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Illinois Corporate Income Tax- Financial Organizations

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Financial organizations in Illinois are required to follow different apportionment rules than general service providers. Prior to December 31, 2017, such businesses were also required to file separate unitary business returns from taxpayers that filed their income tax returns under the standard apportionment rules. Beginning with the tax year ending December 31, 2017, however, financial organizations must be included in the combined return with the entire unitary business group.[1] It is therefore crucial for taxpayers to understand the nuances as to how to calculate the apportionment factor for financial organizations in Illinois.

Identifying Financial Organizations

The threshold issue in apportioning income of financial organizations is determining whether an entity is in fact a "financial organization" under Illinois law. The term "financial organization" means "any bank, bank holding company, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, building and loan association, credit union, currency exchange, cooperative banks, small loan company, sales finance company, investment company, or any person which is owned by a bank or bank holding company."[2] Illinois regulations provide a number of "characteristic services" that help illustrate the types of activities in which these financial organizations may engage. Although the definition of "financial organization" appears clear, it nonetheless occasionally raises problems.

In 2017, the Illinois Tax Tribunal addressed whether a particular entity qualified as a financial organization. In that case, the entities at issue provided short term loans to businesses which used those loan proceeds to finance their commercial property and casualty insurance premium obligations. The entities earned income by charging financing fees on the loans, and were regulated by the Premium Financing Regulation Act.[3] The taxpayer contended that these entities should not have been treated as financial organizations, but instead as general corporate organizations because they were in the business of financing insurance, not for funding purchases of tangible personal property or services. The Tribunal ultimately concluded that "a company which is in the business of making loans for the express purpose of funding purchases of insurance can be considered a 'sales finance company' and, therefore, a 'financial organization[.]'".[4] The entities were therefore treated as "sales finance companies" and were subject to the apportionment rules for financial organizations.

When an entity is engaged in a combination of financial organization activities and other types of activities, the Illinois Department of Revenue requires that the business be "predominantly engaged" in financial activities. For this to be the case, the financial organization must earn more than 80% of its gross income, averaged over a period of three years, from activities characteristic of one or more of the categories of financial organizations.[5] In the case of sales finance companies, only 50% of gross income must be earned from such activities. For purposes of this analysis, finance leases are treated as extensions of credit rather than true leases, and engaging in such leasing activity should qualify for the financial organization characterization.

Apportionment of Financial Organization Income

Once it has been established that an entity qualifies as a financial organization for Illinois apportionment purposes, it must apportion its income using a single gross receipts factor.[6] Consistent with the state's transition to market based sourcing in 2008, the apportionment for financial organizations generally looks to the location of the market for the financial services. This approach is not always intuitive. It is also important to keep in mind that unlike the sale of services or tangible personal property, Illinois does not impose a throwback or throwout rule for financial organizations.

First, receipts from the lease or rental of real or tangible personal property should be sourced to the state in which the property is located. Interest income, commissions, fees, gains on disposition, and other receipts from assets in the nature of loans that are secured by real or tangible property should be sourced to the state in which the property is located. Interest income, commissions, fees, gains on dispositions, and other receipts from consumer loans not secured by property should be sourced to the state in which the debtor is a resident. Interest income, commissions, fees, gains on disposition, and other receipts from commercial loans and installment obligations that are not secured by property must be sourced to the state in which the proceeds of the loan are to be applied. If that location cannot be determined, the office of the borrower from which the loan was negotiated should govern. Interest income, fees, gains on disposition, service charges, merchant discount income, and other receipts from credit card receivables must be sourced to the state where the credit card charges are regularly billed to the customer. Receipts from fiduciary, advisory, brokerage, and other related services are sourced to the location where the services are received, and receipts from travelers checks and money orders are sourced to the state where they are issued. [7]

Perhaps the most complex category of revenue, receipts from investment assets must be sourced according a number of different rules. Interest, dividends, net gains, and other income from investment assets must be sourced to a fixed place of business. This location must be the location where the taxpayer has its "preponderance of substantive contacts." The state has provided a presumption that the proper location will be the location where the taxpayer has assigned, in the regular course of its business, such activity on its records to a fixed place of business consistent with federal or state regulatory requirements.[8] It is therefore important for such taxpayers to adequately document in their books and records the location from which the taxpayer manages its investments.

Conclusion

As the above rules demonstrate, financial organizations' Illinois apportionment rules reflect a combination of market based sourcing and income producing activity concepts. This, of course, makes sense in light of the fact that many financial activities, such as investing, do not necessarily have a "market." Moreover, it is often very difficult to discern the location where a financial service is in fact received. As financial organizations must now be included in the same Illinois unitary return as other services providers, it is important that businesses understand the extent to which some or all of their businesses may be Illinois financial organizations and the resulting differences in how such businesses' receipts must be apportioned to the state.

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[1] IL Public Act 100-0022.

[2] 35 ILCS 5/1501(a)(8)(A).

[3] *Premier Auto Finance, Inc. v. Illinois Dep't of Rev.*, 15 TT 175 (9/7/2017).

[4] *Id.*

[5] 86 Ill. Admin. Code 100.9710(b).

[6] 35 ILCS 5/304(c).

[7] 35 ILCS 5/304(c)(i)-(vii).

[8] 35 ILCS 5/304(c)(viii).