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AN ALERT FROM THE BDO STATE AND LOCAL TAX PRACTICE

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SUBJECT

ILLINOIS GOVERNOR SIGNS HISTORIC TAX INCREASE AND OTHER TAX CHANGES

DETAILS

On January 13, 2011, Governor Pat Quinn signed into law Senate Bill 2505, the "Taxpayer Accountability and Budget Stabilization Act ("SB 2505" or the "Act"), which takes effect immediately. The new law is projected to raise an estimated $6.8 billion on an annual basis. The Act provides for several changes to the state's Income Tax Act as a direct result of its looming budget crisis. The Act consists of the following significant changes: (1) increases the Illinois personal income tax rate, (2) increases the total corporate income tax rate, (3) suspends the net operating loss absorption for most entities, (4) sets state spending limitations, (5) potentially increases required estimated tax payments, and (6) reinstates the Illinois estate and generation-skipping transfer taxes.

In addition, on January 10, 2010, the Illinois General Assembly passed House Bill 3659 ("HB 3659" or the "Amazon Nexus Bill") which amends Illinois use tax and service use tax laws to create a sales tax nexus presumption for certain Internet businesses that have more than $10,000 in gross receipts in the state annually. HB 3659 is currently awaiting the Governor's signature.

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Personal Income Tax Rate Increase

SB 2505 establishes rate schedules for taxpayers based on whether the taxpayer has a calendar year-end or fiscal year-end.1

A. Calendar-Year Taxpayers

In the case of an individual, trust, or estate with a calendar year-end, SB 2505 increases and decreases the tax rates according to the following periodic rate schedule:

Calendar Tax Periods	Total Rate
Through 12/31/2010	3%
1/1/2011 – 12/31/2014	5%
1/1/2015 – 12/31/2024	3.75%
1/1/2025 Forward	3.25%

B. Fiscal-Year Taxpayers

Fiscal-year taxpayers will be required to perform separate calculations in order to comply with the calendar-year rate changes referred to above. The Act provides specific guidelines for fiscal-year taxpayers to follow for those taxable years in which the taxpayer encounters two applicable tax rates under the rate schedule.[2]

- *Statutory Method:*

The statutory method for determining the tax liability implicitly assumes that all income is earned ratably throughout the taxable year. In effect, a weighted average of the two tax rates determines the tax rate for the year. Under this method, two ratios are constructed. The first ratio is determined by comparing the number of days in the taxable year after December 31 with the total number of days in that taxable year. This ratio is then multiplied by the taxpayer's net income for the taxable year. The amount derived from this calculation is then multiplied by the applicable tax rate to determine tax liability for that portion of the year.

Similarly, the second ratio is determined by comparing the number of days in the taxable year prior to January 1 with the total number of days in that taxable year. This ratio is then multiplied by the taxpayer's net income for the taxable year. The amount derived from this calculation is then multiplied by the applicable tax rate to determine tax liability for that portion of the year.

The sum of these two calculations will be the fiscal-year taxpayer's total liability for the taxable year. The following generally illustrates how a fiscal-year taxpayer will calculate its Illinois state income tax:

Calculation 1 (First Part of Taxable Year):
Net Income X (# of Days Pre 1/1) / (Total Days in Taxable Year) X Pre 1/1 Tax Rate = A

Calculation 2 (Second Part of Taxable Year):
Net Income X (# of Days Post 12/31) / (Total Days in Taxable Year) X Post 12/31 Tax Rate = B

Calculation 3 (Full Taxable Year):
Calculation 1 (A) + Calculation 2 (B) = Tax Liability

- *Specific Accounting Election Method:*

Alternatively, taxpayers may elect on a timely filed return, including extensions, to determine net income on a specific accounting basis for the two portions of the taxable year as if the books had been closed at the end of each period. The election is irrevocable once made. The base income computed for each period shall only include those items earned,

[1] *Corporate and personal income tax rate changes are effective as of January 1, 2011.*
[2] *The Illinois Department of Revenue should issue additional guidance on compliance for fiscal-year taxpayers.*

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received, paid, incurred, or accrued in each period. The base income will be apportioned on the basis of the taxpayer's full taxable year, without regard to the other fiscal-year taxpayer provisions. The net operating loss ("NOL") carryforward deduction may not exceed the combined net income for both portions of the taxable year. The NOL must be used against the first portion of the taxable year first (*i.e.*, the period prior to December 31) before any remaining amount is used against the net income of the latter portion of the taxable year.

Corporate Income Tax Rate Increase

Consistent with the approach used for the rates applicable to individuals, trusts, and estates, the corporate tax rates are applied differently based on whether the taxpayer has a calendar year-end or fiscal year-end.

A. Calendar Year Taxpayers

In the case of a corporation with a calendar year-end, SB 2505 increases and decreases the tax rates according to the following periodic rate schedule:

Calendar Tax Periods	Corporate Tax Rate	Replacement Tax Rate[3]	Total Rate
Through 12/31/2010	4.8%	2.5%	7.3%
1/1/2011 – 12/31/2014	7.0%	2.5%	9.5%
1/1/2015 – 12/31/2024	5.25%	2.5%	7.75%
1/1/2025 Forward	4.8%	2.5%	7.3%

B. Fiscal-Year Taxpayers

Similar to the provisions applicable to individuals, trusts, or estates with fiscal taxable years, the Act provides specific guidelines for corporate taxpayers with fiscal year-ends. Although the rates for corporate taxpayers will be based on the corporate rates above, the calculation should be made in the same manner as described above for non-corporate taxpayers. Moreover, the specific accounting election method is also available to corporate fiscal year-end taxpayers.

Net Operating Loss Suspension

SB 2505 suspends the net operating loss deduction for corporations, except for S corporations, for any taxable year ending after December 31, 2010, and before December 31, 2014. The current carryover provisions (twelve years for losses incurred on or after December 31, 2003) will be extended by the number of years affected by the suspension.[4]

State Spending Limitation and Tax Reduction

The Act includes certain provisions that would limit state spending growth at two percent annually. The Act specifically provides that if, beginning in the state's fiscal year 2012 and continuing through the state's fiscal year 2015, the state spending for any fiscal year exceeds the state spending limitation (see below), then the new tax rates (see chart above) shall be reduced to 3% of the taxpayer's net income for individuals, trusts, and estates and to 4.8% of the taxpayer's net income for corporations for the taxable year when the spending limit has exceeded the limit and for all subsequent taxable years as well.[5]

[3] Senate Bill 2505 does not provide for a rate increase to the Illinois Personal Property Tax Replacement Income Tax.

[4] It is understood that the Illinois General Assembly intended to suspend the net operating loss deduction for the same period (January 1, 2011, through December 31, 2014) as the increased personal and corporate income tax rates of 5% and 7%, respectively. As written, however, the net operating loss suspension currently applies for three years rather than the four-year increased tax rate period. A technical correction bill is expected to follow for purposes of addressing this matter and any other clarification to SB 2505.

[5] See generally SB 2505, specifically the section enacted as 35 ILCS 5/201.5(a). It should be noted that the spending limitation provisions provide that any public act is subject to audit by the Auditor General, and a report shall be made specifying spending amount, the amount of spending allowed and whether the public act exceeds the amount allowed by statute. 35 ILCS 5/201.5(c).

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The State spending limitations provided in the law are summarized as follows:

Fiscal Year	Limit (in billions)
2012	$36.818
2013	$37.554
2014	$38.305
2015	$39.072

Estimated Tax Payments

SB 2505 potentially increases the estimated tax payments required to be made within the next 12-month period in order to avoid the imposition of penalties. The Act amends the provisions pertaining to the "required annual payment" to achieve this objective. As written, a taxpayer's "required annual payment" for installments due prior to February 1, 2011, and after January 31, 2012, remain consistent with historical estimated tax payment calculation guidelines.[6]

However, for installments due after January 31, 2011, and prior to February 1, 2012, a taxpayer's required annual payment is the lesser of 90% of the tax shown on the return for the taxable year, or if no tax return is filed, 90% of the tax for such year, or 150% of the tax shown on the return of the taxpayer for the preceding taxable year if a return showing a liability for tax was filed by the taxpayer for the preceding taxable year and such preceding year was a taxable year of 12 months. Thus, for taxpayers relying on the prior year's tax liability as the basis for making estimated tax payments for the current year, the required payments are increased from 100% to 150% of the prior year's tax liability.

The Illinois Estate and Generation-Skipping Transfer Tax Act

SB 2505 reinstates the Illinois estate and generation-skipping transfer tax for deaths occurring after December 31, 2010. The tax had previously been allowed to sunset on December 31, 2009. The state tax credit is an amount equal to the full credit determined under section 2011 or 2604 of the Internal Revenue Code as in effect on December 31, 2001. The exclusion amount is limited to $2 million.[7]

Illinois Sales Tax: Click-Through Nexus or "Amazon Rule"

As expected, Illinois has followed the lead of New York, North Carolina, and Rhode Island by adopting its own "Amazon rule" under HB 3659.[8] The "Amazon rule" typically targets an Internet retailer without physical presence in a particular jurisdiction that utilizes Web site owners residing in the jurisdiction to advertise for the Internet retailer, in return for a commission on sales resulting from the followed link. A presumption of taxability exists if the Internet retailer generates more than $10,000 through these referrals during the last four quarterly sales tax periods. It is important to note that the Illinois bill does not provide any opportunity for the retailer to rebut any nexus presumption. A "retailer maintaining a place of business in this State" includes:

> a retailer having a contract with a person located in this State under which the person, for a commission or other consideration based upon the sale of tangible personal property by the retailer, directly or indirectly refers potential customers to the retailer by a link on the person's internet website. The provisions of this paragraph 1.1. shall apply only if the cumulative gross receipts from sales of tangible personal property by the retailer to customers who are referred to the retailer by all persons in this State under such contracts exceed $10,000 during the preceding 4 quarterly periods ending on the last day of March, June, September and December.[9]

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[6] *Prior to the enactment of SB 2505, required annual payments for all periods were the lesser of 90% of the tax shown on the return for the taxable year, or if no tax return is filed, 90% of the tax for such year, or 100% of the tax shown on the return of the taxpayer for the preceding taxable year if a return showing a liability for tax was filed by the taxpayer for the preceding taxable year and such preceding year was a taxable year of 12 months.*

[7] *See generally SB 2505, specifically the section enacted as 35 ILCS 405/2 (definition of "State tax credit"). The allowable credit is calculated without the reduction in the state death tax credit as provided in section 2011(b)(2) or the termination of the state death tax credit as provided in section 2011(f) as enacted by the Economic Growth and Tax Relief Reconciliation Act of 2001.*

[8] *See generally New York's Amazon rule at N.Y. TAX LAW § 1101(b)(8)(vi); TSB-M-08(3)S, New York State Department of Taxation and Finance, May 8, 2008; TSB-M-08(3.1)S, New York State Department of Taxation and Finance, June 30, 2008.*

[9] *See generally Illinois House Bill 3659.*

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OTHER CONSIDERATIONS

Given the tax landscape and timing of the tax changes, taxpayers should consider the impact of the new provisions on their current income and sales and use tax status and positions, including for financial statement income tax provision purposes. Fiscal-year taxpayers should pay close attention to the application of the various methods available to compute their Illinois income tax and account for specific NOL limitations as well.

Additionally, taxpayers should take note of certain provisions that were excluded from the bills but that could still be considered by the Illinois legislature or Illinois Department of Revenue prospectively, including the following:

- **Unpaid Corporate Income Tax Refunds** – The tax community expected certain provisions mandating the state to borrow funds for the purposes of paying approximately $900 million in corporate income tax refund claims. The Act did not address funding of corporate income tax refunds. It is unclear how Illinois will ultimately resolve this issue.

- **Federal Bonus Depreciation** - SB 2505 did not address the federal 100% bonus depreciation provisions recently enacted under the Tax Relief, Unemployment Insurance Reauthorization, and Jobs Creation Act of 2010. The Illinois Department of Revenue had previously issued unfavorable administrative guidance to corporate taxpayers by requiring an addback modification for 100% bonus depreciation with no corresponding subtraction modification.[10] Subsequently, however, the Department withdrew the guidance.

  Current Illinois law provides that Illinois taxpayers are required to add back the 100% bonus depreciation to base income, but also receive a corresponding subtraction modification for the same amount. This result occurs because the Illinois statutes generally require a subtraction modification where the taxpayer continues to own an asset in its last year of depreciation (year 1, because all depreciation is allowed in one taxable year) for which an addback modification was required (see above).[11]

- **Services Taxable** - Neither SB 2505 nor HB 3659 imposes a sales tax on services. In several prior bills over the last few years, Illinois has proposed taxing approximately thirty services. Should the Illinois budget not improve, the taxation of services could become a topic for discussion in the future.

- **Franchise Tax Elimination** – The elimination of the onerous Illinois franchise tax was also excluded from the bills despite extensive discussions among representatives of the Taxpayers' Federation of Illinois, the Secretary of State, and other governmental agencies voicing taxpayers' concerns about inconsistent practices administering the tax and the difficulty of complying with the tax over the last few years. It is unclear what reform, if any, will be effectuated in the future regarding the franchise tax.

[10] *See Informational Bulletin FY 2011-07 (December 2010).*
[11] *See 35 ILCS 5/203 (E-10) (bonus depreciation addback modification), (T) (bonus depreciation subtraction modification), (U) (bonus depreciation subtraction modification).*