EQUIPMENT LEASING AND FINANCE ASSOCIATION
1825 K Street NW
Suite 900
Washington, DC 20006
P 202.238-3400
F 202.238-3401
www.elfaonline.org

Public Comment and Testimony
Equipment Leasing & Finance Association
Proposed Rules 86 Ill. Adm. Code 220

The Equipment Leasing and Finance Association (ELFA) represents financial services companies and manufacturers in the commercial equipment lease finance sector. More than 575 member companies doing business in all 50 states include many of the nation's largest services companies and manufacturers, as well as, regional community banks, and small finance companies. ELFA Members include:

- Independent leasing and finance companies
- Broker and packagers
- Captive finance companies
- Investment banks
- Commercial banks
- Service providers
- Diversified financial services companies

ELFA membership also includes a number of multinational financial and manufacturing companies operating in the U.S. The clients of ELFA members range from Fortune 100 companies to small and medium sized enterprises to governments and non-profit.

About the Commercial Leasing Industry

The leasing industry is not like the traditional main street retail industry in Illinois. ELFA's member companies arrange for the financing of the equipment, do not have physical possession of equipment prior to a lease and must often rely on equipment descriptions and information contained in vendor invoices. Our membership is comprised of financial institutions and different types of banks, and they do not have a physical equipment retail location. Some of ELFA's wide array of members have manufacturing parent companies in one state, while their financing arm is located somewhere entirely different. This leasing and financing is specifically concerned with Business to Business (B2B) financing, and does not make arrangements with individuals, and is not in the consumer financing marketplace.

As a general rule, leases with a nominal or mandatory end of lease purchase option are taxed as conditional sales in the state of Illinois; meaning they are taxed on the receipts as received. After the lessee has selected a retailer and the equipment they desire to purchase, the lessor will step in and purchase the equipment and then sell it to the lessee under a lease intended as a security agreement wherein it is certain the lessee will become the owner upon completion of all payments. The lessor holds the title (security interest) to the equipment until the lessee has completed all of the agreed upon payments. The proposed rules are lacking guidance on how to source the receipts from conditional sales type leases that are taxed on the receipts as received over the life of the agreement.

Retailing activities associated with conditional sale type leases, as demonstrated above, are significantly different than traditional brick and mortar retailing activity. Most of the mainstream B2B retailing activity occurs prior to a point when the buyer of equipment decides to purchase or to lease. Third party lessors (many of ELFA's members) are brought into the retail transaction after the buyer has selected the equipment and the seller of same. At that point, credit review and credit approval become the most significant activity in pricing and approving a customer's choice of financing under conditional sales type leases.

Location Concerns Specific to the Leasing Industry

Location concerns pose a major problem to the leasing industry. Since a significant number of our members (the lessor) are headquartered outside of Illinois, lessee requests for lease quote, credit review, credit approval, signed lease contracts and purchase order (if issued) are retailing activities of a lessor occurring predominately outside of Illinois. In some instances an employee or other representative of Lessor may work in Illinois and serve as a conduit contact point for the lessee throughout the process. Under the proposed regulations many of the primary activities of lessor could take place outside of Illinois, such as credit review and approval or purchase order acceptance, while other primary and secondary functions could take place within Illinois, such as making offers and delivery of the equipment. This activity in multiple jurisdictions leads to the "government services factor" in which is the Department's "look through factor" in determining where the tax is due. This factor could be used to determine where the lessor would receive the most government services, or benefit. This creates ambiguity during the audit process, where state auditors are given authority to make a case-by-case determination of where tax is due.

As currently written, the proposed regulations fail to address the relevance of equipment securing payments under the conditional sale as to whether it would be used as a primary, secondary or look-through factor for purposes of sourcing the receipts. The solution to the ambiguity that the regulations create issue the location of the equipment used to secure payments under the conditional sale. The commercial equipment leasing industry requests guidance on how to implement new regulations within our multifactor marketplace involving in-state and out of state activities.

Info Graphic Explaining How Proposed Rules Affect the Leasing Industry

Looking at the chart below, the first column reviews retailing activities involving leases that don't necessarily occur for other retailers – such as credit reports – and gives a sense of what lessors face that is different from brick and mortar retail stores. These activities could occur within Illinois, outside the state or more often in multiple locations.

The Primary and Secondary columns present factors the Department reviews at audit and demonstrates the subjective nature of decisions. For example, what if all the Primary Factors occur both inside and outside Illinois and Secondary Factors are in the state? How many the Primary Factors need to occur in the state to have secondary factors considered? At what point does the balance of instate and out-of-state factors result in the "tie-breaker" look through factors? This chart shows that audits revolving around case-by-case examination of transactions are not neutral exercises. These activities of lessors usually occur in more than one jurisdiction with an audit decision on a Conditional Sale Agreement being determined as much by the individual examining them as the particulars of a transaction. The final column represents the Department's look through factors based on the benefit of Government Services provided inside Illinois as the probable factor that could be employed to determine where the transaction is sources. .

FINANCE LESSOR RETAILING ACTIVITIES:	PRIMARY Officers & negotiating employees Where offers are prepared/made Purchase Order acceptance Inventory location Lease ("CSA") Contracts signed (suggested addition) Credit Decisions (suggested addition) CSA terms & conditions negotiated (suggest) Pricing approval (suggested addition) Assignee/funding source if condition to consummating a sale (suggested addition)	SECONDARY Marketing & solicitation Lease Quotes(suggested addition) Purchase Order / signed lease contracts received Location of delivery (should FOB terms be included – suggested addition) Delivery location of property securing CSA (destination based, not FOB – suggested addition) Back office administration (invoicing, lease contracts, accounting, collections)	Government Services FACTOR and DOR LOOK THROUGH FACTOR (DOR Determination when multiple retail activity locations within & without IL) Government services include: Fire, police security/protection, roads/infrastructure, employee welfare/residence benefits and various other indirect benefits,
Officers	Outside of Illinois		
Negotiating employee	Chicago, IL, can also be varied by CSA and customer		

Offers prepared	Chicago, IL		
PO acceptance	Outside of Illinois		
CSA signed	Outside of Illinois		
Credit review & pricing approval	Outside of Illinois		
CSA terms negotiated	Chicago, IL		
Assignee/funding source – primary or secondary	Springfield, IL		
Marketing & solicitation (customer location)		Varied by CSA, may be outside or within IL	
Bid preparation		Chicago, IL	
PO / signed lease received		Chicago, IL	
Delivery		Varied by CSA, can be multiple on single CSA	
Back Office Admin		Outside of Illinois	
Location of property securing CSA			Fire, police, infrastructure – varied by CSA, can be multiple on a single CSA
Originating vendor/dealer selling property			Varied by CSA, can be multiple on a single CSA
Affiliate entities referring finance	?	?	?

opportunity?			

Concerns Specific to B2B Equipment Leasing and Finance

1. **<u>The proposed rules lack guidance on how to source the receipts from conditional sales type leases</u>**. Leases with a nominal or mandatory end of lease purchase option are taxed as conditional sales in the state of Illinois. The lessor/lender holds title (security interest) to the underlying goods until the lessee/debtor has completed all the agreed upon payments. Tax on these conditional sale type leases is collected on the receipts as received over the life of the agreement. Prominent retailing activities associated with these arrangements are significantly different than the mainstream retail transactions. Most mainstream Business-to-Business (B2B) retailing activity occurs prior to a point when the buyer of goods decides to purchase or to lease. However, in conditional sale type leases, third party lessors are often brought into the retail transaction well after the buyer has selected the goods and identified the seller of those goods. At that point, credit review and credit approval become the lessor's most significant selling activity, as pricing and approving a customer's choice of financing under a conditional sales type lease is key to ultimately closing the transaction.
   a. What is the relevance of the mainstream retail selling activities occurring outside the state when an Illinois buyer directs shipment of goods to an Illinois location under a "sale on approval" (as defined under UCC) that is conditioned upon buyer securing the necessary finances?
   b. What if the financing company's home base is in Illinois but the final decision on the buyer's credit occurs outside of the state?
   c. As written, the proposed rules can drive a different sourcing treatment from one transaction to the next. Particularly with regard to the B2B commercial equipment transaction in today's marketplace:
      i. How much relevance or weight is given to the joint efforts of multiple businesses involved with making the selection and sale of equipment?
      ii. How much relevance or weight is given to the location of property at the time of negotiating its sale as compared to:
         1. its location at time of title transfer
         2. its inventory location (of any involved participant to a series of transactions leading to the end user – retail sale
         3. Its location as to the duration of the conditional sale as ownership vests upon completion of payments and security title is released
2. <u>Location concerns.</u>
   a. Similar to the location of a retailer's inventory, should the physical location of goods securing payments under a conditional sales type lease be a primary factor for where a lessor sources the receipts for local sales tax?
   b. How much weight should be given to the governmental protection and benefits derived from the location of the equipment for the duration of a conditional sale in contrast to the weight given the credit review and approval?
3. <u>Sales tax uncertainty.</u>

   a. As a buyer of goods to be leased to others under a true lease, an equipment lessor must pay the Illinois state and local sales tax, as applicable, to retailers registered to collect Illinois tax. Margins are very slim and 2 – 3% swings in the tax rate will significantly devastate any profits.
   b. As a buyer, it is important that there be transparency and certainty in the sales tax rate charged by retailers registered to collect Illinois tax. The former order acceptance location provided that certainty; the proposed rules have eliminated that certainty.

General Concerns with the Rules

4. <u>Rules fail to address B2B sales in today's marketplace.</u> The primary and secondary factors of the proposed rules are lacking a definitive hierarchy and weight on various retailing activities, particularly with multiple parties (both in and out-of-state) involved with consummating many of the B2B equipment sales in today's marketplace. This uncertainty leaves sellers at risk for penalties and lawsuits.
5. <u>Primary factors</u>. The regulations require additional clarity with respect to implementation of the primary and secondary factors. For instance, what happens if a taxpayer has only three primary factors (i.e., no inventory)? Do you source the sale based on only the three primary factors, or do you look to secondary factors in this instance? What if some of the factors are out-sourced or off-shored to a third party outside of Illinois?
6. <u>Presumptions</u>. The regulations are void of any presumptions and burdens of proof. The Department should not use its "alternative" sourcing rules: (i) secondary factors, (ii) substance over form or (iii) where a taxpayer enjoyed the greater benefit of government services, unless the Department can clearly show that the primary factors are not controlling.
7. <u>Tax calculation software deficiencies.</u> One of the more critical considerations is the ability to integrate the proposed rules in tax rate determination software and invoicing programs. Today's ERP systems, standard off-the-shelf invoicing software and tax logic software is not programmed to accept the various data elements representing retailing activities used to source Illinois local sales tax under the proposed rule. Such analysis would require manual intervention, impacting efficiency, effectiveness and accuracy.
   a. Given today's technology, how does the Department propose we manage all the variable location activities necessary to meet the fact intensive determination of how and where to source a transaction for Illinois local sales tax purposes? Particularly, when the factors will vary from one transaction to the next?
   b. The reality of software deficiencies needs to be a critical factor when there are multiple primary factors occurring in multiple locations.
8. <u>Examples</u>. There are no examples in the regulations. Examples of how the Department will apply its regulations to common, but complicated fact scenarios will likely be very helpful to taxpayers as they attempt to apply the multifactor analysis to their respective situations.
9. <u>Long-term contracts</u>. Long-term contracts are addressed in the emergency regulations but are left out of the proposed, permanent regulations.
10. <u>Inventory</u>. The Department's long-standing sourcing rule with respect to in-state inventory and out-of-state retailers may also run afoul of the Illinois Supreme Court's

holding in *Hartney*, since it too allows "for only one, potentially minor step in the business of selling to conclusively govern tax situs . . . ."

11. The regulations encourage retailers to minimize their presence in Illinois. Taxpayers may look to create their own bright-line by moving their "selling activities" outside of Illinois, including any inventory. (In such instances, a retailer only has to collect Illinois use tax at the current rate of 6.25%.)
12. Safe Harbors. Because of the subjective nature of the multifactor test, retailers should only be subject to a 6-month look back period if found in good-faith to have sourced sales to the wrong local taxing body.

ELFA Contact Information for Further Inquiries

Dennis Brown
Vice President, State Government Relations
1825 K Street NW, Suite 900
Washington, DC 20006
Phone: (202) 238-3411
Fax: (202) 238-3401
dbrown@elfaonline.org
www.elfaonline.org