

**IT 09-4**  
**Tax Type: Income Tax**  
**Issue: Statute of Limitations Application**

**STATE OF ILLINOIS**  
**DEPARTMENT OF REVENUE**  
**OFFICE OF ADMINISTRATIVE HEARINGS**  
**CHICAGO, ILLINOIS**

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**THE DEPARTMENT OF REVENUE**  
**OF THE STATE OF ILLINOIS**

v.

**JOHN DOE AND JANE DOE,**  
  
**Taxpayers**

**No. 08-IT-0000**  
**SSN 000-00-0000**  
**Tax Year 2004**

**Ted Sherrod**  
**Administrative Law Judge**

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**ORDER PURSUANT TO DEPARTMENT OF REVENUE'S MOTION FOR**  
**SUMMARY JUDGMENT**

**PREFACE:**

This matter comes on to be heard upon a motion for summary judgment entitled "Motion for Summary Judgment Department's Notice of Denial" ("Motion") filed by the Illinois Department of Revenue ("Department"). The matter at issue concerns the Department's denial of a claim for refund filed by John Doe and Jane Doe ("taxpayers") for the tax year 2004 on the grounds that there is no statutory basis in Illinois law for the taxpayers' claim. The Department has included in its Motion factual pleadings which are not disputed by the taxpayers. It has also submitted documentation in support of its Motion. The taxpayers have submitted a response to the Department's Motion opposing

it. A hearing on the Department's Motion was held on March 11, 2009. During this hearing, arguments in support of and in opposition to the Department's Motion were made. Following an examination of the documents submitted in this cause, and a consideration of arguments made at hearing, this matter is concluded in favor of the Department. In support of this determination, I make the following findings of fact and conclusions of law.

**Findings of Fact:**

1. The taxpayers, John Doe and Jane Doe are residents of Illinois residing in Chicago, Illinois. Department's Motion Exhibit ("Ex.") 1. The taxpayers have elected to file their federal and state income tax returns "married filing jointly" as permitted by the Internal Revenue Code ("IRC") and the Illinois Income Tax Act. *Id.*; Department's Motion p. 1.
2. During the calendar year ending December 31, 2004, Jane Doe ("Doe") was selected by the The Bank (the "Bank") to be an employee of the Bank and was scheduled to commence her employment during 2005. Department's Motion p. 2. It was agreed between the Bank and Doe that in addition to a stated salary, Doe was to receive a signing or "Employment" bonus in 2004 ("signing bonus") and a relocation payment in 2005. *Id.* Pursuant to the foregoing agreement, Doe received a signing bonus of \$30,000 in 2004 and a relocation payment of \$10,000 in 2005. *Id.* The Bank and Doe agreed that Doe would forfeit and repay these amounts if she was employed by the Bank for less than 12 months. *Id.*

3. Some time prior to 12 months from the date she commenced her employment with the Bank, Doe resigned as an employee of the Bank. *Id.* Pursuant to her agreement with the Bank at the time she was hired, Doe was required to repay the Bank the relocation payment she received in 2005 and the signing bonus she received in 2004. *Id.*<sup>1</sup>
4. Doe was required to repay the gross amount of the signing bonus and relocation payment she received in 2004 and 2005 net of social security and Medicaid taxes pursuant to U.S. Treasury Regulations, as indicated below:

<b>2005</b>		<b>2004</b>	
<b>Relocation Payment</b>	<b>\$10,000</b>	<b>Signing Bonus</b>	<b>\$30,000</b>
<b>Medicare</b>	<b>\$ 145</b>	<b>Medicare</b>	<b>\$ 435</b>
<b>Social Security</b>	<b>\$ 620</b>	<b>Social Security</b>	<b>\$ 1860</b>
<b>Net Repayment</b>	<b>\$ 9235</b>	<b>Net Repayment</b>	<b>\$27,705</b>

*Id.*

5. The above-indicated repayments were made by Doe to the Bank in 2006. *Id.* The Bank issued a W-2C zeroing out her signing bonus of \$30,000 net of the amounts paid to Social Security and Medicare as required by law. *Id.*
6. The taxpayers reported Doe's repayment of her relocation payment received in 2005 and her signing bonus received in 2004 on Schedule A, Line 27 of the their joint return for 2006 as "Other Miscellaneous Deductions." Department Ex. 1. The

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<sup>1</sup> During the hearing on this matter, the taxpayers advised that they have received a refund from the Department based upon their repayment of the relocation payment Doe received in 2005 and that this relocation payment is not at issue in this case.

taxpayers did not claim any amount related to Doe's repayment of her relocation payment received in 2005 and her signing bonus received in 2004 as a credit against their 2006 federal income tax liability and the Internal Revenue Service ("IRS") made no changes related to these repayments to their adjusted gross income reported on their federal return for 2004. Department's Motion p. 2.

7. On February 7, 2008, the taxpayers filed a Form IL-1040-X Amended Illinois Income Tax Return for the tax year ending December 31, 2004 reducing the taxpayers' originally reported adjusted gross income from \$148,557 to \$118,557. *Id.* On March 14, 2008, the Department issued an "LTR-405 Amended or Duplicate Filer Letter" denying the taxpayers' claim for refund because there was no final federal change reducing the taxpayers' adjusted gross income for 2004. Department's Motion p. 3.
8. On March 24, 2008, the taxpayers timely filed a protest asserting that their claim for refund was valid and attaching a corrected 2004 IL-1040-X and corrected Schedule CR reporting items unrelated to Doe's relocation payment and signing bonus. *Id.* Also attached were the following: a copy of the taxpayers' 2006 U.S. form 1040 and Schedule A thereto, a copy of a bank statement related to the taxpayers' 2006 U.S. form 1040, copies of previously submitted supporting documents confirming repayment of the bonus to the Bank, viz., a letter from the Bank and a corrected W-2 for 2004, and an Amended New York State Income Tax Return (form IT-203-X). *Id.*

**Conclusions of Law:**

In 2006, Jane Doe ("Doe"), one of the taxpayers, repaid approximately \$30,000 to her former employer, the The Bank (the "Bank"), which she received in the taxable year 2004 under claim-of-right. When she received the payment in 2004, she included it in

the taxpayers' gross income for that year. The claim-of-right doctrine is designed so that in a later year when a taxpayer discovers he or she had no right to a payment reported as income in an earlier year and is required to repay it, the taxpayer can deduct the repayment in the year in which it is made. See 2 Mertens Law of Fed. Income Taxation § 12A:126. The IRC provision authorizing this relief for claim-of-right income is 26 U.S.C.A. 1341 ("IRC section 1341") which provides in part as follows:

§ 1341. Computation of tax where taxpayer restores substantial amount held under claim of right

(a) General rule. —If—

- (1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
- (2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
- (3) the amount of such deduction exceeds \$3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:
  - (4) the tax for the taxable year computed with such deduction; or
  - (5) an amount equal to —
    - (A) the tax for the taxable year computed without such deduction, minus
    - (B) the decrease in tax under this chapter (or the corresponding provision of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).

As the provisions of IRC section 1341 noted above indicate, the IRC's treatment of claim-of-right amounts that are required to be repaid provides for either a deduction (where the deduction exceeds \$3,000) pursuant to IRC section 1341(a)(4) or a credit pursuant to IRC section 1341(a)(5) based on the amounts repaid. A deduction is allowed in the year of repayment for the amount of claim-of-right income repaid. However, IRC

section 1341 provides for a credit in lieu of a deduction where the deduction exceeds \$3,000. If the tax determined with the credit is less than that determined with the deduction the credit must be taken. Conversely, if the tax determined with the deduction is less than that determined with the credit the deduction must be taken.

In the instant case, the credit provided by IRC section 1341(a)(5) was not taken on the taxpayers' federal return. The taxpayers were not allowed to take the credit because the deduction for the 2004 signing bonus claim-of-right amount repaid in 2006 yielded a lower federal income tax than the credit.

Illinois allows individual taxpayers to modify their adjusted gross income used to compute Illinois income tax with a subtraction equal to repaid amounts that were "held under claim of right for the taxable year pursuant to section 1341 of the Internal Revenue Code" if these amounts are used to compute the federal tax credit. 35 ILCS 5/203(a)(2)(P) ("section 203(a)(2)(P)").<sup>2</sup> Because a taxpayer must take either a federal credit or a federal deduction depending on which produces the lowest tax (see IRC section 1341(a)(3)) all taxpayers must compute the federal credit to see if it produces the lowest tax even if the credit is not taken, and the taxpayers did so in this case. Nevertheless, the Department contends that only taxpayers that have not only computed, but have actually taken a federal credit for amounts repaid under "claim of right" are entitled to this subtraction modification. If a taxpayer claims the deduction federally, as

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<sup>2</sup> Section 203(a)(2)(P) of the Illinois Income Tax Act provides as follows:

- (2) Modifications. The adjusted gross income referred to in paragraph (1) shall be modified by ... deducting ... the sum of the following amounts:  
\*\*\* (P) An amount equal to the amount of the deduction used to compute the federal income tax credit for restoration of substantial amounts held under claim of right for the taxable year pursuant to Section 1341 of the Internal Revenue Code of 1986 ...[.]

the taxpayers did in this case, the Department contends that this Illinois subtraction modification is not allowed. The taxpayers do not agree with the Department. There is no reason to address which party offers the correct theory on this point because the taxpayers' right to make the subtraction modification allowed by section 203(a)(2)(P) is not dispositive of this case.

The record indicates that the taxpayers seek to subtract their 2006 repayment of claim-of-right income included in income in 2004 in determining their tax liability for 2004. Federal tax law recognizes an adjustment for income received under claim-of-right that is later repaid, whether applied as a deduction or a credit, only as an adjustment to a taxpayer's tax liability reported for the year of repayment. The taxpayers, without explanation, contend that the signing bonus repayment made in 2006 should be allowed as a deduction from their 2004 adjusted gross income. This argument is made even though the taxpayers deducted the amount of the signing bonus Doe received in 2004 on their federal return for 2006. Presumably, the taxpayers believe that, in as much as the calculation of their 2004 taxable income for Illinois income tax purposes relies upon gross income for 2004, an adjustment reducing previously reported gross income for 2004 should be allowed as a deduction from the taxpayers' income for that year. While a logical argument can be made for this claim, it is supported by neither section 203(a) (2) (P) or by any other provision of Illinois or federal tax law.

Federal tax law requires that a taxpayer include income in its return filed for the year in which the income is received. North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). Accordingly, for federal income tax purposes income, including income received upon a claim-of-right is includable in gross income in the year in which

it is received even though the income may be required to be repaid in a subsequent taxable year. *Id.* In such cases, a deduction of the repayment is allowable in the year of repayment. *Id.* However the tax return for the year of inclusion is not reopened. *Id.* Since Illinois adjusted gross income is based on adjusted gross income for federal income tax purposes pursuant to section 203(e) of the IITA, 35 **ILCS** 5/203(e), the taxpayer was required to use adjusted gross income determined under federal law which, pursuant to the holding in North American Oil Consolidated, *supra*, included the claim-of-right income the taxpayers seek to exclude. Consequently, the taxpayers have no legal basis for modifying adjusted gross income for 2004 by deducting claim-of-right income repaid in 2006 as they have done in their amended return for 2004 which is at issue in this case.<sup>3</sup> Moreover, for the reasons enumerated below, the taxpayers were not permitted to deduct this income from adjusted gross income pursuant to section 203(a)(2)(P).

Consistent with the federal tax treatment of claim-of-right repayments, the Department's instructions to the IL-1040 provide that the subtraction permitted by section 203(a)(2)(P) based upon the federal claim-of-right income must be taken in the year of repayment. See Schedule M 1040 Instructions, p. 2. The Department's forms and instructions have the force and effect of regulations pursuant to section 1501(a)(19) of the Illinois Income Tax Act ("IITA"), 35 **ILCS** 5/1501(a)(19), and, like other regulations promulgated by the Department, have the force and effect of law. Union

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<sup>3</sup> As the Department correctly points out on page 1 of its Motion, even if the taxpayers could deduct claim-of-right income repaid in 2006 in determining their adjusted gross income for 2004, the IRS would have to amend the taxpayers' 2004 return changing the taxpayers' adjusted gross income for federal tax purposes in order for Illinois to change adjusted gross income used to compute Illinois taxes. See 86 Ill. Admin. Code, ch. I, section 100.9200(a)(4).

Electric Co., 136 Ill. 2d 385, 391 (1990); Tivoli Enterprises v. Zehnder, 297 Ill. App. 3d 125, 132 (2<sup>nd</sup> Dist. 1998).

The State's income tax law imposes a tax upon net income, the computation of which begins with adjusted gross income for federal income tax purposes. 35 ILCS 5/203(a)(1). Adjusted gross income for an individual means its federal adjusted gross income as defined by the laws of the United States for the taxable year. 35 ILCS 5/203(e). In arriving at net income, the IITA allows for various modifications specified in section 203(a)(2). As noted above, the modification at issue in this case is provided by section 203(a)(2)(P).

The taxpayers' refund claim is based upon the deduction of claim-of-right income in 2004, the year it was received for federal income tax purposes. Because section 203(a)(2)(P) only provides for modification of the taxpayers' income in the year of repayment (in this case, 2006), this section provides no basis for any modification to the taxpayers' 2004 adjusted gross income in computing their 2004 Illinois net income. Since section 203(a)(2)(P) provides no legal basis for modification of the taxpayers' 2004 adjusted gross income, federal adjusted gross income, as originally reported for 2004 without modification for claim-of-right income repaid in 2006, must be used to determine the taxpayers' Illinois tax liability for 2004 even though a repayment of some of the income received in that year was made in 2006. As a consequence, the taxpayers' 2006 repayment cannot be deducted from their 2004 adjusted gross income to arrive at their Illinois taxable income for 2004. For this and other reasons enumerated herein, I find that the taxpayers' claim for refund for 2004 was properly denied.

A motion for summary judgment is appropriate where the pleadings, affidavits and depositions on file, when viewed in a light most favorable to the non-moving party, show no genuine issue of material fact and that the moving party is entitled to judgment as a matter of law. Busch v. Graphic Color Corp., 169 Ill. 2d 325 (1996). The material facts in this matter are not at issue and, therefore, the only determination to be made is whether the Department is entitled to a judgment as a matter of law. For the reasons enumerated herein I find that the taxpayers' claim for refund for 2004 lacks any legal basis in Illinois law and that, as a consequence, the Department's denial of the taxpayers' refund claim for 2004 was proper.

**IT IS THEREFORE ORDERED** that the Department's Motion is granted. It is further ordered that the denial of the taxpayers' refund claim for the tax year 2004 be finalized as issued.

Ted Sherrod  
Administrative Law Judge

Date: March 23, 2009