Calculating Allocation Factor for Illinois Franchise Tax Purposes

By Jordan Goodman and Jesse Feinstein

This series of articles is intended to provide a deep dive into the Illinois State Franchise Tax (the "Franchise Tax") and should be read sequentially to be best understood. To view the first article in this series on which entities the Franchise Tax applies to, please click here. To view the second article in this series which lays out the basics of the Franchise Tax, please click here. For an overview of the Franchise Tax generally, please see our prior article on the topic here.

The importance of calculating your Franchise Tax Allocation Factor cannot be understated. Improper calculation of this factor can lead to over and underpayment of Franchise Tax, triggering penalties, interest accrual, and the stripping of a business's good standing in Illinois. As such, we have provided a brief recap of the Allocation Factor here, followed by a more in-depth look at the various elements of each figure in its calculation.

Allocation Factor Generally

The Franchise Tax Allocation Factor is broken into two central figures—a numerator and a denominator. Much like the apportionment factors used in calculating the state Income or Corporate Tax, the numerator represents what fraction of taxable activity is attributable to business or business activities derived from the State of Illinois. The denominator, by contrast, represents the business activity conducted everywhere in the United States and abroad. This function will produce a fraction which, when multiplied against the total taxable base, represents the fraction of that tax base attributable to the State of Illinois.

According to the Illinois State Tax Code, the Franchise Tax Allocation Factor is defined as the value of the sum of gross revenues and assets located within the State of Illinois divided by the *gross amount of business transacted* by the corporation everywhere.[1] This formula is represented mathematically below:

$$\text{Allocation Factor} = \frac{(\text{Illinois Assets} + \text{Illinois Revenues})}{(\text{Everywhere Assets} + \text{Everywhere Revenues})}$$

The following sections will delve deeper into what the Franchise Tax includes and excludes from the terms Gross Assets, Gross Revenues, Illinois Assets, and Illinois Revenues. While often used in other areas of Illinois State taxation, such as the state Income and Corporate taxes, these terms have a different meaning in the context of the Franchise Tax. The guiding document throughout this process will be Illinois Form BCA 1.35, which provides several rules and guidance in the composition of the Allocation Factor for use in a corporation's Illinois Annual Report.

Gross Assets:

As the name implies, Gross Assets in a Franchise Tax context attempt to account for your business's total assets, regardless of their presence or connection to the State of Illinois. Calculating this figure is relatively straightforward and most likely can be done entirely from the information in your federal Form 1120 Schedule L. To begin, take the figure from Line 15 from Schedule L of your Form 1120 and add back the allowance for doubtful accounts (Line 2b), accumulated depreciation (Line 11b), accumulated depletion (Line 13b), accumulated amortization (Line 10b), and any other net credit balance shown on Schedule L. The formula is represented more simply below:

$$\text{Gross Assets} = \text{Line 15} + \text{Line 2b} + \text{Line 10b} + \text{Line 11b} + \text{Line 13b} + \text{any other net credit balance on Schedule L}$$

It is important to note that property for Franchise Tax purposes varies distinctly from income tax purposes. While intangible assets are rarely used for income tax calculations, they are essential to accurately calculating your Franchise Tax liability. This gives rise to many potential tax planning strategies, such as getting certain intangibles certificated and holding such property outside of Illinois to reduce the allocation factor and perhaps the Franchise Tax liability.

Once the above formula has been calculated, the resulting amount is placed in the "Gross Assets" section of the denominator.

Gross Revenues:

Gross Revenues capture all of a business's revenues, much like the term Gross Assets. Unlike Gross Assets, however, there is no simple way to calculate this from federal Form 1120 Schedule L entry lines. The calculation formula is displayed below:

$$\text{Gross Revenues} = (\text{Gross Receipts} - \text{Returns}) + \text{Dividends} + \text{Interest} + \text{Gross Rents} + \text{Gross Royalties} + \text{Gross Sales Price} + \text{Other Income} + \text{Any Non-Taxable Dividends, Interests, or Other Items}$$

It is important to note that all net debit balances or losses are excluded from Gross Revenues. Once each value has been assigned, calculate the final figure and place it next to Gross Assets in the Allocation Factor formula above. By adding these two numbers together, you have found the denominator of the Allocation Factor.

Illinois Assets:

Determining which assets are attributable to business or business activities within Illinois is more complex and is a significant source of confusion and error in the Franchise Tax. As noted above, the best resource we have found for taxpayers on this subject is on Page 3 of the Illinois Form BCA 1.35, which provides a series of rules for various assets and whether they do or do not qualify as an "Illinois Asset" for purposes of the Franchise Tax. This form breaks down different common types of assets and clarifies what aspects and elements such assets must have to be deemed an Illinois-based asset. These rules are discussed in more detail below:

CATEGORY	INCLUSION RULES	EXAMPLES
Real and Personal Tangible Property	Included if *physically* located within Illinois	Real estate, inventories, uninvested cash
Trade Notes & Accounts Receivable	Included if such assets *arise* from Illinois sales	Accounts receivable
Investments	Included if notes, securities, or certificates evidencing the investment are *physically* located in Illinois	Tax-exempt securities, Mortgage and Real Estate Loans, Government Obligations
Intangible Property	Included if *acquired, produced, or primarily used* in Illinois	Trademarks, Copyrights, Patents
All Other Property	Included if *acquired, produced, or primarily used* in Illinois	

Real and Personal Tangible Property:

Real and Personal Tangible Property will be included in the Illinois Assets figure if they are *physically* located within Illinois.[2] If such property is located outside the state's borders, it will not be included in this category. It is important to note that the term "Real and Personal Tangible Property" includes assets such as (but not limited to) inventories, buildings, other depreciable assets, depletable assets, land, and uninvested cash.[3] If your business has property akin to any of the examples listed above, you must take the value of such property and include it in your Illinois Asset figure.

Trade Notes and Accounts Receivable:

Trade Notes and Accounts Receivable are deemed Illinois assets if they arise from Illinois sales.[4] Sales will arise from Illinois if the income-producing activity is performed in Illinois or is administered, managed, or controlled by an entity or individual within the State of Illinois.[5] Thus, any amount in your accounts receivable derived from sales that arose from Illinois must be included in the Illinois Assets figure.

Investments, Government Obligations, Tax-Exempt Securities, Loans to Stockholders, Mortgage & Real Estate Loans, and Other Investments:

These investments will only be certificated and deemed Illinois Assets if notes, securities, or certificates evidencing such investments are physically located within the State of Illinois.[6] If no such physical evidence exists, these investments will be deemed located in Illinois if they are administered, managed, or controlled by entities within Illinois.

If your business is headquartered in Illinois, paying attention to this class of assets is incredibly pertinent. Kilpatrick has found that it pays for such corporations to be certain that all "investments," such as cash, short- and long-term investments, notes receivable, stock certificates, evidence of memberships, partnership agreements, patents, trademarks, other intangibles, or other assets are "evidenced," by certification or otherwise, *and* that such evidence of this investment is contained in a "lockbox" or other secure account located outside of Illinois. If such business fails to do so, these assets must be included in the Illinois Asset figure, and your Illinois Franchise Tax liability will increase as a result.

Intangible Property:

Unlike tangible property, intangible property will only be included in the Illinois Assets figure if such property arose from acquiring a business located within the State of Illinois.[7] In the modern era, where considerable value is often attributed to the intellectual property of an acquired business, such a notion is essential to consider. If your business acquires another business through a merger or acquisition, and such company is located in Illinois, the value of those intangible assets, such as patents and trademarks, will be included in the Illinois Assets figure and contribute to increasing your Illinois Franchise Tax liability.

All Other Property:

Any other kind of property, including other intangible assets, property patents, copyrights, trademarks, prepared expenses, and other miscellaneous assets, will be deemed located in Illinois if the property was acquired, produced, or primarily used in Illinois.[8]

Illinois Revenues:

The final figure used in calculating the Franchise Tax Allocation Factor is Illinois Revenues. Much like Illinois Assets above, this figure seeks to capture the portion of your Gross Revenues attributable to business or business activities derived from the State of Illinois. Page 4 of Illinois Form BCA 1.35 offers another set of instructive rules to help us determine what revenue is and is not attributable to Illinois. This document contains specific rules for various forms of revenues that might be included, and each listed is discussed in more detail below:

CATEGORY	INCLUSION RULES	EXAMPLES
Sale of Tangible Personal Property	Included if the sale occurs in Illinois, is shipped from Illinois, or the contract evidencing the sale is accepted in Illinois	Online sales with inventory stored in Illinois Warehouse
Service Income or Income from Sales of Non-Tangible Personal Property	Included if the income-producing activity occurred in or was controlled by an entity within Illinois	Income derived from providing a service or selling IP rights
Investment Income	Included if the investments are administered, managed, or controlled within Illinois	Interest and Dividends
Subsidiary Interest and Dividends	Included if the subsidiary transacts business *primarily at* or *from places of business* within the State of Illinois and the taxed corporation owns at least 10% of the subsidiary	The taxed corporation owns 100% of a subsidiary that issues dividends to the parent company
Gross Rents	Included if the rented property is located within the State of Illinois	Rents collected from the lease of land
Gross Royalties from Oil, Mineral, or Other Leases	Included if the leased property is located within the State of Illinois	Royalties collected from the extraction of oil on leased land
Gross Sales Prices for Dispositions of Real Estate, Property, and Capital Assets	Included if the property or asset sold was located in Illinois at the time of the sale	Sale of real estate

Sale of Tangible Personal Property:

The revenue derived from the sale of Tangible Personal Property will be attributable to the State of Illinois if the sale occurs within the State, is shipped from an Illinois location, or the contract evidencing the sale is *accepted* within the State.[9] This is in stark contrast to how such revenues are apportioned in both the Illinois State Income and Corporate taxes, which are included in such a figure based on their "destination" rather than their "origin," as seen here. As you can see, this leads to staunchly varying numbers between the Allocation Factor and other apportionment factors used in these other respective taxes.

Practically speaking, the result of this rule means that if the business's warehouse contains Tangible Personal Property in the form of inventory and ships the inventory from the warehouse, every sale of this inventory will be sourced to Illinois regardless of the ultimate destination of the products. Similarly, this also means that when a sales contract is accepted, you must consciously note where the contract itself was "accepted" and signed. If your business accepts a contract within the State of Illinois, every sale under such contract, regardless of origin or destination, will be factored into your Illinois Revenues. The inverse of the above example is true as well.

For example, suppose your business has no inventory in Illinois, and sales contracts are "accepted" outside Illinois. In that case, *no* sales of tangible personal property will contribute to your Illinois Revenues, even though the sale may ultimately be shipped to an Illinois location and is or was reported as a destination sale for Illinois State Income or Corporate Tax purposes. In summary, it pays to be particularly mindful of these factors when deciding how to coordinate and organize sales of Tangible Personal Property and sales contracts for such property to minimize Franchise Tax liability.

This is highly analogous to the structure of Public Law 86-272 ("PL 86-272"). This law prohibits a state from imposing a net income tax on foreign corporations whose business activities in the taxing state are limited to the solicitation of orders for tangible personal property. Under PL 86-272, a foreign corporation does not "engage in business" within a state by simply having solicitations for sales of tangible property occur within its borders. Instead, the business must take some action that crosses over this mere solicitation to fall out of PL 86-272 protection. Generally speaking, if a corporation has a headquarters and inventory warehouse in California and only solicits orders from Illinois residents, it may only be responsible for the minimum Illinois Franchise Tax and avoid the corporate net income tax.

Service Income, Sales Other Than Tangible Personal Property, and Other Receipts:

Any revenue derived from services or sales outside of tangible personal property and other receipts will be allocated to Illinois Revenues only if the income-producing activity was performed in Illinois or was administered, managed, or controlled by a person or entity in Illinois.[10]

This inclusion rule is highly analogous to the "Cost of Performance" principle used in calculating state corporate income tax for service income and sales of intangible personal property. The Cost of Performance is a concept used to apportion where the income-producing activity is attributable to and, thus, how such income will be apportioned for state income tax purposes. Under this principle, the income derived from the service or sale will be assigned to the state where the costs of performing such services are located. For example, if Company X performs a service in State Y for a customer who is a resident of State Z, State Y will be assigned the income. The critical difference between the Cost of Performance and the method Illinois uses for Franchise Tax purposes is that Illinois will source income derived from services performed in another state if such services or sales were administered, managed, or controlled by a person or entity within Illinois. For example, suppose you are a landscaping corporation from California with an office in Illinois and perform landscaping services in Indiana controlled by those in your Illinois office. In that case, the income derived from this service will be assigned to Illinois despite no services being rendered there. Again, this method contrasts the market-based sourcing rules used for the corporate net income tax.

Income From Investments (Dividends & Interest):

If a corporation derives any income or revenues from investments, such as through dividends or interest accrued from such investments, it may also have to include this in its Illinois Revenues. This can be the case regardless of whether such income is or is not taxable. This income will only be included if these investments are administered, managed, or controlled within Illinois.[11]

Dividends & Interest from Subsidiary:

If a corporation owns at least 10% of, or operates a subsidiary, any dividends and interest the parent company receives may also be included in their Illinois Revenues and thus subject to the Franchise Tax.[12] Such income will be allocated as Illinois Revenues if the subsidiary transacts business *primarily at* or *from places of business* within the State of Illinois. So, if your subsidiary operates a warehouse within the State of Illinois and collects and fulfills online sales from said warehouse, any dividends or interest paid to the parent company will be allocated to Illinois Revenues for the *parent company* on their Franchise Tax liability.

Gross Rents:

Gross rents are allocated to Illinois if the rented property is located within the State of Illinois. Thus, if you operate an apartment building within Illinois, your rent will be allocated to your Illinois Revenues and contribute towards your Franchise Tax liability.[13]

Gross Royalties from Oil, Mineral, or Other Leases:

Any gross royalties your business may receive from oil, mineral, or other material leases will be allocated to Illinois only if the leased property is located within the State of Illinois.[14] These natural resources are specifically carved out from royalties generally, which will only be allocated to Illinois Revenues if the activity giving rise to the payment of royalties was transacted at or from a location within the State of Illinois.[15] So, for any oil leasing agreements your business may have that drill into Illinois ground, your royalties will be subject to Illinois Revenues. For example, imagine you own an oil business with a headquarters in Illinois. One day, at this Illinois headquarters, you sign a lease agreement that gives your business the right to extract oil from a parcel of land in Oklahoma. This action will qualify any royalties earned from extraction as Illinois Revenue, increasing your business's Illinois Franchise Tax liability.

Gross Sales Prices for Dispositions of Real Estate, Property, and Capital Assets:

If your business decides to sell any real estate in a taxable year, income from such sale may also be allocated to your Illinois Revenues.[16] All gross prices for dispositions of real estate, property, and capital assets are allocated in this fashion if the property or asset sold was located in Illinois at the time of the sale.

Conclusion:

Calculating a business's Franchise Tax Allocation Factor can be tricky. Failure to do so correctly can lead to severe complications and result in over or underpayment of a business's tax liability, potentially jeopardizing its ability to conduct business within Illinois. Moreover, underpayment leads to the imposition of late penalties and interest.[17] Underpayment will incur a penalty of 10% of any delinquent amount due on the corporation's annual report.[18] At the same time, a 2% interest rate will be applied each month that the liability remains unpaid.[19] As such, we urge you to carefully examine your books and past filings to ensure that your Allocation Factor has appropriately accounted for your Illinois Assets and Illinois Revenues. As seen in these examples, it is incredibly easy to mistakenly include or not include items in your Illinois Revenues or Illinois Assets, which will impact the final Allocation Factor and ultimately impact the amount of Franchise Tax you pay.

The next and final article in this series on the Franchise Tax is dedicated to some common problems Kilpatrick has seen and resolved when dealing with Franchise Tax issues.

Thank you for reading, and please reach out to the State and Local Tax group at Kilpatrick if you have any questions about your business and potential Franchise Tax liability.

[1] 805 ILCS 5/14.05(h)(2)
[2] IL From BCA 1.35 Notes to Computation of Property (Part I) (1)
[3] IL From BCA 1.35 Notes to Computation of Property (Part I) (1)
[4] IL From BCA 1.35 Notes to Computation of Property (Part I) (2)
[5] IL From BCA 1.35 Notes to Computation of Property (Part I) (2)
[6] IL From BCA 1.35 Notes to Computation of Property (Part I) (3)
[7] IL From BCA 1.35 Notes to Computation of Property (Part I) (4)
[8] IL From BCA 1.35 Notes to Computation of Property (Part I) (5)
[9] IL From BCA 1.35 Notes to Computation of Property (Part II) (1)
[10] IL From BCA 1.35 Notes to Computation of Property (Part I) (2)
[11] IL From BCA 1.35 Notes to Computation of Property (Part I) (3)
[12] IL From BCA 1.35 Notes to Computation of Property (Part I) (4)
[13] IL From BCA 1.35 Notes to Computation of Property (Part I) (5)
[14] IL From BCA 1.35 Notes to Computation of Property (Part I) (5)
[15] IL From BCA 1.35 Notes to Computation of Property (Part I) (5)
[16] IL From BCA 1.35 Notes to Computation of Property (Part I) (6)
[17] 805 ILCS 5/16.05(a)
[18] 805 ILCS 5/16.05(a)
[19] 805 ILCS 5/16.05(c)