Introduction to the Illinois Franchise Tax and its Importance to Your Company

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The Illinois Franchise Tax (the "Franchise Tax") is an extremely complex tax that places unique burdens on corporations conducting business in Illinois. Based on our experience, many corporations incorrectly calculate their obligations, leading to the over or underpayment of their tax liabilities. Neither of these scenarios is desirable, and as such, the following series of articles are designed to familiarize you with the basics of the Franchise Tax and reveal a few common problems we at Kilpatrick have identified and resolved over the years.

For any corporation conducting business within Illinois or any corporation considering a merger or acquisition of a corporation operating within Illinois, the Franchise Tax and its impact should be carefully considered. Failure to do so could cause your corporation to lose its "good standing" with the Illinois Secretary of State, thereby risking the right to conduct business within the state.[1] Furthermore, your corporation may incorrectly calculate the Allocation Factor (defined below), leading to under or overpayment of your tax liability. Under-payment could again result in this loss of good standing, additional penalties, and interest, while over-payment is not in the best interest of any corporation either.

This series of articles will be divided into four topics. This first will cover the businesses and entities required to pay the Franchise Tax and the mechanics of the Franchise Tax system. The second will define the essential terms to understand the Franchise Tax and its calculation and cover some significant differences between the Franchise Tax and the state Income and Corporate Income Tax. The third will provide specific resources and examples on correctly calculating your Allocation Factor for the Franchise Tax. The fourth and final section will cover some of the common issues and problems we have seen corporations and clients struggle with in calculating, understanding, and ultimately paying the Franchise Tax.

Who is Liable?

The first step is to confirm that you and your business are subject to the Franchise Tax. In this context, this is a relatively uncomplicated process. The Illinois Secretary of State is the government office responsible for levying, collecting, and enforcing the Franchise Tax.[2] As such, entities registering with or reporting to the Illinois Secretary of State are subject to Franchise Taxing.[3] This includes *domestic and foreign corporations* which are conducting business in Illinois.[4] While LLCs will have annual filing obligations with the Secretary of State, they will not be subject to the Franchise Tax *unless* they have elected to be treated as a corporation for federal income tax purposes.[5] Specifically, LLC's must file an annual report with the IL Secretary of State with a $75 renewal fee attached.[6] Failure to timely file this report with the associated fee incurs a $100 late fee.[7] By contrast, banks and insurance companies, which register with separate state agencies outside the Secretary of State, will *not* have any Franchise Tax liability.[8]

Domestic v. Foreign Corporations

Domestic corporations will *always* be responsible for the Franchise Tax because they are Illinois-formed entities.[9] However, foreign corporations (i.e., entities formed in another state, territory, or country) registered with the Illinois Secretary of State to conduct business in Illinois may not be responsible for the Franchise Tax under certain circumstances.[10] Just because a corporation has sufficient nexus with the State of Illinois to trigger a state corporate income or sales tax liability (or any other state levied tax), such corporation *may* not incur a Franchise Tax liability. Similarly, a corporation may incur a Franchise Tax liability, yet incur no Illinois corporate income or sales tax liability. The liability requirements for each of these taxes are separate; therefore, special attention must be paid to their qualifying factors. Illinois law provides a list of activities foreign corporations may permissibly conduct in Illinois that do not constitute "transacting business" in the State for Franchise Tax purposes.[11]

These activities include, but are not limited to:

1. Maintaining, defending, or settling any legal proceeding;
2. Holding meetings of the board of directors or shareholders or carrying on other activities concerning internal corporate affairs;
3. Maintaining bank accounts within the State of Illinois;
4. Maintaining officers or agencies for the transfer, exchange, and registration of the corporation's own securities, or maintaining trustees or depositories with respect to such securities;
5. Selling through independent contractors;
6. Soliciting or obtaining orders, if such orders require acceptance outside of the State of Illinois before they become contracts;
7. Owning, without more, real or personal property;
8. Conducting an isolated transaction that is completed within 120 days and that is not one in the course of repeated transactions of a like nature; or
9. Having a corporate officer or director who is a resident of the state.

If a foreign corporation is conducting business activities outside the scope of these exceptions, it is likely subject to the Franchise Tax and incurs liability. Ensuring compliance with the amount due will be essential to maintaining smooth operations within Illinois.

Mechanics of the Franchise Tax:

The Franchise Tax can be thought of as three separate taxes: the initial tax, the annual tax, and the additional tax. The initial tax applies when a corporation initially registers with the Illinois Secretary of State for the right to conduct business within the state. For domestic corporations, this will be due when shares are first issued. For foreign corporations, this will be paid upon the date the application to conduct business in Illinois is filed. As the name implies, the annual tax will be paid each year based on the calculations discussed in this series of articles. The "filing" of this tax will be included in the corporation's Illinois Annual Report and must be submitted to the Illinois Secretary of State by the corporation's anniversary.[12]

A corporation's "anniversary" will be one of the following: the date an Illinois-formed corporation files its articles of incorporation, the date a non-Illinois-formed corporation's Illinois registration is approved, or the close of the (foreign or domestic) corporation's fiscal year. To use the close of a corporation's fiscal year as its anniversary for Franchise Tax purposes, the corporation must elect to do so by filing an IL Form BCA-14.01.

The additional tax is collected whenever the corporation's Paid-In Capital (defined in article #2) increases during a given year.[13] The Franchise Tax for foreign corporations is also subject to a cap of $2 million annually, regardless of their Allocation Factor.[14] However, it is essential to note that this cap applies exclusively to the annual franchise tax and will not cap the additional franchise tax imposed due to increases to Paid-In Capital.[15]

Why You Should Care - Overpayment Remedies & Statute of Limitations:

As a general practice, the Illinois Secretary of State does not alert a business if it has overpaid its Franchise Tax. Unfortunately, this means you must discover it for yourself. You are entitled to a refund of the overpayment if you make such a discovery.[16] However, Illinois law imposes a three-year statute of limitations on refunds of this kind.[17] So, if you discover that you have overpaid for the last five years, you can only recollect the funds from the previous three years despite your overpayments in those first two years. Unfortunately, this scenario is more common than it may appear, so we urge you to examine your books and records now to maximize the amount you receive on your return should overpayment have occurred.

Why You Should Care - Underpayment & The Tax Amnesty Program:

On the other hand, underpayment of your owed Franchise Tax liabilities could draw attention from the Illinois Secretary of State. Failure to pay the amount owed could trigger an audit, resulting in your corporation losing its good standing with the Secretary of State, threatening its ability to conduct all business within Illinois unless and until resolved.[18] Furthermore, underpayment will incur a penalty of 10% of any delinquent amount due on the corporation's annual report.[19] In addition, interest will be applied at 2% each month if the liability remains unpaid.[20]

Every once in a while, the Illinois Secretary of State (in conjunction with the Illinois State Governor) offers a tax amnesty program for corporations that have fallen into non-compliance with their tax obligations to the state and thereby underpaid their liabilities. Historically, this program has been extended to corporations whose liabilities include underpaying the Illinois State Franchise Tax.[21] However, it is incredibly unwise and ill-advised to rely on a potential amnesty program being offered. For reference sake, the last amnesty was in 2019 and covered unreported increases to paid-in capital, annual franchise tax deficiencies, any increase of paid-in capital or issued shares pursuant to section 14.30 or 14.35, and initial franchise tax deficiencies.[22]

While these programs have provided relief to many, it is far less stressful and more ideal for your business to comply from the start rather than fall out of compliance, risk losing your good standing with the state, and rely on the reasonableness of the Illinois Secretary of State when such issues come to light. As such, we highly recommend that you continue reading this series of articles to ensure that you and your business remain in compliance or quickly fall into compliance with the Franchise Tax.

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 13.50(b) & 805 ILCS 13.50(h)
[2] 805 ILCS 5/15.05(c) & 805 ILCS 15.80(a)
[3] 805 ILCS 5/14.05 & 805 ILCS 5/15.65
[4] 805 ILCS 15/14/05 & 805 ILCS 5/15.65
[5] 805 ILCS 180/45-5 & https://www.finaloop.com/blog/illinois-franchise-tax
[6] 805 ILCS 180/50-10(b)(11).
[7] 805 ILCS 180/50-15(b)(1).
[8] 805 ILCS 5/14.05
[9] 805 ILCS 5/14.05
[10] 805 ILCS 5/13.75
[11] 805 ILCS 5/13.75
[12] 805 ILCS 5/15.80
[13] 805 ILCS 5/15.65
[14] 805 ILCS 5/15.75(a)
[15] 805 ILCS 15/75(a)
[16] 805 ILCS 5.1.17(a)
[17] 805 ILCS 5/1.17(a)
[18] 805 ILCS 13.50(b) & 805 ILCS 13.50(h)
[19] 805 ILCS 5/16.05(a)
[20] 805 ILCS 5/16.05(c)
[21] State Collects Nearly $240 Million Through Tax Amnesty Program (illinois.gov)
[22] Illinois Corporate Franchise Tax Amnesty Information Sheet