Sales Tax Credits, the R&D Credit and Corporate Franchise Tax

Department of Revenue

April 9, 2014

Summary

- Sales Tax Credits
  - Manufacturing Machinery and Equipment exemption (MM&E)
  - Manufacturer's Purchase Credit (MPC)
  - Vendors Discount
  - Sales Tax Credit Summary
- Research and Development Credit (Corporate Income Tax)
- Revisit the Corporate Franchise Tax

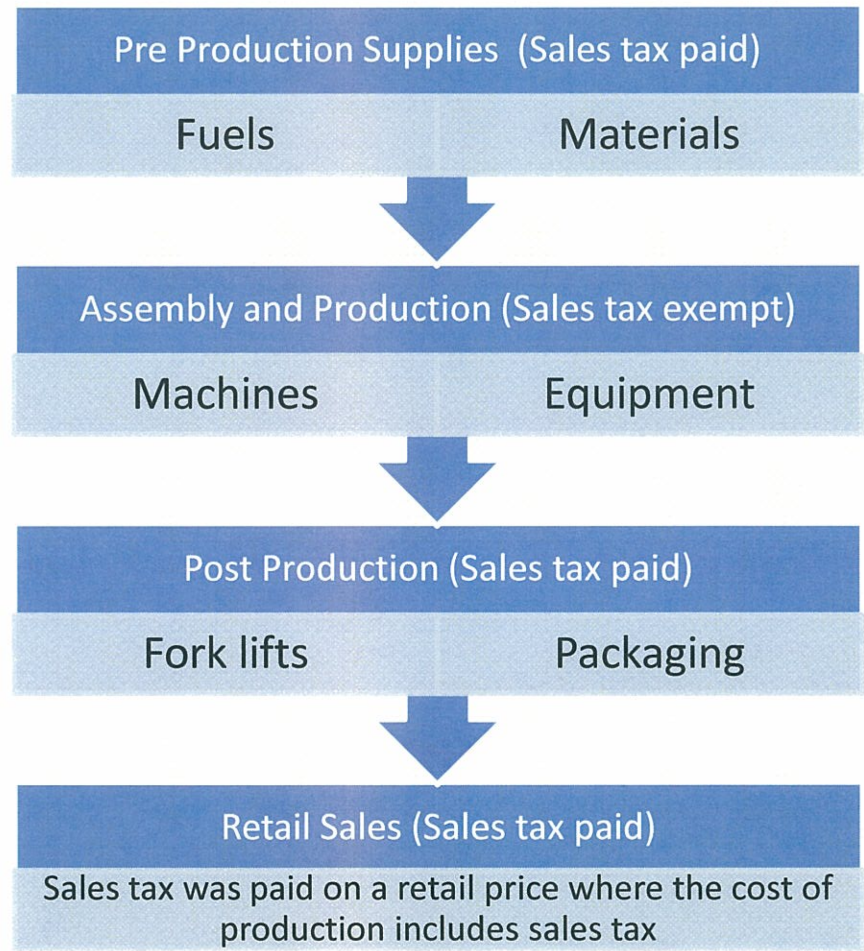
Manufacturing Machinery and Equipment exemption (MM&E)

MM&E Basics

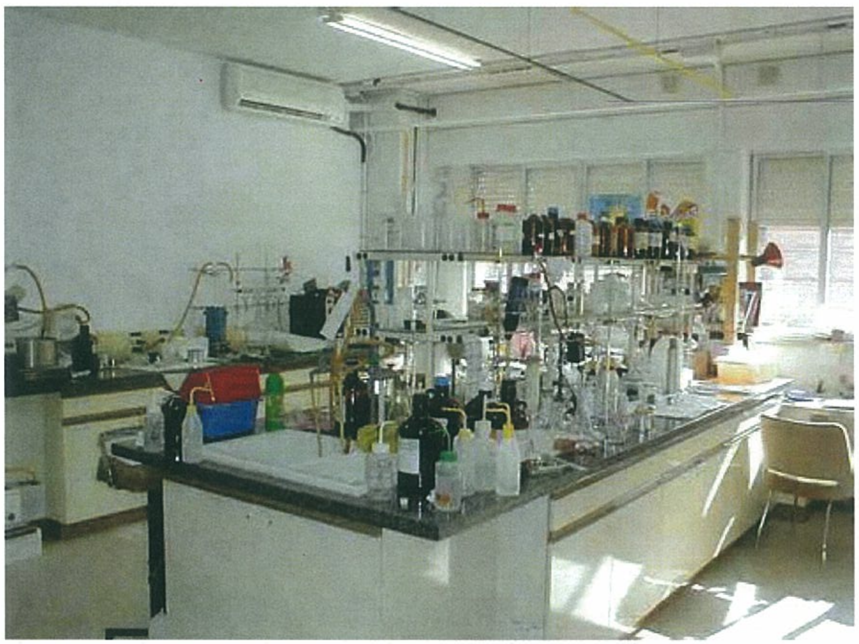
- A sales and use tax exemption for machinery and equipment used primarily in a manufacturing or assembly process.
- FY2013 Cost Estimate $204M (State share)
- The general MM&E does not apply to a broad range of production-related tangible personal property (TPP), such as
  - pre- and post-production equipment and materials,
  - fuels, and building materials,
  - TPP used or consumed in associated research and development activities.

Why we have the Manufacturer's Purchase Credit (MPC)

- Basic principle of taxation:
  - Production input purchases should be exempt to avoid distorting productive economic activity and to prevent tax pyramiding.



Manufacturer's Purchase Credit (MPC)



- Purchases exempt under the general MM&E earn a credit equal to half of the 6.25% state tax that *would have been due* on the exempt MM&E purchase.
- This credit can then be used to cover the 6.25% state tax that was due on designated production-related TPP and research and development TPP
- FY2013 Cost Estimate $35M (State Share)

MPC Criticisms

- Creates additional compliance costs for manufacturing businesses.
- Effectively excludes or handicaps small manufacturing businesses that might not make exempt MM&E purchases large or regular enough to earn sufficient MPC.
  - Roughly half of all MPC is taken by 5 companies.
- It leaves the MPC-related purchases subject to local sales taxes.
- The credit is earned on a tax not paid.
- Approximately 50 percent of MPC goes unused.

ROT/SOT (Sales Tax) Retailer's Discount

- Retailers may reduce the tax they remit by 1.75% if they pay by their due date.
- Intent is to reimburse the retailer for the costs of keeping records, preparing and filing returns, remitting the tax, and supplying data to the IDOR on request.
- $205 million in FY13 ($124M state; $81M local).

ROT/SOT Retailer's Discount

- \$200 cap per month, per account on ST-1 reduces annual discount by \$125 million (\$75M state; \$50M local).
  - This would reduce the discount for about 5% of retailer ST-1 accounts.
- \$500 cap per month, per account on ST-1 reduces annual discount by \$108 million (\$65M state; \$43M local).
  - This would reduce the discount for about 2% of retailer ST-1 accounts.

Discount Cap Considerations

- Need a separate cap for ST-556 vehicle returns, which are filed per vehicle, not per period.
- Discounts are also available under other taxes, including hotel tax, auto rental tax, liquor tax, motor fuel tax, natural gas tax, telecommunications tax, and dry-cleaning solvent tax.

Distribution of State Sales and Use Tax

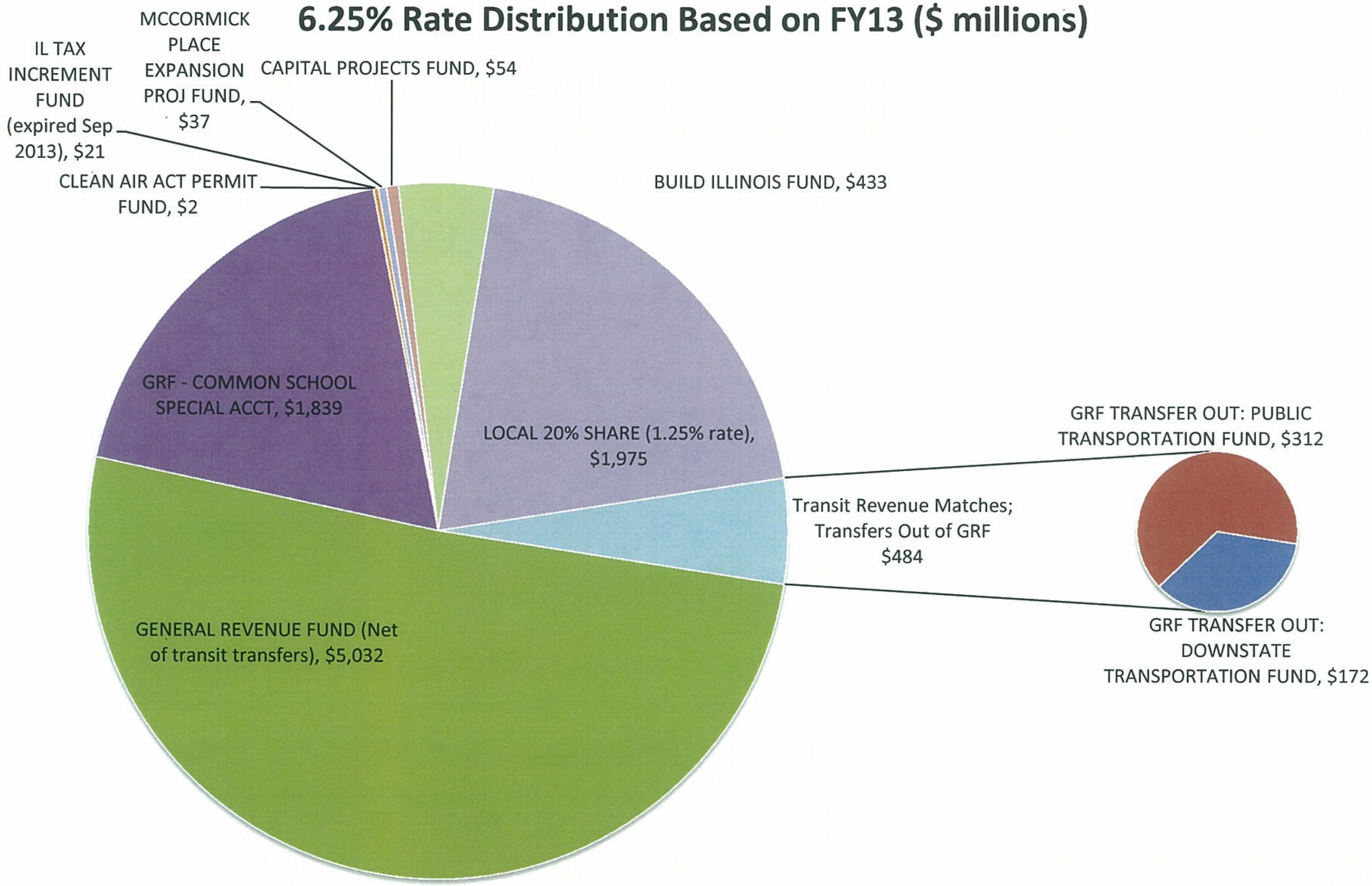
- 6.25% general merchandise rate split 80/20 state/local (80/20 = 5% rate/1.25% rate).
- Some of the state's 80 percent share goes to local governments.
  - Metropolitan Pier and Exposition Authority (McCormick Place). Variable amount off the top, subject to large annual caps. $36.7M receipted in FY13.
  - Revenue matches for mass transit; transfers out of GRF after fund deposits.
    - $171.7M to Downstate Public Transportation Fund in FY13.
    - $312.2M to RTA Public Transportation Fund in FY13.
- 1% rate on qualifying food, drugs, and medical appliances: all revenue goes to locals.

Distribution of State Sales and Use Tax

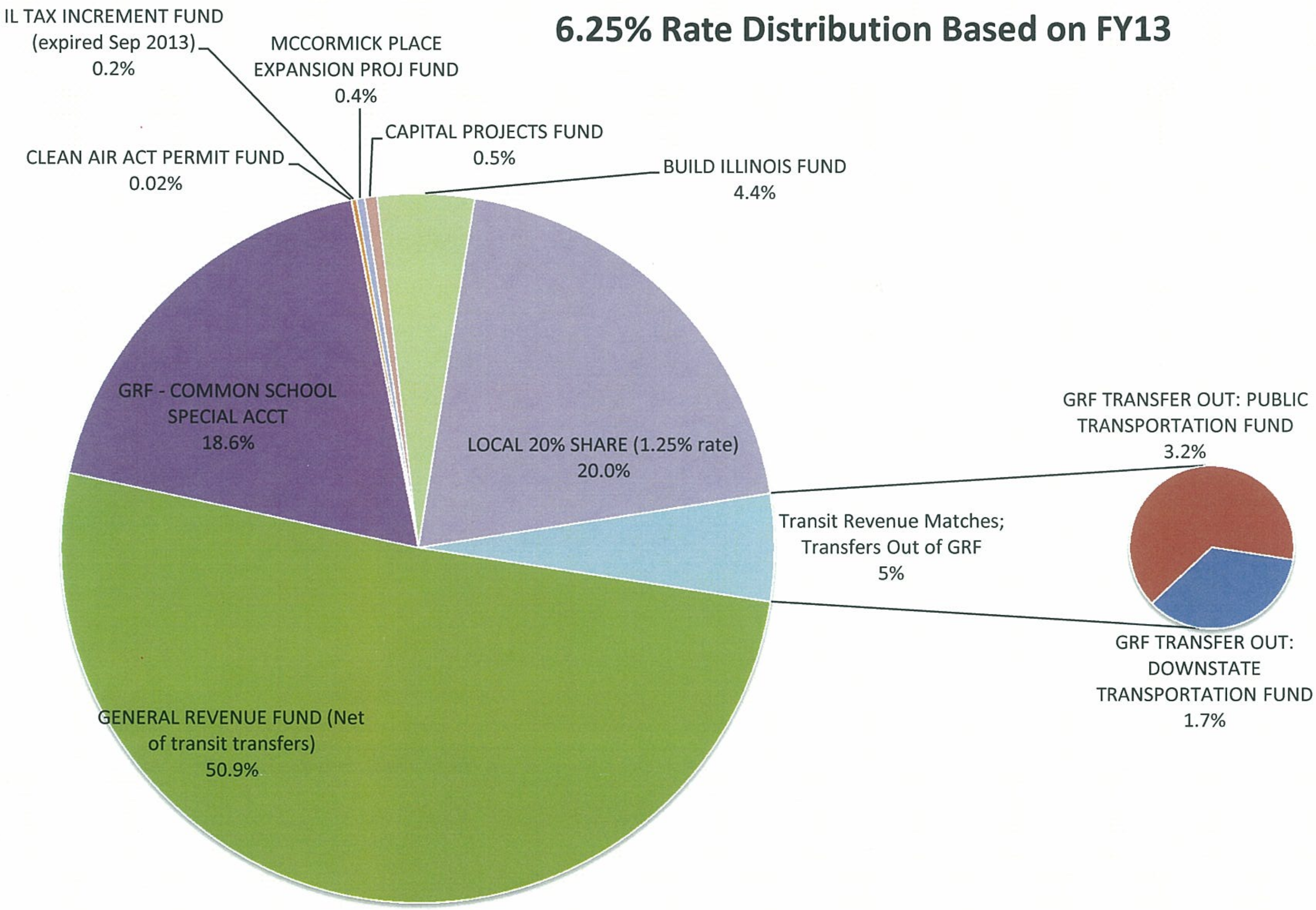
6.25% FY13 Amounts (millions)

STATE 80% SHARE (5% rate)	**$7,902**
GENERAL REVENUE FUND	$5,516
GRF - COMMON SCHOOL SPECIAL ACCT	$1,839
CLEAN AIR ACT PERMIT FUND	$2
IL TAX INCREMENT FUND (expired Sep 2013)	$21
MCCORMICK PLACE EXPANSION PROJECT FUND	$37
CAPITAL PROJECTS FUND	$54
BUILD ILLINOIS FUND	$433
EQUIVALENT LOCAL 20% SHARE (1.25% rate) *timing of disbursements is lagged	**$1,975**
6.25% AMOUNT	**$9,877**

6.25% Rate Distribution Based on FY13 ($ millions)



6.25% Rate Distribution Based on FY13



FY13 Sales/Use Tax Expenditures

Amounts are for state general funds only

Description	FY13 (millions)
Food, Drugs, and Med App. Rate Reduction	$1,644
Sales to Exempt Orgs	$332
Traded-In Property (estimate excludes non-vehicles)	$282
Farm Chemicals (includes feed, seed, and fertilizer)	$267
Manufacturing Machinery and Equipment	$204
Gasohol	$146
Biodiesel	$133
Retailer's Discount	$124
Rolling Stock	$76
Farm Machinery and Equipment	$71
Sales of Vehicles to Automobile Rentors (net of auto rental tax)	$46
Manufacturer's Purchase Credit (MPC)	$35
Newsprint and Ink to Newspapers and Magazines	$32
Building Materials within an Enterprise Zone (plus River Edge)	$24
Designated TPP within an Enterprise Zone	$19
Graphic Arts Machinery and Equipment	$10
Interim Use Prior to Sale	$5
High Impact Business Building Materials Exemption	$5
Legal Tender, Medallions, and Bullion	$2
High Impact Business Designated TPP Exemption	$2
Majority Blended Ethanol	$2
Property Acquired by Non-Resident Before Relocating to Illinois	$1

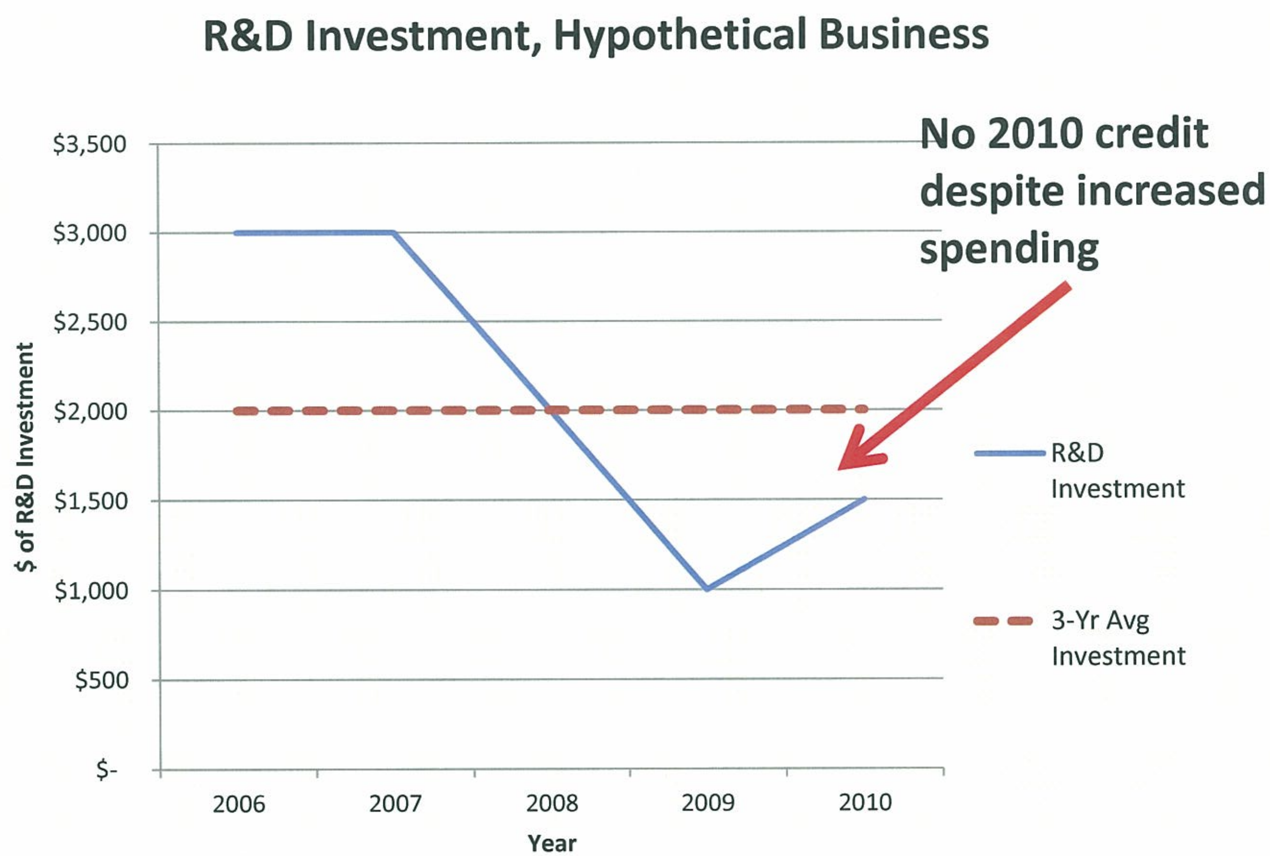
Illinois R&D Credit

- Created in 1991
- Designed to stimulate Illinois R&D
- Followed existing federal credit design
- **Calculation:** Increase over 3-yr average of spending on Illinois R&D * 6.5%
- FY 2013: **$44.7 million** (CIT + IIT), used by 2,124 taxpayers

- IL ranks 10th in private sector R&D spending (Source: National Science Foundation, 2010)

IL R&D Credit - Mechanics

EXAMPLE: Investment declines due to recession, then rebounds



Federal Regular R&D Credit

1.

- STEP 1

  FIXED BASE PERCENTAGE CALCULATION (FBP)

  $$\frac{\text{QUALIFIED RESEARCH EXPENDITURES (QRE) (1984 - 1988)}}{\text{Gross Receipts (1984 - 1988)}}$$

Note: There is an alternative table for start ups and businesses without QREs in 1984 - 1988

STEP 2 FBP X AVG. GROSS RECEIPTS, LAST 4 YEARS = BASE AMOUNT

STEP 3 QRE – BASE AMOUNT = EXCESS OVER THE BASE AMOUNT

STEP 4 EXCESS OVER THE BASE AMOUNT X 20% = R&D CREDIT

Federal Regular R&D Credit
(Alternative Simplified Credit)

2. Current Year QRE – (3 year Avg QRE X 50%)
   X 14% = Credit Amount

Franchise Tax Overview

- The Annual Franchise Tax Assessed at the rate of 1/10 of 1% ($1.00 per $1,000) of Paid-In Capital Represented in the state ($25 minimum and $2 million cap)
- 15/100 of 1 percent ($1.50 per $1,000) for initial tax and new issuance (no cap)
- Allocation formula = Gross Receipts and Property in Illinois ÷Gross Receipts and Property Worldwide.
- Raises approximately $180 million for GRF.

Issues Identified

- Lack of audit authority in the statute.
- Treasury Shares are not subtracted from the tax-base.
- The allocation formula is difficult to calculate and is inconsistent with Corporate Income tax apportionment.

Options

- Amend the statute to fix the issues on the prior slide.
- Eliminate the Franchise tax and replace the lost revenue to the General Fund with the closure of Corporate Income tax loopholes.