

General Information Letter: Sourcing of membership fees under new sales factor statutes discussed.

August 1, 2008

Dear:

This is in response to your letter dated July 1, 2008, in which you request a General Information Letter (GIL). A GIL is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 86 Ill. Adm. Code 1200.120(b) and (c), which may be accessed from the Department's web site at www.Iltax.com.

Your letter states as follows:

This letter is a request for a general information letter on the application of the new sourcing rules under the Illinois Income Tax to web-based discount membership clubs. A detailed description of the clubs is set forth below.

Facts

The Company we represent (the "Company") is a multistate corporation that provides internet based ("web-based") discount membership programs/clubs to members throughout the United States. It has no office, facilities, property or personnel in Illinois. Rather, its headquarters is located in STATE1 with some computer services also located in STATE2.

To become a member of one of the Company's membership programs/clubs, a person must sign up over the internet. Moreover, the Company also solicits members through contracts with web-based service providers and sellers which allow the Company to solicit the customers of such sellers and service providers to become members in the Company's various membership programs/clubs. The company occasionally sends representatives into Illinois to sign up web based providers. (The company itself is not a shopping club or organization that sells tangible personal property.) In the Company's membership programs/clubs, for a monthly membership fee, the members receive membership privileges and benefits, such as discounts to hundreds of third-party attractions, restaurants, hotels, car rentals and air fares, best price guarantees protection, delivery guarantees, road and towing protection, credit card fraud protection and theft and loss protection on the member's internet purchases. Some of the additional membership benefits offered include access to the member's credit report, daily credit report monitoring services and identity theft protection. Notably, any services accessible by a club's member are normally provided by a third party vendor with whom the Company contracted for the benefit of such club's members.

The seven Membership Programs/Clubs are listed below:

1. Club A – provides up to 50% discount at hundreds of attractions, restaurants, retailers, service providers and cinemas for members. The membership benefits also include trip delay, hotel over-booking, baggage delay and loss, road and towing protections.
2. Club B – provides up to 50% discount on hundreds of hotels, up to 25% discount on car rentals, the receipt of road and tow protection, up to \$500 savings (discounts) on airfare and hotel fire/theft protection.

3. Club C – provides discounts and rebates at hundreds of online merchants. It also provides best price guarantee protection of up to \$100 per claim on the difference between the price paid by a member to various retailers and any lower price offered by those retailers within 90 days. Other benefits include delivery guarantees, and protection for credit card fraud and unauthorized charges. It also automatically protects any members' qualifying purchases from retailers, by giving the members free extended limited warranty protection on their purchase equal to the original warranty period provided by the manufacturer. In addition, damage, theft and loss protection is provided for purchases for 90 days.

4. Club D – provides essentially the same benefits and privileges as Club C, except it does not provide discounts and rebates at hundreds of online merchants.

5. Club E – provides free unlimited online credit report access to a member, as well as daily credit monitoring service. The credit report information is available through a third party credit card reporting agency. A \$25,000 Identity Theft Insurance and \$1,000 in credit card loss and theft protection is included. Dispute forms and tools and assistance services are also provided to assist members in correcting any inaccuracies in their credit reports.

6. Club F – provides a twenty-four (24) hour concierge service, discounts at national amusement parks and movie theaters, reimbursement for an approved magazine subscription, discounts on hotel and car rentals, and travel related protections including trip delay, hotel overbooking, hotel fire/theft, baggage delay and loss, travel accident insurance and credit card fraud protection.

Issue

1. Are the gross receipts generated from the membership dues paid to the clubs required to be sourced based on the location of the customers of the clubs or the income-producing activity of the clubs?

2. If the income-producing activity test is used, would none of the membership fees be sourced to Illinois, since all of the Company's officers, property, and employees that manage the club's websites are located outside of Illinois?

3. If the customer receipt location is used, would the home address of the customer be used for sourcing purposes?

Law

35 ILCS 304(a)(3)(C-5)(iii)(b) – the sale of intangible personal property is in Illinois, if:

“the income-producing activity of the taxpayer is performed in this State or, if the income-producing activity of the taxpayer is performed both within and without this State, if a greater proportion of the income-producing activity of the taxpayer is performed within this State than in any other state, based on performance costs.

35 ILCS 304(a)(3)(C-5)(iv) –

“Sales of services are in this State if the services are received in this State. For the purposes of this section, gross receipts from the performance of services provided to a corporation, partnership, or trust may only be attributed to a state where that corporation, partnership, or trust has a fixed place of business. If the state where the services are received is not readily determinable or is a state where the corporation, partnership, or trust receiving the service does not have a fixed place of business, the services shall be deemed to be received at the location of the office of the customer from which the services were ordered in the regular course of the customer’s trade or business. If the ordering office cannot be determined, the services shall be deemed to be received at the office of the customer to which the services are billed. If the taxpayer is not taxable in the state in which the services are received, the sale must be excluded from both the numerator and the denominator of the sales factor. The Department shall adopt rules prescribing where specific types of service are received, including, but not limited to, broadcast, cable, advertising, publishing, and utility service.”

Analysis

According to the new sourcing rules in the Illinois Income Tax, if the Company’s web-based discount membership clubs sell intangible rights and benefits, the gross receipts from such memberships are required to be sourced based on the location of the income-producing activity of the Company. On the other hand, if the web-based membership club is selling a service, then the customer’s receipt location is used for sourcing purposes.

It would appear that the essence of the Company’s web-based discount membership service is the sale of intangible rights and benefits. In ST-99-0037-GIL (1/12/1999), the Department of Revenue (“DOR”) held that sales of business membership fees to obtain various benefits and account services is not subject to sales tax since “a membership fee is considered an intangible.” Likewise, in ST-99-0028-GIL (1/08/1999), the DOR, in a Telecommunications Tax opinion, concluded that the purchase of a membership “which enabled purchasers to take advantage of member services” was not taxable since such sales represented “sales of intangibles.” See *also* ST-05-0016-GIL (1/28/2005) (Hotel Tax) (“a membership fee is considered an intangible”). See *similarly Dine Out Tonight Club v. Dept. of Revenue Services*, 210 Conn. 567 (1989) (true object of dining membership was conveyance of intangible rights).

In addition, the Company has received opinion letters from other states that have concluded that its fees are considered from sales of intangibles. See *e.g.* California Board of Equalization, Opinion Letter dated June 21, 2006 (attached).

Moreover, it is significant that a member can elect to access or use a wide range of benefits, including access to some services (performed by third parties) as a member. Therefore, a member may never access and use any third party services, but rather may only use discounts or other intangible benefits as part of his or her membership. In that regard, the member can access and receive such benefits almost anywhere in the United States.

Based on the above, it would appear that the Company’s web-based discount membership club fees are sourced based on their income-producing activity under Section 304(a)(3)(C-5)(iii)(b). If that is correct, in that all of the Company’s costs and activities in managing the website providing the intangible benefits occur outside of Illinois, none of the membership fees

would appear to be sourced to Illinois. Please confirm if you agree.

RULING

Section 304(a)(3)(C-5) of the Illinois Income Tax Act ("IITA" ; 35 ILCS 5/304(a)(3)(C-5)) states:

For taxable years ending on or after December 31, 2008, sales, other than sales governed by paragraphs (B), (B-1), (B-2), and (B-5), are in this State if any of the following criteria are met:

(i) Sales from the sale or lease of real property are in this State if the property is located in this State.

(ii) Sales from the lease or rental of tangible personal property are in this State if the property is located in this State during the rental period. Sales from the lease or rental of tangible personal property that is characteristically moving property, including, but not limited to, motor vehicles, rolling stock, aircraft, vessels, or mobile equipment are in this State to the extent that the property is used in this State.

(iii) In the case of interest, net gains (but not less than zero) and other items of income from intangible personal property, the sale is in this State if:

(a) in the case of a taxpayer who is a dealer in the item of intangible personal property within the meaning of Section 475 of the Internal Revenue Code, the income or gain is received from a customer in this State. For purposes of this subparagraph, a customer is in this State if the customer is an individual, trust or estate who is a resident of this State and, for all other customers, if the customer's commercial domicile is in this State. Unless the dealer has actual knowledge of the residence or commercial domicile of a customer during a taxable year, the customer shall be deemed to be a customer in this State if the billing address of the customer, as shown in the records of the dealer, is in this State; or

(b) in all other cases, if the income-producing activity of the taxpayer is performed in this State or, if the income-producing activity of the taxpayer is performed both within and without this State, if a greater proportion of the income-producing activity of the taxpayer is performed within this State than in any other state, based on performance costs.

(iv) Sales of services are in this State if the services are received in this State. For the purposes of this section, gross receipts from the performance of services provided to a corporation, partnership, or trust may only be attributed to a state where that corporation, partnership, or trust has a fixed place of business. If the state where the services are received is not readily determinable or is a state where the corporation, partnership, or trust receiving the service does not have a fixed place of business, the services shall be deemed to be received at the location of the office of the customer from which the services were ordered in the regular course of the customer's trade or business. If the ordering office cannot be determined, the services shall be deemed to be received at the office of the customer to which the services are billed. If the taxpayer is not taxable in the state in which the services are

received, the sale must be excluded from both the numerator and denominator of the sales factor. The Department shall adopt rules prescribing where specific types of service are received, including, but not limited to, broadcast, cable, advertising, publishing, and utility service.

IITA Section 304(a)(3)(B) relates to gross receipts from sales of tangible personal property. IITA Section 304(a)(3)(B-1) and (B-2) relate to gross receipts from the licensing, sale, or other disposition of a patent, copyright, trademark, or similar item of intangible personal property. IITA Section 304(a)(3)(B-5) relates to gross receipts from the sale of telecommunications service or mobile telecommunications service. As indicated above, IITA Section 304(a)(3)(C-5) applies to sales that are not governed under IITA Sections 304(a)(3)(B), (B-1) and (B-2), or (B-5).

In this case, the gross receipts from membership fees do not represent gross receipts from sales of tangible personal property, gross receipts from the disposition of a patent, copyright, trademark or similar intangible, or gross receipts from sales of telecommunications or mobile telecommunications service. Accordingly, the membership fees are assigned to the Illinois sales factor under the rules of IITA Section 304(a)(3)(C-5). In particular, the membership fees would be considered income from intangible personal property under subparagraph (iii) of paragraph (C-5). The membership fees in this case would not be considered gross receipts from sales of services. Although the rights and benefits available to a club member result from services undertaken by the taxpayer, the membership interest sold to the taxpayer's members constitutes an item of intangible personal property for purposes of Section 304(a)(3)(C-5)(iii). Based on the description contained in your letter, a membership interest appears to be primarily comprised of commitments of third parties to perform services and/or provide goods or services at a discount to the taxpayer's members. Those commitments were not procured by the taxpayer pursuant to an agreement with any member to obtain such commitments, but rather were procured by the taxpayer on its own account on the expectation and subject to the risk that prospective members may wish to acquire the benefit of such third-party arrangements. Moreover, the rights embodied in a membership interest would be considered intangible personal property. See Lynch v. United States, 54 S.Ct. 840, 843 (1934); Metropolitan Trust Co. v. Jones, 51 N.E.2d 256, 258 (Ill. 1943); In re Berman's Estate, 187 N.E.2d 541, 544 (Ill. App. Ct. 1963); Stilo v. Stilo, 270 Ill. App. 527 (Ill. App. Ct. 1933). Accordingly, gross receipts from sales of memberships are governed by IITA Section 304(a)(3)(C-5)(iii).

Whether gross receipts from sales of intangible personal property under Section 304(a)(3)(C-5)(iii) are assigned to Illinois for sales factor purposes depends on whether the taxpayer "is a dealer in the item of intangible personal property within the meaning of Section 475 of the Internal Revenue Code." If the taxpayer is a dealer within the meaning of IRC Section 475, the gross receipts are assigned to Illinois if the customer is in Illinois. If the taxpayer is not a dealer within the meaning of IRC Section 475, the gross receipts are assigned to Illinois if the income-producing activity is in Illinois. For purposes of this rule, a taxpayer is a dealer with respect to an item of intangible personal property if that person is a dealer with respect to the item under IRC Section 475(c)(1), or would be a dealer with respect to the item under IRC Section 475(c)(1) if the item were a security for purposes of IRC Section 475. IRC Section 475(c)(1) defines the term "dealer in securities" as a taxpayer that:

(A) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business; or

(B) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in

securities with customers in the ordinary course of a trade or business.

Your letter indicates that the taxpayer regularly sells memberships to customers in the ordinary course of its trade or business. Therefore, the taxpayer is considered a dealer with respect to the memberships under IITA Section 304(a)(3)(C-5)(iii)(a). Accordingly, gross receipts from membership fees are assigned to the numerator of the Illinois sales factor to the extent that the fees are received from members in Illinois. If the member is an individual, trust, or estate, the gross receipts are in Illinois if the member is a resident of Illinois. For all other members, the gross receipts are in Illinois if the member's commercial domicile is in Illinois. However, if the taxpayer lacks actual knowledge of the member's residence or commercial domicile, then the gross receipts are in Illinois if the member's billing address, as shown in the taxpayer's records, is in Illinois.

As stated above, this is a GIL. A GIL does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department. If you have questions regarding this GIL you may contact Legal Services at (217) 782-7055. If you have further questions related to Illinois income tax laws, visit our website at www.revenue.state.il.us or contact the Department's Taxpayer Information Division at (217) 782-3336.

Sincerely,

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