

ILLINOIS CORPORATE TAX “LOOPHOLE” LEGISLATION SIGNED

Introduction

On August 16, 2007, Illinois Governor Blagojevich signed into law Senate Bill 1544, the FY2008 Budget Implementation (Revenue) Act (“Bill 1544”), to amend various provisions of the Illinois Income Tax Act. Bill 1544 generally eliminates Illinois income tax benefits from structures and transactions that enable companies earning income from Illinois sources to “shelter” such income through the use of intercompany transactions with related parties doing business outside the State. The key provisions of the new law (Public Act 95-0233) include the following that generally apply to taxable years ending on or after December 31, 2008:

- All partnerships, trusts and S-corporations will be required to withhold an amount equal to business income allocated to each nonresident partner, S-corporation shareholder or trust beneficiary multiplied by the Illinois rate of tax for such nonresident partner, S-corporation shareholder or trust beneficiary, whether or not such income is distributed;
- In computing taxable income in Illinois, taxpayers will be required to add back insurance premiums, interest, royalties, intangible expenses or costs paid, accrued or incurred directly or indirectly to any related party qualifying as a member of the same unitary business group;
- New apportionment rules will apply to service revenues and income derived from transportation services and airline services;
- New apportionment rules will apply to financial organizations, which includes a rule that eliminates the lockbox rule for the location of the receipt of interest;
- Dividends paid to a corporate shareholder by a captive real estate investment trusts (a “REIT”) will no longer be deductible;
- Illinois net operating loss carryovers for cancellation of debt income otherwise excluded in bankruptcy will be reduced; and
- The deduction for tax-exempt income on bonds and other indebtedness will be reduced by an amount equal to the premium amortization attributable to such bond or indebtedness, interest expense incurred on the bond or other obligation, expenses incurred in producing the income to be deducted and all other related expenses.

In addition, an amnesty program will be in place from February 1, 2008, to March 15, 2008, that will allow taxpayers to pay any unpaid and owing franchise taxes and license fees without interest or penalties for the four (4) most recent years for which the taxes or fees are due.

Withholding by Partnerships, S-Corporations and Trusts

For each taxable year ending on or after December 31, 2008, every partnership (other than a publicly traded partnership under Section 7704 of the Internal Revenue Code of 1986, as amended (the “Code”)), S-corporation and trust must withhold from each nonresident partner, shareholder, or trust beneficiary an amount equal to the distributable share of the business income of the partnership, S-corporation, or trust apportionable to Illinois of that partner, shareholder, or trust beneficiary under Sections 702 and 704 and Subchapter S of the Code, whether or not distributed, multiplied by the applicable rates of tax for that partner, shareholder or trust beneficiary under the Illinois Income Tax Act. The new withholding requirements do not apply to a partner, shareholder, or trust beneficiary included on a composite return filed by the partnership, S-corporation or trust for the taxable year.

Any amounts withheld are credited to the partner, trust beneficiary or S-corporation shareholder as having been made on the last day of the taxable year such person incurred liability with respect to the income.

Under Bill 1544, amounts withheld must be paid no later than the due date (without regard to extensions) of the tax return of the partnership, S-corporation, or trust for the taxable year. For a calendar year taxpayer, the first withholding payments will be due in 2009. If such amounts are not withheld by the partnership, S-corporation or trust, but are, however, paid by the individual partner, s-corporation shareholder or trust beneficiary, the partnership, s-corporation or trust is relieved of its liability with respect to such amounts but not of liability for

penalties and interest.

New Add-Back Provisions

In computing taxable income in Illinois, taxpayers will be required to add back interest, royalties, or intangible expenses or costs paid, accrued or incurred directly or indirectly to certain related parties. In general, foreign related persons of a taxpayer with at least 80% of its business activities outside the United States are excluded from such taxpayer's unitary business group; however, in 2004, the Illinois Income Tax Act was amended to eliminate this exception and create an add-back of interest, royalties or intangible expenses or costs paid accrued or incurred, directly or indirectly, to a foreign related person that would otherwise have been part of the taxpayer's unitary group but for 80% of the foreign related person's business activities being outside the United States. Under Bill 1544, for taxable years ending on or after December 31, 2008, the add-back rule is expanded to include payments made directly or indirectly to any domestic related person who otherwise would have been part of a taxpayer's unitary business group but for the domestic related person being excluded from the taxpayer's unitary business group because it is ordinarily required to apportion business income under a different apportionment formula.

In addition, Bill 1544 includes a new add-back rule for insurance premium expenses and costs paid, accrued or incurred, directly or indirectly, to an insurance company that otherwise would have been part of a taxpayer's unitary business group but for the insurance company being excluded from the taxpayer's unitary business group.

In all instances in which the new add-back provisions apply (payment of interest, royalties, intangible expenses and costs and insurance premiums), the related entity will be entitled to a subtraction equal to such add-back. In addition, the add-back is reduced to the extent that dividends were included in base income of the unitary business group for the same taxable year and received by the taxpayer or by a member of the taxpayer's unitary business group with respect to the stock of the same person to whom the intangible expenses and costs were directly or indirectly paid, incurred or accrued.

As a result of these modifications, a multistate taxpayer will no longer be able to reduce its Illinois income tax liability by transferring interest, royalties, intangible expenses or costs or insurance premiums to a nonresident related party that is part of such taxpayer's unitary business group.

New Apportionment Rules

Apportionment Rules for Sales of Services

Under current Illinois tax law, sales of services in Illinois are allocated under the cost of performance method. Bill 1544 provides a shift from the cost of performance method for sales of services in Illinois (other than sales of patents, copyrights, trademarks and similar intangible personal property and gross receipts from the license, sale or the disposition of patents, copyrights, trademarks and similar items of intangible personal property). Under Bill 1544, for taxable years ending on or after December 31, 2008, sales of such services will be taxable in Illinois if the purchaser is in Illinois or "the sale is otherwise attributable to this State's marketplace." Further, Bill 1544 provides, "if the benefit of the service is realized both within and without Illinois," the gross receipts from the sale will be divided among those states in which the taxpayer is taxable in proportion to the benefit of service realized in each state.

The Illinois Department of Revenue may adopt rules prescribing where the benefit of specific types of services, including, but not limited to, telecommunications, broadcast, cable, advertising, publishing, and utility service, is realized.

Apportionment Rules for Transportation Services (Other than Airline Services)

Under Bill 1544, the apportionment formula for business income derived from providing transportation services in Illinois (other than airline services) will be modified for taxable years ending on or after December 31, 2008. Under current Illinois tax law, the amount of income derived from providing transportation services that is apportioned to Illinois is determined by multiplying such income by the ratio of the revenue miles of the taxpayer in Illinois to the revenue miles of the taxpayer everywhere. Under Bill 1544, for taxable years ending on or after December 31, 2008, the amount of income derived from providing transportation services that is apportioned to Illinois is the ratio of (a) gross receipts from the shipment of people, goods, mail, oil, gas or any other substance (other than by airline) in Illinois to (b) total gross receipts from shipment of such items, determined on a mileage basis. Under Bill 1544, the gross receipts in Illinois will be equal to (x) all receipts from any movement or shipment of such items that both originates and terminates in Illinois, plus (y) that portion of the taxpayer's gross receipts from movements of such items passing through, into, or out of Illinois determined by the ratio of the miles traveled in Illinois to total miles from point of origin to point of destination. Further, if a taxpayer derives business income from activities in addition to transportation services (other than airline services), the income from such other activities will be apportioned separately under the applicable provisions of the Illinois Income Tax Act.

Apportionment Rules for Airline Services

Bill 1544 will also modify the apportionment formula used to calculate business income derived from providing airline services in Illinois. For taxable years ending on or after December 31, 2008, the amount of income derived from providing airlines services to be apportioned to Illinois is equal to the ratio of "arrivals of aircraft to and departures from this State weighted as to cost of aircraft by type" to "total arrivals and departures of aircraft weighted as to cost of aircraft by type."

Apportionment Rules for Financial Organizations

Under current Illinois tax law, business income of a financial organization is apportioned to Illinois on a cost-of-performance method and is calculated as the ratio of business income from sources within Illinois to business income "from all sources." Under current Illinois tax law, business income derived from interest is included as income within Illinois only to the extent the interest is received in Illinois from Illinois customers. This current provision has allowed many financial organizations to take advantage of the "lockbox rule," which allows a financial organization (even if such financial organization has offices in Illinois) to receive most interest outside of Illinois and, in turn, avoid paying Illinois tax on such interest income. Bill 1544 moves away from the cost-of-performance method to a market-based approach and eliminates the lockbox rule. Under Bill 1544, for taxable years ending on or after December 31, 2008, interest income of a financial organization apportioned to Illinois is equal to the amount of such income multiplied by the ratio of gross receipts from "all sources in this State or otherwise attributable to this State's marketplace" to "gross receipts everywhere during the taxable year." Further, Bill 1544 modifies the definition of "gross receipts" to mean "gross income, including net taxable gain on disposition of assets, including securities and money market instruments, when derived from transactions and activities in the regular course of the financial organization's trade or business." If a taxpayer derives business income from activities in addition to the provision of financial services, the income from such other activities will be apportioned separately under the applicable provisions of the Illinois Income Tax Act.

Bill 1544 includes specific examples of how to apportion various types of business income of financial organizations. Such examples include (but are not limited to) the following:

- Receipts from the lease or rental of real or tangible personal property are in Illinois if the property is located in Illinois during the rental period;
- Receipts from the lease or rental of tangible personal property that is characteristically moving property

(e.g., motor vehicles, rolling stock, aircraft, vessels, or mobile equipment) are from sources in Illinois to the extent that the property is used in Illinois;

- Interest and other income on loans secured primarily by real estate or tangible personal property are from sources in Illinois if the security is located in Illinois;
- Interest and other income on an unsecured loan are from sources in Illinois if the borrower is a resident of Illinois;
- Interest and other income from unsecured commercial loans and installment obligations are from sources in Illinois if the proceeds of the loan are to be applied in Illinois;
- Interest and other income from credit card receivables are in Illinois if card charges are regularly billed to a customer in Illinois; and
- In the case of a financial organization that accepts deposits, receipts from investments and from money market instruments are apportioned to Illinois based on the ratio that the total deposits of the financial organization from Illinois to total deposits everywhere. Deposits are attributed to Illinois whether or not the deposits are accepted or maintained by the financial organization at locations within Illinois.

A more complete list of examples is included in the full text of Bill 1544. Finally, a special apportionment rule for international banking facilities is repealed for taxable years ending on or after December 31, 2008.

Elimination of deductibility of captive REIT dividends

In general, under federal tax laws, the taxable income of a REIT is reduced by a deduction for dividends paid by the REIT to its shareholders under Section 857(b)(2)(B) of the Code. Under Bill 1544, for taxable years beginning after December 31, 2008, dividends paid to a corporate shareholder by a captive REIT will no longer be deductible in Illinois. Thus, the dividends paid by the REIT to its corporate shareholders that may be deductibles by the REIT for federal income tax purposes must be added back to the REIT's Illinois taxable income. Note that this provision, unlike the remainder of the new rules, applies to taxable years "beginning after December 31, 2008" (rather than taxable years ending on or after December 31, 2008).

Further, Bill 1544 amends the definition of captive REIT. The new definition of captive REIT includes privately held REITs of which more than 50% of the voting power or value of the

beneficial interest of shares is owned or controlled by a single corporate entity (other than another REIT that is not also a captive REIT, a REIT that intends to become public, a tax-exempt organization and a listed Australian property trust).

Reduction of Net Operating Loss Carryovers

Under current Illinois tax law, Illinois treatment of net operating loss ("NOL") carryovers does not necessarily follow federal treatment of NOL carryovers. In this regard, cancellation of indebtedness in bankruptcy or due to insolvency under Section 108 of the Code results in a federal reduction of NOL carryovers and/or other tax attributes. However, under current Illinois tax law, the federal reduction does not automatically apply to reduce Illinois NOL carryovers.

Under Bill 1544, for each year ending on or after December 31, 2008, an Illinois taxpayer will be required to reduce its NOL carryovers of debt discharged in bankruptcy or due to insolvency in an amount equal to the apportioned share of the reduction required under Section 108(b)(2)(A) of the Code.

Modification to Deduction for Tax-exempt Income on Bonds and Other Indebtedness

Under current Illinois tax law, the deduction for certain tax-exempt income on bonds and other indebtedness is reduced by an amount equal to premium amortization attributable to such bond or other indebtedness. Under Bill 1544, for taxable years ending on or after December 31, 2008, the deduction for tax-exempt income on bonds and other indebtedness will continue to be reduced by an amount equal the premium amortization attributable to such bond or indebtedness and will also be reduced by an amount equal to interest expense incurred to carry the bond or other indebtedness, expenses incurred in producing the income to be deducted, and any other related expenses.

Franchise Tax and License Fee Amnesty Act of 2007

Bill 1544 creates an amnesty program for taxpayers owning any franchise taxes or license fees. Under the amnesty program, from February 1, 2008 to March 15, 2008, taxpayers are permitted to pay their unpaid franchise and licenses taxes without penalties and interest. Taxpayers are only required to pay unpaid franchise taxes and license fees that would have been payable during the most recent 4-year period.

Further Assistance

The foregoing is intended only for general information purposes. If you have questions regarding Bill 1544 or other provisions of the Illinois Income Tax Act, feel free to contact the Goldberg Kohn attorneys with whom you work, or Goldberg Kohn attorneys, Gerald Jenkins 312.201.3902, Stephen Legatzke 312.201.3911, or Lisa Lauer 312.201.3904.

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