

Illinois Allows Third-Party Auditors, but Are They Necessary?

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In this installment of Insights From Former Insiders, Bogdanski, Dorner, and Gove review Illinois P.A. 101-0628, its potential impact on taxpayers and local governments, and whether the law is necessary.

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On January 24, 2020, Illinois Gov. J.B. Pritzker (D) signed Public Act 101-0628 into law, enacting the Local Government Revenue Recapture Act (the Act).¹ The Act allows Illinois municipalities and counties (collectively, localities) to contract

with private third-party auditors to review and monitor whether the Department of Revenue is correctly disbursing local sales tax (retailers' occupation tax and service occupation tax) collected on behalf of Illinois localities.²

While the Act has the potential to increase compliance and transparency, it may also create rivalry and animosity, given that one locality's gain will be another's loss. In this article, we review P.A. 101-0628, its potential impact on taxpayers and local governments, and whether the law is necessary.

P.A. 101-0628

For years, third-party, contingent-fee tax auditors have lobbied state legislators and government officials to enact a law allowing third parties to audit Illinois sales tax disbursements on behalf of local governments. To justify the need for third-party auditors, the interested parties often cited the success they have had with audits in other states and with local utility taxes and franchise fees in Illinois. The relatively recent *Wayfair*³ decision provided additional ammunition, as lobbyists for third-party auditors commonly asked local officials if they have seen any increase in their sales tax payments from the DOR because of *Wayfair*. In many instances, they had not, because before January 1, 2021,⁴ *Wayfair* had only increased the amount of *use tax* collected on Illinois-destined sales, which had less of an

² Among other things, under the Act, third-party auditors must register with the DOR and pay an annual fee of \$15,000. 50 ILCS 355/5-30(a).

³ *South Dakota v. Wayfair Inc.*, 585 U.S. ____ (2018).

⁴ Beginning January 1 many remote sellers and online marketplaces will start to collect both state and local sales tax based on the tax rate in effect at the point of delivery (*i.e.*, destination sourcing). Accordingly, starting in 2021, localities in Illinois should notice an uptick in their sales tax disbursements. The DOR has created a helpful flowchart to assist retailers and marketplace facilitators in determining the correct tax rate to apply to Illinois-destined sales.

¹ 50 ILCS 355/1-1 et seq.

impact for many local governments, as use tax is distributed among most Illinois localities based on population. Nonetheless, the question planted seeds of doubt with local governments regarding whether they were reaping their fair share of “Wayfair” tax dollars from the state. Against this well-orchestrated backdrop, Illinois enacted P.A. 101-0628.

Generally speaking, the Act provides localities with the ability to contract with private, third-party auditors to verify whether the DOR is correctly remitting the tax it collected on behalf of the contracting locality.⁵ To perform their services, third-party auditors are limited to reviewing specific “financial information” from the locality provided by the DOR when collecting tax on the locality’s behalf.⁶ Third-party auditors are prohibited from requesting financial information directly from the DOR, nor can they contact taxpayers operating within the locality. The third-party auditors are also limited in how they may use, store, and retain confidential financial information received from localities.⁷ Under the Act, localities are allowed to compensate third-party auditors on a contingent-fee basis.⁸

If a third-party auditor determines that a locality has not received its correct share of sales tax revenue from taxpayers conducting business within the locality, the third-party auditor is to prepare a report of its finding, which is then provided to the DOR for review.⁹ The DOR will consider the report within 60 days of receipt.¹⁰ If the DOR determines the report is actionable, the DOR will then notify the taxpayer identified in the report that it has been identified for audit and that the taxpayer may either be audited by the department or engage the services of a “qualified

practitioner” (discussed below) to conduct an audit on behalf of the department.¹¹

To assist the DOR with the potential increase in audits, the legislature included within the Act a pilot program that encourages taxpayers receiving an audit notice from the department regarding a possible misallocation of tax revenue to engage (at the taxpayer’s expense) a duly qualified Illinois certified public accountant (qualified practitioner) to conduct a sales and use tax compliance review on behalf of the DOR.¹² The qualified practitioner’s tax compliance review is limited to:

- whether the taxpayer is reporting receipts to the proper locality;
- whether assets purchased by the taxpayer were taxed properly;
- a review of sales reported as exempt from taxation;
- whether the proper tax rate was charged;
- whether the transaction was properly reported as sales or use tax; and
- any other factors that may affect the DOR’s allocation of sales and use tax revenue to the locality in which the taxpayer reports sales tax.¹³

To encourage taxpayers to engage a qualified practitioner to conduct the tax compliance audit, the legislation allows for the abatement of any penalties, except for fraud penalties and penalties imposed on taxes collected by the taxpayer but not remitted to the DOR.¹⁴ At the conclusion of its review, the qualified practitioner performing the tax compliance review must provide the department with a certified audit report disclosing its findings.¹⁵ Based on the results, the DOR will either issue a proposed assessment to the taxpayer, document an overpayment by the

⁵ “A municipality or county that receives a disbursement of tax proceeds from the Department may contract with a third party for the purpose of ensuring that the municipality or county receives the correct disbursement from the Department and monitoring disbursements.” 50 ILCS 355/5-10.

⁶ 50 ILCS 355/5-5 (“financial information” means the specific information provided to localities under section 11 of the Retailers’ Occupation Tax Act (35 ILCS 120/11)); *see also* 50 ILCS 355/5-10.

⁷ 50 ILCS 355/5-15; 5-20; and 5-50.

⁸ A third-party auditor may receive a percentage of the amount of additional distributions the locality receives for no more than three years following the first disbursement to the locality as a result of the third-party auditor’s services under the Act. 50 ILCS 355/20(b).

⁹ 50 ILCS 355/5-50(b).

¹⁰ 50 ILCS 355/10-30(c).

¹¹ *Id.* at 10-30(d). As part of the DOR’s notice to a taxpayer that it has been selected for audit, the department will also inform the taxpayer of the name of the elected chief executive (e.g., mayor, village board president, and so forth) that contracted with the third-party auditor to review the taxpayer’s taxes, and that it was the elected official who referred the taxpayer to the DOR for a certified audit. This notice requirement may have a potentially chilling effect on whether some localities are willing to engage third-party auditors.

¹² 50 ILCS 355/10-15; 10-20(a).

¹³ 50 ILCS 355/10-20(a).

¹⁴ *Id.* at 10-20(b).

¹⁵ 50 ILCS 355/10-40(a).

taxpayer, or find there is no change to the taxpayer's filings.¹⁶ Any tax assessment issued by the DOR is entitled to the same appeal rights as other assessments issued by the department.¹⁷ If no change is made to the taxpayer's tax returns, the certified audit report is then a final and conclusive determination regarding the taxes and tax periods covered by the audit report.¹⁸

Is This Law Really Necessary?

After the *Wayfair* decision, Illinois enacted a marketplace fairness law, which requires remote sellers with economic nexus to pay retailers' occupation tax (sales tax) at the rate in place at the customer's location. To ease the burden of determining the proper tax rate, the law requires the DOR to create a tax rate database using a customer's street address. The database allows retailers and online marketplaces to more easily and accurately determine the proper tax rate to charge on their Illinois-destined sales. Using this central tax rate database, and other information routinely provided by the DOR, localities should have few problems verifying and working with the department to make sure all tax revenue from taxpayers doing business in their locality is being correctly captured, without the need for third-party assistance and without paying contingent fees to third parties — which can be as high as 45 percent of the revenue recovered.

The DOR provides localities with REG702-01, "Annual Taxpayer Location Address List," which the department sends annually to every locality in Illinois identifying the taxpayers registered within their locality by address. The DOR also provides localities with the IDOR-50-L-1M, which is a monthly notification of every business that has registered, changed its registration, or discontinued operations in the locality. These two reports, coupled with the above-mentioned tax rate lookup database and other financial information localities can obtain from the DOR, should make it easy for localities to determine whether they are receiving their fair share of local sales tax. Any errors can easily be corrected,

without the need for outside, third-party assistance.

Conclusion

While the Act may be well intended, inviting private parties to occupy a traditionally government function will likely create serious friction between the DOR, localities, taxpayers, and the private parties. And changes to Illinois sales tax reporting as of January 1 will eliminate much of the justification for the use of third-party auditors, because under the marketplace fairness law, retailers should have no problem applying the correct tax rate to sales. At the same time, under the new law, local governments should have no problem verifying the accuracy of the department's tax allocations, without having to sacrifice much-needed tax revenue to pay contingency fees. ■

¹⁶ *Id.* at 10-40(b).

¹⁷ *Id.*

¹⁸ *Id.*