2013 PRACTITIONERS' MEETING

Court Decisions
November 19, 2013

I. Sales Tax

A. Electronic Commerce

Performance Mktg. Ass'n, Inc. v. Hamer, 2013 IL 114496 (Oct. 18, 2013)

Performance Marketing Association challenged the so-called "click-through" nexus law passed by the Illinois General Assembly in 2011. The law requires an out-of-state retailer or serviceman to collect Illinois use tax if that out-of-state internet retailer or serviceman has a contract with a person in Illinois who displays a link on his or her website that connects an Internet user to that remote retailer or serviceman's website. The law imposes a use tax collection duty on those engaged in online "performance marketing." "Performance marketing" refers to marketing programs in which an affiliate displays the retailer's advertisement and is compensated by the retailer when a sale is completed. The retailer tracks these referrals and bases the affiliate's compensation on the "performance."

The trial court held that the law was unconstitutional on its face because it failed the "substantial nexus" requirement under the Commerce Clause. It further held that it was presently preempted by the federal Internet Tax Freedom Act, which prohibits "discriminatory taxes on electronic commerce." Because the ruling declared an Illinois statute unconstitutional, it was appealed directly to the Illinois Supreme Court.

The Supreme Court affirmed the circuit court on federal preemption grounds. The Court found the law targeted only performance marketing accomplished through the Internet but did not treat "offline" performance marketing the same way. The court reasoned that the "click-through" nexus law imposed a use tax collection obligation on internet advertisements that were inherently national in scope, while the offline print or broadcast advertisements that were national in scope were not subject to use tax collection requirements. The Supreme Court did not address the constitutional arguments under the Commerce Clause.

B. Bad Debt Deduction

Citibank, N.A. v. Illinois Department of Revenue, No. 13 L 050072 (Cir. Ct. Cook County) (Oct. 17, 2013)

As part of normal operations, numerous retailers offer their customers the opportunity to finance their purchases, including both the purchase price and the Retailers Occupation Tax. Citibank had such agreements with various retailers. The retailers transferred these receivables to Citibank, and some customers subsequently defaulted on the amounts owed to Citibank. Citibank eventually wrote off the bad debt on its federal income tax returns, and then filed a claim for a refund or credit of the portion of the bad debt that was attributable to the ROT. The Department denied Citibank's claim, and it then sought review in the circuit court.

The Department argued that the taxpayer must be a retailer to claim a refund for taxes under Section 130.1960. The trial court disagreed and looked to Section 6 of the ROTA to determine that there is no requirement that the taxpayer be a retailer. The court found that Citibank was entitled to a credit because: 1) it bore the burden of the tax; 2) it was not reimbursed for the tax; and 3) there was no understanding or agreement whereby Citibank could be relieved of the burden of the tax.

C. Gross Receipts

Mattoon Kawasaki Yamaha, Inc. v. Department of Revenue, 2013 IL App (4th) 121116-U (Oct. 23, 2013)

Mattoon sells new and used Kawasaki and Yamaha motorcycles and all-terrain vehicles. When Mattoon purchased a vehicle from the manufacturer, it paid the "dealer invoice amount," which included three separate amounts: (1) the wholesale cost of the vehicle, (2) shipping, and (3) the "dealer reserve amount." The "dealer reserve amount" is held by the manufacturer until the retailer makes a retail sale that meets certain criteria. If the retailer meets those criteria, the entire dealer reserve amount is returned to the retailer. The Department audited Mattoon and determined that such "dealer reserve amounts" were taxable under the Retailers' Occupation Tax Act and assessed the tax. The trial court granted summary judgment in favor of the Department, ruling that, because the dealer reserve payments are returned to Mattoon only upon the sale of a vehicle, such payments constitute incentives for the retail sale and thus qualify as taxable gross receipts under 86 Ill. Admin. Code § 130.2125(e)(1).

The appellate court reversed, holding that the dealer reserve payments are not subject to the Retailers' Occupation Tax because they did not supplement the purchase price of the vehicle to Mattoon's benefit and thus should not be included in gross receipts.

D. Exempt Sales

ILMO Products Co. v. Department of Revenue, 2013 IL App (4th) 120973-U (Sept. 5, 2013)

ILMO sells gases and rents high-pressure gas cylinders to its customers. ILMO also owns and leases to its customers cryogenic systems that store liquid gases and convert them to gaseous form. It charges a "HAZMAT" fee to the customers renting the high-pressure gas cylinders related to ILMO's own compliance with hazardous material laws and regulations.

The appellate court concluded that the "HAZMAT" fees ILMO imposed on its high-pressure gas cylinders were not subject to ROT because they related to a nontaxable rental, and that ILMO's cryogenic systems were exempt from use tax because they are manufacturing machinery.

E. Charitable Exemptions

Web Innovations & Technology Services, Inc. v. Department of Revenue, 2013 IL App (4th) 120749-U (Aug. 28, 2013)

This case was the consolidated appeal of two separate circuit court cases in Sangamon County and Vermillion County affirming on administrative review the Department's decisions to deny Web Innovations & Technology Services' ("WITS") requests for charitable exemptions under the Retailers' Occupation Tax Act and the Property Tax Code. The appellate court, reviewing the administrative decisions for clear error, affirmed the judgments of the trial courts.

WITS recycles and refurbishes electronic equipment. Its mission statement is "to keep reusable materials out of the landfill and improve technology awareness and availability to the underserved through recycling/refurbishing and educational opportunities using recycled and refurbished technologies." WITS offered services including "free computer" programs that provided refurbished computers to students and seniors who met certain requirements. In some cases WITS required a donation of service hours in exchange for the free computers. WITS also donated computers to other organizations. WITS generated funding from three primary sources: (1) monetary donations and grants, (2) selling refurbished electronics, and (3) selling scrap materials to end processors. The majority of its funding came from the sale of scrap materials generated as a result of the recycling process.

WITS argued that it is a charitable organization that puts its property to primarily charitable use, entitling it to exemptions from both the retailers' occupation tax and property tax. WITS alleged two separate charitable activities: (1) providing low cost and free technology and (2) recycling. The appellate court agreed with the ALJ's determination that WITS primarily used its property for recycling activities and that the charity it did dispense, giving away electronic items for free or reduced price, was minimal in comparison. The court also agreed with the ALJ's determination that the recycling activities themselves, while laudable, were not charitable.

II. Income Tax

A. Pass-Through Miles

Witte Brothers Exchange, Inc. v. Department of Revenue, 2013 IL App (1st) 120850 (Sept. 30, 2013)

At issue in this case was whether miles traveled through Illinois by an interstate trucking company without picking up or delivering goods in Illinois should be included in the numerator of the apportionment factor pursuant to IITA section 304(d)(1). The trial court ruled in favor of the taxpayer, concluding that such pass-through miles were not within the scope of section 304(d)(1). The appellate court reversed.

Witte Bros. maintained that there was no consideration exchanged in Illinois with regard to the pass-through miles so that they should not be considered revenue miles in this state. Witte Bros. attempted to distinguish *Panhandle Eastern Pipeline Co. v. Hamer,* 2012 IL App (1st)

113559, which had ruled that flow-through miles of natural gas should be included in the numerator, arguing that pipelines are fixed in the land and, therefore, the revenue generating activity was firmly located in Illinois.

The appellate court concluded that the trucking company's pass-through miles established a physical and economic presence in Illinois that must be taxed under the statute. Just as the pipelines traversed Illinois in *Panhandle,* the trucks here traveled on Illinois roadways, whether or not goods were picked up or delivered. Contrary to the taxpayer's contention, the inclusion of pass-through miles in the numerator is not conditioned on generating income from within the state. Rather, the only requirement is that the miles be traveled "for a consideration." As long as Witte Bros. received compensation for its shipping services, its pass-through miles must be included in the numerator of the apportionment factor.

The appellate court also pointed to the purpose of article 3 of the Illinois Income Tax Act as additional support for its interpretation. Apportionment is designed to assure that 100% of a multistate corporation's business income is taxed by the states having jurisdiction to tax it. Not including pass-through miles would create a gap in taxation and, therefore, would be contrary to the purpose of the statute.

B. Captive Insurance Companies

Wendy's International, Inc. v. Hamer, 2013 IL App (4th) 110678 (Oct. 7, 2013)

This case concerned whether a captive insurance company should be excluded from the parent's unitary business group based on the non-combination rule in IITA section 1501(a)(27). Wendy's argued that its captive insurance company Scioto Insurance Co. was required to apportion income using the formula in IITA section 304(b) and could not be combined with Wendy's unitary business group. The Department determined that Scioto was not an insurance company because less than half its revenue was derived from premiums. Most of its revenue resulted from royalties paid by Wendy's affiliates for use of trademarks owned by Oldemark LLC, a disregarded entity. The trial court granted summary judgment in favor of the Department.

On appeal, Wendy's argued that the trial court erred in finding that Scioto was not an insurance company for Illinois income tax purposes. The appellate court agreed with Wendy's and reversed the trial court judgment. Noting that the term "insurance company" is not defined for Illinois income tax purposes, the appellate court construed the meaning under federal income tax principles. Even though the royalty income dwarfed the premium income, the appellate court focused on what it considered to be the character of the business actually conducted. Scioto's business was furnishing insurance to Wendy's affiliates, and ownership of Oldemark, which engaged in the business of licensing intellectual property, did not alter that conclusion. The court also found that ownership of Oldemark was related to Scioto's insurance business because it enabled Scioto to satisfy the capitalization requirements under Vermont's captive insurance regulations.

C. Residency

Grede v. Illinois Department of Revenue, 2013 IL App (2d) 120731-U (April 22, 2013)

Grede was an executive vice president at the Chicago Board of Trade and had resided in Illinois for a number of years with his wife and two children. In 1999, he was recruited to launch a stock exchange in Hong Kong and serve as its deputy chief operating officer. He signed a three-year contract and began working April 1, 2000, while his family remained in Illinois. He opened a bank account in Hong Kong, as require, to deposit his paychecks. He maintained brokerage and bank accounts in Illinois and regularly transferred funds to support his family. He extended a six-month lease on an apartment in Hong Kong several times, eventually signing a two-year lease. In 2003, Grede learned his employment contract would not be renewed, and he returned to Illinois.

On his 2001 Illinois income tax return, Grede reported his status as married filing separately and claimed to be a non-resident. The Department determined that Grede remained a resident and issued a notice of deficiency. Grede protested the notice and argued that the decision not to move his children and enroll them in school in Hong Kong should not be considered a failure by him to abandon his Illinois domicile. In response, the Department argued that the steps taken toward abandoning the Illinois domicile were limited. The Department prevailed at the administrative hearing, but the trial court reversed.

The appellate court found that the Department's determination that Grede had not remained an Illinois domiciliary was not clearly erroneous. However, the appellate court found that Grede nevertheless was absent for more than a temporary or transitory purpose and thus did not meet the statutory definition of resident. In so finding, the appellate court relied on testimony that renewing employment contracts with senior officers was common practice, and that Grede's main incentive for accepting the job in Hong Kong was the receipt of stock options lasting up to 10 years that did not fully vest until he completed 5 years. Given that Grede reasonably expected his employment would potentially last as long as 10 years as specified in the options contract, the court determined that the Department's decision that he remained a resident was clearly erroneous.

III. Amnesty

A. Metropolitan Life Insurance Co. v. Hamer, 2013 IL 114234 (June 20, 2013)

Marriott Int'l, Inc. v. Hamer, 2012 IL App (1st) 111406 (Aug. 22, 2012), petition for leave to appeal denied (Sept. 25, 2013)

From October 1 through November 17, 2003, the Department administered an amnesty program, whereby interest and penalties were abated for all liabilities accruing from June 30, 1983, until July 1, 2003, and satisfied during the amnesty period. Failure to participate in the amnesty program resulted in penalties and interest being doubled. At the time of the amnesty program, MetLife was undergoing a federal audit for 1997 through 1999. The federal audit was not finalized until July 29, 2004.

The Department's emergency regulations required taxpayers to make a good-faith estimate of any potential federal change, file an amended return and pay during the amnesty period. MetLife did not participate in the amnesty program; rather in August 2004, it provided the federal adjustments to the auditor conducting an Illinois income tax audit. The auditor incorporated the final federal changes into her workpapers dated December 10, 2004. MetLife paid the additional tax due at the conclusion of the audit in May 2007. Subsequently, the Department issued a bill in the amount of $2,207,456, which constituted interest at twice the normal statutory rate. MetLife paid this amount under protest and filed a complaint in circuit court.

MetLife argued that it should not be subject to the amnesty penalty because it was negotiating with the Internal Revenue Service, which had raised a number of substantial issues, and it could not make a good-faith estimate as to what the final federal changes would be. Also, MetLife argued that the imposition of a 200% interest charge upon taxpayers who failed to pay a tax liability eligible for amnesty under the 2003 Amnesty Act violated substantive due process. The Department argued that amnesty applied to "all taxes due," and that pursuant to IITA section 601(a), taxes are due on the due date of the original return. Furthermore, IITA section 203(e) defines taxable income as the amount *properly reportable* not actually reported for federal income tax purposes.

The circuit court construed the term "all taxes due" as due and assessed. Given that MetLife was not yet required to report the federal changes, the additional tax was not due within the meaning of the Amnesty Act. The court relied on *Schmidt v. Department of Revenue*, 163 Ill. App. 3d 269 (5th Dist. 1987), which interpreted an earlier amnesty statute and concluded that "all taxes due" meant taxes assessed and due at the time of the amnesty application. As a result, the taxpayer in *Schmidt* could not receive amnesty and subsequently litigate the amount of liability.

In affirming the circuit court, the appellate court was unable to discern any logical interpretation for the requirement in the amnesty regulations that the entire tax liability be paid whether or not it was yet known. The appellate court also concluded that the provisions in the regulations for estimating state and federal audit changes exceeded the legislative intent behind the amnesty program. Justice Hoffman dissented. He disagreed with the majority's holding that income tax liabilities in excess of what was reported on the returns as filed become due only as the result of an audit. He interpreted the plain meaning of section 601(a) as establishing that taxes are due on the date for filing the return, without assessment, notice or demand, including any amounts later determined to be underpaid as the result of an audit.

Meanwhile, in Marriott, another case involving amnesty double interest, the appellate court ruled that, based on IITA section 203(e), Marriott's taxable income was not limited to what it reported on the returns as filed but included the amount properly reportable for federal purposes. The appellate court also ruled that the plain reading of IITA section 601(a) is that the entire tax liability was due on the date for filing the returns. Therefore, the appellate court interpreted the phrase "all taxes due" as meaning those taxes due as of the date for filing the returns, "irrespective of whether the Department or the taxpayer is aware of their existence and irrespective of whether the Department has issued a formal assessment." Because Marriott did not satisfy the entire liability during the amnesty period, it owed double interest.

The Illinois Supreme Court in *MetLife* agreed with Justice Hoffman's dissent and with the appellate court in *Marriott*, holding that "the plain and ordinary meaning of the phrase 'all taxes due' in the 2003 Amnesty Act refers to taxes that are due based upon properly reportable income at the time the taxpayer's return is required to be filed." The Supreme Court also determined that the 200% interest provision does not violate substantive due process.

B. Con-Way Transportation Services, Inc. v. Hamer, 2013 IL App (1st) 113410-U (Jan. 17, 2013)

In this administrative review case, the Department determined that Con-Way's claim for a refund of the amounts it overpaid during a corporate tax amnesty program was untimely under the generally applicable one-year limitations period in section 911(a) of the Income Tax Act. The trial court affirmed the Department's decision, but the appellate court reversed.

On November 17, 2003, Con-Way participated in the amnesty program by filing an amended return to estimate an anticipated federal change. About nine months later, the federal audit concluded with an increase in federal taxable income that was less than what Con-Way had previously estimated. On November 29, 2004, Con-Way filed a second amended return seeking a refund of part of its amnesty payment.

The Department's emergency regulations provided an exception to the general rule against refunding amnesty payments when a taxpayer overestimated a federal change. However, the Department nevertheless denied Con-Way's refund claim as barred by the statute of limitations, having been filed more than one year after the date of payment. Con-Way argued for applying the provision in IITA section 911(b), which allows refund claims to be filed within two years after a federal change is required to be reported.

Finding no requirement in section 911(b) that the overpayment must arise solely from federal action, the appellate court determined that the Department must give effect to the first amended return, and the second amended return constituted a decrease in federal taxable income. Therefore, the two-year statute of limitations for federal changes applied and Con-Way's request for refund was timely.