PROBING BENEATH THE SURFACE:

Understanding Why So Many Corporations Do Not Pay Illinois Corporate Income Tax

A report by JD Michael LLC

Funded by: Illinois Chamber of Commerce
Taxpayers' Federation of Illinois

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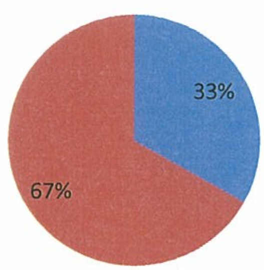
Two-Thirds of Corporations Don't Pay Tax in Illinois



2007 - 2011 Average

- Returns with Tax Liability: 37,402
- Returns without Tax Liability: 75,517

Source: Table 2-2

- The facts are undisputable
- The question is, WHY?

Answering the Question

- That "2/3 don't pay tax" statistic is frequently used to justify a variety of proposals, but never examined or explained
- TFI and the Chamber engaged JD Michael to dig deeper into the data for answers
- This Report is a starting point

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Methodology

- Freedom of Information Act requests to the Illinois Department of Revenue
- Line-by-line analysis of IL-1120 and 1299-D (the corporate income tax return and credits schedule)
- Goal: determine at what point corporations "fall out" of tax-payer to no-tax-payer status

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Corporation Income Tax Basics: Step One: Federal Taxable Income

Federal Gross Income
- (-) Deductions

Federal Taxable Income (Line 30 of Federal Return)
- (x) Federal Tax Rate

Federal Income Tax
- (-) Federal Tax Credits

Total Tax Liability

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Corporation Income Tax Basics: Step Two: Illinois Tax Calculation

Federal Taxable Income ("FTI") (Line 30 of Federal Return)
- (+) Illinois Addition Modifications
- (-) Illinois Subtractions/Deductions

Illinois Base Income
- Apportion Base Income
- (-) Illinois Net Operating Deduction (NOLD)

Taxable Income x Tax Rate = Tax
- (-) Credits

Illinois CIT Liability

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Things to Keep in Mind:

- **Scope of the Study**: Corporations without CIT liability. (Cannot use this data to evaluate particular income tax provisions because it does not include all corporations.)

- When we are talking about $ amounts shown in line 1 and subsequent additions and subtractions, we are generally talking about nation-wide income amounts *before* apportionment—**NOT tax $**.

- **Not all businesses pay CIT** (income earned by partnerships, S Corps, LLC's, LLP's, and sole proprietorships is generally subject to the individual income tax).

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Federal Taxable Income is the Driver

- 95% of corporations with no CIT liability had either negative or zero Federal Taxable Income
- 98% of corporations with negative Federal Taxable Income had no CIT liability

- 88.9% of corporations with positive Federal Taxable Income <u>have</u> a CIT liability.

Source: Tables 2-3 and 2-4

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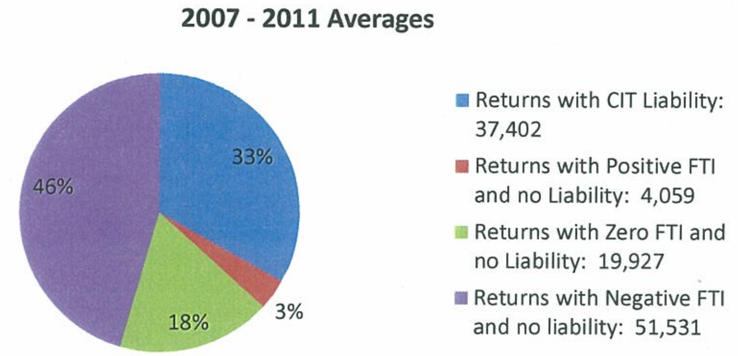
Looking at it Another Way:



Source: Table 2-2

There are still, on average, 4,059 returns with positive FTI but no tax liability—our review is not complete

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Which Modifications?

- Most common additions:
  - Federal Net Operating Loss (17% of returns with liability)
  - Special Depreciation (11%)

Both provisions are federal deductions disallowed for Illinois purposes because Illinois has enacted its own counterpart.

- Most common subtractions:
  - Special Depreciation (17% of returns with no liability)
  - Foreign Dividends Received (4%)
  - Tax Exempt Interest (2%)

Each is grounded in sound tax policy.

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Illinois Modifications—
the 3% with Positive FTI

- Of the positive-FTI returns, Illinois additions and subtractions put 17.8% (or 722) into a loss position (Table 4-1)
- Modifications also reduced their FTI by roughly half (Table 4-2)

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Illinois Modifications—
More of the Story

- Some returns with zero or negative FTI had net Illinois additions
- After modifications, 14,010 firms had positive income (but still no tax liability) (Table 5-1)
- Income was further reduced by virtue of apportionment, Illinois NOLDs, or tax credits—still more analysis required

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  Each is grounded in sound tax policy: our own depreciation calculation, reducing double-taxation, and complying with federal law

Source: Tables 3-1 and 3-3

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Next Steps

Key adjustments in determining taxable income, but data was unavailable:

- Apportionment
- Illinois NOLs

We do know that an average of only 132 firms used credits. The other 13,878 (14,010 – 132) must have had 0% apportionment or Illinois losses to put them into a no-tax position. (Table 5-1)

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Last but not Least--Credits

- 1299D: credits are *claimed* in the year earned
- 1120: credits are *used* in the year tax is reduced
- Credits used range from 21% to 52% of credits claimed each year, for this group (Table 6-4)
- Of all corporate filers, only 0.2% fall into the no tax liability category through the use of tax credits.

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Bottom Line

- Our original question:

  Why do 2/3 of corporations not pay Illinois corporate income tax?

- The answer can be complicated, but one thing is clear:

  Illinois' tax code is NOT the major driver

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What's Next?

- Ideally, DOR would be able to make the missing data available—NOLDs, apportionment
- Can use similar methodology to evaluate provisions for all filers
- Illinois is not alone:
  - GAO report: 1998 -2005: 60.9% - 69.3% of corporate return-filers paid $0 federal income tax
  - 43 states currently piggyback the federal code and find themselves in a similar position

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Corporate Tax Reform

- Discussions ongoing at the federal level about lowering tax rates and broadening the tax base.
- States will automatically benefit from any federal base increases.

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Questions?

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