

Illinois Corporate Franchise Tax

Department of Revenue

3-21-2014

House Joint Committee of Revenue and
Finance and State Government

Objectives

- Provide committee members with some basic accounting framework to evaluate the economics of the Corporate Franchise Tax.
- Describe the Illinois Franchise Tax in broad strokes (The Secretary of State will provide a more detailed presentation).
- Identify other states with a similar tax.
- Enumerate several objections to the tax structure.
- Recommend changes to the tax structure.

Accounting Terminology

- Paid-in Capital

- Capital contributed to a corporation by investors through purchase of stock from the corporation in the primary market.

=

- Par Value times the number of shares issued.

+

- Value in excess of Par times the number of shares (Often called “Additional Paid-in Capital” or “Paid-in Capital in Excess of Par”).

Accounting Terminology

- Retained Earnings
 - a corporation's cumulative net income (from the date of incorporation to the current balance sheet date) minus the cumulative amount of dividends declared.
 - If a corporation has experienced net losses since it was formed, it could have negative retained earnings. In this case, the account is described as "Deficit" or "Accumulated Deficit" on the corporation's balance sheet.

Accounting Terminology

- Treasury Stock
 - If a corporation reacquires some of its stock and does not *retire* those shares, the shares are called treasury stock.
 - Treasury stock reflects the difference between the number of shares *issued* and the number of shares *outstanding*.

Stockholders Equity

- $\text{Paid-in Capital} + \text{Retained Earnings} - \text{Treasury Stock} = \text{Total Stockholders Equity}$
- Can also be thought of as the net worth of the corporation (Total Stockholders equity also equals asset minus liabilities).

Accounting of Paid-in Capital

Stockholders' Equity

Paid-in capital	
Common stock, \$0.10 par, 10,000 shares authorized, 2,000 shares issued, 1,900 shares outstanding	\$ 200
Paid-in capital in excess of par - common	<u>49,800</u>
Total paid-in capital	50,000
Retained earnings	<u>28,000</u>
Subtotal	\$ 78,000
Less: treasury stock, at cost (100 shares at \$20)	<u>– 2,000</u>
Total stockholders' equity	<u><u>\$ 76,000</u></u>

Franchise Tax at Incorporation

- The initial franchise tax is assessed at the rate of 15/100 of 1 percent (\$1.50 per \$1,000) on the paid-in capital represented in this state. (The minimum initial franchise tax is \$25.)
- Paid-in Capital = Paid-in Capital + Additions to Paid-in Capital
- Allocation formula = $\frac{\text{Gross Receipts and Property in Illinois}}{\text{Gross Receipts and Property Worldwide}}$.

Franchise Tax on Paid-in Capital Previously Reported

- The Annual Franchise Tax
 - Assessed at the rate of 1/10 of 1% (\$1.00 per \$1,000) for the 12 month period commencing the first day of the anniversary month of the corporation.
 - Same allocation formula applies
 - The minimum tax is \$25.00 and maximum tax is \$2,000,000.

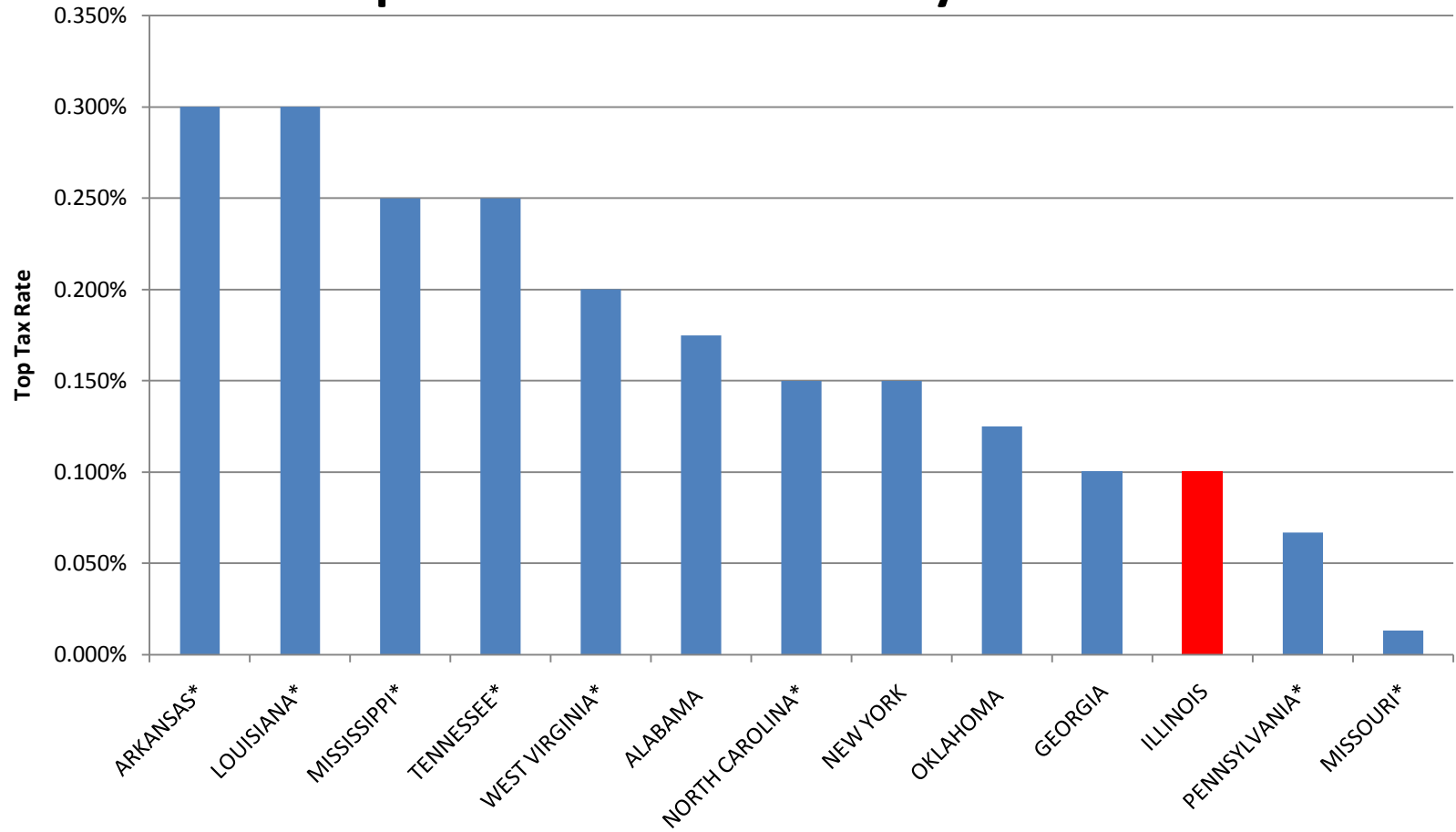
Franchise Tax on the Cumulative Change of Paid-in Capital

- Cumulative change is new issuances less reduction and cancellations.
- Treasury Shares are not a reduction.
- Assessed at the rate of 15/100 of 1 percent (\$1.50 per \$1,000) on additional paid-in capital

Franchise Tax in other States

- 13 other states have a Franchise Tax
- WV, PA, MO will eliminate their Franchise Taxes by 2016
- Illinois' rate of 0.10% is 3rd lowest
- 8 states do not cap tax liability
- 9 states use corporate net worth as their tax base, Illinois uses paid-in capital

Top Franchise Tax Rates by State



* States without Franchise Tax cap

Criticism of the Franchise Tax (Treasury Stock)

- Companies that redeem or cancel shares of stock may reduce their paid-in capital and their Illinois tax base. However, under Illinois franchise tax law, companies that redeem their stock but do not cancel the shares (they become treasury stock held for later sale or distribution) may *not* reduce their paid-in capital or Illinois tax base.
- This approach is inconsistent with general financial accounting treatment of treasury stock - -where it is treated the same as authorized but *not outstanding* stock (see slides 5 and 7).

Criticism of the Franchise Tax (Apportionment)

- The apportionment method used for Illinois franchise tax purposes is significantly different from the single sales factor formula used in calculating the Corporate Income Tax.
- Even before Illinois became a single sales factor apportionment, taxpayers had to use two separate apportionment methodologies to compute Illinois franchise tax and Illinois corporate income tax.

Criticism of the Franchise Tax (Apportionment)

- The current franchise tax apportionment methodology includes intangible property, such as stock in another corporation, in the property factor. That means taxpayers have to determine if stock is Illinois or non-Illinois property. The current rule looks to the physical location of the stock certificates to make this determination. Stock certificates are merely moved to a location outside of Illinois to avoid having them treated as Illinois property.
- Assets that are no longer used in a company's business are still counted in the sales factor for purposes of computing how much business is actually conducted in Illinois.

Reforms to Consider

- Allow reduction of Paid-in Capital for Treasury Stock.
- Single Sales Factor apportionment consistent with the Corporate Income Tax.