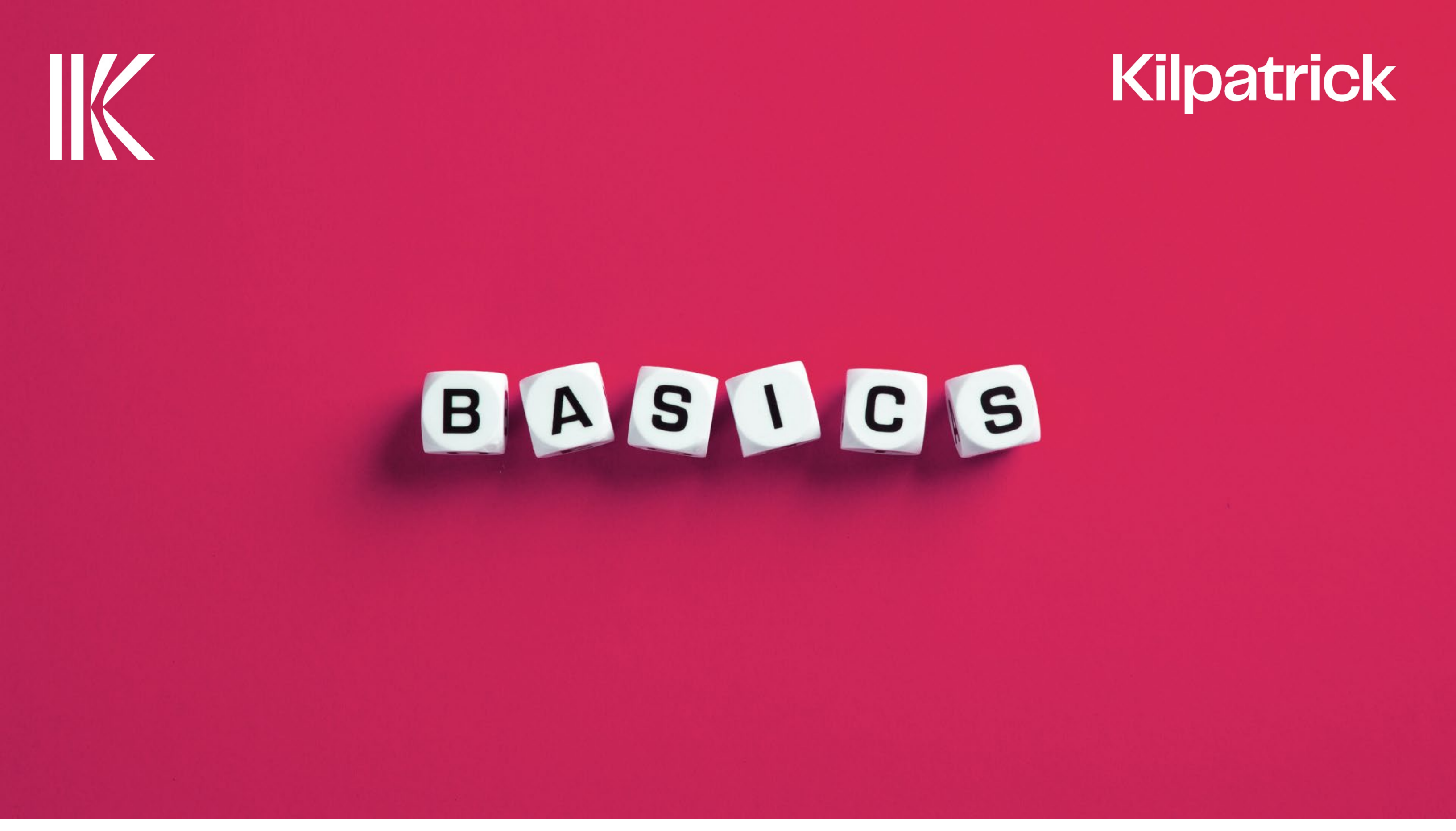

Laying Out the Basics of the Illinois Franchise Tax

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 what entities the Franchise Tax applies to and its basic mechanics, please click here. For an overview of the Franchise Tax generally, please see our prior article on the topic here.

Understanding the Franchise Tax requires an understanding of four critical terms used throughout its computing and filing process. These terms are: Paid-In Capital, Taxable Year, Fiscal Year, and Allocation Factor. While some of these terms have more common and general definitions in the context of federal and state taxation, the Franchise Tax somewhat modifies these traditional definitions. Each will be explained in more detail later in this series of articles. To begin, we have provided a bird's eye view of these terms and their definitions in the chart below:

TERM	DEFINITION	CITATION
Paid-In Capital	Paid-in capital is the figure by which the Franchise Tax is measured. This is typically calculated by combining the amounts listed on federal form 1120, Schedule L, Lines 22 and 23. However, many other factors may influence the overall calculation.	805 ILCS 5/1.80(j)
Taxable Year	Taxable Year describes the 12-month period commencing with the first day of the corporation's anniversary month in the state. Simply put, once a corporation files with the Illinois Secretary of State, their "Taxable Year" will begin and cover the following 12-month period.	805 ILCS 5/1.80(q)
Fiscal Year	Fiscal Year describes the 12-month period for which a corporation operating in Illinois and subject to the Franchise Tax ordinarily files its federal tax return.	805 ILCS 5/1.80(r)
Allocation Factor	Despite the similar nomenclature, the Allocation Factor used in determining Franchise Tax liability vastly differs from the apportionment factor used for Illinois Income or Corporate Tax purposes. The Allocation Factor used here is defined as the value of *all* the gross assets the corporation owns, *and* the gross amount of business transacted by the corporation everywhere compared to the gross assets owned and gross revenues located within Illinois.	805 ILCS 5/14.05(h)(2)

Paid-In Capital:

According to the Illinois Business Corporations Act, Paid-In Capital is defined as the sum of the cash and other consideration received, less expenses, including commissions paid or incurred by the corporation, in connection with the issuance of shares by or on behalf of its shareholders, plus amounts added or transferred to shareholders pursuant to a share dividend, share split or others.[1] This definition is represented mathematically below:

$$\textbf{Paid-In Capital} = \begin{array}{l}\textbf{(Cash + Other Consideration) - (Expenses,}\\ \textbf{including Commissions and Shares Issued)}\\ \textbf{+ (Amounts Added or Transferred to}\\ \textbf{Shareholders via Dividends, Splits, Etc.)}\end{array}$$

This definition typically translates into the sum of two amounts detailed on a corporation's books and balance sheet. These are the "Capital Stock" line (listed in dollars at Par value) and the balance sheet account line of "Additional Paid-In Capital" (consideration received/contributed over par value). Typically, these amounts are lifted directly from lines 22 and 23 in Schedule L of federal Form 1120. Simply adding these two figures together should result in the total Paid-In Capital. Knowing this amount is crucial to calculate and pay your Franchise Tax liability correctly and should be carefully monitored.

Paid-In capital can increase and decrease yearly, directly impacting a corporation's Franchise Tax liability. For example, a corporation can reduce its Paid-In Capital by its board of directors passing a resolution that charges dividends paid on preferred shares against its Paid-In Capital.[2] Paid-In Capital may increase by simply issuing new shares in the corporation.[3]

Taxable Year:

Your taxable year is typically based on your registration date with the Illinois Secretary of State and the 12-month period thereafter.[4] This information is vital to filing your Illinois Franchise Tax documents and will be recorded on Page 1 of your corporation's IL BCA Form 14.05.

Fiscal Year:

Unlike your taxable year, your Fiscal Year is determined solely by when your business typically files its federal income tax return.[5] This 12-month period is akin to what is also commonly called your "financial annual" or "corporate fiscal year." The financial fiscal year-end, which precedes the end of the Franchise Tax Taxable Year end, will be the data used to prepare your Illinois Franchise Tax (via your Allocation Factor). This information will be similarly placed on Page 2 of your corporation's IL BCA Form 14.05.

Allocation Factor:

The Allocation Factor used in determining your Franchise Tax is markedly different from the apportionment factor you may have used in determining your state Income or Corporate Tax liability. Using the apportionment factors from such tax calculations can lead to stark over or underpayments of the tax liability owed and cause substantial consequences with the Illinois Secretary of State Office. One of the few similarities between the Allocation Factor here and the apportionment factors found elsewhere is that they are both fractions that seek to fairly allocate only those business activities that are attributable to the State of Illinois relative to those that occur elsewhere in the United States or abroad.

However, this is where the similarities end between the Franchise Tax Allocation Factor and other apportionment factors. The numerator (representing business activities and Paid-In Capital derived from Illinois activities) and denominator (representing *everywhere* business activities and Paid-In Capital) are calculated much differently than the Corporate Income Tax apportionment factors and thus warrant special attention to detail to ensure compliance. 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 and gross assets everywhere*.[6] Much like our definition of Paid-In Capital, this definition is obtuse in word form. As such, we have represented this formula mathematically below:

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

But what makes an asset an Illinois Asset? Which revenues are attributable to Illinois, and which are not? These essential questions must be answered to calculate a corporation's allocation factor correctly. Failing to do so will necessarily result in an over or underpayment of the Franchise Tax. Per Illinois law, underpayment leads to the imposition of late penalties and interest.[7] Underpayment will incur a penalty of 10% of any delinquent amount due on the corporation's annual report.[8] Additionally, interest rates will be applied at 2% each month that the liability remains unpaid.[9] As such, we have dedicated the following article in this series entirely to answering these questions and encourage you to follow us there now.

Thank you for reading this article. 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 5/1.80(j)
[2] 805 ILCS 5/9.20(a)(1)
[3] 805 ILCS 5/15.65(b)(1)
[4] 805 ILCS 5/1.80(q)
[5] 805 ILCS 5/1.80(r)
[6] 805 ILCS 5/14.05(h)(2)
[7] 805 ILCS 5/16.05(a)
[8] 805 ILCS 5/16.05(a)
[9] 805 ILCS 5/16.05(c)