Personal Property Replacement Tax
Allocation Error

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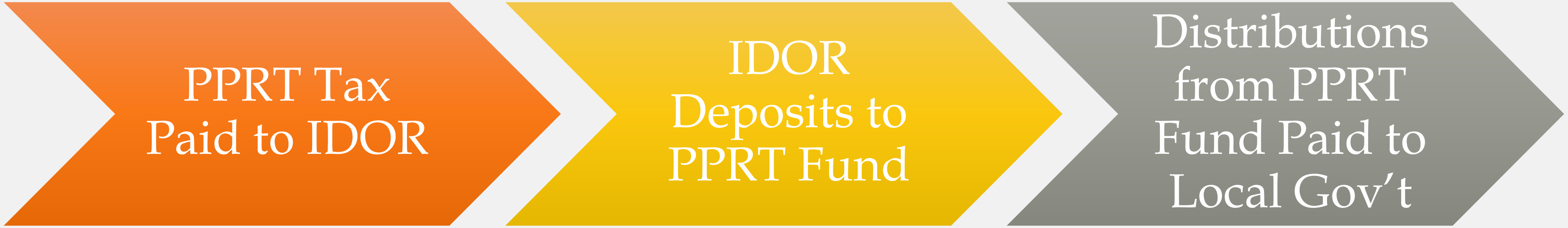
Background – Personal Property Replacement Tax

- Personal Property Replacement Taxes (PPRT) are revenues collected by the State of Illinois, and paid to local governments, to replace money that was lost by local governments when their powers to impose personal property taxes on corporations, partnerships, and other business entities were abolished in the 1970 Constitution.

- Business entities pay PPRT to the Department of Revenue throughout the year by making estimated payments, extension of time to file payments, and final payments with their income and replacement tax returns.

Background *(Continued)*

- The revenues received are deposited into a special State fund known as the ***Personal Property Replacement Tax Fund***.
- Distributions are made from this fund to local governments eight times per year coinciding with the timing of the revenues received by the Department of Revenue.



Law Change #1 (Public Act 95-707)

- S-corporations, partnerships, and trusts pay Illinois replacement tax.
- Shareholders, partners, and beneficiaries (owners) of these entities are required to pay Illinois tax on the income they derive from the entities.
- The owners can be residents of other states. It was discovered that some of the nonresident owners were not filing Illinois income tax returns and the State was not collecting the taxes owed.
- A new law (Public Act 95-707) became effective for tax years ending on or after December 31, 2008. This law requires S-corporations, partnerships, and trusts to make Illinois income tax payments on behalf of nonresident shareholders, partners, and beneficiaries.
  - These payments are known as pass-through withholding.
  - These income tax payments are not distributed to the PPRT Fund.

Law Change #1 *(Continued)*

- Form IL-1000 was created as the mechanism for entities to make pass-through withholding payments on behalf of their owners to the Department of Revenue. If those nonresident owners had no other Illinois liability, they were not required to file their own income tax returns with Illinois.

- The IL-1000 did not allow for a refund. This meant that if the taxpayer over withheld for their owners on Form IL-1000 the only way for the owners to get the money back was to file their own Illinois income tax return, thus defeating one of the purposes of the form.

- In addition, because the IL-1000 was separate from the entity's replacement tax returns, many entities did not know they needed to file the IL-1000.

Law Change #2 (Public Act 98-478)

- Public Act 98-478 became effective January 1, 2014.
- This Act adjusted the reporting of pass-through withholding to be reported and paid directly on the following tax returns:
  - Form IL-1120-ST (S-corporations),
  - Form IL-1065 (Partnerships), and
  - Form IL-1041(Trusts).
- The intent of the law change was to allow for a refund on the return if the taxpayer over withheld for its owners. A supporting schedule was required to be attached to the return having all of the owner information in one place to allow for improved tracking and reporting.
- In addition, the change also resulted in the elimination of a number of forms (including the IL-1000) to make the payment and filing process simpler for taxpayers.

Tax Classification

- The forms were consolidated as a result of the law change.
- The system captured the pass-through withholding payments as replacement tax rather than income tax.
- This misclassification was discovered during our review.
- The majority of replacement tax is paid by C-corporations. Those entities do not pay pass-through withholding. The payments received from these entities have been properly classified as replacement tax.
- S-corporations, partnerships, and trusts pay pass-through withholding in addition to replacement tax.
  - ***These pass-through withholding payments are the taxes that were misclassified as replacement tax and subsequently distributed to local governments.***
- The misclassification represents approximately 6% of total distributions.

Timing of Returns and Payments

Filing of returns:

- S-corporations, partnerships, and trusts file annual returns with the Department.
- S-corporation returns are due by March 15th following the end of the calendar year. Partnership and trust returns are due by April 15th.
- S-corporations are permitted to extend the filing of their returns by as much as seven months, partnerships and trusts by six months, pursuant to Illinois regulations.
- Many of these entities elect to extend their returns meaning the Department may not receive them until October.

	Return Due	Return Extension Due
S-Corporation	March 15	October 15
Partnership	April 15	October 15
Trust	April 15	October 15

Timing of Returns and Payments *(Continued)*

Tax Payments Received:

- The tax system is structured by statute on a pay-as-you-go basis. Payments are received throughout the year from taxpayers as they earn income.
- Monies are received via estimated prepayments (four times per year), extension payments at the original due date of the return, and final payments when the return is filed.

Prepayments Received:
4x per year

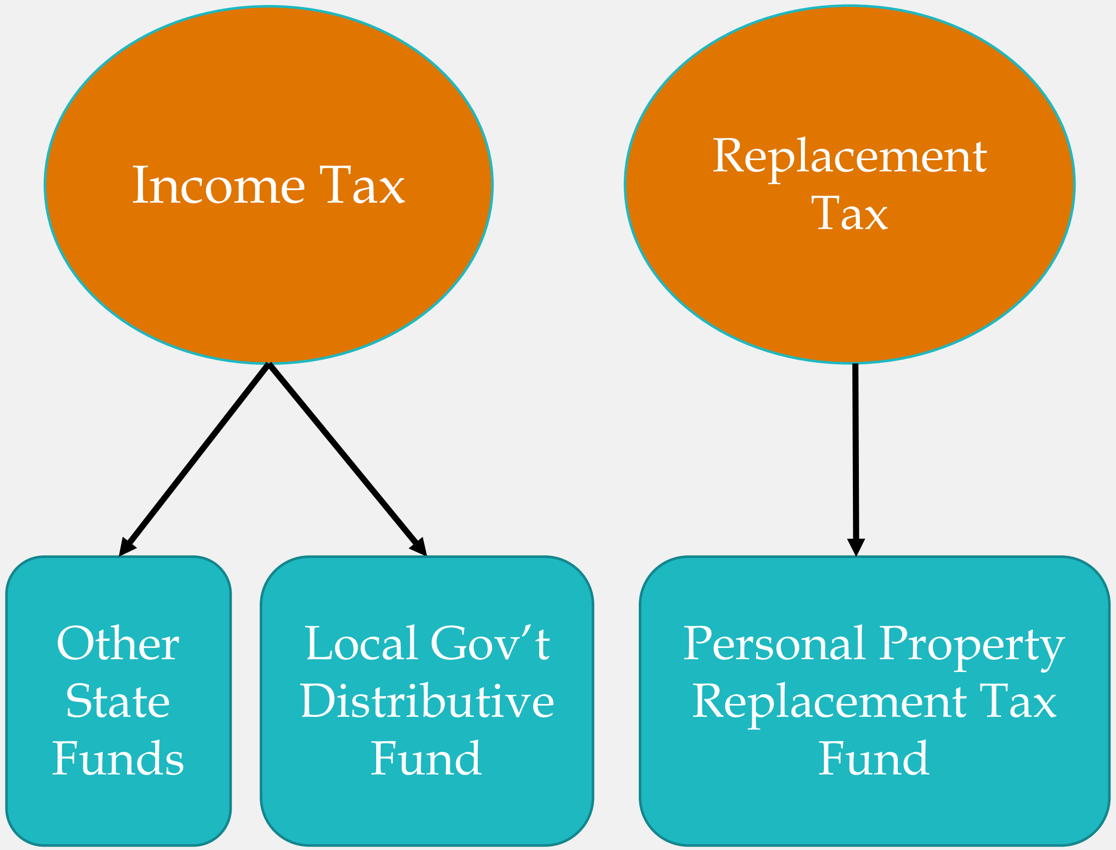
Extension Payments Due:
Date of Return

Final Payment Due:
When Return is Filed

Timing of Fund Deposits

Depositing money into proper funds:

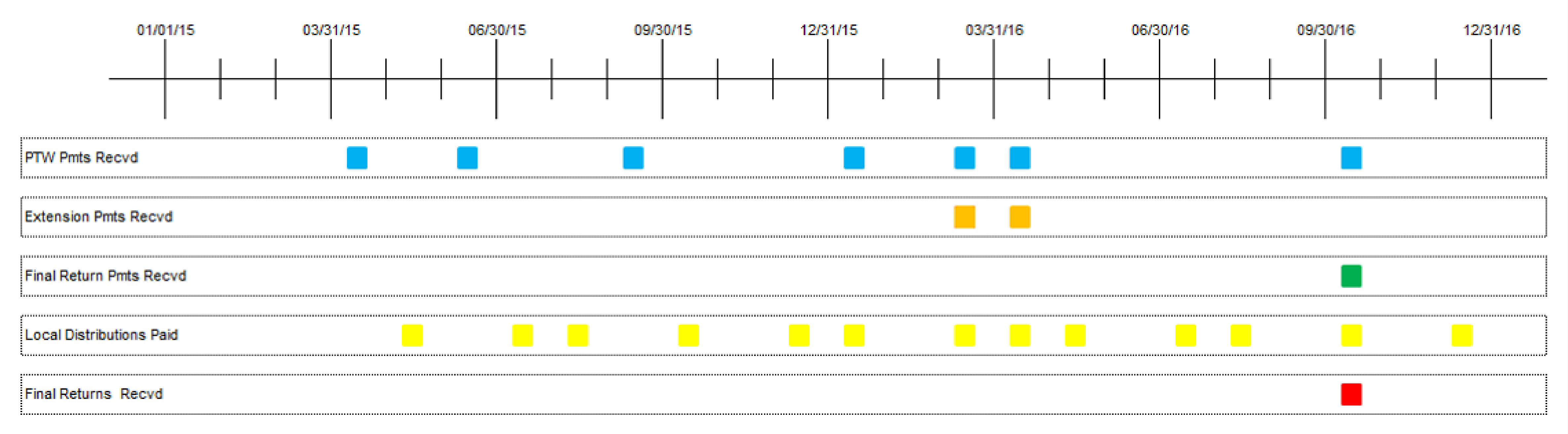
- The Income Tax Act directs the Department to deposit taxes collected into specific State funds.
  - Replacement tax is deposited in the Personal Property Replacement Tax Fund.
  - Regular income tax is deposited into other funds, including the Local Government Distributive Fund.
- Payments received from S-corporations, partnerships, and trusts throughout the year can be for their own liability (replacement tax) and/or for pass-through withholding (individual income tax, corporate income tax, or replacement tax).



Timing of Fund Deposits *(Continued)*

- The breakdown is not provided to the Department until the tax returns are received.
- Consequently, the Department must estimate the tax types that the payments apply to at the time of the payment and deposit the payments into PPRT and other funds accordingly.
- A reconciliation occurs later when the returns are received and the actual tax type classifications are known. Fund deposits, including PPRT, are adjusted at that time.

Timing of Deposits, Distributions, and Returns



- Payments received are initially classified and deposited as PPRT using historic data.
- Distributions to local governments occur the following month using the same historic data.
- The returns, with the information necessary to accurately classify PPRT, are received as much as 18 months later.
- A reconciliation and “true-ups” occur afterwards.

Where Are We Now?

- An estimated $168 million of income tax was misclassified as replacement tax.
- The $168 million estimate includes both TY2014 and TY2015 returns. The Department of Revenue has the TY2014 returns and is in the process of reconciling the information now. The reconciliation will be provided to the Office of the Auditor General for review.
- Many of the TY2015 returns have been extended. They will be received some time between now and October 2016 as taxpayers complete and file them. Reconciliations will be performed during this time as returns are received to calculate the actual amount of the TY2015 misclassification.
- The reconciled information from the TY2014 returns will be used to improve the estimation process for TY2015 and TY2016 payments to more accurately classify payments as they are received.