

Who Does—and Doesn't—Pay Corporate Income Tax?

By Dr. Natalie Davila

Natalie Davila is an economist with an extensive background in public finance. She was Director of Research for the Illinois Department of Revenue for 10 years.

In April 2014 the Taxpayers' Federation of Illinois and the Illinois State Chamber of Commerce published an extensive report on the characteristics of C-Corporations in Illinois.

The 2014 report concluded that for the period 2007-2011:

- On average one-third of Corporate Income Tax filers had an Illinois tax liability while two-thirds did not.
- 95 percent of those C-corporations without a Corporate Income Tax liability had zero or negative Federal Taxable Income.
- Illinois modifications to Federal Taxable Income play a very limited role in explaining why firms do not have an Illinois Corporate Tax liability.
- The role of Illinois tax credits on Illinois tax liability was minimal.

This article adds to this knowledge by analyzing 2012 C-Corporation tax liability data by firm size. The first thing to note, in **Table 1**, is that the

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NOTES FROM THE INSIDE...

By Carol S. Portman

As our Governor and state lawmakers plod towards aligning state revenues and spending, this edition of *Tax Facts* examines several key revenue issues as part of TFI's role of providing reliable information to policy makers and the public.

Dr. Natalie Davila updates the piece she did almost two years ago examining corporations that don't pay Illinois income tax. Natalie finds that the percentage of corporations without tax liability increased in 2012, as corporations were allowed to begin claiming a portion of their losses. Data not included in the earlier study provides an interesting additional point: the larger a corporation, the more likely it is to have a tax liability.

Going along with Natalie's report, a trio of authors from Grant Thornton has reprised a presentation from TFI's State and Local Tax Conference on trends in apportionment of corporate income tax. This is a readable explanation of the move from cost-of-performance to market based sourcing that - even for non-tax geeks - illustrates the significance of apportionment in corporate taxation.

Finally, we have completed the latest update of the TFI effective property tax rate study in which we calculate the taxes paid on a hypothetical \$250,000 home in 89 cities across Illinois. The study again finds Chicago (which benefits from the Cook County classification system and a significant commercial property tax base) with the lowest effective tax rate. However, Chicago is no longer joined at the bottom by other Cook County communities, which have seen their effective tax rates rise. number in 2012 of C-Corporations without a tax liability is 64.5 percent – slightly below average for the study period but significantly higher than in 2011. This can be largely explained by the changes in treatment of Net Operating Losses in Illinois. For tax year 2011, legislation was enacted that suspended the use of NOLs. As the data below illustrates, this correlates with a significant increase in the number of firms with a tax liability. For tax year 2012, in an attempt to help smaller businesses, firms were allowed to use up to \$100,000 in Net Operating Losses, and the number of firms having no tax liability increased, although not to pre-suspension levels.

Tax Liabi	lity, 2007	-2012*		
Year	All Returns with a Tax Liability	All Returns with No Tax Liability	Total Returns	Percent of C-Corps. with no Tax Liability
2012	38,612	70,102	108,714	64.48%
2011	44,115	65,120	109,236	59.61%
2010	33,595	76,989	110,584	69.62%
2009	33,000	77,990	110,990	70.27%
2008	37,255	78,904	116,159	67.93%
2007	39,291	79,082	118,373	66.81%
Average	37,568	74,650	112,219	66.48%

TABLE 1. Percent of C-Corporations Without a

*Note that 2010 and 2011 data have been updated since our original report was published

Firm size for purposes of this analysis is measured by total US gross receipts, or sales, for most companies because this is the measure Illinois uses to calculate what portion of total profits are apportioned to Illinois and taxed here.

TABLE 2. C-Corporations b	y Sales, Tax Y	ear 2012			
Sales Amount	Number of Firms	Number with Liability	Percent with Liability	Average Tax Liability (\$)	Total Tax Liability (\$)
Firms with Sales Reported					
Greater than \$1 billion	1,914	1,368	71.5%	877,410	1,679,362,160
\$500 million - \$1 Billion	1,062	681	64.1%	131,396	139,542,170
\$100 - \$500 Million	3,880	2,310	59.5%	50,458	195,777,007
\$50 - \$100 Million	2,286	1,234	54.0%	21,059	48,140,618
\$25 - \$50 Million	2,782	1,406	50.5%	13,067	36,352,661
\$10 - \$25 Million	3,940	1,951	49.5%	9,775	38,513,128
\$5 - \$10 Million	2,830	1,324	46.8%	4,703	13,308,369
\$0 - \$5 Million	12,103	4,621	38.2%	2,255	27,286,513
Subtotal	30,797	14,895	48.4%	70,730	2,178,282,626
Taxpayers Without Sales Reported					
Illinois-Only Businesses	77,191	23,334	30.2%	1,392	107,437,307
Transportation Firms	726	383	52.8%	104,569	75,917,194
Subtotal	77,917	23,558	30.2%	2,353	183,354,501
Grand Total	108,714	38,612	35.52%	21,723	2,361,637,127

Table 2 illustrates that generally speaking the larger the firm the greater the probability that they have a tax liability. More than 70 percent of firms with US sales of greater than \$1 billion had tax liability in 2012, compared with 38.2 percent of firms with sales of less than \$5 million.

It should be noted that there were 77,191 firms that made sales only in Illinois. Because of the way tax data is collected, no information is available on the size of these Illinois-only firms and therefore they are not included in the analysis by size information. An Illinois-only company, however, is unlikely to be very large, because its sales and activities are limited. (See the trend illustrated in Table 4—the smaller the firm, the larger its Illinois apportionment factor.) Only 30.2% of these presumably small firms had Illinois tax liability in 2012. Also, firms in the transportation sector are listed separately because they have special methods for calculating gross receipts that cannot be added to the basic sales measure used by firms in other sectors.

Table 3 on page 4 illustrates that 67.7 percent of the total tax liability in 2012 was generated by only 0.4 percent of all firms. On the other end of the spectrum, 26.1 percent of firms with a liability generated only 1.3 percent of total taxes.

However, the largest grouping is that 64.5 percent of all firms with no tax liability.

Table 4 presents additional information on businesses by size. We can see that average apportionment of sales to Illinois (percent of Illinois sales divided by total sales) varies from 2.4 percent for the very large firms to 29.2

percent for firms with total sales of less than \$5 million. This is logical; the larger the firm, the broader its business activities are likely to be and the smaller its presence in Illinois, as a percentage of total activities. This also supports the theory that the Illinois-only firms, only 30.2% of whom pay any corporate income tax, are likely

TARIE 3	Size of Firm a	nd Perce	nt of Total I	Tax Liahili	t v/	to be quite small in
	. 5126 01 1 11 11 a					terms of gross
Tax Liability	Liability Amount	Number of Firms	Average Liability	Percent of Firms	Percent of Total Tax Liability	receipts.*
\$1 Million and Above	1,598,150,394	405	\$3,946,050	0.4%	67.7%	The above analysis
\$500,000 - \$1 Million	212,368,466	299	\$710,262	0.3%	9.0%	supports the
\$250,000 - \$500,000	181,521,901	516	\$351,787	0.5%	7.7%	commonly held and
\$100,000 - \$250,000	150,959,216	961	\$157,086	0.9%	6.4%	intuitive belief that in
\$50,000 - \$100,000	77,244,211	1,079	\$71,589	1.0%	3.3%	absolute terms, on
\$25,000 - \$50,000	49,439,377	1,382	\$35,774	1.3%	2.1%	average, the larger
\$10,000 - \$25,000	40,197,033	2,533	\$15,869	2.3%	1.7%	the firm the more it
\$5,000 - \$10,000	21,401,529	3,060	\$6,994	2.8%	0.9%	pays in CIT. Another,
\$1 - \$5,000	30,355,000	28,377	\$1,070	26.1%	1.3%	less intuitive but
\$0		70,102		64.5%	0%	equally indisputable,

TABLE 4. Size of Fi	rm and Relative P	resence in Illi	nois
Sales Amount	Average Total Sales Everywhere	Average Total Sales Inside Illinois	Average Apportionment Factor
Greater than \$1 Billion	\$12,048,311,841	\$287,958,642	2.4%
\$500 Million - \$1 Billion	\$708,129,092	\$39,304,186	5.5%
\$100 - \$500 Million	\$233,292,684	\$17,251,504	7.4%
\$50 - \$100 Million	\$71,165,953	\$7,713,404	10.8%
\$25 - \$50 Million	\$35,631,844	\$4,402,809	12.4%
\$10 - \$25 Million	\$16,266,214	\$2,741,563	16.9%
\$5 - \$10 Million	\$7,231,633	\$1,471,112	20.3%
\$0 - \$5 Million	\$1,223,450	\$358,244	29.3%
Subtotal	\$814,362,261	\$23,022,113	2.8%
\$0		\$70,102	

the very large firms incur a tax liability compared with smaller firms. As a result, the percent of total CIT paid is heavily concentrated among firms with a tax liability of more than \$1 million.

*We do not know anything about the Illinois-only firms, and so can only speculate as to their size and nature. Condominium and similar home-owners associations may constitute a sizeable portion of this group.

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Effective Property Tax Rates for 89 Illinois Communities

By Mike Klemens

Mike Klemens, President of KDM Consulting Inc., does tax policy research for the Taxpayers' Federation.

INTRODUCTION

A home's effective property tax rate is the percentage of the house's value paid in property taxes for a given year. The Taxpayers' Federation of Illinois periodically calculates effective tax rates for selected cities throughout Illinois. The rates presented here are for 2013 property taxes paid in 2014, the most recent data available.

The 89 communities studied are those that were included in our 2005, 2008 and 2010 studies. Earlier studies included just 60 cities. The communities have been chosen for their size and availability of data, with an eye towards providing an accurate representation of the entire state.

For this effort we are assuming a home with a market value of \$250,000 – the same market value used in the three previous studies. For comparison purposes we used the same value home for each city, although we recognize that housing values vary widely between cities or even within a city.

The intra-city variation is evident in Chicago. We use the overall level of assessment for Triad 1 in Cook County, to calculate the assessment level in Chicago. That makes sense because Triad 1 is Chicago. However, the sales ratio calculations present the data by township within the city. (Yes, there are townships within Chicago even if nobody knows which one they live in.) Using the city-wide level, we calculated a 1.71 percent effective tax rate. Had we used township levels, effective tax rates would have ranged from 1.48 percent for North Chicago Township to 2.36 for Rogers Park Township.

The intra-city data illustrates that use of averages masks a lot of differences, but the value of the study – looking at identical communities over time – remains valid. We added a column to the table to show where the cities ranked in 2005 and show how communities have moved in the rankings over this period that saw the collapse of market values of homes, particularly in the Chicago metropolitan area.

We assume the house is eligible for a homestead exemption, but not eligible for the additional senior citizens homestead exemption or for any other kind of homestead exemption. In 101 counties the homestead exemption was \$6,000. The General Homestead Exemption in Cook County was \$7,000.

METHODOLOGY

The calculation of an effective property tax rate for a community requires the following steps for a hypothetical house worth \$250,000.

Step 1 – Determine the Assessed Value (AV)

Obtain the adjusted median level of assessment for residential property for the township in which the community is located from the Illinois Department of Revenue's sales ratio studies and multiply times \$250,000. For Chicago we use the median level for Triad 1.

Step 2– Determine the property's Equalized Assessed Value (EAV)

Multiply the assessed value by the county's "multiplier" (equalization factor) to determine the property's equalized assessed value. The Department of Revenue assigns a multiplier to each county to equalize assessments across the state, bringing the median level of assessment to the required 33 1/3%. When assessments in a county are within 1% of the required level, they do not need to be adjusted, and the county is given a multiplier of 1.

Step 3 – Determine the EAV after exemption (taxable value)

Subtract the homestead exemption from the EAV. In 2010 General Homestead Exemptions were \$6,000 outside of Cook County. For Cook, where the General Homestead Exemption was \$7,000. Cook's Adjusted General Homestead Exemption (the so called Seven Percent Solution) had been largely wiped out by falling property values and was only in effect for the South Suburbs (Triad 3).

Step 4 – Figure the tax bill

Obtain the community's aggregate tax rate from the Department of Revenue's Annual Property Tax Statistics report. The aggregate tax rate is the sum of property tax rates calculated for cities, counties, townships, fire protection districts, park districts, school districts, sanitary districts, airport authorities, and a host of other governmental entities. Multiply it by the taxable value.

Step 5 – Calculate the Effective Tax Rate

Divide the tax bill by the \$250,000 fair market value of the home to find the effective tax rate.

FINDINGS

Tax rates are rising. Effective tax rates rose an average of 21 percent for the 89 selected cities between 2010 and 2013, offsetting declining property values.

Chicago's effective tax rate remains the lowest of the 89 selected cities in Illinois, due to the Cook County classification system that shifts tax burden off homeowners onto other properties. Classification appears to be doing less for Cook County homeowners outside Chicago, as other Cook County cities moved up in the rankings toward higher effective tax rates. For 2005 the five lowest effective tax rates were in Cook County; by 2013 only Chicago was in the five lowest.

The study is not all good news for Chicago homeowners, whose effective tax rate rose faster than did other cities'. Chicago's effective tax rate increased 34 percent since 2010, while the average for all 89 cities was only a 21 percent increase.

Effective tax rates and estimated 2013 property taxes (collected in 2014) on a \$250,000 home in 89 Illinois cities

2013

Effective Ta	Rate as a	% of Fair	Market	Value	7.98%	7.24%	7.03%	6.17%	5.48%	5.31%	5.27%	5.14%	5.04%	4.85%	4.82%	4.65%	4.63%	4.62%	4.48%	4.47%	4.35%	4.21%	4.18%	4.14%	4.08%	4.01%	3.96%	3.95%	3.83%	3.80%	3.71%	3.70%	3.67%	3.56%
2013	Tax Bill	on a	\$250,000	Home	\$19,944	\$18,112	\$17,575	\$15,426	\$13,705	\$13,280	\$13,165	\$12,861	\$12,612	\$12,113	\$12,060	\$11,624	\$11,565	\$11,558	\$11,188	\$11,176	\$10,864	\$10,515	\$10,453	\$10,345	\$10,210	\$10,037	\$9,902	\$9,863	\$9,575	\$9,504	\$9,275	\$9,240	\$9,171	\$8,892
			Tax Rate	(%)	19.510	18.026	24.411	21.425	14.909	16.922	14.002	17.863	14.842	12.990	12.446	12.905	12.303	13.491	11.609	15.522	12.585	11.270	11.576	11.987	11.959	10.942	10.763	10.753	11.261	10.840	12.882	12.716	11.080	9.991
			Taxable	Value	\$102,225	\$100,476	\$71,998	\$71,998	\$91,925	\$78,475	\$94,025	\$71,998	\$84,975	\$93,250	\$96,900	\$90,075	\$94,000	\$85,675	\$96,375	\$71,998	\$86,325	\$93,300	\$90,300	\$86,300	\$85,375	\$91,725	\$92,000	\$91,725	\$85,025	\$87,675	\$71,998	\$72,663	\$82,775	\$89,000
			Homestead	Exemption	\$6,000	6,000	7,000	7,000	6,000	6,000	6,000	7,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	7,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	7,000	7,000	6,000	\$6,000
				Multiplier	1.0000	1.0300	2.6621	2.6621	1.0000	1.0000	1.0000	2.6621	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	2.6621	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	2.6621	2.6621	1.0000	1.0000
			Assessment	Level	43.29	41.35	11.87	11.87	39.17	33.79	40.01	11.87	36.39	39.70	41.16	38.43	40.00	36.67	40.95	11.87	36.93	39.72	38.52	36.92	36.55	39.09	39.20	39.09	36.41	37.47	11.87	11.97	35.51	38.00
				County	Lake	Alexander	Cook	Cook	Kankakee	St. Clair	Winnebago	Cook	Lake	Will	DeKalb	McHenry	McHenry	Lake	Kane	Cook	Will	Kane	McHenry	Will	Stephenson	Kendall	Vermillion	Kendall	Will	Boone	Cook	Cook	Henry	Rock Island
				City	Zion	Cairo	Park Forest	Dolton	Kankakee	East St. Louis	Rockford	Chicago Heights	North Chicago	Lockport	DeKalb	Woodstock	McHenry	Waukegan	Aurora	Cicero	Joliet	Elgin	Crystal Lake	Plainfield	Freeport	Yorkville	Danville	Oswego	Frankfort	Belvidere	Oak Lawn	Streamwood	Kewanee	Rock Island
			2005	Rank	ъ	Ч	2	40	4	ŝ	7	62	42	51	55	52	71	28	99	69	65	46	56	64	6	74	23	68	70	63	75	83	14	16
			2013	Rank	-	7	m	4	ഹ	9	7	∞	6	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30

Effective tax rates and estimated 2013 property taxes (collected in 2014) on a \$250,000 home in 89 Illinois cities (continued) 2013

Effective Ta	Rate as a	% of Fair	Market	Value	3.52%	3.51%	3.49%	3.42%	3.41%	3.41%	3.36%	3.33%	3.32%	3.28%	3.26%	3.23%	3.18%	3.12%	3.10%	3.07%	3.06%	3.04%	3.03%	3.02%	3.00%	2.98%	2.95%	2.95%	2.94%	2.93%	2.91%	2.90%	2.89%	2.87%
2013	Tax Bill	on a	\$250,000	Home	\$8,802	\$8,764	\$8,733	\$8,548	\$8,516	\$8,514	\$8,398	\$8,322	\$8,292	\$8,191	\$8,161	\$8,073	\$7,949	\$7,798	\$7,752	\$7,665	\$7,642	\$7,591	\$7,573	\$7,561	\$7,502	\$7,457	\$7,381	\$7,365	\$7,345	\$7,317	\$7,287	\$7,238	\$7,230	\$7,181
			Tax Rate	(%)	12.225	10.783	10.872	9.942	10.462	9.416	10.106	9.857	10.231	10.767	10.020	11.110	9.108	10.732	9.144	9.365	9.908	9.401	9.933	8.956	10.324	9.588	9.759	9.778	8.628	9.233	8.779	9.062	9.029	9.421
			Taxable	Value	\$71,998	\$81,275	\$80,325	<u>\$85,975</u>	\$81,400	\$90,425	\$83,100	\$84,425	\$81,050	\$76,075	\$81,450	\$72,663	\$87,275	\$72,663	\$84,775	\$81,850	\$77,125	\$80,750	\$76,243	\$84,425	\$72,663	\$77,775	\$75,629	\$75,325	\$85,129	\$79,250	\$83,000	\$79,875	\$80,075	\$76,219
			Homestead	Exemption	7,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	7,000	6,000	7,000	6,000	6,000	6,000	6,000	6,000	6,000	7,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000
				Multiplier	2.6621	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	2.6621	1.0000	2.6621	1.0000	1.0000	1.0000	1.0000	0.9823	1.0000	2.6621	1.0000	1.0284	1.0000	1.0300	1.0000	1.0000	1.0000	1.0000	1.0287
			Assessment	Level	11.87	34.91	34.53	36.79	34.96	38.57	35.64	36.17	34.82	32.83	34.98	11.97	37.31	11.97	36.31	35.14	33.25	34.70	33.49	36.17	11.97	33.51	31.75	32.53	35.39	34.10	35.60	34.35	34.43	31.97
				County	Cook	Cass	Knox	LaSalle	Champaign	LaSalle	Madison	Kane	Whiteside	Iroquois	Jackson	Cook	DuPage	Cook	Livingston	Ogle	McDonough	Macon	Franklin	St. Clair	Cook	Moultrie	Logan	Warren	Bond	Rock Island	DuPage	Tazewell	Fayette	Jefferson
				City	Oak Park	Virginia	Galesburg	Ottawa	Urbana	LaSalle	Alton	Geneva	Sterling	Watseka	Carbondale	Palatine	Addison	Northbrook	Pontiac	Oregon	Macomb	Decatur	Benton	Belleville	Des Plaines	Sullivan	Lincoln	Monmouth	Greenville	Moline	Lombard	East Peoria	Vandalia	Mt. Vernon
			2013 2005	Rank Rank	31 79	32 6	33 8	34 30	35 36	36 37	37 53	38 27	39 12	40 11	41 41	42 84	43 81	44 88	45 13	46 58	47 15	48 19	49 17	50 21	51 86	52 22	53 32	54 77	55 33	56 25	57 76	58 39	59 26	60 38

Effective tax rates and estimated 2013 property taxes (collected in 2014) on a \$250,000 home in 89 Illinois cities (continued)

2013	Effective Ta	Rate as a	% of Fair	Market	Value	2.85%	2.85%	2.80%	2.80%	2.79%	2.77%	2.75%	2.72%	2.67%	2.65%	2.64%	2.64%	2.63%	2.63%	2.63%	2.57%	2.51%	2.51%	2.50%	2.50%	2.46%	2.44%	2.43%	2.25%	2.19%	2.18%	2.16%	2.11%	1.71%
	2013	Tax Bill	on a	\$250,000	Home	\$7,129	\$7,136	\$6,996	\$6,990	\$6,963	\$6,919	\$6,868	\$6,811	\$6,674	\$6,622	\$6,600	\$6,599	\$6,586	\$6,586	\$6,584	\$6,428	\$6,278	\$6,274	\$6,259	\$6,245	\$6,140	\$6,106	\$6,081	\$5,633	\$5,465	\$5,450	\$5,412	\$5,270	\$4,272
				Tax Rate	(%)	9.749	9.820	9.218	8.643	8.985	8.524	7.612	8.233	8.337	7.588	8.370	8.117	8.512	8.561	7.932	8.283	7.985	8.082	8.102	7.960	8.450	7.313	7.654	8.439	7.949	7.046	7.265	7.126	6.993
				Taxable	Value	\$73,125	\$72,663	\$75,900	\$80,875	\$77,500	\$81,175	\$90,225	\$82,725	\$80,050	\$87,275	\$78,850	\$81,300	\$77,374	\$76,925	\$83,000	\$77,600	\$78,625	\$77,625	\$77,250	\$78,450	\$72,663	\$83,500	\$79,450	\$66,750	\$68,750	\$77,350	\$74,500	\$73,950	\$61,083
				Homestead	Exemption	6,000	7,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	7,000	6,000	6,000	6,000	6,000	6,000	6,000	6,000	7,000
					Multiplier	1.0000	2.6621	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.00000	1.0000	0.9800	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	2.6621	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	1.0000	2.6621
				Assessment	Level	31.65	11.97	32.76	34.75	33.40	34.87	38.49	35.49	34.42	37.31	33.94	34.92	34.03	33.17	35.60	33.44	33.85	33.45	33.30	33.78	11.97	35.80	34.18	29.10	29.90	33.34	32.20	31.98	10.23
					County	Fulton	Cook	Johnson	Morgan	Coles	Peoria	Grundy	Lake	Champaign	DuPage	McLean	Lake	Edgar	Bureau	DuPage	Tazewell	McLean	White	Sangamon	Madison	Cook	DuPage	Christian	Lawrence	Richland	Adams	Effingham	Crawford	Cook
					City	Canton	Evanston	Vienna	Jacksonville	Charleston	Peoria	Morris	Libertyville	Champaign	Elmhurst	Normal	Lake Zurich	Paris	Princeton	Wheaton	Pekin	Bloomington	Carmi	Springfield	Edwardsville	Glenview	Naperville	Taylorville	Lawrenceville	Olney	Quincy	Effingham	Robinson	Chicago
				13 2005	ink Rank	1 24	2 85	3 18	4 49	5 10	6 34	7 67	8 72	9 36	0 83	1 47	2 57	3 31	4 43	5 78	6 50	7 45	8 60	9 48	0 73	1 87	32 80	3 29	34 20	35 44	86 62	37 59	8 35	68 63
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State Corporate Income Tax Apportionment Trends: Market-Based Sourcing, With or Without Statutory Authority

By Rick Strohmaier, Chelsie Nelson, and Chuck Jones of Grant Thornton LLP

This article is based on a presentation at TFI's 2015 State and Local Tax Conference by Ted Bots, partner, Baker & McKenzie LLP; Mariano Sori, partner, BDO USA LLP; and Rick Strohmaier, partner, Grant Thornton LLP

Introduction

A recent trend among states in corporate income apportionment is the move to market-based sourcing from cost-of-performance (COP). [See "What is Income Tax Apportionment" on page 14 for a brief primer on income tax apportionment.] For example, in 2007, the Illinois Income Tax Act was amended to formally adopt the marketbased sourcing method over COP. Other states statutorily shifting to market-based sourcing recently include **Massachusetts** and Pennsylvania. Under COP, receipts are sourced to the location where the income-producing activity occurred. Under market-based, service revenue is sourced to the location of the service provider's customers or where customers received the benefit of the service. Some states with traditional COP statutes and regulations are applying market-based sourcing through audit or administrative rulings.

UDITPA

The Uniform Division of Income for Tax Purposes Act (UDITPA) was created by the Uniform Law

Commission to provide states a uniform method of dividing income among themselves. UDITPA Section 17 was originally based on a COP method of apportionment. This method has become increasingly outdated as customers are more often located outside the state where COP occurs. Therefore, many states which follow the original UDITPA method have taken advantage of a provision allowing taxpayers to use an alternative apportionment method (Section 18) if the activity is not fairly represented, prescribing instead a market-based method. As the states increasingly allowed alternative methods, the MTC followed suit, and on July 30, 2014 at its annual meeting, the MTC replaced the COP method with a market-based sourcing approach.¹ This article focuses on states that have adopted а market-based sourcing approach, even in the absence of explicit statutory authority to do so.

¹ Multistate Tax Compact Art. IV.17.

Use of Market-Based Sourcing Under UDITPA Section 18

Prior to 2014 Pennsylvania adopted the language of UDITPA for apportioning income.² However, the Department of Revenue (DOR) did not strictly follow traditional COP principals. In one example, an onboard computing/carrier fleet communications provider apportioned all its income outside Pennsylvania, although its customers received а benefit only in Pennsylvania. On audit, the DOR argued that the income-producing activity was the receipt of the benefit of the service, apportioning all income to Pennsylvania. In another matter, a mortgage company was required to source a portion of revenue to Pennsylvania because it was present, regardless of whether income was generated there. These decisions indicate the willingness of the DOR to interpret apportionment rules broadly. Effective January 1, 2014 Pennsylvania adopted market-based sourcing for its corporate income tax and capital stock/franchise tax.³

Similarly, Tennessee is using a COP method of apportionment until July 1, 2016.⁴ In one case, the Commissioner found that the COP method did not fairly represent the extent of a telecommunications company's business in Tennessee, rather, an alternative method should be used in limited and specific circumstances when COP produces an incongruous result.⁵ In this case, the alternative apportionment was consistent with a market-based method. In another instance, a taxpayer who published and distributed Yellow Page telephone directories utilized the COP method prescribed by Tennessee which resulted in no receipts sourced to Tennessee. This stance was challenged on audit and the Commissioner required the taxpayer to include advertising sales receipts in addition to the receipts already included in the sales factor.⁶

A similar Section 18 argument was made by Mississippi when a Georgia corporation using the standard COP method had no income attributable to Mississippi.⁷ However, the Mississippi Department of Revenue determined that the standard COP method, although the chosen regulatory method in Mississippi, was not reflective of the extent of the taxpayer's business in Mississippi. The Department enforced a market-based sourcing method.⁸

Historically, receipts were sourced to New York if the service was performed in the state.⁹ Under this law, an "other business receipts" rule was used as a catchall provision.¹⁰ For example, an insurance information supplier was held to have other business receipts attributable to New York if the transmission equipment used by the

² 72 Pa. Cons. Stat. § 7401(3)2.(a)(17), (18).

³ 72 Pa. Cons. Stat. § 7401(3)2.(a)(16.1)(C).

⁴ Tenn. Code Ann. §§ 67-4-2012(i); 67-4-2111(i).

⁵ Vodafone Americas Holdings Inc. v. Roberts, Tennessee Court of Appeals, No. M2013-00947-COA-R3-CV, June 23, 2014, *leave to appeal granted*, Tenn. Supreme Court, Nov. 20, 2014.

⁶ Bellsouth Advertising & Publishing Corp. v. Chumley, 308 S.W.3d 350 (Tenn. Ct. App. 2009), leave to appeal denied, Tenn. Supreme Court, March 1, 2010.

⁷ Equifax, Inc. v. Department of Revenue, 125 So. 3d 36 (Miss. 2013), cert. denied, 134 S. Ct. 2872 (2014).

⁸ See Code Miss. R. 35-III-8.06:402.09.

⁹ Former N.Y. Tax Law § 210.3.(a)(2)(B); N.Y. Comp. Codes R. & Regs. tit. 20, § 4-4.3(a).

¹⁰ See former N.Y. Tax Law Section 210.3.(a)(2)(D).

customer was located in the state.¹¹ Effective January 1, 2015, New York adopted marketbased legislation.¹² Since the change, another administrative decision took another approach, finding the market-based approach not in effect for the years at issue for a certain taxpayer because receipts from online advertising revenue were from services and not other business receipts.¹³ At least one other opinion in New York has taken a similar approach.¹⁴

Use of Market-Based Souring Based on Interpretation of Income-Producing Activity

The alternative apportionment option found in UDITPA Section 18 has not been the states' only avenue for imposing a market-based sourcing regime. Indiana parallels UDITPA for apportionment.¹⁵ Indiana's COP regulations include examples. However, even with examples, the Department of Revenue has issued decisions that instead apply a market-based approach. A healthcare provider was held to have Indiana

receipts because the benefit of the service was received in Indiana, though under a COP method California would be where the sales were sourced.¹⁶ An online education service provider whose costs were incurred outside Indiana was held to have Indiana receipts because students purchased the services from within Indiana.¹⁷ It may be argued that Indiana has unofficially adopted market-based sourcing through these and other rulings.¹⁸

Florida has a COP apportionment regulation and provides guidance for interpretation. However, in multiple instances Florida has taken a position that differs from its regulation. A cable television provider who provided content to distributors was found to have receipts in Florida based on the location of distributors rather than the location of the income-producing activities, which occurred outside Florida.¹⁹ In a separate instance, a provider of educational services was found to have Florida receipts based on the

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¹¹ New York State Department of Taxation and Finance Advisory Opinion TSB-A-00(15)C, Sept. 6, 2000; former N.Y. Tax Law § 210.3.(a)(2)(D).

¹² N.Y. Tax Law § 210-A.10, which was later amended by Ch. 59 (A.B. 3009), Laws 2015, effective April 13, 2015.

¹³ Expedia Inc., N.Y. Div. of Tax App., Admin Law Judge Unit, Nos. 825025, 825026 (2015).

¹⁴ New York State Department of Taxation and Finance Advisory Opinion TSB-A-09(8)C, June 16, 2009.

¹⁵ Ind. Code § 6-3-2-2(f), (I); Ind. Admin. Code tit. 45, r. 3.1-1-55.

¹⁶ *Revenue Ruling 2014-01IT*, Indiana Dept. of Revenue, March 18, 2015.

 ¹⁷ Letter of Finding 02-20140455, Indiana Dept. of Revenue, Jan.
28, 2015.

¹⁸ See Letter of Finding 02-20130238, Indiana Dept. of Revenue, Sept. 25, 2013; see also Letter of Finding 04-0398, Indiana Dept. of Revenue, Sept. 1, 2006.

¹⁹ *Technical Assistance Advisement 11C1-008,* Florida Dept. of Revenue, Sept. 15, 2011.

residence of the students.²⁰ In still more instances Florida has reached results that require taxpayers to source receipts based on customer location rather than the state regulation.²¹

Conclusion

As the economy shifts to become more servicebased, states naturally move toward marketbased sourcing. In states that remain under a COP regime, interpretation of these statutes has shifted in many states to a market-based approach. In other words, some states seem to have unofficially adopted market-based sourcing without enacting legislation. Therefore, corporate taxpayers who follow the regulations of a state may be surprised on audit if they have performed no further analysis in regard to audit practices and administrative decisions by the states.

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²⁰ Technical Assistance Advisement 12C1-006, Florida Dept. of Revenue, May 17, 2012.

²¹ Technical Assistance Advisement 12C1-004, Florida Dept. of Revenue, May 21, 2013; Technical Assistance Advisement 13C1-011, Florida Dept. of Revenue, Nov. 21, 2013.

What is Income Tax Apportionment?

By Maurice Scholten, Legislator Director, Taxpayers' Federation of Illinois

Many corporations conduct business in multiple states. It would be unrealistic (and probably unconstitutional) for a corporation to owe tax on 100% of its income to each of the fifty states. Therefore, each state has to determine how much of a corporation's income should be subject to that state's tax -- how to *apportion* a corporation's income.

The first widely adopted method of apportionment is commonly referred to as 3-factor apportionment. It is calculated by averaging three different factors-- the sales, property, and payroll factors. The sales factor is a fraction where the numerator is the amount of sales (or gross receipts) the corporation made in the state and the denominator is the corporation's total sales. The numerator of the property factor is the value of the property the corporation has in the state and the denominator is the amount of payroll factor numerator is the amount of payroll the corporation has in the state and the denominator is the amount of payroll factor numerator is the amount of payroll the corporation has in the state and the denominator is the corporation's total payroll. The average of the three factors—the apportionment factor—is multiplied by the corporation's total taxable income (the base) to determine that state's share. This is the way Illinois apportioned a corporation's income when it first enacted the corporate income tax in 1969.

States have deviated from the three-factor apportionment method by more heavily weighing the sales factor, and many now use only the sales factor. The "single sales factor" apportionment method was challenged and upheld by the U.S. Supreme Court in *Moorman Mfg. Co. v. Bair* (437 US 267, 1978). An Illinois business argued that Iowa's single sales factor resulted in double taxation. The Court rejected the company's arguments and upheld Iowa's single sales factor as an acceptable approximation of income attributable to Iowa.

As illustrated in the following example, the single sales factor generally increases the tax on out of state businesses, and lowers the tax on businesses with substantial payroll and property in the state (explaining why it was an Illinois business challenging lowa's use of the method in the *Moorman* case). Illinois adopted the single sales factor apportionment method in 1998. 23 states now use the single sales factor, 16 states use a multi factor apportionment with the sales factor more heavily weighted, and only 9 states have the traditional three factor apportionment.

Single Sales Factor Examples

<u>Scenario 1 – Illini Seed Co.</u>

Sales: 50% in Illinois and 50% in Wisconsin Property: 100% in Illinois Payroll: 100% in Illinois Income: \$1 million Illini Seed Co. has nexus in Illinois and Wisconsin

Single Sales Factor: Illinois and Wisconsin both tax \$500,000 of Illini's income. Illini pays income tax on \$1 million of its income.

Illinois has Three Factor Apportionment and Wisconsin retains Single Sales Factor: Illinois taxes 5/6 of Illini's income or \$833,333. $\frac{(100\%+100\%+50\%)}{3}$ = 83% or 5/6. Wisconsin still taxes half of Illini's income or \$500,000. Illini pays income taxes on \$1,333,333 of income even though it only made \$1,000,000.

<u>Scenario 2 – Badger Seed Co.</u>

Sales: 50% in Illinois and 50% in Wisconsin Property: 100% in Wisconsin Payroll: 100% in Wisconsin Income: \$1 million Badger Seeds has nexus in Illinois and Wisconsin

Single Sales Factor: Illinois and Wisconsin both tax \$500,000 of Badger's income. Badger pays income tax on \$1 million of its income.

Illinois has Three Factor Apportionment and Wisconsin retains Single Sales Factor: Illinois taxes 1/6 of Badger's income or \$166,667. $\frac{(0\%+0\%+50\%)}{3} = 17\%$ or 1/6. Wisconsin still taxes \$500,000 of Badger's income. Badger pays income taxes on \$666,667 of its income even though it made \$1,000,000.

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