Introduction to the Illinois Franchise Tax and its Importance to Your Company

By Jordan Goodman and Jesse Feinstein

The Illinois Franchise Tax (the "Franchise Tax") is an extremely complex tax that places unique burdens on corporations conducting business in Illinois. Based on our experience, many corporations incorrectly calculate their obligations, leading to the over or underpayment of their tax liabilities. Neither of these scenarios is desirable, and as such, the following series of articles are designed to familiarize you with the basics of the Franchise Tax and reveal a few common problems we at Kilpatrick have identified and resolved over the years.

For any corporation conducting business within Illinois or any corporation considering a merger or acquisition of a corporation operating within Illinois, the Franchise Tax and its impact should be carefully considered. Failure to do so could cause your corporation to lose its "good standing" with the Illinois Secretary of State, thereby risking the right to conduct business within the state.[1] Furthermore, your corporation may incorrectly calculate the Allocation Factor (defined below), leading to under or overpayment of your tax liability. Under-payment could again result in this loss of good standing, additional penalties, and interest, while over-payment is not in the best interest of any corporation either.

This series of articles will be divided into four topics. This first will cover the businesses and entities required to pay the Franchise Tax and the mechanics of the Franchise Tax system. The second will define the essential terms to understand the Franchise Tax and its calculation and cover some significant differences between the Franchise Tax and the state Income and Corporate Income Tax. The third will provide specific resources and examples on correctly calculating your Allocation Factor for the Franchise Tax. The fourth and final section will cover some of the common issues and problems we have seen corporations and clients struggle with in calculating, understanding, and ultimately paying the Franchise Tax.

Who is Liable?

The first step is to confirm that you and your business are subject to the Franchise Tax. In this context, this is a relatively uncomplicated process. The Illinois Secretary of State is the government office responsible for levying, collecting, and enforcing the Franchise Tax.[2] As such, entities registering with or reporting to the Illinois Secretary of State are subject to Franchise Taxing.[3] This includes *domestic and foreign corporations* which are conducting business in Illinois.[4] While LLCs will have annual filing obligations with the Secretary of State, they will not be subject to the Franchise Tax *unless* they have elected to be treated as a corporation for federal income tax purposes.[5] Specifically, LLC's must file an annual report with the IL Secretary of State with a $75 renewal fee attached.[6] Failure to timely file this report with the associated fee incurs a $100 late fee.[7] By contrast, banks and insurance companies, which register with separate state agencies outside the Secretary of State, will *not* have any Franchise Tax liability.[8]

Domestic v. Foreign Corporations

Domestic corporations will *always* be responsible for the Franchise Tax because they are Illinois-formed entities.[9] However, foreign corporations (i.e., entities formed in another state, territory, or country) registered with the Illinois Secretary of State to conduct business in Illinois may not be responsible for the Franchise Tax under certain circumstances.[10] Just because a corporation has sufficient nexus with the State of Illinois to trigger a state corporate income or sales tax liability (or any other state levied tax), such corporation *may* not incur a Franchise Tax liability. Similarly, a corporation may incur a Franchise Tax liability, yet incur no Illinois corporate income or sales tax liability. The liability requirements for each of these taxes are separate; therefore, special attention must be paid to their qualifying factors. Illinois law provides a list of activities foreign corporations may permissibly conduct in Illinois that do not constitute "transacting business" in the State for Franchise Tax purposes.[11]

These activities include, but are not limited to:

1. Maintaining, defending, or settling any legal proceeding;
2. Holding meetings of the board of directors or shareholders or carrying on other activities concerning internal corporate affairs;
3. Maintaining bank accounts within the State of Illinois;
4. Maintaining officers or agencies for the transfer, exchange, and registration of the corporation's own securities, or maintaining trustees or depositories with respect to such securities;
5. Selling through independent contractors;
6. Soliciting or obtaining orders, if such orders require acceptance outside of the State of Illinois before they become contracts;
7. Owning, without more, real or personal property;
8. Conducting an isolated transaction that is completed within 120 days and that is not one in the course of repeated transactions of a like nature; or
9. Having a corporate officer or director who is a resident of the state.

If a foreign corporation is conducting business activities outside the scope of these exceptions, it is likely subject to the Franchise Tax and incurs liability. Ensuring compliance with the amount due will be essential to maintaining smooth operations within Illinois.

Mechanics of the Franchise Tax:

The Franchise Tax can be thought of as three separate taxes: the initial tax, the annual tax, and the additional tax. The initial tax applies when a corporation initially registers with the Illinois Secretary of State for the right to conduct business within the state. For domestic corporations, this will be due when shares are first issued. For foreign corporations, this will be paid upon the date the application to conduct business in Illinois is filed. As the name implies, the annual tax will be paid each year based on the calculations discussed in this series of articles. The "filing" of this tax will be included in the corporation's Illinois Annual Report and must be submitted to the Illinois Secretary of State by the corporation's anniversary.[12]

A corporation's "anniversary" will be one of the following: the date an Illinois-formed corporation files its articles of incorporation, the date a non-Illinois-formed corporation's Illinois registration is approved, or the close of the (foreign or domestic) corporation's fiscal year. To use the close of a corporation's fiscal year as its anniversary for Franchise Tax purposes, the corporation must elect to do so by filing an IL Form BCA-14.01.

The additional tax is collected whenever the corporation's Paid-In Capital (defined in article #2) increases during a given year.[13] The Franchise Tax for foreign corporations is also subject to a cap of $2 million annually, regardless of their Allocation Factor.[14] However, it is essential to note that this cap applies exclusively to the annual franchise tax and will not cap the additional franchise tax imposed due to increases to Paid-In Capital.[15]

Why You Should Care - Overpayment Remedies & Statute of Limitations:

As a general practice, the Illinois Secretary of State does not alert a business if it has overpaid its Franchise Tax. Unfortunately, this means you must discover it for yourself. You are entitled to a refund of the overpayment if you make such a discovery.[16] However, Illinois law imposes a three-year statute of limitations on refunds of this kind.[17] So, if you discover that you have overpaid for the last five years, you can only recollect the funds from the previous three years despite your overpayments in those first two years. Unfortunately, this scenario is more common than it may appear, so we urge you to examine your books and records now to maximize the amount you receive on your return should overpayment have occurred.

Why You Should Care - Underpayment & The Tax Amnesty Program:

On the other hand, underpayment of your owed Franchise Tax liabilities could draw attention from the Illinois Secretary of State. Failure to pay the amount owed could trigger an audit, resulting in your corporation losing its good standing with the Secretary of State, threatening its ability to conduct all business within Illinois unless and until resolved.[18] Furthermore, underpayment will incur a penalty of 10% of any delinquent amount due on the corporation's annual report.[19] In addition, interest will be applied at 2% each month if the liability remains unpaid.[20]

Every once in a while, the Illinois Secretary of State (in conjunction with the Illinois State Governor) offers a tax amnesty program for corporations that have fallen into non-compliance with their tax obligations to the state and thereby underpaid their liabilities. Historically, this program has been extended to corporations whose liabilities include underpaying the Illinois State Franchise Tax.[21] However, it is incredibly unwise and ill-advised to rely on a potential amnesty program being offered. For reference sake, the last amnesty was in 2019 and covered unreported increases to paid-in capital, annual franchise tax deficiencies, any increase of paid-in capital or issued shares pursuant to section 14.30 or 14.35, and initial franchise tax deficiencies.[22]

While these programs have provided relief to many, it is far less stressful and more ideal for your business to comply from the start rather than fall out of compliance, risk losing your good standing with the state, and rely on the reasonableness of the Illinois Secretary of State when such issues come to light. As such, we highly recommend that you continue reading this series of articles to ensure that you and your business remain in compliance or quickly fall into compliance with the Franchise Tax.

Thank you for reading this article. Please reach out to the State and Local Tax group at Kilpatrick if you have any questions about your business and potential Franchise Tax liability.

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[1] 805 ILCS 13.50(b) & 805 ILCS 13.50(h)
[2] 805 ILCS 5/15.05(c) & 805 ILCS 15.80(a)
[3] 805 ILCS 5/14.05 & 805 ILCS 5/15.65
[4] 805 ILCS 15/14/05 & 805 ILCS 5/15.65
[5] 805 ILCS 180/45-5 & https://www.finaloop.com/blog/illinois-franchise-tax
[6] 805 ILCS 180/50-10(b)(11).
[7] 805 ILCS 180/50-15(b)(1).
[8] 805 ILCS 5/14.05
[9] 805 ILCS 5/14.05
[10] 805 ILCS 5/13.75
[11] 805 ILCS 5/13.75
[12] 805 ILCS 5/15.80
[13] 805 ILCS 5/15.65
[14] 805 ILCS 5/15.75(a)
[15] 805 ILCS 15/75(a)
[16] 805 ILCS 5.1.17(a)
[17] 805 ILCS 5/1.17(a)
[18] 805 ILCS 13.50(b) & 805 ILCS 13.50(h)
[19] 805 ILCS 5/16.05(a)
[20] 805 ILCS 5/16.05(c)
[21] State Collects Nearly $240 Million Through Tax Amnesty Program (illinois.gov)
[22] Illinois Corporate Franchise Tax Amnesty Information Sheet

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Laying Out the Basics of the Illinois Franchise Tax

By Jordan Goodman and Jesse Feinstein

This series of articles is intended to provide a deep dive into the Illinois State Franchise Tax (the "Franchise Tax") and should be read sequentially to be best understood. To view the first article in this series on what entities the Franchise Tax applies to and its basic mechanics, please click here. For an overview of the Franchise Tax generally, please see our prior article on the topic here.

Understanding the Franchise Tax requires an understanding of four critical terms used throughout its computing and filing process. These terms are: Paid-In Capital, Taxable Year, Fiscal Year, and Allocation Factor. While some of these terms have more common and general definitions in the context of federal and state taxation, the Franchise Tax somewhat modifies these traditional definitions. Each will be explained in more detail later in this series of articles. To begin, we have provided a bird's eye view of these terms and their definitions in the chart below:

TERM	DEFINITION	CITATION
Paid-In Capital	Paid-in capital is the figure by which the Franchise Tax is measured. This is typically calculated by combining the amounts listed on federal form 1120, Schedule L, Lines 22 and 23. However, many other factors may influence the overall calculation.	805 ILCS 5/1.80(j)
Taxable Year	Taxable Year describes the 12-month period commencing with the first day of the corporation's anniversary month in the state. Simply put, once a corporation files with the Illinois Secretary of State, their "Taxable Year" will begin and cover the following 12-month period.	805 ILCS 5/1.80(q)
Fiscal Year	Fiscal Year describes the 12-month period for which a corporation operating in Illinois and subject to the Franchise Tax ordinarily files its federal tax return.	805 ILCS 5/1.80(r)
Allocation Factor	Despite the similar nomenclature, the Allocation Factor used in determining Franchise Tax liability vastly differs from the apportionment factor used for Illinois Income or Corporate Tax purposes. The Allocation Factor used here is defined as the value of *all* the gross assets the corporation owns, *and* the gross amount of business transacted by the corporation everywhere compared to the gross assets owned and gross revenues located within Illinois.	805 ILCS 5/14.05(h)(2)

Paid-In Capital:

According to the Illinois Business Corporations Act, Paid-In Capital is defined as the sum of the cash and other consideration received, less expenses, including commissions paid or incurred by the corporation, in connection with the issuance of shares by or on behalf of its shareholders, plus amounts added or transferred to shareholders pursuant to a share dividend, share split or others.[1] This definition is represented mathematically below:

Paid-In Capital = **(Cash + Other Consideration) - (Expenses, including Commissions and Shares Issued) + (Amounts Added or Transferred to Shareholders via Dividends, Splits, Etc.)**

This definition typically translates into the sum of two amounts detailed on a corporation's books and balance sheet. These are the "Capital Stock" line (listed in dollars at Par value) and the balance sheet account line of "Additional Paid-In Capital" (consideration received/contributed over par value). Typically, these amounts are lifted directly from lines 22 and 23 in Schedule L of federal Form 1120. Simply adding these two figures together should result in the total Paid-In Capital. Knowing this amount is crucial to calculate and pay your Franchise Tax liability correctly and should be carefully monitored.

Paid-In capital can increase and decrease yearly, directly impacting a corporation's Franchise Tax liability. For example, a corporation can reduce its Paid-In Capital by its board of directors passing a resolution that charges dividends paid on preferred shares against its Paid-In Capital.[2] Paid-In Capital may increase by simply issuing new shares in the corporation.[3]

Taxable Year:

Your taxable year is typically based on your registration date with the Illinois Secretary of State and the 12-month period thereafter.[4] This information is vital to filing your Illinois Franchise Tax documents and will be recorded on Page 1 of your corporation's IL BCA Form 14.05.

Fiscal Year:

Unlike your taxable year, your Fiscal Year is determined solely by when your business typically files its federal income tax return.[5] This 12-month period is akin to what is also commonly called your "financial annual" or "corporate fiscal year." The financial fiscal year-end, which precedes the end of the Franchise Tax Taxable Year end, will be the data used to prepare your Illinois Franchise Tax (via your Allocation Factor). This information will be similarly placed on Page 2 of your corporation's IL BCA Form 14.05.

Allocation Factor:

The Allocation Factor used in determining your Franchise Tax is markedly different from the apportionment factor you may have used in determining your state Income or Corporate Tax liability. Using the apportionment factors from such tax calculations can lead to stark over or underpayments of the tax liability owed and cause substantial consequences with the Illinois Secretary of State Office. One of the few similarities between the Allocation Factor here and the apportionment factors found elsewhere is that they are both fractions that seek to fairly allocate only those business activities that are attributable to the State of Illinois relative to those that occur elsewhere in the United States or abroad.

However, this is where the similarities end between the Franchise Tax Allocation Factor and other apportionment factors. The numerator (representing business activities and Paid-In Capital derived from Illinois activities) and denominator (representing *everywhere* business activities and Paid-In Capital) are calculated much differently than the Corporate Income Tax apportionment factors and thus warrant special attention to detail to ensure compliance. According to the Illinois State Tax Code, the Franchise Tax Allocation Factor is defined as the value of the *sum of gross revenues and assets located within the State of Illinois* divided by the *gross amount of business transacted by the corporation everywhere and gross assets everywhere*.[6] Much like our definition of Paid-In Capital, this definition is obtuse in word form. As such, we have represented this formula mathematically below:

$$\textbf{Allocation Factor} = \frac{\text{(Illinois Assets + Illinois Revenues)}}{\text{(Everywhere Assets + Everywhere Revenues)}}$$

But what makes an asset an Illinois Asset? Which revenues are attributable to Illinois, and which are not? These essential questions must be answered to calculate a corporation's allocation factor correctly. Failing to do so will necessarily result in an over or underpayment of the Franchise Tax. Per Illinois law, underpayment leads to the imposition of late penalties and interest.[7] Underpayment will incur a penalty of 10% of any delinquent amount due on the corporation's annual report.[8] Additionally, interest rates will be applied at 2% each month that the liability remains unpaid.[9] As such, we have dedicated the following article in this series entirely to answering these questions and encourage you to follow us there now.

Thank you for reading this article. Please reach out to the State and Local Tax group at Kilpatrick if you have any questions about your business and potential Franchise Tax liability.

[1] 805 ILCS 5/1.80(j)
[2] 805 ILCS 5/9.20(a)(1)
[3] 805 ILCS 5/15.65(b)(1)
[4] 805 ILCS 5/1.80(q)
[5] 805 ILCS 5/1.80(r)
[6] 805 ILCS 5/14.05(h)(2)
[7] 805 ILCS 5/16.05(a)
[8] 805 ILCS 5/16.05(a)
[9] 805 ILCS 5/16.05(c)

Calculating Allocation Factor for Illinois Franchise Tax Purposes

By Jordan Goodman and Jesse Feinstein

This series of articles is intended to provide a deep dive into the Illinois State Franchise Tax (the "Franchise Tax") and should be read sequentially to be best understood. To view the first article in this series on which entities the Franchise Tax applies to, please click here. To view the second article in this series which lays out the basics of the Franchise Tax, please click here. For an overview of the Franchise Tax generally, please see our prior article on the topic here.

The importance of calculating your Franchise Tax Allocation Factor cannot be understated. Improper calculation of this factor can lead to over and underpayment of Franchise Tax, triggering penalties, interest accrual, and the stripping of a business's good standing in Illinois. As such, we have provided a brief recap of the Allocation Factor here, followed by a more in-depth look at the various elements of each figure in its calculation.

Allocation Factor Generally

The Franchise Tax Allocation Factor is broken into two central figures—a numerator and a denominator. Much like the apportionment factors used in calculating the state Income or Corporate Tax, the numerator represents what fraction of taxable activity is attributable to business or business activities derived from the State of Illinois. The denominator, by contrast, represents the business activity conducted everywhere in the United States and abroad. This function will produce a fraction which, when multiplied against the total taxable base, represents the fraction of that tax base attributable to the State of Illinois.

According to the Illinois State Tax Code, the Franchise Tax Allocation Factor is defined as the value of the sum of gross revenues and assets located within the State of Illinois divided by the *gross amount of business transacted* by the corporation everywhere.[1] This formula is represented mathematically below:

$$\textbf{Allocation Factor} = \frac{\textbf{(Illinois Assets + Illinois Revenues)}}{\textbf{(Everywhere Assets + Everywhere Revenues)}}$$

The following sections will delve deeper into what the Franchise Tax includes and excludes from the terms Gross Assets, Gross Revenues, Illinois Assets, and Illinois Revenues. While often used in other areas of Illinois State taxation, such as the state Income and Corporate taxes, these terms have a different meaning in the context of the Franchise Tax. The guiding document throughout this process will be Illinois Form BCA 1.35, which provides several rules and guidance in the composition of the Allocation Factor for use in a corporation's Illinois Annual Report.

Gross Assets:

As the name implies, Gross Assets in a Franchise Tax context attempt to account for your business's total assets, regardless of their presence or connection to the State of Illinois. Calculating this figure is relatively straightforward and most likely can be done entirely from the information in your federal Form 1120 Schedule L. To begin, take the figure from Line 15 from Schedule L of your Form 1120 and add back the allowance for doubtful accounts (Line 2b), accumulated depreciation (Line 11b), accumulated depletion (Line 13b), accumulated amortization (Line 10b), and any other net credit balance shown on Schedule L. The formula is represented more simply below:

$$\textbf{Gross Assets} = \begin{array}{l}\textbf{Line 15 + Line 2b + Line 10b + Line 11b + Line 13b} \\ \textbf{+ any other net credit balance on Schedule L}\end{array}$$

It is important to note that property for Franchise Tax purposes varies distinctly from income tax purposes. While intangible assets are rarely used for income tax calculations, they are essential to accurately calculating your Franchise Tax liability. This gives rise to many potential tax planning strategies, such as getting certain intangibles certificated and holding such property outside of Illinois to reduce the allocation factor and perhaps the Franchise Tax liability.

Once the above formula has been calculated, the resulting amount is placed in the "Gross Assets" section of the denominator.

Gross Revenues:

Gross Revenues capture all of a business's revenues, much like the term Gross Assets. Unlike Gross Assets, however, there is no simple way to calculate this from federal Form 1120 Schedule L entry lines. The calculation formula is displayed below:

$$\textbf{Gross Revenues} = \begin{array}{l}\textbf{(Gross Receipts – Returns) + Dividends + Interest} \\ \textbf{+ Gross Rents + Gross Royalties + Gross Sales Price} \\ \textbf{+ Other Income + Any Non-Taxable Dividends,} \\ \textbf{Interests, or Other Items}\end{array}$$

It is important to note that all net debit balances or losses are excluded from Gross Revenues. Once each value has been assigned, calculate the final figure and place it next to Gross Assets in the Allocation Factor formula above. By adding these two numbers together, you have found the denominator of the Allocation Factor.

Illinois Assets:

Determining which assets are attributable to business or business activities within Illinois is more complex and is a significant source of confusion and error in the Franchise Tax. As noted above, the best resource we have found for taxpayers on this subject is on Page 3 of the Illinois Form BCA 1.35, which provides a series of rules for various assets and whether they do or do not qualify as an "Illinois Asset" for purposes of the Franchise Tax. This form breaks down different common types of assets and clarifies what aspects and elements such assets must have to be deemed an Illinois-based asset. These rules are discussed in more detail below:

CATEGORY	INCLUSION RULES	EXAMPLES
Real and Personal Tangible Property	Included if *physically* located within Illinois	Real estate, inventories, uninvested cash
Trade Notes & Accounts Receivable	Included if such assets *arise* from Illinois sales	Accounts receivable
Investments	Included if notes, securities, or certificates evidencing the investment are *physically* located in Illinois	Tax-exempt securities, Mortgage and Real Estate Loans, Government Obligations
Intangible Property	Included if *acquired, produced, or primarily used* in Illinois	Trademarks, Copyrights, Patents
All Other Property	Included if *acquired, produced, or primarily used* in Illinois	

Real and Personal Tangible Property:

Real and Personal Tangible Property will be included in the Illinois Assets figure if they are *physically* located within Illinois.[2] If such property is located outside the state's borders, it will not be included in this category. It is important to note that the term "Real and Personal Tangible Property" includes assets such as (but not limited to) inventories, buildings, other depreciable assets, depletable assets, land, and uninvested cash.[3] If your business has property akin to any of the examples listed above, you must take the value of such property and include it in your Illinois Asset figure.

Trade Notes and Accounts Receivable:

Trade Notes and Accounts Receivable are deemed Illinois assets if they arise from Illinois sales.[4] Sales will arise from Illinois if the income-producing activity is performed in Illinois or is administered, managed, or controlled by an entity or individual within the State of Illinois.[5] Thus, any amount in your accounts receivable derived from sales that arose from Illinois must be included in the Illinois Assets figure.

Investments, Government Obligations, Tax-Exempt Securities, Loans to Stockholders, Mortgage & Real Estate Loans, and Other Investments:

These investments will only be certificated and deemed Illinois Assets if notes, securities, or certificates evidencing such investments are physically located within the State of Illinois.[6] If no such physical evidence exists, these investments will be deemed located in Illinois if they are administered, managed, or controlled by entities within Illinois.

If your business is headquartered in Illinois, paying attention to this class of assets is incredibly pertinent. Kilpatrick has found that it pays for such corporations to be certain that all "investments," such as cash, short- and long-term investments, notes receivable, stock certificates, evidence of memberships, partnership agreements, patents, trademarks, other intangibles, or other assets are "evidenced," by certification or otherwise, *and* that such evidence of this investment is contained in a "lockbox" or other secure account located outside of Illinois. If such business fails to do so, these assets must be included in the Illinois Asset figure, and your Illinois Franchise Tax liability will increase as a result.

Intangible Property:

Unlike tangible property, intangible property will only be included in the Illinois Assets figure if such property arose from acquiring a business located within the State of Illinois.[7] In the modern era, where considerable value is often attributed to the intellectual property of an acquired business, such a notion is essential to consider. If your business acquires another business through a merger or acquisition, and such company is located in Illinois, the value of those intangible assets, such as patents and trademarks, will be included in the Illinois Assets figure and contribute to increasing your Illinois Franchise Tax liability.

All Other Property:

Any other kind of property, including other intangible assets, property patents, copyrights, trademarks, prepared expenses, and other miscellaneous assets, will be deemed located in Illinois if the property was acquired, produced, or primarily used in Illinois.[8]

Illinois Revenues:

The final figure used in calculating the Franchise Tax Allocation Factor is Illinois Revenues. Much like Illinois Assets above, this figure seeks to capture the portion of your Gross Revenues attributable to business or business activities derived from the State of Illinois. Page 4 of Illinois Form BCA 1.35 offers another set of instructive rules to help us determine what revenue is and is not attributable to Illinois. This document contains specific rules for various forms of revenues that might be included, and each listed is discussed in more detail below:

CATEGORY	INCLUSION RULES	EXAMPLES
Sale of Tangible Personal Property	Included if the sale occurs in Illinois, is shipped from Illinois, or the contract evidencing the sale is accepted in Illinois	Online sales with inventory stored in Illinois Warehouse
Service Income or Income from Sales of Non-Tangible Personal Property	Included if the income-producing activity occurred in or was controlled by an entity within Illinois	Income derived from providing a service or selling IP rights
Investment Income	Included if the investments are administered, managed, or controlled within Illinois	Interest and Dividends
Subsidiary Interest and Dividends	Included if the subsidiary transacts business *primarily at* or *from places of business* within the State of Illinois and the taxed corporation owns at least 10% of the subsidiary	The taxed corporation owns 100% of a subsidiary that issues dividends to the parent company
Gross Rents	Included if the rented property is located within the State of Illinois	Rents collected from the lease of land
Gross Royalties from Oil, Mineral, or Other Leases	Included if the leased property is located within the State of Illinois	Royalties collected from the extraction of oil on leased land
Gross Sales Prices for Dispositions of Real Estate, Property, and Capital Assets	Included if the property or asset sold was located in Illinois at the time of the sale	Sale of real estate

Sale of Tangible Personal Property:

The revenue derived from the sale of Tangible Personal Property will be attributable to the State of Illinois if the sale occurs within the State, is shipped from an Illinois location, or the contract evidencing the sale is *accepted* within the State.[9] This is in stark contrast to how such revenues are apportioned in both the Illinois State Income and Corporate taxes, which are included in such a figure based on their "destination" rather than their "origin," as seen here. As you can see, this leads to staunchly varying numbers between the Allocation Factor and other apportionment factors used in these other respective taxes.

Practically speaking, the result of this rule means that if the business's warehouse contains Tangible Personal Property in the form of inventory and ships the inventory from the warehouse, every sale of this inventory will be sourced to Illinois regardless of the ultimate destination of the products. Similarly, this also means that when a sales contract is accepted, you must consciously note where the contract itself was "accepted" and signed. If your business accepts a contract within the State of Illinois, every sale under such contract, regardless of origin or destination, will be factored into your Illinois Revenues. The inverse of the above example is true as well.

For example, suppose your business has no inventory in Illinois, and sales contracts are "accepted" outside Illinois. In that case, *no* sales of tangible personal property will contribute to your Illinois Revenues, even though the sale may ultimately be shipped to an Illinois location and is or was reported as a destination sale for Illinois State Income or Corporate Tax purposes. In summary, it pays to be particularly mindful of these factors when deciding how to coordinate and organize sales of Tangible Personal Property and sales contracts for such property to minimize Franchise Tax liability.

This is highly analogous to the structure of Public Law 86-272 ("PL 86-272"). This law prohibits a state from imposing a net income tax on foreign corporations whose business activities in the taxing state are limited to the solicitation of orders for tangible personal property. Under PL 86-272, a foreign corporation does not "engage in business" within a state by simply having solicitations for sales of tangible property occur within its borders. Instead, the business must take some action that crosses over this mere solicitation to fall out of PL 86-272 protection. Generally speaking, if a corporation has a headquarters and inventory warehouse in California and only solicits orders from Illinois residents, it may only be responsible for the minimum Illinois Franchise Tax and avoid the corporate net income tax.

Service Income, Sales Other Than Tangible Personal Property, and Other Receipts:

Any revenue derived from services or sales outside of tangible personal property and other receipts will be allocated to Illinois Revenues only if the income-producing activity was performed in Illinois or was administered, managed, or controlled by a person or entity in Illinois.[10]

This inclusion rule is highly analogous to the "Cost of Performance" principle used in calculating state corporate income tax for service income and sales of intangible personal property. The Cost of Performance is a concept used to apportion where the income-producing activity is attributable to and, thus, how such income will be apportioned for state income tax purposes. Under this principle, the income derived from the service or sale will be assigned to the state where the costs of performing such services are located. For example, if Company X performs a service in State Y for a customer who is a resident of State Z, State Y will be assigned the income. The critical difference between the Cost of Performance and the method Illinois uses for Franchise Tax purposes is that Illinois will source income derived from services performed in another state if such services or sales were administered, managed, or controlled by a person or entity within Illinois. For example, suppose you are a landscaping corporation from California with an office in Illinois and perform landscaping services in Indiana controlled by those in your Illinois office. In that case, the income derived from this service will be assigned to Illinois despite no services being rendered there. Again, this method contrasts the market-based sourcing rules used for the corporate net income tax.

Income From Investments (Dividends & Interest):

If a corporation derives any income or revenues from investments, such as through dividends or interest accrued from such investments, it may also have to include this in its Illinois Revenues. This can be the case regardless of whether such income is or is not taxable. This income will only be included if these investments are administered, managed, or controlled within Illinois.[11]

Dividends & Interest from Subsidiary:

If a corporation owns at least 10% of, or operates a subsidiary, any dividends and interest the parent company receives may also be included in their Illinois Revenues and thus subject to the Franchise Tax.[12] Such income will be allocated as Illinois Revenues if the subsidiary transacts business *primarily at* or *from places of business* within the State of Illinois. So, if your subsidiary operates a warehouse within the State of Illinois and collects and fulfills online sales from said warehouse, any dividends or interest paid to the parent company will be allocated to Illinois Revenues for the *parent company* on their Franchise Tax liability.

Gross Rents:

Gross rents are allocated to Illinois if the rented property is located within the State of Illinois. Thus, if you operate an apartment building within Illinois, your rent will be allocated to your Illinois Revenues and contribute towards your Franchise Tax liability.[13]

Gross Royalties from Oil, Mineral, or Other Leases:

Any gross royalties your business may receive from oil, mineral, or other material leases will be allocated to Illinois only if the leased property is located within the State of Illinois.[14] These natural resources are specifically carved out from royalties generally, which will only be allocated to Illinois Revenues if the activity giving rise to the payment of royalties was transacted at or from a location within the State of Illinois.[15] So, for any oil leasing agreements your business may have that drill into Illinois ground, your royalties will be subject to Illinois Revenues. For example, imagine you own an oil business with a headquarters in Illinois. One day, at this Illinois headquarters, you sign a lease agreement that gives your business the right to extract oil from a parcel of land in Oklahoma. This action will qualify any royalties earned from extraction as Illinois Revenue, increasing your business's Illinois Franchise Tax liability.

Gross Sales Prices for Dispositions of Real Estate, Property, and Capital Assets:

If your business decides to sell any real estate in a taxable year, income from such sale may also be allocated to your Illinois Revenues.[16] All gross prices for dispositions of real estate, property, and capital assets are allocated in this fashion if the property or asset sold was located in Illinois at the time of the sale.

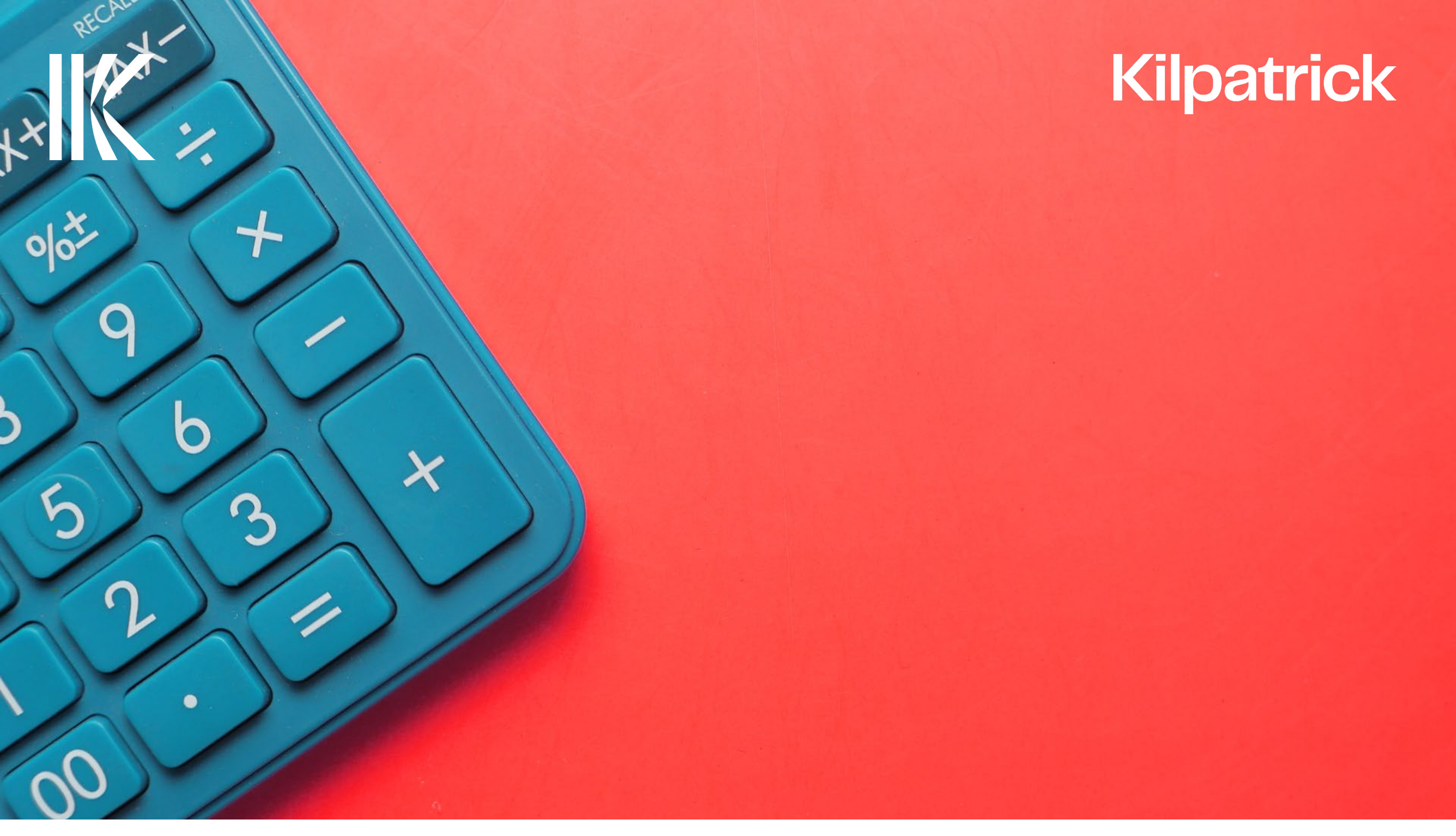
Conclusion:

Calculating a business's Franchise Tax Allocation Factor can be tricky. Failure to do so correctly can lead to severe complications and result in over or underpayment of a business's tax liability, potentially jeopardizing its ability to conduct business within Illinois. Moreover, underpayment leads to the imposition of late penalties and interest.[17] Underpayment will incur a penalty of 10% of any delinquent amount due on the corporation's annual report.[18] At the same time, a 2% interest rate will be applied each month that the liability remains unpaid.[19] As such, we urge you to carefully examine your books and past filings to ensure that your Allocation Factor has appropriately accounted for your Illinois Assets and Illinois Revenues. As seen in these examples, it is incredibly easy to mistakenly include or not include items in your Illinois Revenues or Illinois Assets, which will impact the final Allocation Factor and ultimately impact the amount of Franchise Tax you pay.

The next and final article in this series on the Franchise Tax is dedicated to some common problems Kilpatrick has seen and resolved when dealing with Franchise Tax issues.

Thank you for reading, and please reach out to the State and Local Tax group at Kilpatrick if you have any questions about your business and potential Franchise Tax liability.

[1] 805 ILCS 5/14.05(h)(2)
[2] IL From BCA 1.35 Notes to Computation of Property (Part I) (1)
[3] IL From BCA 1.35 Notes to Computation of Property (Part I) (1)
[4] IL From BCA 1.35 Notes to Computation of Property (Part I) (2)
[5] IL From BCA 1.35 Notes to Computation of Property (Part I) (2)
[6] IL From BCA 1.35 Notes to Computation of Property (Part I) (3)
[7] IL From BCA 1.35 Notes to Computation of Property (Part I) (4)
[8] IL From BCA 1.35 Notes to Computation of Property (Part I) (5)
[9] IL From BCA 1.35 Notes to Computation of Property (Part II) (1)
[10] IL From BCA 1.35 Notes to Computation of Property (Part I) (2)
[11] IL From BCA 1.35 Notes to Computation of Property (Part I) (3)
[12] IL From BCA 1.35 Notes to Computation of Property (Part I) (4)
[13] IL From BCA 1.35 Notes to Computation of Property (Part I) (5)
[14] IL From BCA 1.35 Notes to Computation of Property (Part I) (5)
[15] IL From BCA 1.35 Notes to Computation of Property (Part I) (5)
[16] IL From BCA 1.35 Notes to Computation of Property (Part I) (6)
[17] 805 ILCS 5/16.05(a)
[18] 805 ILCS 5/16.05(a)
[19] 805 ILCS 5/16.05(c)



Common Problems and Simple Solutions

By Jordan Goodman and Jesse Feinstein

This series of articles is intended to provide a deep dive into the Illinois State Franchise Tax (the "Franchise Tax") and should be read sequentially to be best understood. The first article covered the businesses and entities required to pay the Franchise Tax and the mechanics of the Franchise Tax system. The second defined the essential terms to understand the Franchise Tax and its calculation and covered some significant differences between the Franchise Tax and the state Income and Corporate Income Tax. The third provided specific resources and examples on correctly calculating your Allocation Factor for the Franchise Tax. For an overview of the Franchise Tax generally, please see our prior article on the topic here.

At Kilpatrick, we see five common problems with franchise tax filings. These issues relate to improper Allocation Factor calculation, increases in Paid-In Capital, timely reporting to the Illinois Secretary of State, and so-called "push-down accounting" being used on reports following successful mergers and acquisitions. Each of these is discussed in more detail below.

Improper Allocation Factor Calculation:

The Franchise Tax Allocation Factor is broken into two figures—a numerator and a denominator. Much like the apportionment factors used in calculating the state Income or Corporate Tax, the numerator represents what fraction of taxable activity is attributable to business or business activities derived from the State of Illinois. The denominator, by contrast, represents the business activity conducted everywhere in the United States and abroad. This function will produce a fraction which, when multiplied against the total taxable base, represents the fraction of that tax base attributable to the State of Illinois.

According to the Illinois State Tax Code, the Franchise Tax Allocation Factor is defined as the value of the sum of gross revenues and assets located within the State of Illinois divided by the *gross amount of business transacted* by the corporation everywhere.[1] This formula is represented mathematically below:

$$\textbf{Allocation Factor} = \frac{\textbf{(Illinois Assets + Illinois Revenues)}}{\textbf{(Everywhere Assets + Everywhere Revenues)}}$$

If a corporation's Allocation Factor has been improperly calculated, it will necessarily result in the under or overpayment of Franchise Tax. Commonly, corporations will fail to correctly attribute assets and revenues to Illinois, distorting the numerator of the Allocation Factor. To avoid this mistake, it is vital to ensure that your corporation follows the directions on Form BCA 1.35 when determining what assets and revenues are attributable to Illinois. To view our previous article on determining whether property or income is attributable to Illinois for Allocation Factor purposes, please click here.

Increases, Decreases, and Paid-In Capital "Lock-In":

A common problem we see corporations face involves changes to Paid-In Capital from prior tax years and how the corporation has elected to file its Illinois Annual Report. To quickly recap, Paid-In Capital is defined as the sum of two amounts detailed on a corporation's books and balance sheet. These are the "Capital Stock" line (listed in dollars at Par value) and the balance sheet account line of "Additional Paid-In Capital (consideration received/contributed over par value). Typically, these amounts are lifted straight from lines 22 and 23 in Schedule L of your federal Form 1120, and simply adding these two numbers together results in Paid-In Capital. This number can thus be increased or decreased in many ways. Please see our second article in this series for an example of how Paid-In Capital can increase and decrease from year to year.

Noting the increases and decreases in your corporation's Paid-In Capital is essential in correctly calculating your Franchise Tax. Your Illinois Form BCA 14.30, which provides a cumulative report of changes in your corporation-issued shares and Paid-In Capital, will generally be due at the same time as your Illinois Annual Report, provided there are year-over-year changes to the total number of shares or total Paid-In Capital. Changes in Paid-In Capital can benefit a corporation but can simultaneously complicate Franchise Tax calculation. These complications arise depending on your prior year's Allocation Factor and how your corporation filed its Illinois Annual Report.

When a corporation elects to file its Illinois Annual Report online or has elected a 100% Allocation Factor on Form BCA 14.05 for any period, these elections are often binding and cannot be amended following increases or decreases to Paid-In Capital. This rings especially true for Illinois Annual Reports, which have been filed online. However, we have recently seen the Illinois Secretary of State Office accept "Correction Statements" regarding the 100% Allocation Factor election on Form BCA 14.05, which are filed on paper. This is a change from the Office's historical policy of not accepting changes of these kinds regardless of how the Form was filed. Conversely, we have yet to see the Office accept Correction Statements for Allocation Factors elected on such forms that have been filed digitally.

This is important for several reasons. Most notably, if your corporation decides to file its Form BCA 14.05 or Illinois Annual Report online based on convenience, you may be stuck with that elected Allocation Factor despite significant increases to your Paid-In Capital the following year. This will usually result in the corporation being required to pay a larger, sometimes 100%, Allocation Factor on the significant increase in Paid-In Capital, thereby significantly increasing its Franchise Tax liability. This is a costly oversight in the name of convenience and warrants consideration before digitally submitting either of these documents.

Decreases of Shares and Paid-In Capital:

Another common issue occurs when the corporation has a decrease in its Paid-In Capital. This issue often appears when a corporation has issued a stock buy-back, redemption, share return, or some other action that reduces the number of shares issued or reported to the Illinois Secretary of State. As the corporation prepares its Form BCA 14.30 with its Illinois Annual Report, which would report the change in issued shares or Paid-In Capital, the corporation will incorrectly report the number of shares *outstanding*. The Illinois Secretary of State requires that the corporation instead report the number of *issued* shares, not *outstanding* shares.

Should a corporation file their report with the outstanding shares and capital, the Illinois Secretary of State will typically deny or reject such filing. The Illinois Secretary of State has stated that once a share is "issued," it remains an issued share with its historical value until removed from the pool of authorized shares in the corporate charter (most commonly, the articles of incorporation). Simply put, buying back stock and treating it as treasury stock will not decrease Paid-In Capital. The shareholder must additionally cancel the stock and have such action reflected in board minutes and as an amendment in the corporation's articles of incorporation. This is even though the corporation may have "canceled" the same shares for financial reporting purposes.

If your corporation seeks to formally cancel these shares by amending your articles of incorporation, these amended articles must also be filed with the Illinois Secretary of State, along with Form BCA 14.30. Only then will the Illinois Secretary of State allow the reduced capital represented by those canceled authorized shares.[2] Once this has been completed, the corporation's Paid-In Capital will be reduced by these amounts, thereby reducing your Franchise Tax liability for that taxable year.

Timely Reporting:

The complexities of a merger or acquisition can make the thought of Franchise Tax and reporting to the Illinois Secretary of State seem inconsequential. However, this could not be further from the truth, and paying attention to the deadlines presented by the Secretary's office is essential. Failure to do so could result in the stripping of your business's "good standing" with the State and the potential prohibition on conducting business within Illinois. Illinois law requires that Reports of Merger (Form BCA 14.35) be filed with the Illinois Secretary of State within 60 days of the merger, together with a "fresh" certified merger document.[3]

One widespread misconception we have seen is when an Illinois-registered entity (foreign or domestic) is the "survivor" of the merger with an entity not registered or qualified in Illinois. Often, these deals are not reported to the Illinois Secretary of State because the non-surviving entity was not registered in Illinois. This is an incorrect interpretation of the Illinois Business Corporations Act. *Any* time an Illinois corporation is a party to a merger, such merger *must* be reported to the Illinois Secretary of State, with no exceptions. This report must be filed under Form BCA 14.35 and be accompanied by "fresh" merger documents. Similarly, this report must be filed within 60 days of the merger's occurrence.[4]

This is important in the Franchise Tax context because the Illinois Secretary of State has been randomly reviewing the Delaware Secretary of State's filing record (and other Offices with public filing records) for entities registered with Illinois. If a corporation has merged and is found to be out of compliance with the reporting requirements of Illinois law, the Illinois Secretary of State has full authority to reject that corporation's Illinois Annual Report or any other document submission. There have been reported cases of the Illinois Secretary of State rejecting current pending submissions for failure to report mergers going as far back as fifty years.

As discussed in this series of articles, having an Illinois Annual Report rejected could potentially jeopardize your corporation's "good standing" with the State of Illinois. This means the Illinois Secretary of State could ultimately revoke your corporation's authority to do business within the State of Illinois until all unreported merger documents have been reported and perfected by the Illinois Secretary of State Office. This involves a severe amount of paperwork, taxes, fines, fees, and approval wait times. Unfortunately for the corporation, there is no statute of limitations on the fees, taxes, or reporting requirements associated with the change of paid-in capital. Finding the old financial records and merger documents can be further challenging for corporations whose mergers occurred long ago. The Illinois Secretary of State has yet to accept any current document, including Illinois Annual Reports, for entities subject to any unreported mergers until such an unreported merger has been submitted, paid for, and filed or accepted by the Illinois Secretary of State.

Push-Down & Purchase Accounting:

Push-down accounting is defined as a method of accounting for the purchase of another company at the price of the purchase rather than its historical cost. Thus, the "target" company's assets and liabilities are written down (or up) to reflect the purchase price. [5] Kilpatrick Townsend & Stockton LLP is often asked if this accounting style is included in the amounts used for the Franchise Tax. Our answer has been that all bookkeeping entries "pushed down" to the corporation's books and records of the entity are considered part of the corporation's Gross Assets and Total Paid-In Capital. However, to the extent these entries are not "pushed down" to the books of the corporation or not part of Gross Assets or Total Capital on the books, they are instead *not* considered part of the Gross Assets or Total Paid-In Capital of the entries by the Illinois Secretary of State. In other words, if the entries are held in "suspense" or consolidation, they will not be considered part of the corporation's Gross Assets or Total Paid-In Capital by the Illinois Secretary of State.

Wrapping Up and Conclusion:

The Illinois State Franchise Tax is an essential consideration for every corporation registered to do business within the State of Illinois and those seeking to conduct a merger or acquisition for such a corporation. Failure to carefully consider each of the implications mentioned throughout this series of articles could cost you and your corporation valuable time and money. Importantly, underpayment necessarily leads to the imposition of late penalties and interest.[6] Such failure incurs a penalty of 10% of any delinquent amount due on the corporation's annual report.[7] Interest rates will be applied at 2% each month that the liability remains unpaid.[8]

We hope this series has helped you better understand the importance of these considerations and made the Franchise Tax a little bit easier to understand. Please contact the State and Local Tax group at Kilpatrick if you have any questions or concerns regarding your corporation and your Franchise Tax liability.

Thank you for reading.

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[1] 805 ILCS 5/14.05(h)(2)
[2] See 805 ILCS 5/9.20; See also 805 ILCS 5/9.05 & Form BCA 9.05.
[3] 805 ILCS 5/14.35
[4] 805 ILCS 5/14.35(a)
[5] Pushdown Accounting: Definition, How It Works, Example (investopedia.com)
[6] 805 ILCS 5/16.05(a)
[7] 805 ILCS 5/16.05(a)
[8] 805 ILCS 5/16.05(c)
