Illinois Department of Revenue

FY 2005-06

Tax Shelter Voluntary Compliance Program

Informational Bulletin

August 2004

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Director of Revenue

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- Visit our Web site at:
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Printed by authority of the State of Illinois
8,000 copies - 8/04 - P.O. Number 2050140

To:

All taxpayers having investments in tax shelters and all tax preparers completing tax returns on behalf of taxpayers who have investments in tax shelters.

As part of an on-going effort between many states and the Internal Revenue Service (IRS), Illinois has passed new laws (Public Act 93-840) to discourage participation in tax avoidance transactions (tax shelters). In general, the new laws mandate specific filing procedures and registration requirements for taxpayers participating in tax shelter activities, as well as the promoters of tax shelter opportunities.

In addition, the laws outline new, stringent penalties for taxpayers and promoters that do not comply with the tax shelter laws. In order to help taxpayers make the transition to the new reporting requirements, Illinois will be offering a Voluntary Compliance Program (VCP) for taxpayers that failed to report their full taxable income because they participated in tax shelter transactions.

The purpose of this bulletin is to provide general information about tax shelters, the VCP requirements, and the new associated penalties for tax shelter abuse.

What is the definition of a tax shelter?

A tax shelter is the common name for a "tax avoidance transaction." A tax avoidance transaction means any plan or arrangement devised for the principal purpose of avoiding federal income tax, and includes but is not limited to, "listed transactions" as defined by the IRS.

What is a "listed transaction"?

A "listed transaction" is a transaction that is the same as or substantially similar to one that the IRS has determined to be a tax avoidance transaction and identified by IRS notice or other form of published guidance.

What is the Voluntary Compliance Program (VCP)?

The VCP is a program that allows taxpayers who underreported their taxable income by participating in tax shelters to come forward and pay the associated Illinois Income Tax liability without incurring any of the new penalties that have been put into effect for participating in tax shelters.

What are the dates for the VCP?

The VCP period for reporting and paying additional Illinois Income Tax liability will be from October 15, 2004, through January 31, 2005.

Who is eligible to participate?

The VCP is available to any taxpayer who

- filed an Illinois Income Tax return using a tax shelter to reduce their taxable income, or
- did not file an Illinois Income Tax return as a result of participating in a tax shelter.

What years can I amend?

Any taxable year beginning before January 1, 2004, qualifies for the VCP, if you are filing because of your involvement with tax shelter activities.

How do I participate?

In order to receive any benefit from participating in the VCP, you must

- report the correct amount of taxable income and tax liability, without regard to any tax shelters, on an Illinois amended return; and
- pay the total amount of the additional Illinois Income Tax shown on the amended return, plus any applicable interest on the amount of tax that is the result of participating in a tax shelter transaction.

In addition to these requirements, for each year that you amend, you must select one of the following options, indicating your choice of appeal rights. **Once made, this election is irrevocable**.

- **Option 1 - *Voluntary Compliance without Appeal*** - Under this option, you forfeit your rights to file a claim for refund of the additional tax you report on your amended return related to tax shelters.

  In return, the department will not impose any penalty under the Uniform Penalty and Interest Act (UPIA) for the underreporting or underpayment of the additional tax, or the new tax shelter penalties in the Illinois Income Tax Act (IITA). You also avoid civil or criminal prosecution that may be associated with the use of tax shelter transactions for the taxable year.
- **Option 2 - *Voluntary Compliance with Appeal*** - You maintain your right to file a claim for refund for the taxable year that you have amended and shown an additional tax liability.

  In return, you avoid the new tax shelter penalties. You also avoid civil or criminal prosecution. However, you will remain subject to all other applicable penalties under the IITA and UPIA.

Note No penalty may be waived under either option 1 or 2 if the penalty relates to an amount of Illinois Income Tax assessed before October 15, 2004.

What forms must I file?

If you did not file an Illinois return because participation in a tax shelter reduced your taxable income, you will need to file an original return.

If you filed an Illinois return, and must amend in order to include income earned from participating in a tax shelter, you must file an amended return.

If you are

- an ***individual*** - file Form IL-1040, Individual Income Tax Return, **or** Form IL-1040-X, Amended Individual Income Tax Return;
- a ***corporation*** - file Form, IL-1120, Corporate Income and Replacement Tax Return, **or** Form IL-1120-X, Amended Corporation Income and Replacement Tax Return;
- an ***S corporation*** - file Form IL-1120-ST, Small Business Corporation Replacement Tax Return, **or** Form IL-843, Amended Return or Notice of Change in Income, and a revised Form IL-1120-ST, Small Business Corporation Replacement Tax Return;
- a ***partnership*** - file Form IL-1065, Partnership Replacement Tax Return, **or** Form IL-843, Amended Return or Notice of Change in Income, and a revised Form IL-1065, Partnership Replacement Tax Return;
- a ***trust or an estate*** - file Form IL-1041, Fiduciary Income Tax Return, **or** Form IL-843, Amended Return or Notice of Change in Income, and a revised Form IL-1041, Fiduciary Income and Replacement Tax Return.

All taxpayers must attach a VCP Participation Agreement. This form is expected to be on our Web site in the near future.

Note You must mail all Illinois original and amended returns, and the VCP Participation Agreement to the address listed on the VCP Participation Agreement. Do not send any return intended for the VCP to the mailing address listed on the Illinois original or amended return.

What are the new penalties?

- **Failure to disclose participation in a reportable transaction** - Illinois taxpayers that must disclose their participation in a reportable tax shelter to the Internal Revenue Service (IRS), are required to file a copy of that disclosure with the department.

  In addition, Illinois taxpayers must also disclose their participation in a transaction entered into after February 28, 2000, that becomes a "listed transaction" at any time.

  Disclosure is not required if the taxpayer files an amended Illinois return that reverses the tax benefits of the reportable transaction before disclosure would otherwise be due.

  Participating in the VCP will avoid the assessment of this penalty.

- **Reportable transaction understatement penalty** - This penalty applies to any deficiency of Illinois income tax that is caused by participating in any "listed transaction," or a reportable transaction if a significant purpose of the transaction is the avoidance or evasion of federal income tax.

  This penalty applies to tax years ending on or after December 31, 2004. This penalty may also be applied to any reportable transactions entered into after February 28, 2000, that become "listed transactions" at any time.

  Participating in the VCP will avoid the assessment of this penalty.

- **100 percent interest penalty** This penalty will be assessed if a taxpayer has been contacted by the IRS or the department regarding the use of a potential tax avoidance transaction.

  Participating in the VCP will avoid the assessment of this penalty.

What are the new penalty rates?

- **Failure to disclose participation in a reportable transaction** - A penalty in the amount of $15,000 will be assessed for each instance the taxpayer fails to disclose a reportable transaction. However, if a taxpayer fails to disclose a "listed transaction," the penalty for each instance is $30,000.

  The total of this penalty cannot exceed 10 percent of the increase in net income due to the reporting of any tax shelter activities.

- **Reportable transactions understatement penalty** - The amount of this penalty is 20 percent of the deficiency, but increases to 30 percent if the transaction was not disclosed as required.

- **100 percent interest penalty** This penalty is equal to 100 percent of the amount of interest assessed under UPIA from the payment due date through the date that a notice of deficiency is issued.

Are there any changes to how interest is assessed?

Yes. In certain situations where you have not paid your tax liability related to tax shelter activities, your interest rate may be assessed at 150 percent of the current interest rate imposed under UPIA.

Where can I get more information?

As more information regarding the VCP and general filing requirements for tax shelter activities becomes available, we will put the information on our Web site. Visit **www.ILtax.com** for updates.

You can learn more about federal reporting and registration requirements for tax shelter activities at the IRS's Web site, **www.irs.gov.**