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State Tax Return

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Caution: Unless You Plan Properly, Your Refund Is Not as Close as It Appears

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In prior years, it was a no-brainer that a state would automatically refund an overpayment reported on a tax return. These days, however, when state economies are struggling, it seems that some states, such as Illinois, have found a new way to balance their budgets. A state may simply refuse to issue a refund, leaving the taxpayer with merely a vague promise of future repayment. Although this article specifically addresses Illinois and its law, this situation may occur in other states as well.[1]

Unfortunately, when a state refuses to refund an overpayment, the taxpayer is left with few options. Typically, the taxpayer's first reaction would be to request that the state apply the refund to next year's estimated tax payments. In fact, Illinois regulations explicitly permit taxpayers to "elect to have any portion of any overpayment shown on a timely original return applied against the taxpayer's estimated tax liability for the taxable year immediately following the taxable year for which the return is filed."[2]

However, as Illinois regulations provide further, such election, "once made, shall be irrevocable."[3] Therefore, any taxpayer that did not elect to apply the overpayment to next year's estimated payments may not elect to do so after the original return has been filed. Indeed, Illinois has taken the position that if a taxpayer has requested on its return a refund of the overpayment, it may not apply the overpayment to cover the estimated tax payments.[4] Taxpayers that did not think the state would refuse to issue refunds and had no particular reason to elect to carry forward are now being held to their election.

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[1] *See* Martha Kramer, *New York State Tax Refunds Put On Hold*, WCBSTV.com, March 18, 2010, http://wcbstv.com/topstories/paterson.tax.refund.2.1569690.html (web sites herein last visited June 8, 2010). Similar issues have been raised in Alabama, California, Kentucky, and other states.

[2] 86 Ill. Admin. Code § 100.9400(b); 2009 Form IL-1120, Corporation Income and Replacement Tax Return, line 60.

[3] *Id.*

[4] Administrative Hearing Decision No. IT 03-4, 20030523001, Ill. Dep't of Rev., February 18, 2003.

Neither may the taxpayer refuse to pay the following year's estimated taxes by arguing that the state should apply the overpayment to cover the estimated tax liability. Some taxpayers may think that because penalties are imposed on the amount of tax owed,[5] the penalty would be zero if the overpayment equaled or exceeded the tax liability.

The Illinois statute provides that the Department of Revenue "may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of the tax imposed."[6] While analyzing this particular statute, however, Illinois's Office of Administrative Hearings held that because the statute uses the word "may," the Department is not required to offset the estimated tax liability with the overpayment and may still impose penalties on the taxpayer for underpaid estimates in respect of Year 2, even if Year 1 is overpaid.[7]

To add insult to injury, Illinois's current overpayment interest rate is 1 percent for the first year the overpayment is owed and 4 percent for the period after the first year.[8] Although the overpayment rate may be higher than Illinois's cost of borrowing, query whether it is high enough to bring Illinois to the negotiating table in the case of a large overpayment.

Unfortunately, Illinois tax laws do not address what happens when the state refuses to refund overpayments. The only recourse currently available to taxpayers is to file a refund claim.[9] At best, however—if the taxpayer is successful at the end of the refund-claim process—Illinois would still have kept the money during its duration. At worst, Illinois may still refuse to issue the refund. Needless to say, the costs of litigating this issue could far outweigh the amount of the refund, or the value of accelerating the refund.

The moral of this story is that taxpayers filing their state tax returns should seriously consider the possibility that the state may simply refuse to issue a refund. As evidenced by Illinois and several other states, this situation is not only possible, but a real world issue.

In such an economic environment, the election to apply the overpayment to cover next year's estimated taxes may be the better choice. In fact, taxpayers should consider making this election even if they are not owed a refund, in the event subsequent federal changes produce a refund of state taxes.

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[5] See, *e.g.*, 35 ILCS § 735/3-3(b-20)(1) ("The amount of penalty imposed under this paragraph (1) shall be 2% of any amount that is paid no later than 30 days after the due date and 10% of any amount that is paid later than 30 days after the due date").

[6] 35 ILCS § 5/909(a).

[7] Administrative Hearing Decision No. IT 03-4, 20030523001, Ill. Dep't of Rev., February 18, 2003.

[8] http://tax.illinois.gov/Individuals/InterestRate.htm.

[9] 35 ILCS § 5/909(a).