

# Perspective

## Constitutional Limitations

A constitutional challenge to the Illinois' Tax Delinquency Amnesty Act, which imposed double penalties and interest retroactively, was recently struck down by the Illinois Appellate Court. In this article, David A. Hughes of Horwood Marcus & Berk Chartered, takes a close look at the case and concludes that opportunities still remain for Illinois taxpayers to raise a Due Process Clause challenge to the amnesty law.

## Challenges to State Tax Amnesty Laws: *Advanced On-Site*, Other Cases Raise Constitutional Questions About Penalties

By DAVID A. HUGHES

States have resorted to various measures in an effort to raise revenue. Some states simply change their laws by increasing their tax rate, expanding their tax base, or eliminating exemptions. Other states might devote additional resources to discovery and enforcement in an effort to identify nonfilers or to ensure that filers are compliant. Still others pursue aggressive litigation strategies in an effort to create more favorable case law, which will lead to future revenue for the state.

One common tactic that many states have adopted recently in an effort to raise revenue is a tax amnesty program. The concept behind an amnesty program is simple: In exchange for the payment of an amount due (usually tax only), the state offers the taxpayer a reward, typically a full or partial reduction of penalty and/or interest. There is, however, a catch. With most state amnesty programs, a taxpayer who chooses not to participate—or who was never aware of the program in the first place—is subject to increased penalties and/or interest for any tax later determined to be owed.

Although state tax amnesty programs come in various shapes and sizes, they typically present taxpayers with a Hobson's choice: to participate in the program, and forego what might otherwise be legitimate challenges to a state tax, or to decline the amnesty offer and incur increased penalties and interest if a tax is later owed. It is this punitive aspect of amnesty programs that has generated significant controversy among many

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state taxpayers and has led to litigation challenging the validity of several amnesty laws.

The purpose of this article is to summarize and analyze those challenges with a particular focus on a recent, unpublished decision from the Illinois Appellate Court upholding Illinois' amnesty law: *Advanced On-Site Concrete Inc. v. Illinois Dept. of Rev.*<sup>1</sup> This article will also examine some recent amnesty challenges in other states.

### THE ILLINOIS TAX DELINQUENCY AMNESTY ACT

A relatively recent example of a state's amnesty law is the Illinois Tax Delinquency Amnesty Act (Amnesty Act), which became law on June 20, 2003, and which went into effect Oct. 1, 2003.<sup>2</sup> The act allowed taxpayers to pay past due tax liabilities owed to the Illinois Department of Revenue without incurring interest or penalties, albeit with certain conditions. In order for a taxpayer to be eligible to participate in the program, the liability had to be incurred between June 30, 1983, and July 1, 2002, and the amount due had to be paid between Oct. 1, 2003, and Nov. 17, 2003. Amnesty was available for any tax administered by the department other than motor fuel tax.

As with most amnesty laws, there was, of course, a caveat. Any taxpayer who was eligible to participate in the amnesty program, but did not, was subject to penalties and interest at twice the statutory rate of any tax later found to be due. Conversely, any taxpayer who was not eligible to participate in the program—for example, because the tax in question was the subject of a pending lawsuit in court—was not subject to the increased penalties and interest.

<sup>1</sup> *Advanced On-Site Concrete Inc. v. Illinois Dept. of Rev.*, Docket No. 1-06-3426 (Ill. App. Ct. May 22, 2008).

<sup>2</sup> 35 ILCS 745/1 *et seq.*

While the act itself contained little guidance for taxpayers, the department issued emergency regulations in order to clarify the act and its application.<sup>3</sup> The regulations stipulated three conditions for eligibility. Specifically, a taxpayer had to:

- relinquish any right to contest the tax liability being paid,
- not claim a refund of the money paid or protest the denial of a claim for such refund, and
- promptly correct any underpayment.<sup>4</sup>

If a taxpayer did not satisfy all three of these conditions, it would be ineligible to participate in the amnesty program.

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While the emergency regulations contained most of the eligibility conditions, the act itself included one additional condition for eligibility: A taxpayer could not be a party to any civil or criminal action pending in an Illinois court for nonpayment, delinquency, or fraud related to any department-administered tax. The regulation clarified this provision, stating that the exception did not apply to matters pending in the department's Office of Administrative Hearings. Nevertheless, a party who was ineligible could become eligible by dismissing the lawsuit during the amnesty period. Additionally, a taxpayer was ineligible only with regard to tax liabilities that were the subject of the civil action.

Though a taxpayer could be eligible to participate in the amnesty program, there was no guarantee that it would be notified of the opportunity. The emergency regulations made clear that while the department would make "reasonable and practicable" efforts to send written notice to taxpayers, it was under no duty to notify taxpayers of eligible liabilities. Even in circumstances where the department did not issue an assessment, or the liability was not known to a taxpayer, the liability would have to be paid in full in order to reap the benefits of amnesty and avoid the consequences for failing to participate.<sup>5</sup> In such cases, the taxpayer had to make a payment based on a good faith determination of the amount due. Any overpayment would be refunded to the taxpayer, unless the errors were computational, in which case they were refunded at the department's discretion.<sup>6</sup> In the event of an underpayment, a taxpayer was assessed double interest and penalties on the amount of the liability not paid. If this remaining balance was not paid by its due date, the taxpayer was liable for double interest and penalties on the entire amount.

<sup>3</sup> See 86 Ill. Admin. Code §521.101, 105.

<sup>4</sup> 86 Ill. Admin. Code §521.105.

<sup>5</sup> While a taxpayer had to pay the entire liability for a particular tax type, a taxpayer could choose to pay certain liabilities and not others, or pay particular tax periods and not others. However, any nonpayment of eligible liabilities would result in the imposition of increased penalties and interest.

<sup>6</sup> 86 Ill. Admin. Code §521.105(k).

## **ADVANCED-ON SITE CONCRETE CHALLENGE AND DECISION**

In light of the act's onerous penalty and interest provisions, especially for those taxpayers who were unaware of a liability during the amnesty period, it came as no surprise when many taxpayers challenged the Amnesty Act on statutory and constitutional grounds. The first of these cases to reach the Illinois Appellate Court was *Advanced On-Site Concrete*. In *Advanced On-Site*, the Illinois Appellate Court issued an unpublished opinion upholding the validity of the Amnesty Act.

Advanced On-Site Concrete Inc. (Advanced) was engaged in the production and delivery of ready-mix concrete. While the company was also involved in other related activities, most of its resources were directed toward the cement business.

On Dec. 26, 2003, shortly after the close of the Illinois amnesty period, the department issued sales and use tax assessments against Advanced for the periods July 2000 to July 2003. The assessments were for use tax on equipment parts used to repair and replace machinery as well as for sales tax on certain transportation and delivery invoices. The department's assessment included penalties and interest at twice the statutory rate because the assessment was for periods covered by the amnesty act and Advanced had been eligible to participate in the amnesty program. After the department's administrative decision affirmed all assessments against Advanced, the company filed a complaint for administrative review with the Illinois Circuit Court. Advanced sought a declaration that the amnesty act violated the Illinois and U.S. Constitutions and §4 of the Illinois Statute on Statutes. The circuit court denied Advanced's challenges and upheld the department's assessment, including the amnesty penalties and interest.

### **Analysis/Holding**

On appeal, Advanced again contended that the act violated the U.S. and Illinois Constitutions and the Illinois Statute on Statutes.<sup>7</sup> Advanced's state constitutional challenge focused on the Illinois Constitution's Uniformity Clause, which provides that, "in any law classifying the subjects or objects of non-property taxes or fees, the classes shall be reasonable and the subjects and objects within each class shall be taxed uniformly. Exemptions, deductions, credits, refunds and other allowances shall be reasonable."<sup>8</sup> In order to survive scrutiny under the Uniformity Clause, a tax classification must be based on a real and substantial difference between those persons taxed and those not taxed, and must bear some reasonable relationship to the legislature's intent or to public policy.<sup>9</sup>

<sup>7</sup> Advanced also challenged the department's underlying assessment. These challenges were not related to the Amnesty Act per se, but concerned the basis for the department's retailers' occupation tax and use tax assessments, as well as an argument that tax could not be imposed on cartage and fuel surcharges based on the doctrine of equitable estoppel. Advanced was only successful in its challenge to the use tax assessment.

<sup>8</sup> Ill. Const. art. IX, §2.

<sup>9</sup> See *Sun Life Assurance Co. of Canada v. Manna*, 227 Ill. 2d 128, 136-137 (2007).

The court found that the Amnesty Act classified taxpayers into two categories:

- those taxpayers with outstanding debts that paid their liability during the amnesty window, and
- those taxpayers with outstanding debts that did not pay within the amnesty window and thus faced increased interest and penalties.

According to the appellate court, taxpayers in the first group, by paying taxes pursuant to the amnesty law, allowed the state to efficiently collect unpaid tax and, thus, have use of the funds. By contrast, taxpayers in the second group deprived the state of the use of tax dollars and caused the state to expend resources to collect unpaid tax. In the court's view, this distinction was sufficient to create a real and substantial difference between the two groups. Additionally, the court found that the act was reasonably related to the legislative goals of raising revenue, remedying a budget deficit, and providing finality to tax disputes. The court further concluded that because the tax satisfied the requirements for a tax classification under the Uniformity Clause, it also met the requirements of the federal and state Equal Protection Clauses.<sup>10</sup>

Advanced next argued that the Amnesty Act unconstitutionally infringed on its right to appeal the department's assessment. In support of this position, Advanced relied on *Northern Illinois Home Builders Association v. County of DuPage*.<sup>11</sup> In *Northern Illinois*, the Illinois Supreme Court examined a DuPage County ordinance that gave developers who paid road improvement impact fees in accordance with a fee schedule a 15 percent discount on the fee.<sup>12</sup> Significantly, parties who appealed the initial fee assessment forfeited the discount.<sup>13</sup> The court struck down the ordinance as unconstitutional, finding that the ordinance was a burden on the right to appeal, had no reasonable relationship to any valid state objective, and arbitrarily discriminated against a narrow class.<sup>14</sup>

The appellate court rejected Advanced's argument that *Northern Illinois* mandated a finding that the Amnesty Act was unconstitutional. The court found that the act, unlike the DuPage ordinance in *Northern Illinois*, did not arbitrarily discriminate against a narrow class. Rather, the Amnesty Act "sets forth rational classifications that bear a reasonable relationship to a valid state objective." Accordingly, the court found that the act did not violate the Illinois Constitution. Despite the fact that the two statutes seemed to pose similar burdens on the right to appeal a monetary assessment, the court offered little guidance to support its reasoning.

The court next addressed Advanced's argument that the Amnesty Act violated §4 of the Illinois Statute on Statutes by retroactively doubling the interest and penalties. That section states, in relevant part, that,

No new law shall be construed to repeal a former law, whether such former law is expressly repealed or not, as to any offense committed against the former law, or as to any act done, any penalty, forfeiture or punishment incurred, or any right accrued, or claim arising under the former law, or in any way

whatever to affect any such offense or act so committed or done, or any penalty, forfeiture or punishment so incurred, or any right accrued, or claim arising before the new law takes effect, save only that the proceedings thereafter shall conform, so far as practicable, to the laws in force at the time of such proceeding.<sup>15</sup>

According to the interpretation of previous courts, §4 applies only where the Legislature has not indicated whether a statute applies retroactively.

The court disagreed with Advanced's argument that §4 precluded the imposition of increased penalties. As the increased penalties and interest only resulted from a taxpayer's failure to pay its taxes within the amnesty window, the court held that §4 was not violated. The court's rationale appears to be that because the increased penalties are technically the result of a taxpayer's own inaction, the statute is not retroactively applying increased penalties.

## FUTURE CHALLENGES

Although the appellate court ultimately rejected the taxpayer's challenges and upheld the Amnesty Act, there is still hope, for the following reasons, for Illinois taxpayers who seek to challenge amnesty-related penalties and/or interest. First, the decision is an unpublished order of the appellate court. Under Illinois Supreme Court Rule 23, an unpublished order is not precedential and may not be cited as binding authority by any party. Thus, the *Advanced On-Site* decision does not per se bar future challenges to the Illinois Amnesty Act.

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### **The *Advanced On-Site* decision leaves unanswered several important constitutional questions, particularly those concerning a taxpayer's due process rights.**

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In addition to not being binding precedent, the *Advanced On-Site* decision leaves unanswered several important constitutional questions, particularly those concerning a taxpayer's due process rights. The Due Process Clause of the U.S. Constitution requires that there be an opportunity to be heard in "a meaningful time and in a meaningful manner."<sup>16</sup> In *McKesson Corp.*, the U.S. Supreme Court has declared that a state must provide procedural safeguards against an unlawful tax because such tax constitutes a deprivation of property under the Due Process Clause.<sup>17</sup> According to the U.S. Supreme Court, a state can provide these procedural safeguards either by providing a "predeprivation" remedy (for example, by permitting taxpayers to sue to enjoin imposition of the tax prior to payment) or by providing a "postdeprivation" remedy (for example, by af-

<sup>10</sup> *Id.*

<sup>11</sup> *Northern Illinois Home Builders Association v. County of DuPage*, 165 Ill. 2d 25 (Ill. 1995).

<sup>12</sup> *Id.* at 46.

<sup>13</sup> *Id.* at 46-47.

<sup>14</sup> *Id.* at 47.

<sup>15</sup> 5 ILCS 70/4.

<sup>16</sup> *Matthews v. Eldridge*, 424 U.S. 319, 333 (1976).

<sup>17</sup> *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18 (1990).

forfeiting taxpayers the opportunity to request a refund of tax paid).<sup>18</sup> The Illinois Amnesty Act arguably runs afoul of these requirements.

On its face, the Amnesty Act prohibited taxpayers from claiming refunds of any tax paid under amnesty. Thus, the Amnesty Act lacks the “postdeprivation” remedy referred to by the *McKesson* court. A meaningful “predeprivation” remedy is also missing. While taxpayers had the opportunity to withhold payment of tax and challenge the tax in litigation, such a challenge came with a potentially hefty price tag: double penalties and interest if the challenge were not successful. It is debatable how “meaningful” such a remedy is in light of the dire consequences that might result for pursuing the remedy. It is not hard to see the chilling effect that the Amnesty Act could have on a taxpayer’s otherwise statutory and constitutional right to challenge the imposition of a tax.

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**The department’s position relating to amnesty payments made pursuant to a federal audit is contrary to the department’s own regulation and therefore ripe for challenge.**

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Significantly, the Amnesty Act’s reach was very broad. The act applied not only to deadbeat taxpayers who had been assessed tax but somehow avoided paying it, but it also applied to corporate taxpayers that had taken reasonable, bona fide positions on their returns, which could later result in an audit adjustment by the department. These taxpayers, many of whom were being audited during the Illinois amnesty period, were confronted with the choice of paying additional tax to avoid the double penalty and interest sanction or risking that sanction if they chose to defend their position in court after amnesty. Moreover, many taxpayers did not even know that they had such a choice. A taxpayer who was audited and assessed after the close of amnesty was subject to double penalties and interest on any deficiency resulting from an audit adjustment. This deficiency did not exist during the amnesty period, and the taxpayer would have needed a crystal ball to know that the deficiency would arise at a later date and result in amnesty penalties. In such circumstances, the opportunity to be heard “in a meaningful time and in a meaningful manner” clearly seems to be missing.

In this regard, the department’s position relating to amnesty payments made pursuant to a federal audit is contrary to the department’s own regulation and therefore ripe for challenge. Under the Amnesty Act, taxpayers who anticipated an increased Illinois tax liability due to federal changes that would be finalized after the amnesty period expired were “eligible” for amnesty and were required to make a good faith estimated payment of any increased Illinois income tax resulting from the federal audit if they wanted to avoid an amnesty penalty. Failure to make an estimated payment during the amnesty period would result in a doubling of penalties and interest on any additional Illinois income tax

that resulted from the federal audit. Additionally, the department permitted taxpayers to seek refunds of any overpaid estimate as long as the refund was based on a final determination by the IRS.

The department, however, took this position one step further and required taxpayers to file their refund claims within a year of payment even though many federal audits would not have been completed within that time. At least one taxpayer has challenged the department’s refund claim denial.<sup>19</sup> The department’s position in this case seems debatable in light of the fact that it relies on the general one-year-after-date-of-payment statute of limitations for refund claims rather than the special two-year statute of limitations contained in §911(b) of the Illinois Income Tax Act relating to federal changes. Making matters worse for taxpayers was the fact that the department did not announce its position that the statute of limitations would be based on the “one-year-after-date-of-payment” rule until the one-year anniversary of the amnesty program. Further, the department’s position that a refund claim should have been filed within one year of payment is contrary to the department’s long-standing position that Illinois law has no provisions for the filing of a protective claim to extend the statute date.

Another disturbing element of the Amnesty Act is that the double interest sanction is exactly that: a sanction. Interest that is calculated at twice the statutory rate no longer reflects the time value of money, but rather is a strong-armed tactic designed to force taxpayers to pay without a challenge. In this regard, the double interest component of the Amnesty Act really functions more like a penalty. As a penalty, the double interest piece should be subject to full abatement if the taxpayer is able to establish reasonable cause for the filing position that resulted in the liability.

The significance of the foregoing is that none of these issues were addressed by the *Advanced On-Site* court. These issues, coupled with the fact that the decision is not binding precedent, gives Illinois taxpayers hope that a future challenge might prove more successful than the one in *Advanced On-Site*.

## CHALLENGES TO OTHER STATES’ AMNESTY LAWS

The Illinois Appellate Court is not alone in rejecting a taxpayer’s constitutional challenge to an amnesty law. While each challenge has been slightly different, courts in other states have consistently upheld amnesty laws on constitutional grounds. For example, in *Praxair Technology*<sup>20</sup> New Jersey’s amnesty law was challenged on due process grounds. New Jersey’s law provided a 60-day window for taxpayers to pay past due liabilities. If liabilities were not paid within that period, the state imposed an additional 5 percent penalty. After being assessed additional penalties under the amnesty law, Praxair Technology Inc. (PTI) argued that the statute violated its due process rights and should be declared unconstitutional. The tax court disagreed with PTI and upheld the statute.

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<sup>19</sup> *Con-Way Transportation Services v. Hamer*, No. 2008 L 050477 (Ill. Cir. Ct. DATE??).

<sup>20</sup> *Praxair Technology Inc. v. Director, Div. of Taxn.* Tax Court Dkt. No. 007445-05 (N.J. Tax Ct. 2007),

<sup>18</sup> *Id.* at 19.

PTI's argument was twofold. First, PTI argued that it did not receive adequate notice of the amnesty period. Second, it argued that it was being deprived of a significant property interest without the ability to be heard. As to PTI's first argument, the tax court found that PTI, as a taxpayer, had general notice of the tax laws. Further, the director had unnecessarily given PTI specific notice of the amnesty program. While the tax court suggested that the general notice alone was enough to defeat its argument, the fact that PTI also had actual notice was fatal to its claim.

In regard to PTI's second argument, the tax court found that it had the authority to review PTI's tax liability, including the imposition of the additional amnesty penalty. Essentially, because PTI had the opportunity to appeal the entire tax assessment, PTI was not denied any opportunity to be heard and the tax court dismissed this argument. Because PTI chose not to seek amnesty, and thereby assumed the risk that a post-amnesty appeal would be unsuccessful, the tax court was unsympathetic to PTI's claims.

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The PTI court's reasoning casts some doubt on the ability of taxpayers who are eligible for amnesty, but do not take advantage of it, to claim that their due process rights have been violated by the imposition of increased penalties. Under the New Jersey tax court's view, as long as such taxpayers have an opportunity to seek judicial review of an assessment at some point in time, their property is not being deprived without the ability to be heard. Similarly, because taxpayers are on general notice of the tax laws, an argument that a taxpayer had no notice of the opportunity to participate in an amnesty program would likely fail under the approach taken by the tax court.

### California Challenge

California's amnesty act, like those in Illinois and New Jersey, has also survived judicial scrutiny. In *In re: Appeal of Ehrlich*, a taxpayer appealed the imposition of increased penalties pursuant to California's amnesty act. The California State Board of Equalization (SBOE) found that it only had jurisdiction to review the imposition of amnesty penalties in one circumstance: where a taxpayer paid the amnesty penalty, filed a refund claim asserting that the Franchise Tax Board failed to properly compute the amount of the penalty, and the refund claim was denied by the SBOE. Thus, even though the taxpayer was being audited by the IRS, its failure to comply with the amnesty act still resulted in the imposition of penalties.<sup>21</sup> Though the SBOE's opinion does

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<sup>21</sup> In Illinois, the department took the position that taxpayers who were undergoing a federal audit by the IRS were required to make a good faith estimate of any increased tax owed to the department. Under this limited scenario, the de-

partment allowed taxpayers to seek refunds of the amount paid as long as the amount was based on a final determination by the IRS.

### Oklahoma Challenge

One of the more recent tax amnesty challenges occurred in Oklahoma. On June 19, 2008, an Oklahoma taxpayer filed a suit in the Oklahoma Supreme Court challenging the validity of Oklahoma's amnesty program. The taxpayer alleged that the amnesty program, known as Clean Slate 2008, violated state law as well as the U.S. Constitution. Interestingly, the taxpayer was not assessed penalties under the amnesty act, but was upset that taxpayers who did not pay their taxes on time were given the opportunity to free themselves from paying any penalties. On Sept. 23, 2008, the Oklahoma Supreme Court issued a decision denying the taxpayer's request for relief.<sup>22</sup> The opinion was issued per curiam, meaning that it was not authored by one particular justice, but was released by the court as a whole.

The court focused solely on the taxpayer's claim that Oklahoma's act violated Article 5, §53 of the Oklahoma Constitution. Section 53 provides that "the Legislature shall have no power to release or extinguish, or to authorize the releasing or extinguishing, in whole or in part, the indebtedness, liabilities, or obligations of any corporation or individual, to this State."<sup>23</sup> Even assuming that penalties and interest are included in §53, the court found no constitutional basis for striking down the amnesty law. The court's reasoning was based on the case of *City of McAlester v. Jones*<sup>24</sup> in which it held that the Legislature was not constitutionally limited in its ability to direct the refund of penalties on delinquent taxes.<sup>25</sup> The court found no substantial difference between the refund of penalties at issue in *Jones* and the abatement of penalties provided under Oklahoma's amnesty law. Consistent with *Jones*, the court will only declare a law void where the Legislature "clearly, palpably, and plainly" acted in a manner inconsistent with the Oklahoma Constitution,<sup>26</sup> a requirement that the taxpayer could not meet in respect to the amnesty law.

### CONCLUSION

If taxpayer challenges to amnesty laws are viewed as a football game, then we are only in the first quarter. Although cases such as *Advanced On-Site* in Illinois have gone in favor of the states, several arguments and issues that would support the taxpayer's position have yet to be presented to the courts. For this reason, the validity of state tax amnesty laws remains very much in question.

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<sup>22</sup> *Fent v. State ex rel. Oklahoma Tax Comm.*, 2008 OK 88, P.3d \_\_ (Okla. 2008).

<sup>23</sup> Okla. Const. art. V, §53.

<sup>24</sup> *City of McAlester v. Jones*, 72 P.2d 371 (Okla. 1937).

<sup>25</sup> *Id.* at 374.

<sup>26</sup> *Id.* at 375.