

ST 16-0031 GIL 07/29/16 SERVICE OCCUPATION TAX

This letter discusses the methods for calculating Service Occupation Tax on sales made to Medicare and Medicaid. See 86 Ill. Adm. Code 140.108. (This is a GIL.)

July 29, 2016

Dear Xxxxx:

This letter is in response to your letter dated May 10, 2016, in which you requested information. The Department issues two types of letter rulings. Private Letter Rulings (“PLRs”) are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department’s regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter (“GIL”) is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.tax.illinois.gov to review regulations, letter rulings and other types of information relevant to your inquiry.

The nature of your inquiry and the information you have provided require that we respond with a GIL. In your letter you have stated and made inquiry as follows:

“Attached is a request for a General Information Letter. We were referred to you from the Technical Services area.

Upon review of this submission, if you have any questions, please feel free to call me.

In 2010, the State of Illinois issued a General Information Letter No. ST 10-0098 in which the State published a discussion of the application of the Medicare/Medicaid exemption to de minimus servicemen’s purchases of food and consumables for patients in the healthcare industry. The de minimus servicemen in the healthcare industry who service Medicare/Medicaid patients are obligated to provide meals to their residents under federal law. The servicemen, in providing these meals, must purchase food, dietary supplies, and equipment. In the GIL, the State concluded that food and consumables are exempt under the concept of a flow through exemption from the federal government.

The sources of revenue to the servicemen are the dollars that the federal government sends to the servicemen for the care of specific patients. This is the only funding that the servicemen receive for Medicare and Medicaid patients. The servicemen are required to prepare Cost reports to the federal government that delineates all expenses incurred.

In the portion of the GIL covering consumables, the list of items is short. However, in informal discussions with the Department of Revenue, the Department has communicated that the list is not exhaustive. While we believe that all dietary supplies and non-capitalized equipment should be covered by the Medicare/Medicaid exemption, this situation has made it difficult to determine which items in the dietary supply area should be covered by the Medicare/Medicaid exemption. These are items that are essential to the preparation and provision of the meals.

Issue:

What dietary supplies and equipment used in preparing meals is [sic] entitled to the flow through exemption?

Discussion of Law:

There are many portions of the law which govern the Medicare/Medicaid area. The following is a discussion of several of these areas.

- I. U.S. Supremacy Clause – The U.S. Constitution and early cases, such as McCulloch vs. Maryland, validate that states and local governments are prohibited from taxing the federal government. The servicemen are required by the Federal Government to furnish meals to the Medicare and Medicaid patients. The items required to provide the meals should be exempt.
- II. Illinois Department of Revenue General Information Letter No. ST 10-0098, the Illinois Department of Revenue issued its ruling on food and consumables stating that the servicemen step into the shoes of the federal government and are entitled to the government exemption as it relates to food and consumables for Medicare and Medicaid patients.
- III. The Omnibus Budget Reconciliation Act -- OBRA
The Federal Government has issued many rules relating to the care of individuals covered by Medicare and Medicaid. The government sends out team [sic] of auditors to check on whether or not these rules are being followed. Failure to handle food properly or follow cleanliness standards is an infraction of these rules. Healthcare facilities can be shut down to not following the rules.
- IV. Process as a whole; plant as a whole; manufacturing exemption
When manufacturing was robust in the State of Illinois, the industry lobbied for exemptions relating to items purchased for the use in manufacturing. The State would audit this issue and would adopt a narrow construction of the exemption. Manufacturers challenged the State's interpretation and were successful in securing a broad exemption based on the theory of process or plant as a whole. Basically, what this means is that whatever it takes to produce a particular manufactured item should be exempt.

The service industry has expanded tremendously in the United States. The service industry has its own set of exemptions. In this particular

situation, the nursing home servicemen are providing goods and services to Medicare and Medicaid patients. In providing meals to the patients, the servicemen do not just provide raw food; they also provide and use dietary supplies to be able to serve a proper meal to the patient. The process as a whole should be exempt, and a narrow construction of food only is inconsistent with what happened in the manufacturing industry.

Finally, some of the dietary supplies that are purchased are small items such as blenders which are used to prepare meals. Just as companies such as McDonald's [sic] have been able to use the manufacturing exemption for the production of meals, the servicemen should be able to invoke this exemption as well as the exemption noted above.

- V. U.S. Department of Health and Human Service -- Cost reports -- the servicemen have to submit Cost reports to the federal government showing what item were purchased by category. We reviewed selected Cost reports and the detail supporting the Cost reports. Dietary supplies were specifically reported to the federal government. The U.S. Department of Health and Human Services is the agency that manages Medicare and Medicaid.
- VI. Calculations relating to Medicare/Medicaid patients
Gross receipts of servicemen were analyzed to determine what was received from the federal government vs. other sources. The percentage of the Medicare/Medicaid revenues over total revenues multiplied by the tax relating to dietary supplies should be exempt under Illinois law.

For the various reasons stated above, we are requesting clarification of items in the dietary supply area in the form of an additional General Information Letter.”

By email dated June 23, 2016, you provided a list of items commonly used in the dietary supply area: tin foil; Saran Wrap; wax paper; plastic forks, knives and spoons; forks, knives and spoons; serving spoons; paper napkins; paper place mats; plates and bowls; foam cups and lids; paper cups and lids; plastic cups; domes (covers for food); tray cards; paper table clothes; steam table pans; pitchers; plastic soufflé cups and lids; plastic bags; cleaners and soaps; rubber gloves; hand sanitizers; urn filters; oven mitts; thermometers; knives; can liners; aprons; sponges; bleach; hair nets; brooms; pan racks; spatulas; and dish towels.

DEPARTMENT'S RESPONSE:

In general, the Retailers' Occupation Tax does not apply to sales of machinery and equipment used primarily in the manufacturing or assembling of tangible personal property for wholesale or retail sale or lease. The use of machinery or equipment in the preparation of food and beverages by a retailer for retail sales, *i.e.*, restaurants, food service establishments, etc., is an activity that is generally not considered to be manufacturing. See 86 Ill. Adm. Code 130.330(d)(4)(I).

Non-reusable tangible personal property sold to food and beverage vendors, including persons engaged in the business of operating restaurants, cafeterias or drive-ins, is a sale for resale when such property is transferred to customers in the ordinary course of business as part of the sale of food or beverages and is used to deliver, package or consume food or beverages, regardless of where consumption of the food or beverage occurs. Receipts from sales for resale are not subject to the Retailers' Occupation Tax. See Section 130.2070(b)(3). The supplier of such items must be

presented with a Certificate of Resale by the purchaser in order for the transaction to be nontaxable. By way of example, items sold for resale include, but are not limited to, paper and plastic cups, plates, baskets, boxes, sleeves, buckets or other containers, utensils, straws, placemats, napkins, doggie bags and wrapping or packaging materials that cannot be reused by the food or beverage vendor and which are transferred to customers as part of the sale of food or beverages.

Food vendors purchasing items used or consumed in conducting their business and which are not transferred to the customer fully incur Use Tax as the end users of the items sold. Such items include, but are not limited to, paper products, serving trays, serving dishes, utensils or condiment bottles. The supplier's receipts from the sale of items for use or consumption are subject to the Retailers' Occupation Tax. See 130.2070(b)(3) and (c)(1).

The tax treatment of sales of tangible personal property to hospitals or nursing homes may be effected by whether the hospital or nursing home is organized and operated exclusively for charitable, religious or education purposes. Corporations, societies, institutions, associations and foundations that make application to the Department and are determined to be organized and operated for exclusively charitable, religious or educational purposes are exempt from Use Tax when purchasing tangible personal property for use or consumption in the furtherance of organizational purposes. A supplier's receipts from the sale of tangible personal property to a purchaser for use or consumption who has been determined by the Department to be organized and operated exclusively for charitable, religious or educational purposes is not subject to Retailers' Occupation Tax. See 86 Ill. Adm. Code 130.2005 and 130.2007. A home for the aged that is not organized or operated as a business enterprise with a view to profit and which otherwise qualifies as a charitable institution is also considered an exempt buyer. See 130.2005(k)(1).

The Department issues tax exemption identification numbers ("E" number) to organizations determined to be organized for exclusively religious, educational or charitable purposes. A valid E number must be presented to the supplier in order for receipts from sales of tangible personal property to such organizations for use or consumption to be exempt from Retailers' Occupation Tax. With respect to sales to hospitals and nursing homes, they are generally considered service providers and are subject to either the Service Occupation Tax or the Use Tax depending upon whether the facility chooses to register under the Service Occupation Tax Act.

Under the Service Occupation Tax Act, servicemen are taxed on tangible personal property transferred as an incident to their sales of service. The purchase of tangible personal property that is transferred to service customers may result in either Service Occupation Tax liability or Use Tax liability for the servicemen, depending upon which tax base the servicemen choose to calculate their liability. Servicemen may calculate their tax base in one of four ways: (1) separately stated selling price; (2) 50% of serviceman's entire bill; (3) Service Occupation Tax on his or her cost price if he or she is a registered de minimis serviceman; or (4) Use Tax on his or her cost price if he or she is an unregistered de minimis serviceman. See 86 Ill. Adm. Code 140.101.

Using the first method, servicemen may separately state the selling price of each item transferred as a result of the sale of service. The tax is then calculated on the separately stated selling price of the tangible personal property transferred. If the servicemen do not separately state the selling price of the tangible personal property transferred, they must use 50% of the entire bill to the service customer as the tax base (the second method described above). Both of the above methods provide that in no event may the tax base be less than the servicemen's cost price of the tangible personal property transferred. See 86 Ill. Adm. Code 140.106.

The third way servicemen may account for their tax liability only applies to de minimis servicemen who have either chosen to be registered or are required to be registered because they

incur Retailers' Occupation Tax liability with respect to a portion of their business. See 86 Ill. Adm. Code 140.109. Servicemen may qualify as de minimis if they determine that the annual aggregate cost price of tangible personal property transferred as an incident of the sale of service is less than 35% of the total annual gross receipts from service transactions (75% in the case of pharmacists and persons engaged in graphics arts production). Servicemen do not have the option of determining whether they are de minimis on a transaction-by-transaction basis. Registered de minimis servicemen are authorized to pay Service Occupation Tax (which includes local taxes) based upon their cost price of tangible personal property transferred incident to the sale of service. Such servicemen should give suppliers resale certificates and remit Service Occupation Tax using the Service Occupation Tax rates for their locations. Such servicemen also collect a corresponding amount of Service Use Tax from their customers, absent an exemption.

The final method of determining tax liability may be used by de minimis servicemen not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act. Such de minimis servicemen may pay Use Tax to their suppliers or may self-assess and remit Use Tax to the Department when making purchases from unregistered out-of-State suppliers. Those servicemen are not authorized to collect "tax" from their service customers because they, not their customers, incur the tax liability. Those servicemen are also not liable for Service Occupation Tax. See 86 Ill. Adm. Code 140.109. Although liability rests with a serviceman, the Department has determined that a de minimis serviceman incurring a Use Tax liability may claim exemptions predicated upon either the exempt status of his or her customer or upon exemptions claimed by his or her customer based on nontaxable uses of the tangible personal property transferred by the serviceman.

A customer's status as an exempt entity may "flow through" to an unregistered de minimis serviceman. The Department has determined that such a serviceman is relieved of his or her Use Tax liability when making sales of service to customers who have obtained exemption identification numbers ("E" numbers) from the Department. The customer must provide its "E" number to the de minimis serviceman in order to relieve the de minimis serviceman of Use Tax liability on the purchase of tangible personal property being transferred to that customer. In the situation where there are both taxable and exempt purchases, the serviceman will notify the supplier the percentage of purchases that are exempt. The serviceman utilizing this flow through may either present the customer's "E" number to his or her supplier in advance when making the purchase of tangible personal property that will be transferred to the customer or, if tax was paid to the supplier, present it to his or her supplier along with a request that the supplier submit a claim for credit to the Department. If the de minimis serviceman, however, has previously self-assessed the Use Tax on that item to the Department, then the de minimis serviceman may file a claim for credit.

As stated above, sales made to Medicare and Medicaid are exempt from tax as sales to a governmental body so long as the exemption is properly documented through the use of an active E number. Accordingly, under the first method, if a registered serviceman separately states the selling price of the tangible personal property transferred incident to a sale of service and Medicare or Medicaid does not pay the entire amount of the bill, then only that portion of the bill paid by Medicare or Medicaid would be tax exempt. For example, the entire bill is \$300, the separately stated tangible personal property is \$100, and Medicare or Medicaid pays 80% of the bill. Medicare or Medicaid is considered to have paid \$80 of the \$100 charge for the separately stated tangible personal property and the remaining \$20 is paid by another person or entity. Thus, the \$20 paid by the other person or entity would be taxable.

Similarly, using the second method where the serviceman calculates its tax liability based on 50% of the entire bill, only that portion paid directly by Medicare or Medicaid would be tax exempt. For example, the entire bill is \$200, and Medicare or Medicaid pays 80% of the bill. Medicare or Medicaid is considered to have paid \$80 of the \$100 tax base with \$20 paid by another person or

entity. The \$80 paid by Medicare or Medicaid would not be taxable, but the \$20 paid by the other person or entity would be taxable.

Under the third method, a registered de minimis serviceman is authorized to pay Service Occupation Tax (which includes local taxes) based upon his or her cost price of the tangible personal property transferred incident to the sale of service. Thus, if Medicare or Medicaid paid 80% of the entire bill, then 80% of the serviceman's cost price of the tangible personal property transferred would not be taxable. However, the remaining 20% of the cost price of the tangible personal transferred incident to the sale of service would be taxable.

However, if an unregistered de minimis serviceman elects to pay Use Tax on the tangible personal property transferred incident to a sale of service, he may claim exemptions based upon either the exempt status of his or her customer or upon exemptions claimed by his or her customer based on nontaxable uses of the tangible personal property transferred. For example, the serviceman purchases \$350 of tangible personal property from his or her supplier and pays his or her supplier \$21.88 in Use Tax on the purchase. If Medicare or Medicaid pays 80% of the service bill, the "flow through" allows 80% of the Use Tax paid by the serviceman to be considered exempt from tax. The serviceman utilizing this flow through may present the customer's "E" number to his or her supplier along with a request that the supplier submit a claim for credit to the Department for 80% of the \$21.88 in Use Tax paid by the serviceman.

Whether a sale to a hospital or nursing home is considered a sale for resale as explained above will depend on what method the nursing home uses to calculate its tax liability. If the hospital or nursing home chooses to remit Service Occupation Tax using any of the first three methods explained above (i.e., separately stated selling price, 50% of the entire bill to their service customers, or, as a registered de minimis servicemen, on the cost price of the tangible personal property transferred), then the hospital or nursing home may present a Certificate of Resale to the supplier and the transaction will be nontaxable. If, however, under the fourth method the nursing home is a de minimis servicemen that is not registered with the Department, the nursing home must pay Use Tax to its supplier on the cost price of the items to be transferred with service. Unregistered de minimis servicemen cannot claim the transaction as a sale for resale, and therefore, the transaction is taxable and the supplier must collect the Use Tax.

The General Information Letter you reference, ST 10-0098, explains the treatment of sales of tangible personal property to Medicare and Medicaid. I would note that the letter states:

"Lastly, it is not clear what you mean when you say "various consumable paper products" that are consumed 100% by Medicaid recipients. We assume that you are referring to the purchase of toilet paper, paper towels, and tissue used in your facility. If those items are paid for by Medicare or Medicaid, then the above information would apply. If those items are not paid for by Medicare or Medicaid, then the purchase of those items would be taxable.

Some of the items you describe in your email are consumables that may be paid for by Medicaid and Medicare. Other items, for example, steam table pans, pitchers and pan racks, to name a few, are used to serve meals to patients and do not appear to be items that are transferred to patients and paid for by Medicaid and Medicare. Many of these items are used by the serviceman to prepare meals for patients and are a cost of doing business, for example, Saran Wrap, cleaners and soaps, and dish towels. As noted above, food vendors purchasing items used or consumed in conducting their business and which are not transferred to the customer fully incur Use Tax as the end users of the items sold. Such items include, but are not limited to, paper products, serving trays, serving

dishes, utensils or condiment bottles. The supplier's receipts from the sale of items for use or consumption are subject to the Retailers' Occupation Tax. See 130.2070(b)(3) and (c)(1).

I hope this information is helpful. If you require additional information, please visit our website at www.tax.illinois.gov or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Richard S. Wolters
Associate Counsel

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