, the Illinois Supreme Court struck down the order acceptance rule for sourcing sales. In response, the Department promulgated new multifactor sourcing regulations, which aim to source sales to the business location with the most substantive connection to the selling activity.[16] The first part of the test considers five primary factors to determine the location of the retail activity. If one location can claim at least three of the five factors, the sale is sourced to that jurisdiction.[17] If no jurisdiction can claim a majority of the primary factors, a secondary set of factors is considered.[18]

The Cook County Circuit Court denied Chicago's motion to file a fourth amended complaint against Kankakee, stating that the power to enforce tax collection or distribute taxes "vests within the [department]."[19] Essentially, the court indicated that the authority to bring these claims rested solely with the department. The appellate court reversed the circuit court and held that the courts could decide whether sales are correctly sourced for purposes of the use tax.[20] After eight years of litigation, the plaintiff's quest ended when the Illinois Supreme Court reversed again and affirmed the circuit court's decision to dismiss the motion to file a fourth amended complaint. In doing so, the Supreme Court held that the department has exclusive authority to audit tax payment and redistribute tax revenues.[21]

[14] *City of Chicago v. City of Kankakee*, Case No. 11 CH 29745 (filed Feb. 3, 2014) (*rev'd by City of Chicago v. City of Kankakee*, 2017 IL App (1st) 153531; *aff'd by City of Chicago v. City of Kankakee*, 2019 IL 122878)).

[15] 2013 IL 115130.

[16] 38 Ill. Reg. 14292 (2014).

[17] *See* 86 Ill. Admin. Code 220.115(c)(1), (2).

[18] *See* 86 Ill. Admin. Code 220.115(c)(4), (5).

[19] Case No. 11 CH 29745 (filed Feb. 3, 2014).

[20] *City of Chicago v. City of Kankakee*, 2017 IL App (1st) 153531.

[21] *City of Chicago v. City of Kankakee*, 2019 IL 122878.

Replacement Tax Error

The relationship between the department and local taxing jurisdictions further soured after a calculation error in which income taxes were misclassified as personal property tax replacement income taxes (replacement tax), an add-on income tax allocated to local government units.[22] In April 2016, the department discovered that it had mistakenly allocated an estimated $168 million of income tax to more than 6,500 local government units as the replacement tax.[23] The department recouped the overpayments through reductions in subsequent replacement tax distributions. This episode further fueled local government concern about the department's ability to properly allocate local taxes.

Policy Implications and General Observations

Outsourcing of a Government Audit Function to Private Parties

Although the municipalities (and their third-party auditors) would usurp the authority of the department to audit local sales taxes, the General Assembly has tried to preserve that exclusive jurisdiction by permitting municipalities to audit the department rather than directly auditing taxpayers. Suffice it to say, the use of third-party auditors is not a new concept in Illinois. For years, municipalities have entered into franchise and tax audit agreements with third parties to increase utility tax revenue. This and the current act have set a dangerous precedent. In effect, the General Assembly is sanctioning the outsourcing of a government audit function to private parties.

Contingency Fee Arrangement

One of the biggest concerns with the act is the contingency fee arrangement permitted between the third-party audit firms and local jurisdictions. Under the contractual agreement, the municipality agrees to pay the third-party auditor a portion of any gross income generated from the audit. In some cases, these agreements allow third parties to collect up to 50 percent of generated revenue.

In theory, the act will ensure that local governments can recover local taxes mistakenly paid to the wrong jurisdiction. But, after the post-*Hartney* regulations were promulgated, most if not all the arrangements to shift revenue improperly to the wrong jurisdiction were terminated. Thus, these audits are likely to result merely in the shifting of money among local jurisdictions from random and one-off errors, with a 50 percent cut taken by private parties — substantially diminishing the pot of local revenue available to spend on public purposes. The only winner in this arrangement is the third-party auditors.

Confidentiality: Sharing Private Information

Under the act, private third-party auditors will have access to otherwise confidential taxpayer information. While the act prohibits using the financial information for any other purpose and access to private information is conditioned on signing confidentiality agreements, this may not be enough to adequately safeguard taxpayer privacy concerns.

False Claims Act Concerns

Significant concerns have been raised that the act could lead to an increase in whistleblowers suing audited taxpayers under the False Claims Act. An amendment to the act that would have excluded all taxes administered by the state from the Illinois False Claims Act, and essentially quash these lawsuits, was removed from the final bill. By intentionally removing this amendment, some might argue, the General Assembly is tacitly approving these types of suits, notwithstanding the general prohibition against the use of private taxpayer information.

Certified Audit Program

One novel element of the act is the certified public audit program. This type of program could enhance voluntary tax compliance while serving as a check on local governments' use of third-party auditors. By allowing the use of qualified practitioners, the department preemptively

[22]The replacement tax is a state income tax imposed on corporations and passthrough entities established to replace local personal property taxes imposed on businesses; those taxes were abolished pursuant to the 1970 Illinois Constitution.

[23]The Civic Federation, "Local Governments Must Repay $168 Million to the State" (June 23, 2016).

lessens its burden of reviewing all tax referrals and avoids the drain on public money inherent in the contingent fee model. Further, the act's requirement that the department notify taxpayers that they have been targeted for audit by their local government could serve as a powerful "poison pill," making the use of the audit referral program unattractive to local governments.

Closing Thoughts

While it is uncertain whether the revenue recapture act will help to effectively redistribute any misallocated or underpaid municipal tax revenues, the outsourcing of a government function to third-party auditors on a contingent fee basis could have significant unintended consequences. The certified public audit program, however, is a silver lining of the act that may serve as a model for minimizing the reach of contingent fee audits that drain the fisc of local governments. ■