

More Taxes For All – A Parting Gift from the Outgoing Illinois General Assembly

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Publication Date: January 13, 2011

When our founding fathers shook their fists at King George to the cry of "No taxation without representation!" they could not have imagined how bad taxation *with* representation could actually be. Take The Land of Lincoln, where, in the early hours of January 12, 2011, the Illinois Senate was busy imposing unprecedented tax increases on individuals and corporations, as well as enacting a suspension of net operating loss carry-forwards. This increase, together with the federal corporate income tax rate, gives Illinois the third-highest corporate income tax rate in the industrialized world, according to the Washington D.C.-based Tax Foundation.

In the end, the outgoing Illinois Senate voted to pass Senate Bill 2505 by a 30 to 29 vote, with no Republicans voting in favor, less than 12 hours before a new and much more Republican General Assembly would be sworn in. Senate Bill 2505 includes a 67 percent increase in the personal income tax rate and a 46 percent increase in the corporate income tax rate, both effective January 1, 2011. Gov. Quinn (D) promised to sign the law promptly. Senate Bill 2505 does not cut a single dollar of spending, and, even after the massive tax increases included in the bill, Illinois is still projected to run a budget deficit.

Hike in Income Tax Rates and Suspension of NOL Carryforward for 2011

Effective for tax years ending after December 31, 2010 and prior to January 1, 2015, the Illinois corporate income tax rate will increase from 4.8 percent to a new top rate of 9.5 *percent* (the 9.5 percent rate includes the unchanged 2.5 percent rate for the replacement income tax). The individual income tax rate will increase from 3 percent to a new high of 5 *percent* for the same tax periods. For tax years after December 31, 2014, the rates would then fall to 7.75 percent for corporations and 3.75 percent for individuals. For years after December 31, 2023, the rates would further decrease to 7.3 percent for corporations and 3.25 percent for individuals.

Taxpayers reporting on a fiscal year basis with a tax year that overlaps the rate changes will calculate liability using both rates, either by: (i) determining the portion of total annual income

subject to each rate by multiplying total income by the ratio of the number of days in the tax year under each rate to the total number of days in the tax year; or (ii) electing, irrevocably for that tax year, specific accounting of its net income for each period pursuant to regulations the Department of Revenue is required to promulgate. Business income will be apportioned on the basis of a full taxable year, without regard for the method elected to determine net income for each portion of the taxable year to which a different rate applies. Changes were also made to adjust estimated payments due after January 31, 2011, so the "required annual payment" will rise to 150 percent of the tax shown on the return for the preceding 12 month taxable year. The required annual payment for installments due prior to February 1, 2011 remains, and after January 31, 2012 will drop back to, 100 percent of the tax shown on the return for the preceding 12 month taxable period.

Under the law in effect until January 12, 2011, corporations were allowed to carry Illinois net operating losses forward for up to 12 years. Senate Bill 2505 imposes a net operating loss suspension. Under the new legislation, corporate income tax payers, other than Subchapter S corporations, will not be able to carry forward Illinois net operating losses and use such losses to offset taxable income for tax years ending after December 31, 2010 and prior to December 31, 2014. However, taxpayers with net operating loss carryforwards will be able to carry those losses forward an additional four years, thus preventing suspended net operating losses from expiring unused.

These changes are projected to raise \$6.75 billion in new revenues; however, that increase in revenue is not even enough to eliminate half of Illinois' projected budget deficit. Additional borrowing in the amount of \$12.5 billion was originally included in the tax-hike legislation. Nine-hundred and fifty million dollars of this borrowing would have been allocated to pay the considerable backlog of approved corporate income tax refunds. However, the borrowing provisions didn't reach the Senate, so it will be left to the newly sworn-in General Assembly to consider whether and how to increase the state's debt in order to pay for prior operating expenses.

Local governments in Illinois will not share in the new income tax revenue. Previously, local governments received 10 percent of all income tax collections. Under the new legislation, the percentage of income tax receipts that will be distributed to local governments is reduced to 6 percent for individual income tax collections and 6.86 percent for corporate income tax

collections. These distribution rates are scheduled to increase to 8 percent and 9.14 percent, respectively, commencing February 15, 2015.

Spending Limits (and Loopholes) Adopted

While the legislation did not cut any spending, it did impose limits on spending for the 2012 through 2015 state fiscal years. These limits are enforced, curiously, by dropping the corporate and individual income tax rates to 4.8 percent and 3 percent respectively for any fiscal year in which the state spending exceeds the spending limitation designated by law for that year. However, the spending limitations in the legislation may be avoided by a gubernatorial designation of a fiscal emergency and specifying the amount of state funding needed to resolve the emergency, in which case the specified amount will not be considered "state spending" for purposes of the spending limitation. Commentators have noted that the specific dollar spending caps still appear to allow room for growth in spending in the current and next few years, beyond the total revenues generated by the tax hike.

Has Illinois Forfeited Taxpayer Goodwill?

In an era where most publicly traded corporations are becoming increasingly conservative with respect to tax positions, Illinois has managed to create an environment where ordinary business care and prudence dictates that taxpayers do everything legally possible to avoid becoming a creditor of Illinois through the overpayment of taxes. The rate hikes and the NOL suspension in the new legislation will only further poison the environment for business taxpayers in Illinois.

Consider some of the factors contributing to the negative environment for the business taxpayer in Illinois, even before the tax hike legislation:

- Three years ago, the General Assembly changed the apportionment of service income for tax years ending on or after 12/31/2008 from the income-producing activity and cost-of-performance test to a market-based approach, with throw-out of sales, and directed the Department to issue regulations to administer the new method. December 31, 2010 passed without such regulations being proposed, and taxpayers continue to apportion such income and report it on returns without any guidance from the Department, except what they may receive during an audit. Illinois is adding auditors and surely they will focus on apportionment, despite the lack of guidance to taxpayers, so taxpayers need to build support for their current apportionment approach.

- Last year, the Illinois Supreme Court ruled in the *Exelon* decision that a taxpayer qualified for the Investment Tax Credit for the past 10 years and was entitled to refunds. However, on reconsideration prompted by the state's claim that the decision would cost local governments millions of dollars, the court modified its decision and said Exelon would receive nothing because the court's decision would be applied prospectively so the Legislature could determine whether to approve the court's interpretation. The court neglected to mention that, while it was reconsidering its decision, the Legislature had done precisely that and wiped out the credit prospectively, so Exelon got nothing for prior or future years. The inability to rely on the amended return claim for refund provisions will encourage taxpayers to claim credits and take other disputed positions on original tax returns, retaining the use of the funds until and unless a deficiency is assessed and finally determined in favor of the state.
- In October of last year, in running a Tax Amnesty Program, the Department of Revenue's regulations prohibited a participating taxpayer from deducting from its payments under amnesty, any overpayments that the state acknowledged receiving but had not yet refunded; so in essence, a taxpayer had to overpay twice to get the benefits of the amnesty. At about the same time, the state acknowledged that it had failed to refund and was unable to pay nearly \$1 billion in unpaid corporate tax overpayments, and so, to avoid a rush of amended return filings to protect the three-year statute of limitations to claim those pending refunds, it was extending the statute of limitations until such time as the Department took action to approve, adjust or deny the overpayment claim. Yet, in this last-gasp of the outgoing General Assembly, they could not pass the portion of the proposed legislation that would have allocated \$950 million of potential new bond proceeds to pay the backlog of refunds.

Despite all of this, the governor and the outgoing 96th General Assembly congratulated themselves on finally passing the tax hike legislation. The governors of Indiana and Wisconsin quickly invited Illinois businesses to move over the state line, so with the flaws in the legislation and its further damage to the state's already tattered reputation, these congratulations are likely already short-lived.

For more information on the Illinois tax rate hike and net operating loss suspension, and how it may affect your business, contact the author of this Alert or another member of the Reed Smith



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