ILLINOIS CHAMBER
OF COMMERCE

Taxpayers' Federation of ILLINOIS

February 19, 2014

Dear Friends and Colleagues:

The underlying presumption in the debate over tax reform in Illinois has been that the use/abuse of tax incentives is the primary reason so few corporations pay Illinois corporate income tax. But some critical information has been missing from the discussion to-date—the evidence to support that presumption.

The attached report, *Probing Beneath the Surface*, answers the fundamental questions: Why do so few corporations have an Illinois corporate income tax liability? How significant is the impact of deductions and credits in eliminating tax liability?

Based on a series of Freedom of Information Act requests to the Department of Revenue for aggregated data off the corporate income tax returns (Form IL-1120 and Credit Schedule 1299), our study looks at the roughly two-thirds of Illinois corporate income tax filers that show no tax liability. The study covers tax years 2007 through 2011, a period which represents both highs and lows in the economic cycle. The answers we received challenge many of the underlying assumptions in the ongoing corporate tax reform debate. What we found:

1. **Federal taxable income (FTI) which is the starting point for computing Illinois tax liability is <u>by far</u> the primary factor in determining whether an Illinois filer will have an Illinois corporate income tax liability—not Illinois deductions or credits.** The most significant factor in determining whether a corporation would have an Illinois tax liability was whether or not that corporation showed federal taxable income (FTI) on line 1 of their Illinois return. In fact, over the 5 year period, 98.3 percent of corporations with negative FTI on line one of their Illinois return had no corporate income tax liability, while 88.5% with a positive FTI on line 1 had corporate income tax liability.

2. **In addition, Illinois corporate tax *deductions* play a very minor role in reducing a corporation's tax liability to zero even if the corporation does have a positive FTI.** The average number of returns filed showing no Illinois corporate income tax (Illinois CIT) liability over the 5 year period was 75, 517. Of those 75,517 filers, on average 4059 corporations had a <u>positive</u> FTI on line 1 of their Illinois return but no CIT liability. Only 17.8% of those returns initially showing FTI wound up with no tax liability after applying Illinois deductions.

3. **More specifically, the 2011 suspension of the Net Operating Loss Deduction did not have a significant impact in moving corporations with a negative FTI from a non-taxpaying status to a taxpaying status. It appears that the burden of the 2011 NOLD suspension was borne, for the most part, by taxpayers that were already paying corporate income tax.** Logically, if you have no income against which to apply a deduction, loss of the deduction will have little impact and the data bears that presumption out—the number of returns with negative FTI and no tax liability remains consistent despite the 2011 NOLD suspension. However, the data suggests that suspending NOLD's did create a tax liability for approximately 2000 filers (only 3% of total filers without a corporate income tax liability) that otherwise would have used their NOLD to offset positive income. It should be noted, however, that these corporations will still be able to use any unused NOLD's in future years when the suspension is lifted.

4. **Illinois tax *credits* have almost no impact in explaining why businesses have no corporate income tax liability.** Of the total 75,517 returns filed with no CIT liability, only 132 (0.2%) fall into the no liability category through the use of tax credits. Looking at the 4,059 filers who had a positive FTI but no CIT liability, only 0.9% on average moved from positive income to negative income as a result of tax credits. In other words, use of tax credits does not explain why 99.1% of all returns with no tax liability and positive business income do not pay corporate income tax.

From the data derived from the study, it is apparent that Illinois deductions and credits play a minimal role in reducing corporate income tax liability to zero for the 66.9% of corporations with no Illinois corporate tax liability. *But it does suggest that the vast majority of the revenue that would be derived from repealing income tax deductions and credits would result in a tax increase for those corporations that are paying corporate income tax—as opposed to those that are not.*

We are not unique in Illinois. The number of Illinois filers with no tax liability directly tracks federal government statistics in terms of the number of federal corporate income tax filers with no tax liability, and since the vast majority of states piggyback the federal income tax code in some capacity, their income tax systems are similarly affected. The federal Government Accountability Office (GAO), in a 2008 study of corporate domestic and non-domestic taxpayers, found that that two-thirds of corporate filers pay no federal income taxes. The data in the GAO report explains in large part why federal taxable income--line 1 of the Illinois return--is frequently a negative number. The study also computed the percentage of filers that dropped out of a federal tax liability for each line item on the federal return. The top 3 deductions causing taxpayers to reduce taxable income to zero or below were the deductions for salaries and wages, interest and depreciation. The GAO pointed out that tax deductions were responsible for almost all of the two-thirds that did not pay federal income tax and that credits had a very minimal impact. [See: GAO Report to Congress: A Comparison of the Reported Tax Liabilities of Foreign and U.S.-Controlled Corporations 1998-2005].

[Note: While some may think it is tempting to consider decoupling from the federal tax, doing so would subject the State to some very significant costs in developing and administering a unique tax, as well as losing the extensive auditing and data matching capability of the federal government. Decoupling from the federal tax would make Illinois, once again, an outlier in business tax policy as almost every state with a corporate income tax piggybacks the federal tax system. In addition, taxpayers, who rely on our consistency with the federal tax code, would find a unique Illinois corporate tax law extra burdensome from a compliance standpoint.]

Many are anticipating that the U.S. Congress will re-visit the corporate tax code in the near future. Discussions are ongoing at the federal level about lowering tax rates and broadening the tax base. If that were to happen, then states will benefit from any base increases automatically—as they do now.

We urge the Department of Revenue to make more aggregate information available to tax researchers so that tax policymakers have the data to make informed decisions as they consider Illinois tax reform proposals. There is much more that can be learned about the corporate income tax through the use of aggregated data.

Respectfully submitted,

Carol S Portman

Carol Portman
President
Taxpayers' Federation of Illinois

Connie Beard

Connie Beard
Tax Director
Illinois Chamber of Commerce