



Taxpayers' Federation of Illinois

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April 28, 2014

Mr. Paul Berks
Deputy General Counsel
Illinois Department of Revenue
100 West Randolph Street, 7th Floor
Chicago, IL 60601

Dear Mr. Berks:

The Taxpayers' Federation of Illinois submits the following comments on the Department of Revenue's proposed amendments to 86 Ill. Admin. Code §§ 220.115, 270.115, 320.115, 370.115, 395.115, 630.120, 670.115, 690.115, 693.115, and 695.115, as published in the Illinois Register on February 7, 2014. Our comments apply equally to all ten local taxes impacted by these nearly-identical proposed changes, but for simplicity will refer only to the proposed changes to the Home Rule County Retailers' Occupation Tax regulations, 86 Ill. Admin. Code §220.115.

We applaud the Department of Revenue (hereinafter, the "Department") for approaching this task with what was obviously a great deal of thought and deliberation, and yet doing so within a few weeks of the Illinois Supreme Court's decision in *Hartney Fuel Oil Co. v. Hamer*. Nevertheless, we have serious concerns about the overall workability of these proposed changes, as detailed below. Our comments fall into two categories: those relating to the proposed regulations generally, and those pertaining to specific provisions. Finally, we have attempted to apply the regulations to the examples provided in an earlier statement, to illustrate our point that more explicit guidance is needed.

General Comments

As outlined in our statement presented on December 12, 2013, during the Department's meeting on this topic, one of the fundamental tenets of good tax policy is predictability, and each of the groups impacted by this issue (customers, sellers, the Department, and local governments) deserves clear, workable guidance. The proposed regulations take a step in that direction by setting forth bright line (but not single-factor) rules for certain situations, and as stated in our testimony at the Department's hearing on these proposed regulations on March 21, 2014, subsection (c) is particularly helpful. Nevertheless, we believe that additional clarity is necessary, and possible.

Generally speaking, we encourage the Department to expand both the scope and number of fact patterns included in subsection (c). We also believe that, for sellers and transactions not falling within that guidance, 9 factors is too many to be a useful test. And perhaps most importantly, the exact application of those factors needs to be better and further explained.

The proposed regulations do not provide any indication how the listed 4 "primary" factors and 5 "secondary" factors should be weighed against each other, or when it is necessary to resort to the

secondary factors. The only guidance along those lines is found at subparagraph (d)(4)(A), that the Department will look to the jurisdiction where the retailer “enjoyed the greater part of governmental protection.” As currently written, we fear the 9-factor test will frequently not lead to a conclusive result and taxpayers will have to resort to this provision often. The statement is, unfortunately, of little help—is this to be determined based on the amount of money expended by a municipality in providing services to the seller, or on some other consideration (such as real estate taxes paid)?

Sourcing regulations should not be necessary for the vast majority of retail transactions, which are traditional over-the-counter sales properly sourced to the jurisdiction of the retail store. The business of selling, however, has evolved over time, and continues to become more and more complex. As a result, more and more businesses are going to find themselves in the unenviable position of determining where they are engaged in the occupation of selling by applying these regulations. On the same day these proposed changes were originally published, the Department also published proposed changes to an income tax regulation that will impact, at most, only 11 taxpayers. The hundreds, and probably thousands, of sellers who have adopted more complicated modern business practices and are collecting millions of dollars in tax revenues deserve the same level of assistance.

Specific Comments

As indicated above, we do have some specific comments on language contained in the regulations. Other groups have also submitted comments, and we are generally supportive of those seeking to increase clarity in the regulations, particularly as they apply to particular business or transaction types. Those suggestions are not repeated here.

Paragraph (c)(2) repeats language from the earlier version of the regulation, stating that over-the-counter sales are sourced to the jurisdiction in which the store is located. That paragraph also sources a sale to the store’s jurisdiction if merchandise is shipped to the customer from in-store inventory. This is frequently not the case—retailers ship from warehouses or from other stores. Shouldn’t those transactions also be sourced to the store where the customer was physically present? Deleting the phrase “from the location where the sale was made” would modernize this provision to reflect current retailing practices. Other possible changes to (c)(2) are outlined in the examples below.

The provisions governing long-term or blanket contracts, originally at paragraph (c)(4), have been removed from the proposed regulations. We strongly urge the Department to reinstate this language. If there are particular problem areas associated with the provisions, a better solution would be to deal with them directly, rather than by revoking a very helpful and very logical bright-line (but not single-factor) test.

Similarly, long-term contracts in existence at the time of the adoption of these regulations should be provided guidance on whether they are covered under these new regulations, or if the state of the law at the time the contracts were entered into continues to govern them. There are at least two possible fact patterns impacted: those where the only Illinois connection is order acceptance (so as a result are likely to switch from ROT to use tax transactions under the new regime) and those where the seller engages in a number of activities in Illinois (and under the new regulations sales would be sourced to a different location). Each should be addressed, whether or not the language of original (c)(4) is retained.

It is not clear how these regulations will impact taxpayers who avail themselves of the expanded temporary storage exemption. As explained in Regulation §150.310(a)(6)(E) and (F), when a taxpayer

purchases an item pursuant to the exemption, intending to store it temporarily in Illinois before shipping it out of state, instead uses that item in Illinois, it must calculate and remit Retailers' Occupation Tax and any applicable Local Retailers' Occupation Tax. Expecting a customer to apply the 4-factor, and possibly also the 5-factor, tests of these proposed regulations to the facts of their seller is unrealistic. TFI strongly urges the Department to provide clear guidance and possibly a safe harbor for these taxpayers.

As stated above, we believe there should be additional guidance at the end of (d)(2), indicating how to weigh the four primary factors. Similar language should also be inserted at the end of paragraph (d)(3). The introductory paragraph of (d)(3) should also be revised to contain a stronger statement of when these secondary factors come into play.

Delivery location, the third secondary factor, found at subparagraph (d)(3)(c), does not seem to be a particularly relevant fact in the context of an occupation tax. We suggest that this factor be deleted, particularly if title passage, another secondary factor at subparagraph (d)(3)(D), remains a factor in the regulations. Delivery location is a more appropriate factor in a destination sourcing regime, and is likely to needlessly complicate the analysis. (TFI does not oppose destination sourcing in and of itself; we merely question whether it is possible under current law.)

Additional examples would be helpful throughout the regulations. Areas where that might be particularly helpful include the following: demonstrate application of the primary factors; show when use of the secondary factors is, and is not, necessary; and illustrate what kind of related party transactions will be, and won't be, respected under subparagraph (d)(4)(B).

Real-World Situations

In our December statement, filed jointly with the Illinois Retail Merchants' Association, the Illinois Manufacturers' Association and the Illinois State Chamber of Commerce, we provided several examples that illustrate the depth and breadth of this issue. Each is restated below, followed by an attempt at applying the proposed regulations to that fact pattern. These were based on real-world fact patterns of, and questions raised by, members of our organizations, and were not mere hypotheticals. Many transactions occurring in Illinois are less complicated, and are easily sourced to a particular jurisdiction. Regulations should provide some guidance in these more complicated situations. As the analysis below indicates, the proposed regulations frequently fall short of that goal.

- A customer places an order with a seller, through a website or online call center, and has no contact with the seller's retail store except that the customer picks up the merchandise there—is the transaction sourced to the store's location? Does it matter if the retailer's other activities associated with that sale all occurred outside Illinois?

In-store pick-up is a fairly common option with retailers offering both internet and brick-and-mortar stores. Paragraph (c)(2) should be revised to include this fact pattern in its guidance.

- A customer places an internet order while physically located in a retailer's only Illinois store and the order is processed by the system (accepted out-of-state, fulfilled from a warehouse out-of-state, etc.) just as if the order had been placed from the customer's home. Is that enough to convert what was traditionally considered a use tax transaction not associated with a particular in-state location to an in-state transaction subject to the rate in effect at that store?

Again, the customer's presence in the store when the transaction was consummated ought to bring this transaction into the arms of paragraph (c)(2), if it were updated to reflect modern retailing practices, particularly if the internet access was provided by the store, or a sales rep assisted with the transaction.

- If the seller's only in-state activity associated with a transaction is order acceptance, is that transaction now a use tax transaction not subject to any local ROT?

It appears that the answer to this question is yes, under paragraph (b)(8).

- Many sellers spend considerable time and money designing, sourcing and procuring inventory—is that a relevant factor? It is a necessary part of the business of retailing.

This question, too, was answered in the regulations. The design and procurement processes are not listed in the 9 factors, except perhaps as part of the administrative functions included in subparagraph (c)(3)(E).

- A customer places a large order of widgets with retailer's sales representative. Although the sales rep is at one of the retailer's sales offices, the retailer's home office in a different jurisdiction approves the sale, processes the order, evaluates the business's credit-worthiness, checks inventory availability, stores inventory, fulfills orders, etc. The next day, the customer decides to order additional widgets, places an order online, and the identical process follows, but without the sales rep. Assume the local tax rates differ for each location. Would different tax rates apply to these two transactions, even though from the business customer's perspective they are virtually identical?

In this example, two of the four primary factors (employee with discretion to bind seller and location where offers are prepared and made) are at the sales rep's location, while the other two (purchase order is accepted and inventory is located) are at the headquarters. Looking to the 5 secondary factors, one (marketing/solicitation) is where the sales rep is located, two (delivery and transfer of title) are where the customer is located, and two (documents received and administrative functions) are at the headquarters. That's a score of 3 to 4 to 2. Does headquarters win on sheer numbers, would it matter if the sales rep-related costs were twice those associated with the headquarters functions for this particular sale, or is it necessary to determine the governmental benefits at each of these locations? As stated above, further guidance in this area is desperately needed.

- Traditionally, the first question to ask when evaluating what tax rate to apply is whether a sale occurs in Illinois, and if so the next question is what local jurisdiction may subject the transaction to its local ROT. (*Hartney* dealt only with the second question.) Do the same factors apply when answering both of these questions?

These proposed changes apply only to taxes imposed by local jurisdictions, so they do not directly address the first question. It is only reasonable, however, to use the same guidelines for answering both questions: which state can tax, and which local jurisdiction can tax.

- Will businesses with direct pay permits now need to evaluate their seller's business practices in order to determine what local ROT to pay?

The proposed revisions to the regulations do not mention the direct pay permit program. Presumably, then, the answer to this question is yes. As with the temporary storage example above, TFI believes that the Department should provide bright line guidance to taxpayers in this situation, rather than making them delve into the inner workings of their suppliers' business practices. Overall, participation in these

programs increases the amount and accuracy of taxes collected. It is in the State's best interest to encourage taxpayers to obtain these permits; these regulations provide an opportunity to do so.

Thank you again for the opportunity to comment on these proposed regulations. Let me know if you have any questions or want to talk about these or any other points.

Regards,

A handwritten signature in cursive script that reads "Carol S. Portman".

Carol S. Portman
President

cc: JCAR staff