



BDO Seidman, LLP
Accountants and Consultants

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Subject:

Changes to Illinois Franchise and Corporate Income Tax Laws

State and Local Tax Alert

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Overview

Governor Rod Blagojevich signed into law Senate Bill 1544 ("S.B. 1544") adopted as P.A. 95-0233 FY2008 Budget Implementation (Revenue) Act ("P.A. 95-0233" or "S.B. 1544" or "the Act") on August 16, 2007. S.B. 1544 significantly changes Illinois franchise and corporate income tax laws as follows: (1) it offers franchise tax amnesty program; (2) disallows certain insurance premiums expenses and costs between affiliates; (3) disallows the dividends paid deduction for captive real estate investment trusts ("REITs"); (4) expands the interest and intangible expense add-back provisions to related non-unitary affiliates; (5) revises exempt bond income subtraction modification; (6) changes the apportionment sourcing rules for sales other than sales of tangible personal property, financial organizations, and transportation companies; (7) imposes nonresident owner withholding; and (8) modifies Illinois net operating losses ("NOLs") for discharge of indebtedness. It is estimated that S.B. 1544 will increase state revenues by \$250 million per year as a result of closing certain perceived corporate income tax "loopholes."

Legislative Background

The adoption of S.B. 1544 was a compromise of various bills, including S.B. 1, Amendment 1 and H.B. 750 that were introduced in the General Assembly addressing the 2008 budget. Governor Blagojevich supported adoption of S.B. 1, Amendment 1. That bill proposed a gross receipts tax ("GRT") that would have completely overhauled Illinois corporate income tax law. Alternatively, H.B. 750 proposed tax rate increases and taxation of services for sales and use tax purposes amongst other changes. The proposed GRT and H.B. 750 tax legislation were never passed.¹

Effective Date

The legislative changes adopted in P.A. 95-0233 are effective for tax years ending on or after December 31, 2008 except as otherwise denoted.

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Franchise Tax and License Fee Amnesty

The new law establishes a franchise tax amnesty program for delinquent franchise taxes owed by domestic and foreign corporations (e.g., non-Illinois corporations) for any taxable period. The amnesty reporting period runs from February 1, 2008 through March 15, 2008. The significant benefits of the amnesty program include abatement of interest and penalties on taxes reported during the amnesty reporting period. In addition, the amnesty program limits the look back period to four years (normally seven years) for taxes that are owed due to previously unreported increases in paid-in-capital that occurred prior to the general seven year statute of limitation period.

The Illinois Secretary of State (“IL SOS”) administers the Illinois Franchise Tax and License Fees imposed on domestic and foreign corporations. In general, the Franchise Tax is composed of two parts: (1) Annual Franchise Tax imposed at .001 of paid in capital allocated to Illinois and (2) Cumulative Change in Additional Paid-in-Capital imposed at .0015 of additional paid-in-capital allocated to Illinois during the taxable year. New domestic or foreign corporations paying for the first time are required to pay an initial franchise tax of .0015 on the amount of paid-in-capital that is allocated to Illinois on its initial state filings. Generally, the IL SOS adopts a strict liability approach to the collection of franchise taxes.

Participation in the franchise tax amnesty program should not subject participating taxpayers to 200% interest and penalty provisions imposed under the Illinois Tax Delinquency Amnesty Act (“ITDAA”) of 2005. The ITDAA was a tax amnesty program administered by the Illinois Department of Revenue (“IL DOR”) for all taxes imposed by Illinois law and were collected by the IL DOR for the period June 30, 1983 through July 1, 2002. Since the franchise tax is not a tax collected by the IL DOR it does not fall under the purview of that amnesty program.² Thus, the 200% interest and penalty regime imposed on non-participating taxpayers under the ITDAA should not apply to taxpayers that participate in the franchise tax amnesty program.

Illinois Corporate Income Tax

A. Modifications to Federal Taxable Income

P.A. 95-0233 makes numerous add back and subtraction modifications to federal taxable income (“FTI”) in order to arrive at Illinois base income.

1. Captive Insurance Premium Deduction

Taxpayers are now required to add back to FTI the federal deduction taken for insurance premium expenses and costs paid, accrued, or incurred to a person who would be a member of the same unitary business group, but for the fact that the insurance company must use a different apportionment formula. The insurance premium expense add-back would be reduced to the extent that dividends with respect to stock of the captive insurance company were included in the base income of the unitary group for the same tax year and received by a member of the taxpayer's unitary business group.³

Historically, Illinois preserved federal deductions for intercompany premiums paid to captive insurance companies. As a result, wholly owned insurance companies would receive income while the paying company would record a premiums expense. The income and expense entries were never eliminated since the two affiliated companies could not be combined because their income was apportioned pursuant to different apportionment methodologies.

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2. Captive Real Estate Investment Trusts Dividends Paid Deduction

P.A. 95-0233 will require REIT's to add back dividends paid to corporate shareholders to FTI to arrive at Illinois base income. The Act defines a "captive REIT" in pertinent part as a corporation, trust, or association; that is considered a REIT for federal income tax purposes; not regularly traded on an established securities market; and of which greater than 50% of the voting power or value of the beneficial interest or shares, at any time during the last half of the taxable year, is owned or controlled, directly or indirectly by a single entity that is a C-corporation.

Currently, dividends paid by a REIT are deductible for both federal and Illinois income tax purposes. As a result of the new law, a REIT will now be subject to Illinois taxation on all of its income even if it pays no federal income tax.

3. Intercompany Interest & Intangibles Expense Deductions

P.A. 95-0233 expands existing Illinois related party expense disallowance rules applicable to 80/20 companies by requiring similar add back of interest⁴ and intangible expenses and costs paid, accrued or incurred to a person who would be a member of the taxpayer's unitary business group, but for the fact that the person is ordinarily required to apportion business income under a different apportionment method than the taxpayer. The new law defines "intangible expenses and costs" as including:

“...(1) expenses, losses, and costs for, or related to, the direct or indirect acquisition, use, maintenance or management, ownership, sale, exchange, or any other disposition of intangible property; (2) losses incurred, directly or indirectly, from factoring transactions or discounting transactions; (3) royalty, patent, technical and copyright fees; (4) licensing fees; and (5) other similar expenses and costs.”⁵

Similarly, the Act defines "intangible property" to include patents, patent applications, trade names, trademarks, service marks, copyrights, mask works, trade secrets, and similar types of intangible assets. In order to provide for parity in taxation, the Act allows taxpayers to the extent subject to Illinois taxation a subtraction modification for receipt of intercompany interest and/or income from intangible property from the taxpayer that is required to add back to FTI those same amounts. The historical related party disallowance exceptions applicable to 80/20 companies will apply to all other non-combinable entities as well.

The effect of the expanded related party expense disallowance rules is to close certain tax benefits achieved by various intercompany planning opportunities between different unitary groups. Like many other states that have adopted such provisions on a separate return basis, intercompany borrowing transactions, factoring transactions and royalty transactions will no longer secure the income tax deductions once realized under prior Illinois law.

4. Bond Income Subtraction

S. B. 1544 further reduces the subtraction modification for exempt bond income for Illinois income tax purposes by requiring taxpayers to decrease the subtraction by *all* expenses incurred to carry the tax-exempt bonds. The subtraction, however, is limited to exempt income. This is a change from prior Illinois law that excluded exempt bond interest income from Illinois base income by permitting a subtraction modification for all exempt income, reduced only by bond premium amortization.

B. Market Sourcing Apportionment

S.B. 1544 modifies the legacy greater cost of performance sourcing rules related to sales other than sales of tangible personal property for all taxpayers except as otherwise denoted. In general, the Act adopts general rules applicable to most taxpayer organizations as well as specific rules applicable to service companies, financial organizations and transportation companies.

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1. General Marketplace Sourcing Rules

Utilizing the new marketplace sourcing approach, the following changes have been adopted in Illinois tax law for receipts attributable to the following items:⁶

- i. **Sale or Lease of Real Property:** Sales from sale or lease of real property are sourced to Illinois if the property is located in Illinois.
- ii. **Lease or Rental of Tangible Personal Property:** Sales from the lease or rental of tangible personal property are sourced to Illinois if the property is located in Illinois during the rental period. Sales from the lease or rental of tangible personal property that is characteristically moving property, including, but not limited to, motor vehicles, rolling stock, aircraft, vessels, or mobile equipment are sourced to Illinois to the extent that the property is used in Illinois.
- iii. **Sale of Intangible Personal Property:** Sales of intangible personal property are in this state if the purchaser realizes benefit from the property in this state. If the purchaser realizes benefit from the property both within and without Illinois, the gross receipts from the sale shall be divided among those states in which the taxpayer is taxable in proportion to the benefit in each state. If the proportionate benefit in Illinois cannot be determined, the sale shall be excluded from both the sales factor numerator and denominator.

Notwithstanding the market sourcing rules attributable to sale of intangible personal property discussed above, these rules do not apply to gross receipts derived from the licensing, sale or other disposition of a patent, copyright, trademark, or similar item of intangible personal property. Those receipts are sourced to Illinois to the extent the property is utilized in Illinois.

2. Services

Sales of services are apportioned to Illinois if the benefit of the service is realized in Illinois. If the benefit of the service is realized in Illinois and another state, the gross receipts from the sale are divided among those states in proportion to the benefit of the service realized in each state. If the proportionate benefit in Illinois cannot be determined, the sale shall be excluded from both the Illinois sales factor numerator and denominator.

Given the effect of these new rules, it is unclear how taxpayers will comply with the law considering that S.B. 1544 does not define the term “benefits received” or how it applies to specific business industries. As such, the Act leaves open to statutory interpretation what is meant by benefits received and how they will be sourced for Illinois purposes.

3. Financial Organizations

S.B. 1544 sets out marketplace apportionment rules specifically for the various sources of business income derived from financial organizations. The new law provides generally that the business income of a financial organization shall be apportioned to Illinois by multiplying such income by a fraction, the numerator of which is its gross receipts from sources in Illinois or otherwise attributable to Illinois’s marketplace and the denominator is its gross receipts everywhere.

“Gross receipts” must be derived from transactions and activities in the regular course of the financial organization’s trade or business. “Gross receipts” is defined as gross income, including net taxable gain on dispositions of assets, which includes securities and money market instruments.

S.B. 1544 provides illustrations of how the following sources of income derived from financial organizations are to be treated: (i) Assets in the Nature of Loans; (ii) Commercial Loans and Installment Obligations; (iii) Credit Card Receivables; (iv) Fiduciary, Advisory, and Brokerage Services; (v) Travelers Checks and Money Orders; and Deposits.

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Based on the above, the new law overhauls current sales factor sourcing methodologies applicable to financial organizations. Historically, business income of a financial organization was included in the Illinois sales factor numerator if it was from sources within Illinois. In addition, Illinois's sourcing rules with respect to dividends and interest were sourced to Illinois if derived from Illinois customers and received in Illinois. This rule was coined for years the "lockbox rule". This rule was most notably applied to factoring transactions. In effect the lockbox rule permitted exclusion of gross receipts from the financial organization's sales factor numerator that was received by a non-Illinois lockbox. This taxpayer friendly sourcing provision has been eliminated under the new law.

4. Transportation Companies

Business income derived from providing transportation services carries its own set of apportionment rules. Receipts from providing transportation services other than airline services include all receipts from any movement or shipment of people, goods, mail, oil, gas, or any other substance that both originate and terminates in Illinois or that pass through, into, or out of Illinois based on a mileage ratio. The new rule differs from legacy Illinois transportation sourcing rules as it does not give effect to weight of cargo.

Moreover, airlines are treated separately from all other transportation service providers under the new law. Business income derived from providing airline services is apportioned to Illinois based on the arrivals of aircrafts in Illinois and departures from Illinois weighted as to cost of aircraft by type. Currently, the term "weighted as to cost of aircraft by type" is undefined under the new law. This lack of definitional guidance is bound to create taxpayer compliance confusion.

Nonresident Owner Income Tax Withholding

In an effort to crack down on nonresident income tax collections, S. B. 1544 imposes a requirement that partnerships (other than publicly traded partnerships), S corporations, and trusts must withhold income tax from nonresident partners, shareholders, and beneficiaries, respectively. The partnership, S corporation, or trust must withhold the tax due for each nonresident owner's distributable share of Illinois taxable income, whether or not any income is distributed. The nonresident owners are entitled to a credit on their Illinois income tax return for the tax withheld by the partnership, S corporation, or trust. However, the mandatory withholding provisions do not apply to the extent the partnership, S corporation or trust is included in a composite return.

NOL Reduction for Debt Cancellations in Bankruptcy

S.B. 1544 requires a taxpayer to reduce the NOL claimed for Illinois tax purposes by an apportioned share of the debt discharged in bankruptcy or due to insolvency. The NOL reduction would be made after the determination of Illinois taxable income for the tax year in which the indebtedness is discharged. This differs from former Illinois law, which allowed apportioned NOLs and NOL carryforwards, to reduce Illinois taxable income (for the year in which the loss occurred) without regard to debts cancelled in bankruptcy or due to insolvency.

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How BDO Seidman, LLP Can Help

With the enactment of PA 95-0233, the various corporate and individual income tax modifications to the Illinois Income Tax Act will have a profound impact on many Illinois taxpayers. The new statutes will need to be reviewed to determine their impact on your company's Illinois tax liability. Additionally, many of the legacy planning opportunities will no longer provide tax savings warranting a review of these strategies in connection with the new law. Given these changes, BDO Seidman, LLP state tax professionals can assist your company in determining the impact of PA 95-0233 as applied to your business activities. Please call Jon Zefi, National State & Local Tax Partner-in-Charge, Mark Siegel, NTO Senior Manager or Joseph Carr, NTO State & Local Tax Services who are available to assist you with any questions or concerns regarding this new legislation.

¹ It should be noted that the House Resolution on the GRT was voted 107-0 against its adoption.

² See generally, 86 Ill. Admin. Code §521.105(h).

³ It should be noted that the reduction in the premiums add back will generally only transpire where there is less than 100% dividends received deduction attributable to the transaction.

⁴ While the neither Act nor existing Illinois tax law define "interest expense", that term should be given the same effect for Illinois income tax purposes as it is for federal income tax purposes. 35 ILCS 5/102.

⁵ See P.A. 95-0233 (August 16, 2007).

⁶It should be noted that the new statutory rules for (i) and (ii) reflect substantially similar provisions enumerated in existing Illinois Tax Regulations 86 Ill. Admin. Code §100.3370(c)(3)(D).