



# State and Local Tax Procedural Issues – Audits, Assessments and Litigation: The Nitty Gritty

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# Objectives

- Ongoing Identification of Potential State and Local Tax Audit Exposure
- Identity and Understand State and Local Tax Jurisdictions and Taxes at Issue
- Understand what can be done before an audit starts
- Know what you can do to minimize your audit exposure
- Appreciate that the auditor is not always the final word
- Know the chain of command and how to access it
- Understand your options before, during and after the audit
- Appreciate that even after it's over, it may not be over ...

# Background

## Tax Audits are here to stay -

- Very difficult for a state or local government to request a tax increase when faced with a perception that everyone is not paying their fair share
- Regular audit process helps assure that required taxes are being remitted
- Annual City and State budget process may identify sources of new tax revenues - City of Chicago budget shortfall could reach between \$789 million and \$1.9 billion by 2026 to be filled using existing revenue sources.
- State and Local Auditors are becoming more sophisticated
- Use of data mining and other public information
- Taxing authority systems access

# What should be done before an audit?

## Know your Business /Industry/Taxing Jurisdictions -

- Be Proactive
- Maintain Required Business Records
- How similar or different are you when compared to your industry
- Gather and save relevant precedents from the jurisdictions where you operate and sell; look at jurisdictions where you plan to have activity
- Build out a taxability matrix, exemption certificate file, establish a state and local tax process, ...
- Consider voluntary disclosure(s), amnesty if available or indemnity, if applicable
- Request written confirmation from the taxing authority concerning material tax issues -
  - An email exchange can be written advice that supports your filing position
  - PLR or GIL if require higher level of certainty or addressing uncertain area

# What should be done before the audit? (Continued)

## What if the law is unclear?

- Reach out to a seasoned professional
- Work with the taxing authority to come to a reasoned interpretation
- Reach out to a legislator or alderperson
- Reach out to an industry organization
- Reach out to the head of the taxing authority

## Review corporate policy, include legal, IT and others -

- Document retention / align with federal, state and local statutes of limitation
- Confidentiality and privileges

# It's your unlucky day; you were picked for an audit

## How could this have happened?

- Industry
- Referral /Significant event
- Tax Filing History
- Prior Audit
- Audit in a Neighboring Jurisdiction
- Auditing Customer or Supplier
- Address Listed on Registration or Licensing filing
- It was just Your Turn

# It's your unlucky day; you were picked for an audit (Continued)

## Now What -

- Determine whether you address the audit with internal resources, outsource or try a hybrid approach – How you start the audit process is extremely important!
- Where will the auditor work, restricted area?
- Will they want to tour your facility?
- Who will act as the taxpayer's sole point of contact?
- What other job responsibilities does the point of contact have?
- Communication is of primary importance
- Know your auditor's email and cell number
- Know the same information for the auditor's supervisor
- Discuss an audit plan using a pre-audit conference



# It's your unlucky day; you were picked for an audit (Continued)

## Communication is extremely important -

- Document everything via an email, request confirmation
- State secured email access to historic emails
- Document review – electronic or paper
- Discuss with the auditor at the start - planned vacations, other audits, return prep and filing, year-end obligations, financial reporting deadlines, life events, ...
- Treat others as you'd like to be treated - Be Professional
- Never underestimate the value of a donut
- Employee the 24-hour rule
- Rules and expectations if the Auditor works from your office or facility

# It's your unlucky day; you were picked for an audit (Continued)

## Best Practices -

- The auditor is not your friend, even if you are friendly
- Threat the audit as if you are going to litigation -
  - Once you turn over a document you cannot get it back
  - Once you make a statement you cannot unsay it
  - Know what you are agreeing to
- Know what is on your company's website
- Know what is in your company's annual report, 10K, other filings and other public documents
- Have an endgame in mind that your management has approved

# It's your unlucky day; you were picked for an audit (Continued)

## Statute of Limitations -

- Does the audit include only periods open under the SOL?
- Was a tax period already extended
- Understand substantial underreporting extended statute requirements
- When / if an assessment is issued, is it timely?
- Does the taxing authority have the correct taxpayer
- Was there a prior audit?
- People involved, areas examined, areas abandoned / not examined, results
- Understand likely issues and areas of concern
- You are not required to extend ...

# The Audit

**Initial contact sets the tone, cooperation and timely responses should be a goal –**

- Schedule regular status meetings
- Drive the process
- Log and review IDRs and responses, as well as communications
- Request all IDRs and questions be written – reduce miscommunication
- Assess impact on overall strategy
- Check privilege status
- Keep file of all documents provided

# The Audit (Continued)

## Sampling -

- Can you select the type?
- Prior audits
- Are there seasonal or other sales anomalies to consider?
- Are there periods with significant purchases that may not be representative?
- Exclusion from sample of large nonrecurring items that end up in the sample?
- Can you break sample into categories based on amount of spend/sale?
- How will overpayments be addressed?
- Only provide what is requested or answer questions asked - Do not elaborate

# The Audit (Continued)

## Information Requests -

- The auditor requests sensitive business data
- The auditor requests copies of corporate minutes, proprietary information
- What are you required to provide?
- The auditor requests information that has been destroyed or never existed
- Can you provide the requested information in some other form?
- Your foreign parent refuses to provide the requested information
- There is no ONE ANSWER

# The Audit (Continued)

## Failure to Furnish Documents or Reply -

- How can failure to furnish requested documents impact you?
- What information and documents are reasonable and relevant?
- What if the auditor is requesting documents subject to privilege?
- What privileges are potentially applicable? Attorney / Accountant
- What if the state issues a subpoena?

# The Audit (Continued)

## Request from Third Parties -

- When can an Auditor request information from a third party?
- Is the Auditor required to give the taxpayer notice when requesting information from third parties?
- Procedures for obtaining lists of third-party requests



# The Audit (Continued)

## Preliminary Audit Results -

Disagreement about application of the law

- Discuss with the Audit Supervisor
- Request that Audit seek technical advice from Legal
- Tell the Auditor you want to draft the request to the TA group
- Seek interaction with Legal group re conclusions

Disagreement about audit exceptions

- Provide missing documents
- Seek to eliminate transaction(s) as an outlier
- Seek to eliminate based on other documents

# The Audit (Continued)

## Preliminary Results (continued) -

A more formal assessment amount is on the horizon

- Continue to seek auditor concessions
- After exhausting discussions with the auditor, take a run at the supervisor

## Final Preliminary Assessment

In Illinois – Informal Conference Board (“ICB”) Option

- What is your issue?
- What are your chances?
- Is there anything the Auditor missed?

# Audit Concluded – Assessment/Refund Denial Issued

## Issuance of Assessment or Refund Denial

- Review Assessment Notice or Notice of Denial to confirm proper tax periods, issues and assessment amounts
- Know filing deadline for Response (Illinois - 60 days to protest)
- Deemed Assessment if do not timely file response
- Collection Proceedings initiated if no response and no payment
- Make full payment to conclude matter
- Pay all or part of tax to stop all or part of interest from accruing
- Initiate litigation by filing Petition before filing deadline

# Litigation – Illinois Department of Revenue

## Initiate Litigation After Assessment/Refund Denial

- IDOR Administrative Hearings Division
  - Less than \$15,000 in tax at issue
  - Less formal rules of civil procedure
  - Administrative Law Judge – Only hear tax cases
  - No payment of tax required when Petition filed
  - Taxpayer not named publicly
  - Appellate Court gives deference to decision
  - Appearance of IDOR preference

# Litigation – Illinois Department of Revenue (Continued)

## Initiate Litigation After Assessment/Refund Denial

- Illinois Independent Tax Tribunal
  - More than \$15,000 in tax at issue
  - More Formal Rules of civil procedure
  - Tax Tribunal Judge – Only hear tax cases
  - No payment of tax required when Petition filed, \$500 filing fee
  - Taxpayer named on Petition, Tribunal willing to redact confidential information
  - Informal Settlement Process Within
  - Appellate Court gives deference to decision
  - Appearance of Independence from IDOR

# Litigation – Illinois Department of Revenue (Continued)

## Initiate Litigation After Assessment/Refund Denial

- Illinois Circuit Court
  - Required to pay tax assessed under Protest Monies Act before Petition filed
  - Formal Rules of civil procedure
  - Circuit Court Judge – May not be familiar with tax issues being litigated
  - Judges have extremely large case loads
  - Taxpayer named on Petition
  - Appellate Court gives deference to decision
  - No appearance of IDOR preference

# Is Settlement An Option – During or After Litigation

**Should you Settle? It depends ....**

- Understanding of the nature of the issue or issues
- Understanding where you are in the process and who has jurisdiction
- Understanding of how the Taxpayer wants to approach the assessment
- Understanding of what the Taxpayer views as a successful resolution of the matter

# Settlement – Understanding the Nature of the Issue(s)

- What is the underlying open issue(s)?
- Can the issue(s) be resolved by providing a better explanation of the issue – Is this simply a misunderstanding of the facts, the law or existing policy
- Is the Issue(s) the result of an internal or audit miscalculation – If so, identify the miscalculation and correct it
- Will external evidence better identify the Issue – What form of external support is acceptable?
- Will statutory, regulatory or case law support assist in the understanding of the Issue(s)
- Issues that are heavily factual in nature where vetting of the facts was not completed, may not be ready for settlement, absent discovery



# Settlement- Are You Able To Settle At This Time

- Department may not be able to settle matter until litigation initiated - Jurisdictional issue
- Department may requires some discovery before settlement even discussed
- Was Taxpayer previously audited and is this a recurring issue
- Has the issue been addressed retroactively or prospectively through recent litigation
- Is the Issue currently being litigated by another Taxpayer with similar facts
- How may years is the underlying issue open to you and other Taxpayers
- Has there been a recent policy change, federal legislation or US Supreme Court Decision
- Available Amnesty, VDA or other available programs or options
- Has the Taxpayer, its CPA or Attorney, or the Department recently settled a similar issue

# Settlement - How Does Taxpayer Wish To Approach

- First objectively evaluate good and bad facts
- Initiate a settlement discussion or offer with Department?
- Range of potential settlement options and amounts
- Do not pay anything, even \$1 to settle
- Initiate settlement through 3<sup>rd</sup> parties
- Is it important to resolve quickly for Taxpayer business reasons?

# Settlement- Understanding What Is Important To Taxpayer

- What is most important to Taxpayer – Cost, Certainty, Clarity, Timing, Privacy, ...
- Evaluate what constitutes a Taxpayer victory on an issue-by-issue basis
- Are you willing to concede some or all of the issues to settle?
- Is management focused on the amount of the reserve for the issues?\
- Does the item(s) at issue impact Taxpayer's business – financially, operationally, other, ...
- Understand that settlement is a compromise

# Decision Issued - Appeal Process And Options

## Decision Issued In You Favor

- You Win 100% - Congrats!
- You Win Some and Lose Some
- Court Agrees With One Or Both Sides But Sends Back With Instructions
- You Loss Issues But Penalties Abated

## Appeal After Initial Decision

- Illinois Appellate Court
- Illinois Supreme Court
- United States Supreme Court

# Settlement- Understanding the Taxpayer

## Confidentiality

- Is the Taxpayer sensitive about publicity?
- Is litigation even an option? If so, can the Taxpayer objectively support its willingness to litigate the matter?

## What is the Taxpayer looking for?

- Matter to go away?
- Forward relief?
- Conclusion to a substantive question of law?

# One Last Settlement Option

## Litigation Ends

- There still may be an option to settle – Varies case to case
- There still may be an option for some form of relief - Penalty abatement, Interest reduction, ...

# It's All Over, Now What?

## Post Audit/Litigation Internal Meeting –

- Document material Issues and Retain Required Documents
- Identify areas that need to be monitored – laws, regulations, policies
- Monitoring of certain facts going forward - business activities, facilities, employees, ....
- Identify audit/litigation successes and failures
- Business planning going forward to avoid audit exposure and tax expense
- Establish an Internal Audit Team responsible for ongoing monitoring of tax calendar, audit correspondence (My Tax), business changes (mergers, expansions, sales, relocations, ...)

# Final Thoughts

## **Audit Defense is Often More an Art Than a Science -**

- Know what is most important - Resolving past exposure, Certainty going forward, ...
- When you know you are legally correct do not concede unless – immaterial, more important issues
- Don't be afraid to involve - Audit supervisors, Department's Legal Group, ...
- Don't take no for an answer without receiving sufficient support
- Take full advantage and utilize the process the taxing authority has put in place
- Almost never too late to seek external assistance but .....



# QUESTIONS???

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