

Illinois Corporate Franchise Tax – Same As It Never Was

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Publication Date: April 27, 2011

If you are old enough, you probably remember "The Twilight Zone," the popular 1960s television show in which each episode concluded with an unexpected twist. One plot that would recur on many "Twilight Zone" episodes involved a situation in which the protagonist would be suddenly thrown into an alternate reality in which his or her fundamental view of the world would be challenged. The protagonist would be baffled by the sudden change, but the other characters would carry on, oblivious to the change, professing that, in fact, nothing had changed at all. Corporations doing business in Illinois and subject to the Illinois corporate franchise tax can be forgiven if they thought they were living through an episode of the "Twilight Zone" last week.

The Illinois corporate franchise tax is a capital-based tax imposed on Illinois corporations and non-Illinois corporations qualified to do business in Illinois. The tax must be paid by corporations annually, in advance. In addition, corporations subject to the tax must pay an additional franchise tax when events occur that trigger a significant increase in the corporation's paid-in capital. The corporate franchise tax is administered by the Secretary of State. The current tax is largely a carry-over of the franchise tax originally imposed by the Illinois Business Corporation Act of 1933 and, for purposes of administering the tax, the Secretary has tended to follow customs and practices that have never been formally promulgated as regulations. Some of these customs and practices date back to the 1930s. One such long-standing practice involved the location of intangibles for purposes of computing the property apportionment factor. (The property factor is one of two factors used to apportion the corporate franchise tax base.) Historically, the Secretary of State always determined the location of securities represented by physical certificates to be where those certificates were physically located. The Secretary of State's policy for determining the location of certificated securities was so ingrained that in the mid-1990s the Secretary of State published documents called "Interrogatories" to be used by the Secretary to inquire about the facts necessary to an accurate calculation of the franchise tax. Over time, corporations also came to rely on these Interrogatories, in lieu of any regulations governing the calculation of the franchise tax.

Specifically, the Interrogatory on determining the location of securities and other investments provided that:

3. Invested cash, U.S. Government obligations, tax-exempt securities, loans to stockholders, mortgage and real estate loans and other investments are located in Illinois if the notes, securities or certificates evidencing such investments are located in Illinois. If there are no notes, securities or securities evidencing such investments, such investments are in Illinois if they are administered, managed or controlled in Illinois. (Italics added for emphasis.)

In April 2011, without any prior warning, the version of the Interrogatory quoted above vanished from the Secretary of State's website, and was replaced by a new version that read as follows:

3. Invested cash, U.S. Government obligations, tax-exempt securities, loans to stockholders, mortgage and real estate loans and other investments are located in Illinois if ~~the notes, securities or certificates evidencing such investments are located in Illinois. If there are no notes, securities or securities evidencing such investments, such investments are in Illinois~~ if they are administered, managed or controlled in Illinois. (Stricken language added for emphasis.)

Of course, the version currently on the Secretary's website does not show the stricken language. When inquiries were made to the Secretary of State's office about the over-night change to the Interrogatory, the response was, essentially: "What change?" According to the Secretary of State's office, the current version of the Interrogatory reflects what has always been the Secretary's policy for determining the location of securities and other investments. Cue the "Twilight Zone" music: the Secretary's position is the same as it never was! Taxpayers that think the Secretary's position has changed are, in essence, being told that they are the ones who have lost touch with reality.

Although a corporation's maximum annual franchise tax liability is \$2 million, complying with the tax can be burdensome, largely because of the cumbersome manner in which the tax is administered by the Secretary of State. For example, there are no audits. Instead, the Secretary of State will simply refuse to accept the filing of a corporation's annual report of paid-in capital until the paid-in capital reported is an amount agreed to by the Secretary. As a result, if the Secretary determines that the paid-in capital reported by a corporation for a prior year was inaccurate—for instance, because the capital amount for the prior years was apportioned to Illinois using a property factor computed using the old version of the Interrogatory on the location of securities and investments—then the Secretary could make the acceptance of the current year's report of paid-in capital contingent on the correction of all prior reports of paid-in capital, and the payment of all additional tax associated with those corrections. Thus, as a practical matter, the Secretary can use his power to administratively dissolve



a corporation to force franchise taxpayers to accept the Secretary's new version of reality, retroactively.

The major taxpayer interest groups have reached out to the Secretary of State to discuss the reason for, and the wisdom and implications of, the change. Taxpayers should not rush to file Statements of Correction to amend prior reports of paid-in capital, but should monitor events, either directly or through their advisors, to determine whether the Secretary will continue to apply the new version of the Interrogatory, and if so, whether it will be applied retroactively. Taxpayers with an imminent deadline for filing their annual report of paid-in capital, or taxpayers that are expecting an imminent transaction that will cause a change in paid-in capital requiring a report to the Secretary of State, should immediately take steps to identify whether the location of intangible property in their reports would change if the new version of the Interrogatory is followed. The legislature is still in session, and the policy change reflected in the new version of the Interrogatory is significant enough that legislation could surface before the end of the current session if the Secretary of State decides to dig in and defend its alternate version of reality.

For more information on the application of the changes to Illinois corporate franchise tax Interrogatories to your business, contact the author of this Alert or another member of the Reed Smith State Tax Group. For more information on Reed Smith's Illinois tax practice, visit www.reedsmith.com/iltax.

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