

THE ILLINOIS CORPORATE INCOME TAX

The corporate income tax is an important tool for state tax progressivity. In the 45 states that levy one, a corporate income tax helps offset the regressivity of the property and sales taxes which make up the bulk of state and local tax revenues. Illinois lawmakers have enacted a set of specialized tax breaks that undercut this important tax base. Before enacting any further tax incentives, policy makers should investigate whether the existing tax incentives are achieving their desired effect—and whether these tax breaks are undermining the equity of the state corporate income tax by creating the phenomenon of zero-tax corporations.

Advantages of the Corporate Income Tax

Unique among the major taxes levied by state governments, the corporate income tax is a progressive tax that is largely exported to residents of other states. Both of these traits—its progressivity and its exportability—are due to the fact that corporate income taxes are generally passed through to owners of corporate stock.

Since stock ownership is concentrated among the very wealthiest taxpayers, the corporate income tax is one of the most progressive taxes a state can levy.

Because many corporations with Illinois operations have shareholders throughout the nation, the burden of the corporate income tax is distributed to other states depending on where shareholders live. The ability to export part of the corporate income tax burden in this way is important because out-of-state shareholders benefit indirectly from the public services provided to Illinois corporations.

The corporate income tax is a relatively recent addition to the Illinois tax structure. Introduced in 1969 along with the personal income tax, the corporate income tax is levied at a flat rate of 4.8 percent. The ability of Illinois lawmakers to raise the corporate tax rate is limited because the Illinois constitution requires a flat-rate corporate income tax, and limits this rate to 180 percent of the rate on personal income.

In theory, the Illinois corporate income tax is based on corporate profits. Yet because the state closely follows federal corporate income tax rules, the tax base is subject to many loopholes that allow

corporations to pay far less than they would if they were being taxed on actual profits. And Illinois lawmakers have enacted their own additional corporate tax breaks that further erode the tax base, including a single sales factor provision that greatly reduces the amount of corporate income attributable to Illinois for some large corporations which sell heavily outside the state, and a host of tax credits and deductions that can be used to reduce state tax liability.

The Single Sales Factor

States can only tax corporate income that is reasonably related to the activities of the corporation within its boundaries. This means that states must distinguish between in-state and out-of-state taxable income. In general, states have accomplished this by computing the proportion of a firm’s total sales, property, and payroll located in the state. The percentage of in-state taxable income is then calculated as the average of these three proportions. This “three-factor” formula has been the approach to corporate income apportionment most frequently used by states since the 1950s.

Corporate Income Apportionment				
	Property	Payroll	Sales	Total
Standard				
Three-factor	1/3	1/3	1/3	1
Illinois Pre-2000	1/6	1/6	2/3	1
Illinois Post-2000	0	0	1	1

In recent years, two deviations from the three-factor approach have become more common: heavier weighting of one of the three factors, and entirely eliminating one or more factors. Before 2000, Illinois’s system took the former approach by double-weighting the sales factor; since 2000, Illinois has eliminated the property and payroll factors, going to the *single sales factor* (SSF) approach. The goal of the 1999 legislation creating the single sales factor formula was to encourage the growth of manufac-

turing industries in the state. Since SSF reduces the income tax burden on firms that have a relatively large share of their payroll and property in Illinois while making most of their sales out of state, this approach might seem tailored toward encouraging the growth of Illinois industry. However, any positive effect this move might have on manufacturing industries is probably offset by two factors:

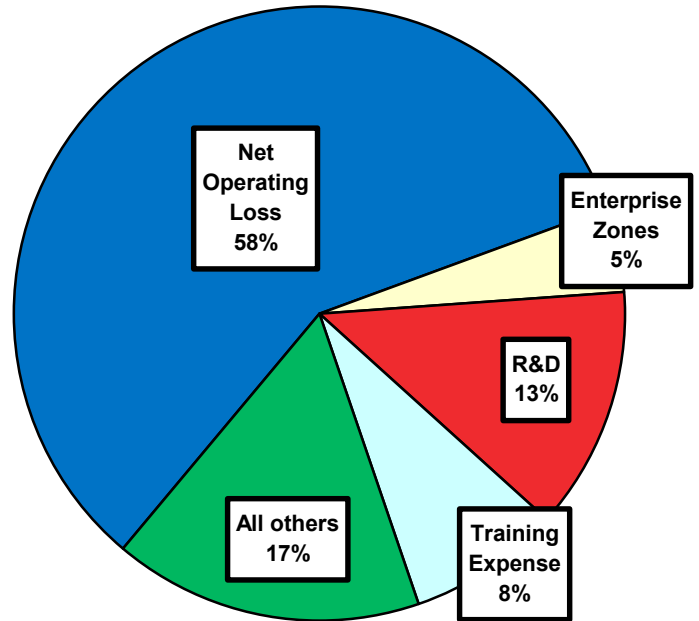
- Every other neighboring state now applies a higher weight to the sales factor.²⁹ As surrounding states move toward uniformly adopting the single sales factor, the locational incentive generated by SSF in any particular midwestern state will disappear, since the rest of them already offer the same incentive. The unhappy result of this race to the bottom is that states offering the single sales factor pay all of its costs in the form of reduced corporate income tax revenues, but enjoy none of the locational incentives SSF is said to offer.
- For each corporation that benefits from SSF because most of its sales are out of state, there are other corporations that will be punished by SSF because their sales are mostly *in* Illinois. Smaller corporations that tend to make most or all of their sales within Illinois will actually experience a tax *increase* under the single sales factor—hardly the wisest approach to economic development. As a result, adoption of the SSF ultimately benefits some corporations while punishing others in an arbitrary way.

Perhaps most troubling, there is some evidence that the tax benefits from the single sales factor may be dominated by a few of the very largest manufacturers. One 1997 analysis found that more than 60 percent of the tax reductions from the single sales factor change would accrue to a small group of five corporations.³⁰

²⁹Among neighboring states, Iowa and Missouri use the single sales factor. Michigan apportions 90 percent of in-state income according to sales—as close as a state can get to enacting a single sales factor without actually doing it. Indiana, Wisconsin and Kentucky use a double-weighted sales formula, and legislation enacted in 1999 (HF 2420) changed Minnesota’s formula from 70-15-15 to 75-12.5-12.5 (where the 75% is sales).

³⁰Copley News Service, Apr. 27, 1998, Bernard Schoenburg.

Corporate Tax Breaks in Fiscal 2000



Illinois Tax Breaks: Bang for the Buck?

Since 1991, Illinois has allowed corporations to claim a *Research and Development tax credit* based on the federal R&D credit. The credit is 6.5 percent of qualifying research and development expenditures—that is, a dollar-for-dollar reduction of a company’s corporate income tax bill equal to 6.5 percent of eligible research and development expenses. This credit reduced state tax collections by \$27 million in fiscal year 2000.

The theory behind the R&D credit is that it encourages corporations to engage in research and development expenditures that will produce useful technological innovations, new products, and therefore new jobs. Unfortunately, the credit has three critical problems.

First, a credit that rewards risky yet innovative research must determine what such research looks like. Yet federal rule-makers have struggled for the past fifteen years to come up with a sensible test for eligible research. The uncertainty surrounding these eligibility rules on the federal level is a problem for Illinois, since the state credit borrows from the federal credit’s rules.

Second—and more important—the R&D credit, like all credits designed to encourage particular corporate behaviors, may often reward firms for engaging in investments or research that they would have done anyway if the credits did not exist. There

is no test to verify that the research would not have taken place “but for” the credit.

Third, there is no guarantee that the real jobs resulting from the new products will be created in Illinois. Indeed, a pharmaceutical company taking credit for research in Naperville may patent a product and produce it in El Paso or Singapore.

Illinois corporations are also allowed a generous *net operating loss deduction*. This provision allows corporations to apply any unused deductions against future tax liability and (to a lesser extent) past tax liability. Illinois corporations can carry operating losses back two years and forward twenty years. Each of these provisions is generous by comparison to the rules used by many other states. More than half of the 45 states with corporate income taxes allowed a carryback of less than two years in 2001—and 25 did not allow net operating loss carrybacks at all. Similarly, the 20-year carryforward allowed by Illinois is more generous than 21 other states.

The net effect of the various tax credits used to reduce Illinois corporate income tax liability is to narrow the tax base substantially. The Department of Revenue estimates that in fiscal year 2000, Illinois corporations claimed tax breaks equal to almost fifteen percent of corporate income tax collections. Just four of the largest tax breaks—the net operating loss deduction, the R&D tax credit, the enterprise zone investment credit, and the training expense credit—accounted for more than 80 percent of these tax expenditures in fiscal year 2000. By itself, the net operating loss deduction accounted for more than half of these corporate tax breaks.

Do Corporate Tax Incentives Work?

These tax breaks erode the state’s corporate income tax base. But supporters of these breaks often argue that to focus on the direct revenue loss from these tax breaks is to miss the point entirely: the stated goal of these tax loopholes is usually to encourage economic growth in Illinois. Still, there is little empirical evidence to suggest that the level of state taxation has a measurable impact on a state’s economic well-being—or on the location decisions made by businesses. One comprehensive review³¹ of the economic literature on this issue found that:

³¹*Do State and Local Tax Incentives Work?*, Robert G. Lynch, Economic Policy Institute, 1996.

- There is no evidence that state and local tax cuts, when paid for by reducing public services, either stimulate economic activity or create jobs.
- There is little indication that state and local tax levels affect business location decisions.
- Factors such as the cost and quality of labor, the quality of public services (schools, roads and highways, sewer systems, recreational facilities, higher education, health services, etc.), the proximity to markets, and the access to raw materials and supplies are more important than tax incentives in business location decisions.
- There is little evidence that job losses or job transfers from one state to another are a consequence of business tax incentives.

Although it is hard to quantify any effect that corporate tax breaks may have on economic development, it is comparatively easy to determine the effect these breaks have on state revenues, as the following chart demonstrates. However, there is little information available about how these tax breaks affect individual corporations.

Do Illinois Corporations Pay Their Fair Share?

Even as the overall importance of corporate income tax revenues have declined nationally, an increasing number of horror stories are being told about the impact of federal tax breaks on individual companies.

Federal Corporate Income Taxes Paid by Navistar, 1996-1998				
	1996	1997	1998	3 year total
Profit Before Tax (\$-millions)	\$ 106	\$ 236	\$ 400	\$ 742
Federal Income Tax	\$ 1	\$ 8	\$ 4	\$ 13
Effective Tax Rate	0.9%	3.4%	1.0%	1.8%

Source: "Corporate Income Taxes in the 1990s," ITEP (October 2000), <http://www.itepnet.org/corp00pr.htm>

A recent ITEP analysis of 250 of the largest and most profitable corporations in America found that 133 of these corporations—more than half—paid

less than half of the nominal federal corporate income tax rate of 35 percent in at least one year between 1996 and 1998, and that 41 of these companies actually received net tax rebates from the federal government during this period. The same federal loopholes also have an effect on the tax payments of Illinois corporations.

The ITEP analysis was made possible by the fact that publicly held corporations must disclose information about their federal corporate income tax payments to shareholders and the Securities and Exchange Commission (SEC). As a result, we know that some large Illinois-based employers have been able to take advantage of loopholes in the federal corporate income tax. For example, ITEP's study found that Warrenville-based Navistar Corporation earned \$742 million in pretax profits between 1996 and 1998, but paid just \$13 million in federal income taxes. The effective tax rate paid by Navistar during this three-year period was 1.8 percent—far below the statutory federal rate of 35 percent, and substantially lower than the average effective tax rate paid by low-income Illinoisans estimated in Chapter Two of this study.

If Navistar and 132 other corporations were this successful in reducing their tax liability through completely legal tax loopholes on the federal level, it seems reasonable to assume that corporations may be finding loopholes at the state level as well. Unfortunately, neither the SEC nor most state governments require corporations to release information on the loopholes they have claimed.

The Illinois Department of Revenue's annual "Tax Expenditure Report" is an important step toward greater transparency and accountability in the process of making Illinois tax policy, because it reports the aggregate cost of the tax breaks enjoyed by corporations operating in Illinois. Without the Tax Expenditure Report's wealth of information on these tax breaks, we would know very little about the extent to which the corporate tax base has been reduced by these loopholes. Yet this data tells us nothing about the taxpaying behavior of individual corporations (or about the amount of tax credits each corporation claims), so it is currently difficult to know how big an impact these loopholes are having on the effective tax rate paid by profitable in-state corporations.

As a result, it's not currently possible to determine whether the loopholes described here have spawned an epidemic of state tax avoidance. However, the recent downturn in federal corporate tax payments, combined with the introduction of the single sales factor in Illinois, suggests that more open disclosure of state corporate tax information might be warranted. As ITEP's Good Jobs First project has documented, nine states now require corporations to disclose some information about the state or local tax breaks they receive. Most recently, in the fall of 2001 North Carolina legislators amended the state's tax-subsidy law to require extensive company-specific reporting of tax credits. The disclosure requirements cover tax credits for training, research and development, and machinery and equipment credits. It also requires disclosure, when a company claims development zone credits, of how many of the new jobs went to zone residents. This sort of disclosure requirement could help Illinois lawmakers determine the overall effect of these tax breaks on individual companies' tax-paying behavior.

Conclusion

The Illinois corporate income tax is an important source of tax progressivity. In the absence of a healthy corporate income tax, state lawmakers must increase their reliance on other tax sources—including individual income and property taxes. Sadly, in recent years Illinois has joined the race to the bottom among midwestern states offering broad, uneven corporate tax breaks that fail to ensure their stated goals of economic development.

Data from the Department of Revenue allow us to confirm that these tax breaks substantially reduce the corporate income tax base—forcing the state to look elsewhere for needed tax revenues in an economic slowdown. But we know very little about which companies have benefitted most from these tax breaks, and therefore it is impossible to know if they have fostered job creation or retention. As the specter of widespread corporate tax avoidance reappears on the federal level, Illinois lawmakers should assess the aggregate impact of these corporate tax breaks on individual corporations by requiring disclosure of state tax incentives.