Closing Corporate Loopholes, Bolstering Illinois' Budget

by Thomas Cafcas
and Greg LeRoy

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www.goodjobsfirst.org
1616 P Street NW #210
Washington, DC 20036
202-232-1616

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Summary

By reforming four corporate tax loopholes—three involving how taxable corporate income is computed and another that allows stores to "skim" from consumers' sales tax payments—Illinois could have bolstered its revenue by about $1.5 billion over fiscal years 2011, 2012 and 2013. As a measure of how ill-equipped Illinois' tax code is, it leads the nation in revenue lost to three of the four loopholes detailed here.

Closing the four loopholes would make Illinois' rules more consistent with many other states and generate badly needed revenue to sustain investments in education, infrastructure and other public goods that are proven winners for long-term job creation and income growth.

1. Decoupling on Depreciation and Deductions—instead of passively allowing temporary federal rules to dictate how quickly companies can take depreciation charges against taxable profits, Illinois could be requiring companies to depreciate investments at traditional rates. The Center on Budget and Policy Priorities last year estimated that Illinois stands to lose $1.01 billion over three years to this loophole; no state is losing more. Closing a similar "domestic production" loophole could raise $103 million per year.

2. Capping or Eliminating the Sales Tax "Vendor Discount"—an obscure vestige of pre-computer tax law allows Illinois retailers to keep 1.75 percent of the sales tax revenue they collect from consumers. No state loses more than Illinois to this needless loophole: it cost the state $109 million in 2010 and likely costs more now as retail sales recover. The loophole apparently allowed Wal-Mart alone to keep more than $9 million in Illinois during FY 2011. About half the states have no vendor discount at all, and about a fourth cap the dollar amount each company can retain.

3. Repealing Single Sales Factor—enacted amidst promises that it would boost factory employment, this gimmick likely gave enormous windfalls to the state's very largest manufacturers, with no strings attached, while costing the state $63 million a year at last estimate. Meanwhile, the state has continued to hemorrhage manufacturing jobs—even from companies that lobbied for the loophole.

Decoupling From Federal Accelerated Depreciation

Three times since the 2001 recession, the federal government has sought to stimulate capital investment by enacting temporary rules allowing for "accelerated depreciation." That is, instead of directing companies to expense the cost of new machinery and equipment over its expected useful life, the special rules allow companies to charge half or even all of such expenses in the year they were made.

Most recently, as part of the federal tax compromise enacted in December 2010, Uncle Sam allowed companies to expense 100 percent of eligible investments made between September 8, 2010 and December 31, 2011. For expenses incurred in 2012, a "bonus depreciation" of 50 percent applies, with normal depreciation schedules thereafter. However, there are now bipartisan proposals in Washington to extend 100 percent depreciation, retroactively starting January 1, 2012, which would cost Illinois even more lost revenue.

Forgoing revenue in the short term to help stimulate the economy is possible for the federal government because it is allowed to run a deficit. But for the states, with their balanced-budget requirements, such a revenue loss during a recession would only force deeper budget cuts. That's why most states have "decoupled" from the federal tax changes each time, requiring companies to use normal depreciation schedules when computing their taxable income.

However, 18 states remain passively tied to the federal rules, including Illinois, and these states are losing an estimated $4.6 billion in state corporate and individual income tax revenue over the fiscal years of 2011, 2012 and 2013. That revenue loss would grow sharply if additional bonus depreciation proposals in Congress become law. Illinois is projected to be by far the biggest loser: a 2011 Center on Budget and Policy Priorities paper estimated the state's three year cost at more than **$1 billion**.[1] That number would grow if 100% depreciation gets extended.

To close this tax loophole, Illinois could do what about half the states do to protect themselves from the vagaries of federal rules: decouple and adopt an enduring rule on depreciation independent from federal definitions. (The remaining several states that are not passively tied or decoupled don't tax corporate profits.)

Small businesses in Illinois would likely not be affected by decoupling because a separate and permanent federal tax provision, which states including Illinois conform to, allows small companies to expense 100 percent of investments the year they are made.

Another revenue-draining loophole harming Illinois' budget—also because Illinois has failed to fully decouple—is from the domestic production deduction.[2] Beginning in 2004, this federal tax break lets companies deduct a broad array of "qualified production activities." Again, like depreciation, some states including Illinois passively allow Uncle Sam to redefine taxable income. In 2010, it was estimated to cost 25 states a total of $500 million each year. Again, Illinois loses more than any other state, with an estimated revenue loss of **$103 million**.[3]

Capping or Eliminating the Sales Tax "Vendor Discount"

In an obscure bit of tax history dating back to the Great Depression, just over half the states allow retailers to keep a little of the sales tax they collect as a sort of handling fee. This "vendor discount" costs these states about $1 billion per year in lost revenue.[4]

About half of the states with a vendor discount fail to cap the dollar amount any one retailer can keep, Illinois among them. Given the size of its economy and the generosity of its vendor discount rate (at 1.75 percent of dollars collected), Illinois loses far more to this loophole than any other state—a total of $1,145,536,000 over the past ten years, or about **$115 million** in an average year.[5]

Prior to the recession, Wal-Mart was estimated to be receiving about $60 million a year nationwide from this loophole, with more than $8 million of that coming from Illinois alone.[6] In FY 2011, Wal-Mart reported that it collected $552,600,000 in sales tax in Illinois, suggesting that Wal-Mart was legally entitled to keep about $9.7 million due to the vendor discount (equal to almost 9 percent of the total Illinois revenue lost in FY 2010 [7] and up from less than 7 percent prior to the recession, apparently reflecting the mega-retailer's growing market share).[8]

Nobody likes paying taxes, but taxpayers should at least be able to take comfort in knowing that the taxes they pay at the cash register are supporting education, health care and public safety. Few retail customers in Illinois realize that some of their sales tax payments effectively are retained by the store.

By capping or eliminating the vendor discount, Illinois could close this corporate loophole and return millions in sorely needed revenue to the State.

Repealing Single Sales Factor

How'd you like to change the way you compute your taxable income so that your state income tax bill drops 70 or 80 percent? All in the name of jobs, of course, except you don't have to create—or even retain—any jobs. That's the net effect of Single Sales Factor, a loophole deal large manufacturers (and sometimes other industries) have lobbied for and won in more than 20 states.

Here is how the Single Sales Factor loophole works. Historically, the states agreed upon a system using three factors, or variables, to divvy up (or apportion) the taxable income of multi-state corporations among the states. First, the share of its payroll the company has in a state; second, the share of its property in a state; and third, the share of its sales that occur in a state.

A hypothetical Illinois firm under that traditional system might have looked like this. Say it was a consumer goods manufacturer with its headquarters and largest factory in the state, and it sold its products in all 50 states. If it had 40 percent of its payroll and 40 percent of its property in Illinois, and sold 4 percent of its goods in Illinois, then its Illinois apportionment computation looked like this:

$$\frac{40\%\ (\text{payroll}) + 40\%\ (\text{property}) + 4\%\ (\text{sales})}{3} = 28 \text{ percent}$$

So if the company had $100 million in nationwide profits, it would report $28 million to Illinois and pay the Illinois tax rate on that much of its income.

But after Single Sales Factor phased in, the same company would compute its Illinois taxable income using only one variable—sales. The computation would be:

$100 million X 4 percent = $4 million

In other words, the company's tax bill declined by 86 percent, no strings attached.

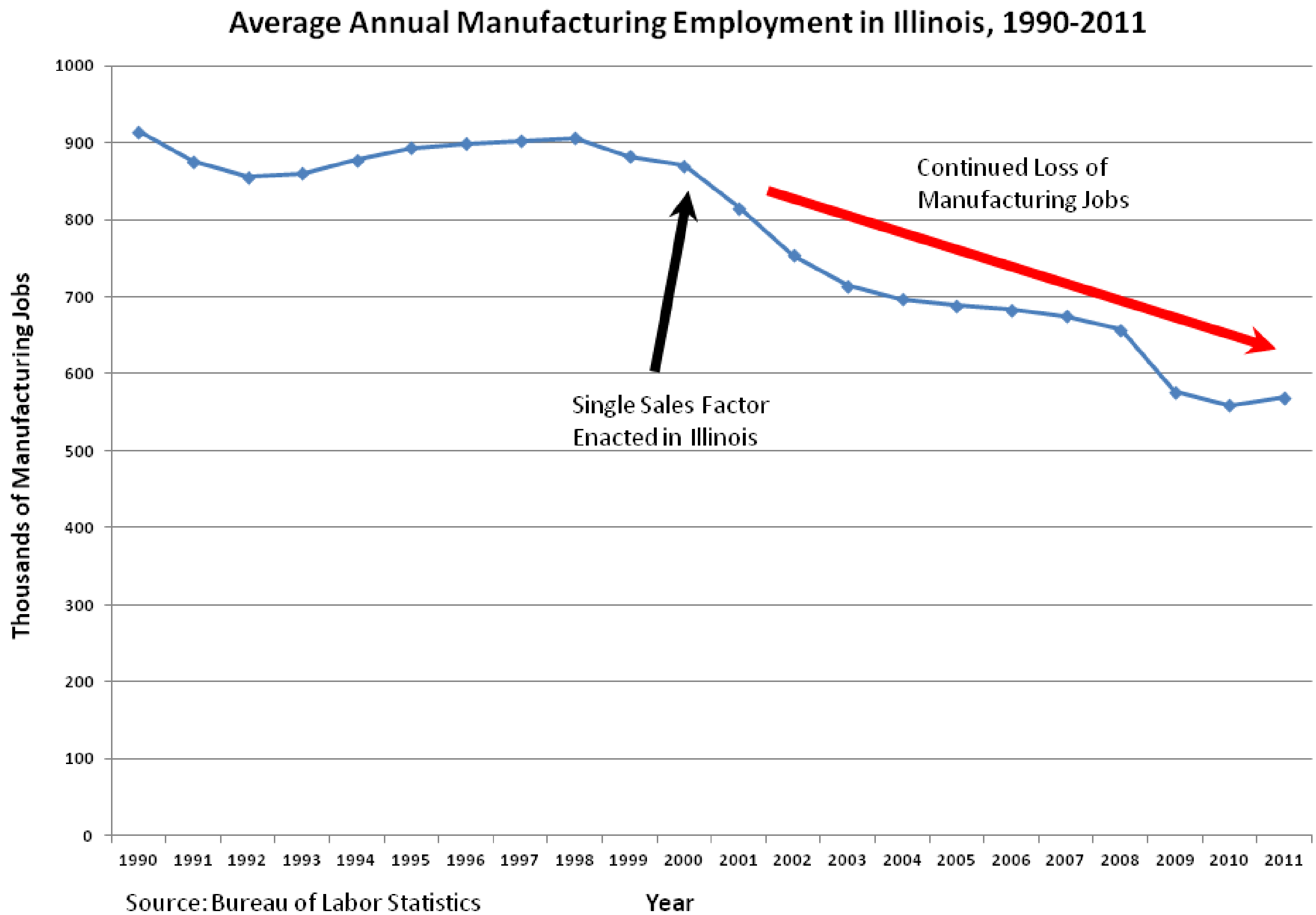
(This drastic reduction in the taxable <u>base</u> for certain large Illinois firms was poorly understood by the news media in 2011 when the state raised the corporate income tax <u>rate</u>, and a controversy ensued. For firms that resemble the hypothetical company described above, a change in the tax rate matters little if that rate applies to such a small base.)

Small Illinois businesses that produce and sell only in-state gained no benefit from Single Sales Factor (since all of their factors were 100 percent before and after). But a handful of the state's largest manufacturers probably got enormous (though undisclosed) tax cuts. In fact, as the state legislature debated Single Sales Factor, the state's revenue department estimated that just six big companies would get 60 percent of the tax-break dollars.[9]

The Illinois Manufacturers Association and individual corporations advocated for Single Sales Factor by arguing that it would create more manufacturing jobs. The state has instead lost an enormous share of its factory jobs. All that can be said for sure about Single Sales Factor is that it has cost the state treasury dearly. The Illinois Bureau of the Budget estimated that in FY 2000, Single Sales Factor reduced total corporate income tax revenues by **$63 million**.[10] No study has been conducted since to determine whether that number has increased.

However, there is evidence from one of the state's economic development subsidy programs that suggests Single Sales Factor is reducing some companies' income tax bills to very low levels. Specifically, as the *Chicago Tribune* has documented, more than half of the companies awarded income tax credits under the Economic Development for a Growing Economy (EDGE) program don't actually claim their credits because they don't have any tax liability.[11] Low profits or losses during the recent recession may explain that fact in some years, but Single Sales Factor is also likely a major cause.

Perhaps the state could afford to lose some revenue if jobs were created, but Single Sales Factor has not delivered on creating manufacturing jobs in Illinois. In fact, as the chart on the following page displays, since the enactment of Single Sales Factor, manufacturing job loss has accelerated in Illinois.



Remarkably, many of the companies that reportedly lobbied for Single Sales Factor in Illinois have since laid off large numbers of workers in the state, according to official notices issued by the companies as required under the federal Worker Adjustment and Retraining Notification (WARN) Act.

The following companies lobbied for Single Sales Factor or were reported to have been major beneficiaries[12] but have had major layoff events since it went into effect:

Company	Total Announced Layoffs Since 1999[13]	Number of Layoff Events
Abbott Labs	792	2
Amoco/BP[14]	1,833	5
Archer Daniels Midland[15]	125	2
AT&T/SBC/Ameritech[16]	1,368	14
Caterpillar	972	2
Kraft/Nabisco[17]	991	5
Motorola	5,589	15
Nalco Chemical	145	1
R.R. Donnelly	398	4
Total:	**12,213**	**50**

Source: State of Illinois, DCEO, WARN Act Filings; Online at: http://www.ildceo.net/dceo/Bureaus/Workforce_Development/WARN/

Endnotes

[1] Ashali Singham and Nicholas Johnson, "States Can Avert New Revenue Loss and Protect Their Economies by Decoupling from Federal Expensing Provision," Center on Budget and Policy Priorities, April 14, 2011. Online at: http://www.cbpp.org/files/3-1-11sfp.pdf

[2] Section 199 of the federal Internal Revenue Code.

[3] Nicholas Johnson and Ashali Singham, "States Can Opt Out of the Costly and Ineffective "Domestic Production Deduction" Corporate Tax Break," Center on Budget and Policy Priorities, January 14, 2010. Online at: http://www.cbpp.org/files/7-29-08sfp.pdf

[4] Philip Mattera with Leigh McIlvaine, "Skimming the Sales Tax: How Wal-Mart and Other Big Retailers (Legally) Keep a Cut of the Taxes We Pay on Everyday Purchases," Good Jobs First, November 2008. Online at: http://www.goodjobsfirst.org/sites/default/files/docs/pdf/skimming.pdf

[5] Illinois Tax Expenditure Budgets, 2001 through 2010. Online at: http://www.ioc.state.il.us/index.cfm/resources/reports/tax-expenditure/

[6] Mattera and McIlvaine, op cit.

[7] Wal-Mart only reported the sales taxes it collected for the 2011 fiscal year. The Illinois Comptroller has not yet released the state's 2011 tax expenditure report. Thus, we divided Wal-Mart's FY 2011 figure by the state's total reported figure for 2010.

[8] "Walmart collected on behalf of the state of Illinois more than $552.6 million in sales taxes in FYE 2011." See Wal-Mart's Website online at: http://walmartstores.com/pressroom/StateByState/State.aspx?st=IL

[9] Jeff McCourt and Greg LeRoy, "A Better Deal for Illinois: Improving Economic Development Policy," Good Jobs First, January 2003. Online at: http://www.goodjobsfirst.org/sites/default/files/docs/pdf/il.pdf

[10] Illinois Bureau of the Budget, Quarterly Financial Report for FY00, Second Quarter FY00, p. 7. In 2003, the Bureau of the Budget was renamed the Governor's Office of Management and Budget.

[11] Alejandra Cancino. "State's Economic Development for a Growing Economy Program More about Maintaining than Growing Jobs." *The Chicago Tribune*. November 6, 2011. Online at: http://articles.chicagotribune.com/2011-11-06/business/ct-biz-1106-edge-tax-credits--20111106_1_greg-leroy-jobs-pat-quinn

[12] See pages 23-24, McCourt and LeRoy, op cit.

[13] Former Governor Jim Edgar signed Single Sales Factor into law in 1998. Companies were therefore aware of the ensuing tax changes to come that were phased in 2000 through 2002.

[14] Amoco and BP merged in 1998.

[15] This includes the closure of Gooch Foods, Inc. in 2001, a subsidiary of Archer Daniels Midland.

[16] Ameritech merged with SBC in 1998. SBC bought AT&T in 2005.

[17] Kraft acquired Nabisco in 2000.