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## *Illinois: Changes to franchise tax apportionment rules?*

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In March 2011, the Illinois Secretary of State, via revisions to franchise tax form instructions, modified the way the capital is apportioned to the state. The secretary on April 28, 2011, withdrew the revised form from its website, but indicated an intention to pursue the revisions through the administrative rule-making process. In addition, the secretary agreed to establish a commission to consider how to revise the franchise tax in the future. Taxpayers should take note that the March 2011 revisions may significantly impact their franchise tax liability.

The revisions, which were incorporated into the form instructions without prior notice, would have changed the way certain components of the property and business transacted (i.e., receipts) factors were sourced for apportionment purposes. Most notably, the revisions would have replaced the “lock box” property factor sourcing rule with a “location of control” property factor sourcing rule for intangible investments evidenced by notes, securities or other certificates. In addition, the revisions would have modified the property factor sourcing rule for miscellaneous intangible property by eliminating the requirement that such property be primarily used in the state before being included in the property factor numerator. The revisions would have also modified the sourcing rule for property that arises from the acquisition of a business located in Illinois. Changes to the sourcing of receipts would have included expanding the definition of Illinois receipts to include sales from service contracts accepted in Illinois. In addition, the revisions would have eliminated sourcing rules specific to dividends and interest from subsidiaries.

[[Illinois Form BCA 1.35, Allocation Factor Interrogatories](#), March 2011]



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## Franchise tax

The corporate franchise tax is administered by the Illinois Secretary of State in accordance with the provisions of the Business Corporation Act of 1983 ("Business Corporation Act"), as amended. (805 ILCS 5/15.05) The tax is based on Illinois paid-in capital apportioned to the state via a two-factor formula based on property and business transacted (i.e., receipts). (805 ILCS 5/15.40) While there are no regulations or rules per se, secretary of state guidance regarding the computation of the franchise tax is set forth in various form instructions (i.e., interrogatories), including Form BCA 1.35, which contains the sole published guidance on how the franchise tax allocation/apportionment factor should be computed.

## Property factor changes

Prior to revision in March 2011, BCA 1.35 set out a physical location ("lock box") rule, which stated that investment intangible property evidenced by notes, securities, or certificates was Illinois property if such notes, securities, or certificates were located in the state. Simply stated, provided the tangible manifestation of intangible property was located outside of Illinois, the property was included in property factor denominator but not the numerator. The March 2011 revised Form BCA 1.35 would have eliminated the lock box rule and sourced investment intangible property evidenced by notes, securities, or certificates based on where the property is administered, managed or controlled.

In addition to eliminating the lock box rule, the March 2011 version of Form BCA 1.35 would have modified rules dealing with the sourcing of intangible property arising from the acquisition of a business. Historically, the form provided that Illinois property included intangible property arising from the acquisition of a business if the property arose from the acquisition of a business located in Illinois. The March 2011 version would have narrowed the focus of the acquisition rule to Goodwill. Accordingly, the revisions would have required that all other property that arises from the acquisition of a business be sourced using other rules applicable to real, tangible and intangible property.

The revised form would have also modified the property factor sourcing rule for miscellaneous intangible property by eliminating a provision that defines Illinois property to include property *primarily* used in the state. Rather, the March 2011 version would have included in Illinois property miscellaneous intangible property to the extent such property is acquired, produced or used in Illinois. The revisions did not provide any guidance as to how a taxpayer would determine the extent to which miscellaneous intangible property is used in a state.

## Business transacted factor changes

Changes to the sourcing of receipts would have included adding a requirement that sales from a service contract be included in the numerator if the contract was accepted in Illinois. Accordingly, as revised, Form 1.35 would have required service receipts to be included in the numerator if the income-producing activity was performed in the state, the contract for services was accepted in the state, or the performance of service was administered, managed or controlled in the state.

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The revisions would have eliminated rules specific to the sourcing of dividends and interest from subsidiaries, which are defined as entities more than 10 percent owned. Historically, dividends and interest from a subsidiary were sourced based on where the subsidiary primarily conducted its business. Given that the revised form would have no longer specified rules for the sourcing of dividends and interest from subsidiaries, such income would have been sourced based on rules generally applicable to investment income, which looked to the location from which the investments are administered, managed or controlled.

### **Questions remain regarding scope of secretary's power?**

The Business Corporation Act generally provides that the secretary has the power and authority reasonably necessary to administer the franchise tax and may issue guidance in the form of interrogatories to clarify the provisions of the franchise tax statute. ([805 ILCS 5/1.35](#))

Despite the above authority, when the March 2011 form was issued, questions arose as to whether the secretary could replace long-standing apportionment rules simply by issuing an amended form without prior notice. Specifically, the issue was whether the secretary's action fell under the definitions of "rule" and "rulemaking" contained in the Illinois Administrative Procedure Act. ([5 ILCS 100/1-1, et. seq.](#)) In general, the Administrative Procedure Act requires that any agency statement of general applicability that interprets law or policy, including valid "rulemaking" actions, be accompanied by official notice of intended action followed by at least 45 days of available public comment period. ([5 ILCS 100/1-9](#); [5 ILCS 100/5-4](#))

Given the withdrawal of the revised form, it appears that the secretary questioned whether the Business Corporation Act and the Illinois Administrative Procedure Act granted authority to revise existing apportionment rules absent adherence to the rule making guidelines.

### ***PwC Observes***

“The changes to the sourcing of property and receipts could substantially impact a taxpayer’s Illinois franchise tax liability,” observes Christopher Tobin, SALT Director with PwC in Chicago. Given the indications that the secretary will likely pursue changes to the franchise tax apportionment rules, and consider other revisions in the future, taxpayers are well advised to stay informed about the secretary’s actions.

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