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Probing Beneath the Surface: Understanding Why So Many Corporations Do Not Pay Illinois Corporate Income Tax

By Dr. Natalie Davila

Editor's Note/Summary

There has been considerable focus on the fact that two thirds of corporations that file Illinois corporate income tax returns owe no Illinois tax, but there has been no attempt to answer the question of why they do not pay tax. To answer that question the Taxpayers' Federation, in cooperation with the Illinois State Chamber of Commerce, contracted with JD Michael LLC to undertake a study of why corporations do not pay Illinois Income Tax. The study was conducted by Dr. Natalie Davila, who served as Director of Research for the Illinois Department of Revenue for 10 years.

The report makes two strong conclusions:

1) ***The primary reason that corporations do not owe Illinois Corporate Income Tax (CIT) is because they have no Federal Taxable Income (FTI). Ninety-five percent of corporations with no Illinois corporate income tax liability had Federal Taxable Income that was zero or negative.***

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NOTES FROM THE INSIDE. . .

By Carol S. Portman

This edition of Tax Facts highlights TFI's continuing effort to explain "why" things happen. The centerpiece is an excerpt from the original research paper, "Probing Beneath the Surface: Understanding Why So Many Corporations Do Not Pay Illinois Corporate Income Tax." This study reaches the conclusion (not all that startling, when you think about it) that corporations that have positive Federal Taxable Income (FTI) pay Illinois taxes and those that do not have positive FTI do not. It further concludes that tax credits, often the scapegoat when the tax code is being squeezed for more money, play almost no role in moving corporations into a no-tax status.

We also have shorter pieces in this issue that attempt to answer questions that have been circulating, or that are logical follow-up questions to our main article. We explain *how* the Illinois foreign dividend deduction works, *why* there is a difference in Book Income and Tax Income, *how much* income a typical corporation earns, and *what* other taxes Illinois businesses pay (and how that compares with the rest of the country).

As we move towards the end of this legislative session TFI will continue to pursue a research agenda that emphasizes the need to understand "why" and to provide credible information to both policymakers and the public. Stay tuned – it will be a roller coaster.

2) Tax credits – the source of much attention – do not account for why businesses do not pay Illinois corporate income tax. Only 132 (0.2 percent of the average number of corporations that pay no Illinois corporate income tax) used credits to eliminate tax liability.

The data to conduct the study was obtained via Freedom of Information (FOI) request to the Illinois Department of Revenue. We asked for information from corporate income tax returns in order to determine where on the return, and why, corporations eliminated their tax liability. In order to limit the burden on the department, we asked for information only on returns that owed no tax. We requested five years of information so that we could determine what happened throughout a business cycle, from the "peak" in 2007 through the trough in 2009, and we asked the data to be broken out by returns with positive FTI, returns with zero FTI, and returns with negative FTI.

The Department of Revenue was unable to fulfill our entire request because of limitations in its computer system and the amount of time needed to manually clean data on a per return basis. As a result, we do not have data after the apportionment of income begins on Line 28, except for credits claimed.

The report finds that for the five-year period, taxpayers filed an average of 112,914 returns annually.

This report deals only with the returns that had no tax liability, an average of 75,517 per year. Of those, on average:

- *4,059 had positive Federal Taxable Income, the starting point for the calculation.*
- *14,010 had positive business income after Illinois additions and subtractions (heavily close to the addition of the Federal NOL and the subtraction of foreign dividends).*
- *132 had positive business income after apportionment and the Illinois NOL deduction.*

What follows is an excerpt of the full report, which is available at www.iltaxwatch.org.

OVERVIEW

Table 1 illustrates that the total number of IL-1120 [Illinois' Corporate Income Tax Return] filers has been steadily decreasing throughout the study period. In absolute numbers, there are 9,786 (8.3 percent) fewer filers in 2011 compared to 2007. This decrease is offset by steady increases in the number of Illinois S-Corporations.

TABLE 1. Distribution of All Returns by Federal Taxable Income (FTI) Status

Tax Year	Positive FTI	Zero FTI	Negative FTI	Total Returns
2011	32,337	23,771	52,479	108,587
2010	33,047	25,685	51,756	110,488
2009	32,503	24,307	54,180	110,990
2008	37,314	25,566	53,279	116,159
2007	40,929	26,970	50,474	118,373

Corporate Income Tax Returns with No Tax Liability – Positive, Zero, or Negative Federal Taxable Income Prior to Apportionment

The first observation to be made is that over the five year period, on average, one-third of Corporate Income Tax (CIT) filers had an Illinois tax liability compared with two-thirds that did not (**Table 2** on page 4). At first blush, this statistic seems alarming and has been represented as such in the media. [See page 16, *Book Tax Differences*]

In terms of percent, IL-1120 filers without a tax liability varied annually from 59.5 percent to 70.3 percent of total filers over the study period. As shown in Table 2, the vast majority of C-corporations without a tax liability has either negative or zero Federal Taxable Income.

The total number of filers without a tax liability was relatively consistent through the business cycle until 2011. This 2011 result may be a result of Illinois suspending the use of Net Operating Loss Deductions (NOLDs) imposed in 2011. Further research should be conducted to determine the impact of the NOLD suspension on CIT liability. Data indicate that while the percent of filers with negative FTI has remained relatively constant during the study period, the percent of filers with positive and zero FTI and no tax liability in Illinois fell significantly in 2011.

Table 2. Number of Returns with No CIT Liability by FTI Status						
Tax Year	Positive FTI With No Tax Liability	Zero FTI With No Tax Liability	Negative FTI With No Tax Liability	All Returns with No Tax Liability	Total Returns	Percent of C-Corps With No Tax Liability
2011	2,367	10,737	51,517	64,621	108,587	59.5%
2010	4,494	21,593	50,901	76,988	110,488	69.7%
2009	3,890	20,959	53,141	77,990	110,990	70.3%
2008	4,400	22,358	52,146	78,904	116,159	67.9%
2007	5,145	23,987	49,950	79,082	118,373	66.8%
Average	4,059	19,927	51,531	75,517	112,919	66.9%

Digging behind the headlines - of those companies not having an Illinois CIT liability, on average over the five year period, 69 percent have negative FTI while 26 percent have zero FTI (**Table 3**). The remaining five percent of firms with no tax liability have positive FTI. This five percent represents 4,059 returns (3.6 percent of all returns filed).

Table 3. Distribution of Returns with No Tax Liability by FTI Status				
Tax Year	Positive FTI	Zero FTI	Negative FTI	Total
2011	4%	17%	80%	100%
2010	6%	28%	66%	100%
2009	5%	27%	68%	100%
2008	6%	28%	66%	100%
2007	7%	30%	63%	100%
Average	5%	26%	69%	100%

Finding 1: Ninety-five percent of the corporations with no Corporate Income Tax liability had either negative or zero Federal Taxable Income. Federal Taxable Income is Line 1 of the IL-1120.

Almost all companies with negative FTI (98.3 percent) did not incur an Illinois CIT liability (**Table 4**). The percent of firms with zero FTI and no tax liability averaged 78.9 percent over the period, while the vast majority of firms with positive FTI (88.5 percent) did incur an Illinois tax liability.

Table 4. Percent of Returns in Each FTI Status With No CIT Liability			
Tax Year	Positive FTI-No Tax Liability	Zero FTI-No Tax Liability	Negative FTI-No Tax Liability
2011	7.3%	45.2%	98.2%
2010	13.6%	84.1%	98.3%
2009	12.0%	86.2%	98.1%
2008	11.8%	87.5%	97.9%
2007	12.6%	88.9%	99.0%
5 Year Average	11.5%	78.9%	98.3%

Finding 2: Federal Taxable Income (Line 1 on the IL-1120 return) is the driving factor behind Illinois Corporate Income Tax liability. For 2007 through 2011, on average 98.3 percent of corporations

with negative Federal Taxable Income had no Illinois Corporate Income Tax liability while 88.5 percent with positive Federal Taxable Income had a Corporate Income Tax liability.

Summary

The overview of CIT return data provided above demonstrates that FTI status is the most significant factor in explaining whether or not C-Corporations have an Illinois CIT liability. Less than 2 percent of firms with negative FTI have an Illinois CIT liability, compared with 88.5 percent of firms with positive FTI. [See page 17, *How Much Does the Typical Corporation Make?*]

ILLINOIS ADDITION AND SUBTRACTION MODIFICATIONS

In this section of the report we examine how Illinois' modifications to Federal Taxable Income (FTI) affect Illinois Corporate Income Tax (CIT) liability. Modifications include: additions, subtractions, nonbusiness income, and business income from estates, trusts and non-unitary partnerships. We use two different units of analysis — number of firms and the dollar value associated with available line items. Note that the values associated with various modifications are pre-apportionment income amounts.

Table 5 provides annual average descriptive statistics for Illinois additions. The Federal Net Operating Loss Deduction (NOLD) is the largest both in terms of number of returns adding this item back on the Illinois returns and its total annual average value prior to apportionment. The U.S. Internal Revenue Service (IRS) permits corporations to deduct NOLDs for federal tax purposes. Illinois uses FTI as the starting point for calculating Illinois CIT liability. In order to apportion an appropriate percent of a corporation's nationwide losses, the Illinois tax code requires that the federal NOLD is first added back and then, based on a corporation's apportionment factor, part of this is allowed as an Illinois deduction. Note, however, this Illinois deduction was suspended in tax year 2011. Unfortunately our request for specific information on Illinois NOLDs was denied by IDOR.

Table 5. Illinois Addition Modifications

	Number of Firms (annual avg. 2007-2011)	Total Annual Average Value	Annual Average Value Per Return
Net Operating Loss Deduction from the U.S. 1120 (Line 2)	12,597	$53,853,130,272	$4,274,940
Illinois Special Depreciation Addition (Line 5)	8,237	$40,814,899,027	$4,954,948
State, Municipal and Other Interest Income Excluded from FTI (Line 3)	1,224	$9,969,333,616	$8,142,220
Other Additions from Schedule M (Line 8)	2,319	$4,534,024,028	$7,381,999
Related-Party Expense Addition (Line 6)	95	$24,020,511	$252,184

Table 6. Illinois Subtraction Modifications			
	Number of Returns (annual avg. 2007-2011)	Total Annual Average Value	Annual Average Value Per Return
Foreign Dividend Subtraction (Line 17)	3,202	$72,204,835,210	$22,552,735
Illinois Special Depreciation Subtraction (Line 18)	12,650	$36,109,095,380	$2,854,519
Interest Income from U.S. Treasury & Other Exempt Federal Obligations (Line 10)	1,253	$13,914,756,315	$11,101,609
Other Subtractions from schedule M (Line 21)	1,165	$3,331,184,288	$2,859,386
Distributive Share of Subtractions (Line 20)	236	$13,991,830	$76,458
Related Party Expenses Subtraction (Line 19)	183	$834,650	$3,533

Table 6 provides annual average descriptive statistics for Illinois subtraction modifications to FTI. The Illinois Special Depreciation Subtraction is the largest in terms of number of returns while the Foreign Dividend Subtraction in the largest in terms of annual average value prior to apportionment. Due to their magnitude these two Illinois subtractions warrant special attention.

At the federal level, a credit to avoid double taxation is provided to corporations that receive dividends paid by foreign subsidiaries. Most states provide a deduction for foreign dividends received, but the deduction is not always 100 percent of the dividends received. In such cases, the state tax on the foreign dividends depends not only on the state-specific dividends received deduction, but also on the state tax rate and the taxpayer's apportionment percentage. Illinois provides a 100-percent deduction for dividends received from a wholly owned foreign corporation. In addition, the Illinois deduction is reduced to 80 percent for a less-than-80-percent-owned foreign corporation, and further reduced to 70 percent for a less-than-20-percent-owned foreign corporation. Put in place to avoid double taxation and to be consistent with the IRS, the Illinois Foreign Dividend Subtraction, with an estimated pre-apportionment value of $72.2 billion, is the largest modification to FTI on the IL-1120. [See page 18, *Taxation of Foreign Income*]

The Illinois Special Depreciation subtraction (and its counterpart, the Illinois Special Depreciation addition) was introduced as a way to decouple from federal tax provisions. Given that the starting point of the IL-1120 is FTI, the state is automatically coupled with federal tax changes. The Illinois Special Depreciation Subtraction and Addition decouples Illinois from federal "bonus depreciation". The intent is to reverse the effects of federal "bonus depreciation" and disallow businesses from depreciating their assets more rapidly than traditional depreciation schedules allow.

However, the Illinois law is drafted in such a way that it is not an automatic decoupling, but applies only to two specific bonus depreciation rates: 30 percent or 50 percent. As a result, Illinois was decoupled from federal "bonus depreciation" between September 10, 2001 and before January 1, 2005 and during 2008 through 2010. However, Illinois was not decoupled from the 100 percent bonus depreciation allowed under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

Illinois CIT liability) will be lower than it otherwise would have been)

While special depreciation provisions are designed to provide for more rapid depreciation of assets at the front-end compared with traditional depreciation schedules, it is important to note that, on net, the total amount of depreciation during the life of the asset remains the same. The only difference is timing.

Table 7. Illinois Special Depreciation Additions and Subtractions Modifications

	2007	2008	2009	2010	2011
Returns with Special Addition	4,448	10,658	11,728	9,805	4,547
Value of Special addition	$3,733,620,699	$30,082,510,674	$65,929,810,690	$52,501,385,218	$51,827,167,886
Special Addition Per Return	$839,393	$2,822,529	$5,621,573	$5,354,552	$11,398,102
Returns with Special Deduction	14,057	15,525	16,692	16,031	994
Value of Special Deduction	$12,613,955,273	$15,210,672,460	$44,696,835,662	$43,779,129,233	$64,244,884,272
Special Deduction Per Return	$897,343	$979,753	$2,677,740	$2,730,904	$64,632,680

Table 7 illustrates how the absolute and per-return value varied over the study period. In a year when Illinois is decoupled from federal "bonus depreciation", the value of the addition will increase, as the value of federal "bonus depreciation" has to be added back to the Illinois return. Conversely, in years when Illinois is coupled with federal "bonus deprecation", FTI (the starting point for calculating

Finding 3: Decoupling from federal "bonus depreciation" impacts Corporate Income Tax receipts in the short-run. In the long-run the net effect of this provision on Corporate Income Tax liability is zero.

Taxpayers with Positive Federal Taxable Income and No Corporate Income Tax Liability

Table 8. Returns With Positive FTI and No CIT Liability	2007	2008	2009	2010	2011	5 Year Average
Returns with Positive FTI	5,145	4,400	3,890	4,494	2,367	4,059
Returns with Positive FTI and Additions	5,145	4,400	3,890	1,178	2,365	3,396
Returns with Subtractions	2,655	2,312	2,060	2,508	1,382	2,183
Returns with Positive Business Income	4,223	3,753	3,296	3,806	1,609	3,337
Difference Between Positive FTI and Positive Business Income	922	647	594	688	758	722
Returns with Positive Business Income Divided by Returns with Positive FTI	82.1%	85.3%	84.7%	84.7%	68.0%	82.2%
Returns with a Business Loss Divided by Returns with Positive FTI	17.9%	14.7%	15.3%	15.3%	32.0%	17.8%

Table 8 examines the number of IL-1120 returns with no Corporate Income Tax (CIT) liability and positive Federal Taxable Income (FTI) filed in Illinois over the last five years. Data indicate that while the series moves slightly with the business cycle, the percent of firms that have positive FTI and a negative business income prior to apportionment ranges between 15.3 to 17.8 percent for the period 2007 through 2010. Tax year 2011 is significantly different, at 32.0 percent. This is largely explained by the significantly lower number of firms having no tax liability and positive FTI in 2011 compared with the previous four years. Another difference in 2011 is the number of firms with positive FTI and positive business income prior to apportionment. The data suggests that suspending NOLDs resulted in approximately 2000 returns having a tax liability that otherwise would have used their NOLD to offset positive income. Given data limitations, it is not possible to estimate the resulting CIT revenue associated with this policy change. It is important to note that any increase in revenue arising from the NOLD suspension will be at least partially offset when the current $100,000 cap expires and firms have built up a significant inventory of NOLDs that they can use going forward. This will lead to downward pressure on future CIT revenue.

<u>Finding 4: For the five-year average, of the 4,059 corporations with positive Federal Taxable Income that did not have an Illinois Corporate Income Tax liability, 722 (17.8 percent) showed a business loss after applying Illinois'</u>

income modifications but prior to apportioning income to Illinois.

Table 9 contains income statistics associated with IL-1120 returns that have positive FTI and zero Illinois tax liability. With the exception of 2011, Positive FTI and Business Income appear to move with the business cycle.

On average, Illinois additions increase FTI by $35.6 billion. The average value of Illinois subtractions are double that of additions, resulting in annual average positive business income of $59.1 billion. Over the five-year period, positive business income is 53.5 percent of positive FTI. Income associated with subtractions in 2011 is significantly lower than the average: As noted earlier in the report, the major subtractions are the Foreign Dividend subtraction and the Illinois Special Depreciation subtraction.

Finding 5: For the 4,059 firms with positive Federal Taxable Income and no Corporate Income Tax liability, Illinois modifications reduced their Federal Taxable Income by an average of 46.5 percent, annually.

Table 9. Income Statistics for Returns With Positive FTI and No CIT Liability

	2007 ($b)	2008 ($b)	2009 ($b)	2010 ($b)	2011 ($b)	5 Year Average ($b)
Positive Federal Taxable Income (FTI)	$137.8	$107.1	$92.5	$104.6	$110.7	$110.6
Positive FTI Plus Additions	$158.0	$129.0	$127.5	$136.4	$130.3	$136.2
Subtractions	$75.5	$74.1	$82.3	$78.3	$48.9	$71.8
Positive business Income	$72.7	$47.7	$40.9	$55.6	$78.6	$59.1
Difference Between FTI and Positive Business Income	$65.1	$59.4	$51.6	$49.0	$32.1	$51.4
Positive Business Income Divided by Positive FTI	52.8%	44.5%	44.2%	53.2%	71.0%	53.5%
Business Loss Divided by Positive FTI	47.2%	55.5%	55.8%	46.8%	29.0%	46.5%

Taxpayers with Zero FTI and No CIT Liability

For the years 2007 through 2011, on average 19,927 returns had zero FTI and no Illinois tax liability. For tax year 2011, the number of 10,737 returns is significantly different than previous years. On average, after additions, subtractions, nonbusiness income and income from trusts and partnerships, 50.7 percent of these returns have positive business income.

Table 10 on page 10 illustrates that the value of additions and subtractions for returns with zero FTI and zero tax liability are relatively modest. Annual business income is $11.8 billion, with the actual number for 2011 falling to $0.8 billion.

Table 10. Income Statistics for Returns with Zero FTI and No CIT Liability						
	2007 ($b)	2008 ($b)	2009 ($b)	2010 ($b)	2011 ($b)	5 Year Average
Zero FTI	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Zero FTI Plus All Additions	$20.2	$16.3	$14.7	$29.1	$3.3	$16.7
Subtractions	$4.1	$3.8	$3.3	$8.8	$2.2	$4.4
Positive Business Income	$15.4	$12.3	$10.9	$19.7	$0.8	$11.8

Finding 6: For returns with zero Federal Taxable Income and no Corporate Income Tax liability, the net magnitude of Illinois income modifications resulted in 50.7 percent of these returns having positive business income, totaling $11.8 billion.

Table 11. Income Statistics for Firms with Negative FTI and No CIT Liability						
	2007 ($b)	2008 ($b)	2009 ($b)	2010 ($b)	2011 ($b)	5 Year Average
Negative FTI	-$243.6	-$463.1	-$361.3	-$201.4	-$233.6	-$300.6
Negative FTI Plus All Additions	-$188.3	-$396.0	-$268.8	-$137.9	-$162.2	-$230.6
Subtractions	$34.5	$40.5	$58.6	$49.8	$72.0	$51.1
Business Loss	-$224.5	-$435.0	-$327.6	-$180.6	-$235.0	-$280.5

When added to total negative FTI associated with firms with no tax liability, the net effect of additions and subtractions is to reduce business loss before apportionment by $20.1 billion (**Table 11**).

Finding 7: The Illinois 2011 suspension of Net Operating Loss Deduction does not appear to have had a significant impact on the number of firms with negative Federal Taxable Income and no Corporate Income Tax liability.

Summary

We started with 75,517 returns with no Illinois CIT liability (Table 2). After accounting for additions, subtractions, non-business income, and partnership and trust business income, 61,507 returns did not have positive business income before apportionment, leaving 14,010 (18.6 percent) still to account for (**Table 12**).

Table 12. Returns with Positive Business Income and No CIT Liability				
Returns With Positive Value for Business Income (Line 27)	**Positive FTI**	**Zero FTI**	**Negative FTI**	**Total**
2007	4,223	13,545	808	18,576
2008	3,753	12,547	764	17,064
2009	3,296	11,594	635	15,525
2010	3,806	12,131	540	16,477
2011	1,609	691	106	2,406
Average	3,337	10,102	571	14,010

Our investigation going forward is somewhat limited as our FOIA request for information that would allow us to analyze factors leading from positive business income to base income allocable to Illinois and then to Illinois net income (Lines 28-46) was denied by IDOR.

INCOME TAX CREDITS

The final step in our approach is to subtract the number of firms with tax credits on the IL-1120 return from the number of firms with positive taxable income. This number is our best estimate of firms that do not have an Illinois tax liability due to how they apportion income to Illinois or because of the magnitude of their Illinois NOLD. **Table 13** suggests that on average 13,878 firms fall into this category and reduce their business income to zero though a combination of their apportionment factor and their use of Illinois NOLDs.

Table 13. Returns with Positive Business Income That Claim Tax Credits						
	2007	**2008**	**2009**	**2010**	**2011**	**5 Year Average**
No Tax Liability						
Number of Returns With Positive Business Income	18,576	17,064	15,525	16,477	2,406	14,010
Number of Returns Using Tax Credits	116	125	120	138	154	132
Difference	18,460	16,939	15,405	16,339	2,252	13,878

Summary

Our request for information on Lines 28-39 was denied, so we have to extrapolate the impact of apportionment, the Illinois Net Operating Loss Deduction, and discharge of indebtedness in eliminating firms' CIT liability. Estimates suggest that 13,878 firms fall out during this section of the return.

INCOME TAX CREDIT ANALYSIS

IDOR captures only very basic information from Schedule 1299-D Income Tax Credits. All we can tell from the data captured and provided to us is how much of each credit a firm claims in any given year. It is important to note that not all credits claimed in a given year will actually be used in that same year. As noted earlier, firms can carry most credits forward for up to five years.

Table 14. Returns Using Credits by Federal Taxable Income Status				
Tax Year	Positive FTI	Zero FTI	Negative FTI	Total
2007	112	4	*	116
2008	110	4	11	125
2009	107	6	7	120
2010	118	14	6	138
2011	111	38	5	154
Average	112	13	7	132
* Not disclosed by IDOR for reasons of confidentiality				

We make the rational assumption that firms are using credits on their return in order to reduce or eliminate any remaining tax liability. Making this assumption suggests that:

Finding 8: Of the 75,517 returns with no Corporate Income Tax liability, only 132 (0.2 percent) fall into the no tax liability category through the use of tax credits. Tax credits are an extremely minimal factor in explaining why businesses have no CIT liability.

Given the very small number of firms that use tax credits on their return, **Table 15** illustrates that these returns make up a very small fraction of all returns with no tax liability and positive business income.

Finding 9: Use of tax credits does not explain why 99.1 percent of all returns with no Illinois Corporate Income Tax liability and positive business income prior to apportionment do not pay Corporate Income Tax.

Note that in 2011 more firms claim credits than the average and these firms make up a significantly higher percent of firms with positive business income before apportionment, thereby giving some credence to our hypothesis that the 2011 Net Operating Loss Deduction (NOLD) suspension induced firms to change their historic behavior and use an above average amount of credits. We recommend more research be conducted to determine the relationship between suspending NOLDs and tax credit use.

Table 15. Returns Using Credits as a Percent of Returns with Positive Business Income				
Tax Year	Positive FTI	Zero FTI	Negative FTI	Total
2007	2.7%	0.0%	*	0.6%
2008	2.9%	0.0%	1.4%	0.7%
2009	3.2%	0.1%	1.1%	0.8%
2010	3.1%	0.1%	0.9%	0.8%
2011	6.9%	5.5%	4.7%	6.4%
5 Year Average	3.3%	0.1%	1.2%	0.9%
* Not disclosed by IDOR for reasons of confidentiality				

1299-D Credits - All Returns with No CIT Liability 2007-2011

The top three credits claimed on Schedule 1299-D associated with returns with no CIT liability are displayed in **Table 16**. They are the

- Enterprise Zone Investment Credit,
- EDGE Credit, and
- Research and Development Credit.

It should be noted that due to the limited amount of data captured by IDOR, the only hard numbers available on a credit-by-credit basis are for those claimed on the Schedule 1299-D. IDOR does not capture information on specific tax credits used on the IL-1120 return.

The EZI credit is the most frequently claimed credit on the 1299-D schedule (900 returns over the study period), followed by the R&D credit (749 returns), and the EDGE credit (219 returns).

In terms of the value of credit claimed, over the five-year period the EDGE credit was the most significant ($154.8 million), followed by the R&D credit ($143.5 million), and then the EZI credit ($31.6 million).

Table 16. Most Frequently Claimed Credits for Returns With No CIT Liability

Type of Incentive Claimed on Schedule 1299-D	2007	2008	2009	2010	2011
Enterprise Zone Investment (EZI) Credit					
Returns with EZI Credit	175	180	176	203	166
Value of EZI Credit Claimed	$5,164,743	$5,274,115	$8,310,763	$5,328,400	$7,549,034
Average EZI Credit Claimed	$29,513	$29,301	$47,220	$26,248	$45,476
EDGE Tax Credit					
Returns Earning EDGE Credit	33	41	35	54	56
Value of Edge Credit Claimed	$24,235,479	$22,709,754	$27,206,410	$32,410,590	$48,274,456
Average Edge Credit Claimed	$734,408	$553,896	$777,326	$600,196	$862,044
R&D Credit					
Returns Earning R&D Credit	129	146	136	172	166
Value of R&D Credit Claimed	$32,983,755	$39,255,040	$13,275,469	$21,244,222	$36,734,267
Average R&D Credit Claimed	$255,688	$268,870	$97,614	$123,513	$221,291
Note: More than one credit can be used on any given return.					

In terms of average credit claimed, the EDGE credit is significantly higher than the other 2 credits. The value of credits claimed has increased over the study period. The EDGE credit has grown over the 5-year period both in terms of the number of returns and value. However the R&D credit claimed appears to be countercyclical, while the EDGE credit and the EZI credits claimed do not seem to have fluctuated with the business cycle. For R&D this trend is intuitive. Firms will tend to cut back on R&D spending during an economic downturn. We would anticipate this being the case for the EDGE and EZI credits also. Further research should be conducted to explain trends in EDGE and EZI credits. One hypothesis to be explored for EDGE credits is that the current administration is becoming more aggressive in entering into EDGE agreements with companies.

Credits Claimed on Schedule 1299-D Versus Credits Used on Form IL-1120

Based on the limited data available, we develop a methodology to estimate the percent of credits used, compared with those claimed, to provide a context from which policy makers can discuss how useful credits are in achieving their stated goals. Firms undertake specific behavior with the understanding that they will be able to claim credit if they meet the credit requirements.

As noted earlier, credits can be claimed on Schedule 1299-D in one tax year and used on Form IL-1120 in a different tax year. This carry-forward period is 5 years for the major credits. **Table 17** illustrates that in any given year only a small fraction of the credits claimed are actually used. This ratio ranges from 21.0 percent in 2010 to 52.1 percent in 2007. In 2011, while the ratio of used-to-claimed is comparable with the five-year average compared with the previous 3 years the actual value of credits used is significantly higher for the group as a whole and for returns with positive Federal Taxable Income (FTI) in particular.

Finding 10: Between 2007 and 2011 the ratio of credits used on the IL-1120 to credits claimed on Schedule 1299-D ranges 21.0 percent to 52.1 percent.

The fact that firms who have claimed credits have not been able to use them has been the cause of much debate and resulted in the trend toward passing legislation to allow certain companies to use their EDGE credit against their Illinois withholding tax liability. This practice is somewhat controversial as it treats similarly-situated companies differently and on its face appears to violate basic tax policy principles of equity and transparency. Further research should be conducted to determine the impact of such practices and determine how to make policies consistent across similarly situated firms.

Summary

On average 132 returns (0.2 percent of returns without a CIT liability and 0.1 percent of all returns) use credits to bring about a no CIT liability situation. The average ratio of credits

Table 17. Credits Used Versus Credits Claimed					
	2007	2008	2009	2010	2011
All Returns With No Tax Liability					
Firms Using Credits on 1120	116	125	120	138	154
Number of Credits Claimed on 1299-D	337	372	352	440	400
Value of Credits Used on 1120	$32,525,542	$19,888,835	$17,541,760	$15,010,545	$23,516,136
Value of Credits Claimed on 1299-D	$62,383,977	$71,481,742	$55,913,612	$71,461,430	$92,591,028
Credits Used as a % of Credits Claimed	52.1%	27.8%	31.4%	21.0%	25.4%

claimed on Schedule 1299-D to those used on the IL-1120 over the study period is 30.7 percent. The annual average value of credits used on the IL-1120 is $169,432. The data suggest that credits play a very limited role in explaining why firms have no CIT liability. [See page 19]

CONCLUSIONS

Based on the above research, most C-Corporations do not have an Illinois Corporate Income Tax (CIT) liability primarily because their Federal Taxable Income (FTI) is zero or negative. Illinois' corporate tax return starts with federally taxable income and that is the most important factor determining Illinois tax liability.

We find that Illinois income modifications to FTI play a limited role in explaining why firms do not have an Illinois CIT liability, particularly for returns with negative FTI. Eighty-two percent of returns with positive FTI have positive business income after accounting for Illinois modifications. This figure is 56.5 percent for returns with zero FTI and 1.6 percent of returns for those with negative FTI.

The data did not allow us to determine the specific impact of apportionment and the Illinois Net Operating Loss Deduction (NOLD) on income allocated to Illinois for tax purposes. However, the data is suggestive of the fact that of the 14,010 returns with positive business income prior to apportionment, 13,878 move into a no tax liability situation after apportionment and having accounted for the Illinois NOLD.

Finally, the role of Illinois tax credits on Illinois tax liability was examined and found to be minimal. The data suggest that on average 132 returns use credits to move into a no tax liability situation (0.2 percent of total returns with no CIT liability).

Book-Tax Differences Explained

As *Probing Beneath the Surface* concludes, most companies that pay no Illinois corporate income tax do not have positive Federal Taxable Income. Left unanswered is the question of why so many corporations report losses. Are most unprofitable, or, as is sometimes implied, is something more nefarious going on?

The answer, as with almost all things tax, is complicated. The non-governmental Financial Accounting Standards Board (FASB) establishes corporate accounting standards, called Generally Accepted Accounting Principles (GAAP), for calculation of "book income." At the same time, the Internal Revenue Code (IRC) establishes the standards for the calculation of "tax income", standards that often allow earlier deduction and produce tax income lower than book income. This lack of alignment results in "book-tax differences" that fill scores of accounting textbooks and fuel attacks on the corporate tax code. The following common book-tax differences demonstrate that companies reporting tax losses are neither almost bankrupt nor evading tax.

1. **Depreciation**

Both book and tax accounting require that major capital expenditures be depreciated over time, rather than fully expensed and deducted in the year purchased. For an oversimplified example, consider a $100,000 machine with an expected useful life of 10 years and no salvage value. Under GAAP accounting the taxpayer may depreciate the machine evenly for 10 years ($10,000 per year). For tax purposes the owner may be allowed to depreciate the machine in a shorter time, using what is called accelerated depreciation. The accelerated depreciation yields tax income lower than book income in the initial years (but tax income higher than book income in later years, so that over time the net book-tax difference for any asset will be zero).

2. **Inventory**

Two principle methods are used when accounting for inventory. Under the last-in, first out (LIFO) method, the cost of inputs most recently purchased for use in production or for resale is matched with the revenues generated by items sold in a particular period. Contrary to LIFO, FIFO (first-in, first-out) matches the cost of the oldest inputs with the revenue of goods sold in a given period. Each method disregards which inputs are physically used. A business that uses LIFO for book purposes and FIFO for tax purposes will have tax income higher than book income in inflationary periods, and the opposite during deflationary times.

3. **Other book-tax differences**

While depreciation and LIFO/FIFO inventory are differences in timing only, some book-tax differences are permanent. For example, GAAP allows deductions of fines, penalties, and lobbying expenses; the IRC permanently disallows many of these expenses. Other book-tax differences arise in the area of bad debts. GAAP allows businesses to establish a bad debt reserve, setting aside an amount each year to cover bad debts. The IRC requires that businesses deduct actual bad debt expenses against current income. So, in a year with unusually high bad debt experience, the tax deductions will exceed the book deductions for bad debts, while in a "good" year, the opposite is true.

Conclusion U.S. corporations must keep two sets of books: one GAAP compliant the other IRC compliant. The GAAP rules promote uniform financial statements to convey the financial health of a business, while the IRC is intended to generate revenues and achieve certain public policy goals. Different standards produce different results.

-Carol Portman

How much money does the typical corporation make?

Often when people think of "corporations" they think of companies like ExxonMobil, Wal-Mart, and Apple. But these massive corporations are not representative of most corporations in America. The table below shows the breakdown of American C corporations by size of business receipts. About a quarter of American C corporations have less than $25,000 in annual business receipts, and half of American C corporations have less than $250,000 in annual business receipts.

It is a fact that a large portion of individuals in America do not pay any income taxes because they do not have sufficient taxable income. Similarly, a large portion of American companies may not pay the corporate income tax because they do not have positive taxable income after accounting for expenses.

United States C Corporation Statistics FY2010
Receipts in thousands of dollars

Size of Business Receipts	Total Returns	% of Returns	Total Business Receipts	% of Receipts
Under $25,000	430,399	26%	2,314,754	0.01%
$25,000 under $100,000	251,038	15%	14,293,483	0.08%
$100,000 under $250,000	260,860	15%	42,436,751	0.24%
$250,000 under $500,000	200,140	12%	71,549,433	0.41%
$500,000 under $1,000,000	178,145	11%	126,083,307	0.72%
$1,000,000 under $2,500,000	171,827	10%	265,693,394	1.52%
$2,500,000 under $5,000,000	80,852	5%	274,915,138	1.57%
$5,000,000 under $10,000,000	47,551	3%	314,645,443	1.80%
$10,000,000 under $50,000,000	47,242	3%	871,619,963	4.98%
$50,000,000 or more	18,117	1%	15,507,480,801	88.66%
Total	**1,686,171**		**17,491,032,466**	

Source: IRS Statistics of Income Division

Data: IRS Statistics of Income Division's data on corporate tax returns. 2010 is the latest data available. The separately reported data for S-corporations is subtracted from the data for all active corporations to get our estimate of C-Corporation only information.

Business receipts is the revenue a company earns from doing business, but the corporate income tax is designed to tax corporate profits, not gross income. After accounting for salaries, cost of goods sold, depreciation, taxes other than the corporate income tax, payroll expenses, and all of the other various costs of doing business, a company may not have any profits left to be taxed by the corporate income tax.

-Rob Ross

Taxation of Foreign Income, Including Dividends

The U.S. system of federal corporate taxation differs from that used by most other countries, which do not impose tax beyond their own boundaries. The U.S. system, instead, requires U.S. corporations to include dividends received (and certain other income) from foreign affiliates in their federal taxable income. The U.S. system then seeks to avoid double taxation of that income by providing a foreign tax credit for taxes paid in foreign jurisdictions.

In most states the starting point for determining a corporation's tax liability is federal taxable income, which includes foreign dividends received. The state then determines what portion of a corporations's income it can tax, based on an apportionment formula. To avoid double taxation of the foreign dividends received a state must do one of three things: 1) eliminate the income attributed to foreign activity from the tax base; 2) provide a tax credit; or 3) include the factors attributable to foreign earnings in the apportionment factor calculation. Most states, including Illinois, have chosen the least complex option of the three, the elimination of income method - a dividends received deduction.

Illinois' dividends received deduction represents a smaller share of total tax liability than does the federal credit.

For Tax Year 2010*

The federal credit represented 58 percent of total tax liability, and

The value of the Illinois deduction represented 27 percent of total tax liability.

Interestingly, the federal tax code treats dividends received from domestic subsidiaries differently that it treats dividends received from foreign subsidiaries. Domestic dividends are excluded from Federal Taxable Income while foreign dividends are included. Together the domestic dividends exclusion and the foreign dividends credit assure that the same item of profit earned by the operating business is not taxed multiple times [i.e. there is no tax pyramiding].

Illinois has chosen a simpler approach and expands the federal domestic dividends received deduction to foreign-source dividends, at 35 ILCS 5/203(b)(2)(O). This way, Illinois also avoids tax pyramiding and is not discriminating against businesses engaging in foreign commerce—their dividend income is taxed identically to purely domestic dividends.

Iowa originally followed the domestic dividend treatment of the Internal Revenue Code, but had no foreign dividend counterpart. The United States Supreme Court held that such an uneven system discriminated against foreign commerce, in violation of the Commerce Clause of the U.S. Constitution, in *Kraft v. Iowa*, 505 U.S. 71 (1992). Illinois' foreign dividends received deduction avoids this problem.

Bottom line: the dividends received deduction is an essential component of corporate tax regimes to avoid multiple taxation of income. In addition, the US Constitution requires that domestic and foreign dividends be treated equally.

Sources: IRS Statistics of Income and Illinois Department of Revenue

\- Carol Portman

And One More Thing…

The corporate income tax is the tax most easily and directly associated with businesses. In the Summer 2013 issue of Tax Facts, for example, we estimated that just over half of state tax collected on business income came through the corporate income tax.

However, businesses pay many other taxes as well. In July 2013, a study entitled *Total state and local business taxes* conducted annually by Ernst & Young LLP examined all taxes paid by businesses in FY 2012. The study found that businesses paid $30.8 billion in state and local taxes in Illinois and accounted for 45 percent of all state and local taxes. Of that total, Illinois' corporate income taxes accounted for 11.4 percent of all Illinois business taxes. Illinois is well above the national average that has corporate income tax accounting for 7.6 percent of business taxes.

Taxes Paid by Business

	U.S.	Illinois
Total Business Taxes	$648.8 billion	$30.8 billion
Corporate Income Tax Percentage of Total Business Taxes	7.6%	11.4%
State and Local Business Taxes as Percentage of GSP	4.8%	5.0%
Property Tax Percentage of Total Business Taxes	35.3%	39.2%
Excise Tax Percentage of Total Business Taxes	12.3%	15.8%
Unemployment Income Percentage of Total Business Taxes	7.5%	9.4%

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Thursday, April 10th
Sangamo Club, Springfield
- 8:15 a.m. Registration
- 8:30 - 11:00 Legislative Seminar

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