



Insights: Publications

The Illinois Franchise Tax

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The Illinois Franchise Tax is a weird tax. It is imposed on the privilege of exercising a franchise in Illinois or, in the case of foreign corporations, for the authority to transact business in the state. It is administered by the Illinois Secretary of State, not the Department of Revenue, and is measured by paid-in capital. Knowing the ins and outs of the Franchise Tax is a must for any corporation doing business in the state.

APPLICABILITY OF THE FRANCHISE TAX

The Franchise Tax is imposed upon domestic corporations and foreign corporations for the authority to transaction business in Illinois.[1] The tax strictly applies to corporations; banks and insurance companies, which register with separate Illinois agencies, are not subject to the tax. Similarly, while LLCs have their own registration obligation with the Secretary of State ("Secretary"), they are subject to a \$75 annual fee rather than the Franchise Tax.[2]

Not all foreign corporations with nexus in Illinois need pay the Franchise Tax. Illinois law provides a list of activities that do not constitute "transacting business." [3] Thus, even though a business may have nexus with Illinois for sales tax, corporate income tax, or some other Illinois tax, that business may not be subject to the Franchise Tax. Specifically, a corporation may conduct any of the following activities in Illinois without being subject to the tax:

1. Maintain, defend, or settle any proceeding;
2. Hold meetings of the board of directors or shareholders or carry on other activities concerning internal corporate affairs;
3. Maintain bank accounts;
4. Maintain offices or agencies for the transfer, exchange, and registration of the corporation's own securities or maintain trustees or depositories with respect to those securities;
5. Sell through independent contractors;
6. Solicit or obtain orders if orders require acceptance outside Illinois before they become contracts; own, without more, real or personal property;
7. Conduct 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
8. Have a corporate officer or director who is a resident of the state.

This list of activities is not exclusive, and other analogous activities also should not create an obligation to register with the Secretary and pay the tax.

FRANCHISE TAX BASE

The Franchise Tax can be split into three different taxes: the initial franchise tax, the annual franchise tax, and an additional franchise tax. The initial franchise tax is paid when a foreign corporation applies with the state for authority to transact business in the state. In the case of a domestic corporation, the initial franchise tax is due upon the first issuance of shares. An annual franchise tax must be paid on the corporation's anniversary each year.[4] Additional franchise tax is due upon a number of events that might increase a corporation's paid-in capital during a given year. For instance, additional franchise tax is due upon the report of the issuance of additional shares, a report of an increase in paid-in capital without issuing shares, or a report after a merger if the report shows that the paid in capital of the surviving corporation is greater than the aggregate of Illinois paid-in capital previously reported by the corporations prior to the merger.[5]

In calculating paid-in capital, the Secretary does not necessarily conform to GAAP. Instead, the definition of paid-in capital is 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, plus any cash and other consideration contributed to the corporation by or on behalf of its shareholders, plus amounts added or transferred to paid-in capital by action of the board of directors or shareholders pursuant to a share dividend, share split, or otherwise, minus reductions” provided elsewhere in the act.[6] A corporation may reduce its paid in capital by resolution of its board of directors by charging against its paid-in capital (i) the paid-in capital represented by shares acquired and cancelled by the corporation, (ii) dividends paid on preferred shares, or (iii) distributions as liquidating dividends.[7] A reduction in paid-in capital may also occur pursuant to an approved reorganization in bankruptcy that specifically directs the reduction to occur.[8]

In the case of a “vertical merger,” the paid-in capital of a subsidiary may be eliminated if either (1) it was created, totally funded, and wholly owned by the parent, or (2) the amount of the parent's investment in the subsidiary was equal to or exceeded the subsidiary's paid-in capital.[9] The Attorney General has clarified that a surviving corporation following a vertical merger (when a parent and a subsidiary merge) “may report paid-in capital totaling less than the sum of the paid-in capital of the merging corporations if the revised total is consistent with the economic realities of the merger and with generally-accepted accounting principles.[10]

Finally, the Franchise Tax is apportioned and is subject to a cap. The amount of paid-in capital in Illinois is the sum of (1) the value of the corporation's property in Illinois, and (2) the gross amount of business transacted by it at or from places of business in Illinois compared to the sum of (1) the value of all its property, wherever located, and (2) the gross amount of its business, wherever transacted.[11] In recent years, the State has discussed transitioning to a single sale factor apportionment methodology consistent with the state's apportionment of corporate income. To date, no such change has occurred, and the Franchise Tax looks to both property and sales for apportionment. The annual franchise tax may not exceed \$2 million per year.[12] However, no such limit exists for the tax due on increases in paid-in capital.

APPEALS AND PROTESTS

Because the Franchise Tax is administered by the Secretary of State, challenges to an assessment of tax must be made to the Secretary within three years after the amount to be adjusted should have been paid. Generally speaking, but not always, a corporation should file a statement of correction with the Secretary which will supply the grounds for the need for an adjustment.[13] Decisions by the Secretary are subject to judicial review under the Administrative Review Law.[14] Generally, failure to file or pay the Franchise Tax will result in the Secretary revoking the corporation's certificate of authority to transact business in the state.

CONCLUSION

Very few states employ a tax on paid-in capital in the manner Illinois does. Foreign corporations that may be doing business in Illinois should be careful to examine their business activities to determine whether they have a Franchise Tax obligation. Most importantly, corporations engaged in mergers and acquisitions with Illinois corporations should be careful to examine how such reorganizations may impact any additional franchise tax obligations by virtue of increasing paid-in capital. While it is often possible to structure such reorganizations to avoid an increase in paid-in capital, this tax often goes overlooked, resulting in potentially substantial liabilities.

[1] 805 ILCS 5/14.05; 805 ILCS 5/15.65.

[2] 805 ILCS 180/45-5.

[3] 805 ILCS 5/13.75.

[4] 805 ILCS 5/15.80.

[5] 805 ILCS 5/15.65.

[6] 805 ILCS 5/1.80(j).

[7] 805 ILCS 5/9.20(a)(1).

[8] 805 ILCS 5/9.20(a)(2).

[9] 805 ILCS 5/920(f).

[10] IL Attorney General Opinion, 92-017 (9/24/1992).

[11] 805 ILCS 5/15.50(e); 805 ILCS 5/15.70(e).

[12] 805 ILCS 5/15.75.

[13] 805 ILCS 5/1.15(g).

Related People



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