

Leasing and Rental Companies Chapter Index

Purpose

This chapter will cover information on leasing and rental companies. It will go through some different types of businesses, exemptions, and audit details for these types of companies.

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To apply Illinois tax law to a lease transaction, we must examine the terms and options in the lease contract and classify the lease as a true lease, a conditional sale, or some other type of lease. The characteristics of each are discussed in the following sections.

For Illinois sales tax purposes, there are two types of leasing situations: conditional sales and true leases.

A conditional sale is usually characterized by a nominal or one dollar purchase option at the close of the lease term. Stated otherwise, if lessors are guaranteed at the time of the lease that the leased property will be sold, this transaction is a conditional sale at the outset of the transaction, thus making all receipts (net of interest and finance charges) subject to Retailers' Occupation Tax.

A true lease generally has no buy out provision at the close of the lease. If a buyout provision does exist, it must be a fair market value buy out option to maintain the character of the true lease. Lessors of tangible personal property under true leases in Illinois are deemed end users of the property to be leased. As end users of tangible personal property located in Illinois, lessors owe Use Tax on their cost price of such property. The State of Illinois does not impose tax on true lease payments. Consequently, lessees incur no tax liability. The above guidelines are applicable to all true leases of tangible personal property in Illinois except for (i) automobiles leased under terms of one year or less, which are subject to the Automobile Renting Occupation and Use Tax (ART) found at 35 ILCS 155/1 and (ii) tangible personal property rented under a rental purchase agreement (e.g. "rent-to-own") which is subject to the Rental Purchase Agreement Occupation and Use Tax (RPAT) found at 35 ILCS 180/1.

True Leases

In true leases, also called operating leases or bona fide leases, the lessor assumes the benefits and risks of ownership. The rental payments are considered income to the lessor and are fully deductible expenses by the lessee. The lessor is allowed to take depreciation because the lessor is the owner of the tangible personal property. To classify the lease as a true lease for Illinois purposes, title must remain with the lessor, and any buy out sales price must be indicative of fair market value or greater. Typical true lease contracts may have the following options concerning the disposition of the leased property at the contract's end:

1. The equipment must be returned to the lessor.
2. The lessee has the option to buy the property at fair market value.
3. The lease may be renewed at the same rent or at a substantially lower rent.
4. The lease may be renewed with a nominal (\$1.00 or \$10.00) purchase option at the end of the renewal contract.

Note that in option 4 above, the fact that the optional renewal contains a nominal purchase option does not transform the initial lease into a conditional sales contract. This is true because the lessee is not obligated to continue the lease agreement until there is a nominal purchase option.

Lease agreements that contain purchase options that are equal to the fair market value of the tangible personal property at the end of the lease term are considered true leases, and the lessors

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incur Use Tax liability on their cost price of tangible personal property purchased for rental purposes. See 86 Ill. Adm. Code 130.2010.

Conditional Sales Contracts

Conditional sales contracts, also called financing leases or CSC's, are characterized as leases that transfer all the incidents of ownership of the leased property to the lessee and give the lessee a nominal purchase option. The lessee, under a conditional sales contract, treats the property as his or her own, depreciates the property for tax purposes, claims the investment tax credit if available, and deducts the interest portion of the "rent" payments for federal tax purposes. The lessor treats the transaction as a loan. The lessor will hold the title until the contract is satisfied. The lease contract will have a nominal purchase option at the end of the contract. This is at a price of \$1.00, \$10.00, or at a sum much less than fair market value so that the lessee would most certainly exercise this option. A general rule of thumb for determining whether an amount is nominal is to look at the original value of the property and if the amount at the end of the contract period represents less than 10% of that amount, it is probably nominal.

Tax Application for Conditional Sales Contracts

Determining the application of Illinois sales tax laws to conditional sales contracts is more complicated than with true leases. These leases are considered installment sales from the outset. The proceeds from the conditional sales contract will always yield more than the lessor's acquisition cost.

Conditional sales contracts have an implied interest rate which is not specifically stated. They do not fall under the laws of the federal Truth-In-Lending Act. There is a lease factor rate determined by the lending agency. This rate is determined by such variables as the lessee's credit rating, the length of the contract, the prime rate, type of equipment and future economic predictions.

When auditing a taxpayer involved in conditional sales contracts, it may be very difficult to determine the implied interest charge. Attempt to compute a reasonable interest charge based upon prevailing market conditions for the equipment being sold. Where the difference between purchase price and total charges made for the equipment is reasonably close to the computed interest charge, no additional analysis is necessary. In this case, the taxable basis for such sales would be acquisition cost.

If the difference between acquisition cost and total charges is significantly higher than what is determined to be a reasonable interest charge, a taxable basis other than acquisition cost should be established. This taxable basis would include a markup factor and costs of doing business added onto the acquisition cost. Analyze the taxpayer's operations to compute a reasonable amount for the cost of doing business. If possible, determine industry standards for markup. It may be easier to arrive at a fair interest charge and subtract this amount from the total charges to determine the taxable amount.

Other Leases

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Other types of lease contracts held by the taxpayer may be discovered. Two types of leases that are not subject to Illinois sales tax are chattel mortgages and leveraged leases. In both types of leases, the lending agency has only a security interest or lien against the property. The lending agency does not have title to the property unless the lessee defaults.

Sales to Lessors of Tangible Personal Property

The sale of tangible personal property to a purchaser who will act as a lessor is a sale at retail and is subject to Retailers' Occupation Tax. Also, the sale of tangible personal property that is used, employed, or consumed by the purchaser in or upon other tangible personal property as to which such purchaser acts as a lessor is a sale at retail and is subject to Retailers' Occupation Tax.

However, an exception exists for the sale of an automobile to an automobile renter for use as a rental automobile under lease terms of one year or less, provided the lessor gives proper certification to the seller. The exception does not apply to a retail sale of repair or replacement parts for rental automobiles.

All gross receipts received from the sale of tangible personal property at retail, whether encumbered by leases or other rights vested in third parties, are presumed to be subject to Retailers' Occupation Tax. No deduction will be permitted for any value attributable to intangible property or rights transferred in a sale of tangible personal property at retail if there is not clear evidence from the books and records of the retailer that the sale of such intangible property has been contracted for separately from the sale of the tangible personal property. In no event will the combined sale of tangible and intangible property be permitted to reduce the tax base of the tangible personal property being sold below the fair market value of similar tangible personal property sold separately.

Sales of tangible personal property to lessors are subject to Retailers' Occupation Tax even if the tangible personal property is leased to an exempt entity that has been issued an exemption identification number under Section 130.2007. The only exemption from this provision is if the purchases of the tangible personal property qualify under Section 130.2011 (computers, communications equipment, and equipment used in diagnosis, analysis, or treatment that are leased to exempt hospitals) or 130.2012 (tangible personal property leased to a governmental body).

Use Tax Liability Non-Vehicle

Use Tax is due whenever tangible personal property is purchased for use. For Illinois sales tax purposes, lessors of tangible personal property under true leases are deemed to be the users of that property. Consequently, lessors incur a Use Tax liability (and applicable local occupation tax reimbursement obligations) based on their cost price of the items they purchase for rental purposes. (See Section 130.2010.)

Except as provided in Sections 130.2011 and 130.2012, such lessors incur Use Tax even if the tangible personal property is leased to an exempt entity that has been issued an exemption identification number under Section 130.2007.

The auditor must verify that the lessor paid the Use tax to their suppliers or self-assessed and paid the Use Tax to the Department. The auditor must also verify that the rental agreements are true leases and not conditional sale leases.

Retailers' Occupation Tax Liability - Non-Vehicle

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When persons who are engaged in the business of renting tangible personal property to others for use enter into an original rental agreement which involves a lease with a dollar or other nominal option to purchase, such persons are liable for payment of the Retailers' Occupation Tax. Such a transaction is a conditional sale from the outset, and all receipts (net of interest and finance charges) from the transaction are subject to Retailers' Occupation Tax.

The auditor must review the rental agreement to determine if the rental agreement is a conditional sale contract. If it is a conditional sale contract, the auditor must verify that the lessor bought the item for resale and is paying Retailers' Occupation Tax on the receipts when they are received.

Purchases For Rental – Non-Vehicle

Persons who are lessors and whose only selling activity consists of selling items that come off lease and are no longer needed for rental purposes cannot purchase for resale.

If an item is placed in a rental inventory, it has been purchased for rental purposes and Use Tax is due. "Rental inventory" means that the owner, to state their intended use of the property as rental property, has recorded the property in their books and records as rental property in accordance with generally accepted accounting principles. Depreciation of property used for rental purposes demonstrates an intent to include that property in rental inventory.

Sales Of Used Rental Equipment

The question of whether a lessor's sale of tangible personal property coming off lease that is no longer needed for the lessor's rental inventory is subject to Retailers' Occupation Tax liability depends on whether the seller is strictly a lessor, or whether the seller is otherwise engaged in the business of selling like-kind property.

A person who is strictly a lessor and whose only sales are of items no longer needed for their rental inventory does not incur Retailers' Occupation Tax liability on those sales. For example, a lessor of computer equipment who does not maintain a sales inventory of computer equipment and who does not otherwise hold themselves out as being in the business of selling like-kind property, incurs no Retailers' Occupation Tax liability on sales of computer equipment that they no longer want in their rental inventory. If all the sales are of equipment no longer needed for the lessor's rental inventory and the retailer does not also sell like kind equipment, they constitute non-taxable isolated or occasional sales. (See Section 130.110.)

Receipts From the Rental of Tangible Personal Property

Receipts from the rental of tangible personal property under a true lease are not subject to Retailers' Occupation Tax. (See Section 130.2010.) However, receipts from the rental of automobiles under lease terms of one year or less are subject to Automobile Renting Occupation Tax (ART). (See 86 Ill. Adm. Code 180.) In addition, receipts from the rental of tangible personal property under a rental purchase agreement (e.g., "rent-to-own") are subject to Rental Purchase Agreement Occupation and Use Tax (RPAT). (See 35 ILCS 180/1.)

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The State of Illinois imposes no tax on rental receipts received for a true lease. Consequently, lessees incur no tax liability. In the case of a true lease, the lessors of the property being used in Illinois would be the parties with Use Tax obligations. The lessors would either pay their suppliers, if their suppliers were registered to collect Use Tax, or would self-assess and remit the tax to the Department. If the lessors already paid taxes in another state with respect to the acquisition of the tangible personal property, they would be exempt from Use Tax to the extent of the amount of such tax properly due and paid in such other state. See subsection (a)(3) of 86 Ill. Adm. Code 150.310. Under Illinois law, lessors may not “pass through” their tax obligation to the lessees as taxes. However, lessors and lessees may make private contractual arrangements for a reimbursement of the tax to be paid by the lessees. If lessors and lessees have made private agreements where the lessees agree to reimburse the lessors for the amount of the tax paid, then the lessees are obligated to fulfill the terms of the private contractual agreements.

Purchases of Tangible Personal Property for Resale

If a retailer purchases tangible personal property for resale, no tax is due on that transaction so long as all the requirements of Section 130.1405 are satisfied. If an item is purchased for resale and placed in a sales inventory immediately after it is purchased, the Department will determine that it has been purchased for resale for so long as it remains in the sales inventory. "Sales inventory" means that the owner, to demonstrate their intention to resell the property, has recorded the property in their books and records as being for sale in accordance with generally accepted accounting principles.

No Separate Rental/Sales Accounts

Some persons function as combination lessors/retailers and do not maintain separate rental and sales inventories. These persons purchase tangible personal property to rent to others and purchase tangible personal property to sell to others without making such property available for rental. The question of whether the combination lessor/retailer, who does not maintain separate sales and rental inventories, incurs a Use Tax liability when purchasing items for their combined inventory depends on whether they are primarily engaged in the business of renting or primarily engaged in the business of selling. To make that determination, the auditor will look to the lessor/retailer's gross receipts.

If the gross receipts from Illinois locations are primarily from rentals, the combination lessor/retailer who does not maintain separate rental and sales inventories is primarily a lessor who incurs Use Tax liability on items purchased for rental purposes and Retailers' Occupation Tax liability on all items sold at retail. This combination lessor/retailer can give suppliers certificates of resale, but only for items that will be resold without being rented. If the lessor/retailer knows, at the time of purchase, that a percentage of the items being purchased will be resold without being rented, they may give their supplier a certificate of resale specifying the percentage of items that will be resold without being rented and pay tax only on those items that will be rented before they are sold. The combination lessor/retailer who does not maintain separate rental and sales inventories and who is primarily a lessor incurs Use Tax liability on all items that are rented before they are sold.

If the gross receipts from Illinois locations are primarily from sales, including sales of items coming off lease and sales of items encumbered by leases, the combination lessor/retailer who does not maintain separate inventories is primarily a retailer. This combination lessor/retailer can purchase their entire inventory tax-free by providing certificates of resale to their suppliers. They may use items for rental purposes without incurring a Use Tax liability if the items are used in demonstrations to potential buyers or are put to some other interim use. (See 86 Ill. Adm. Code 150.306.)

Use Tax

If an item is moved from a sales inventory to a rental inventory, Use Tax is due based on the cost price of that item. In this situation, the Use Tax must be self-assessed and paid on a return filed for the month in which the item was moved to the rental inventory.

If an item is moved from a rental inventory to a sales inventory, Retailers' Occupation Tax is due on the gross receipts from the sale when the item is sold to a user or consumer. In this situation, the lessor/seller would collect the complementary Use Tax from the purchaser. A credit may be available

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for Use Tax and local Retailers' Occupation Tax reimbursements paid to an Illinois supplier when the item was purchased for the rental inventory.

Sale of Used Rental Items

Lessors who are otherwise engaged in the business of selling like-kind property incur Retailers' Occupation Tax liability on all their sales, including sales of items coming off lease that are no longer needed for their rental inventories.

Conditional sales contracts are considered retail sales. A lessor of tangible personal property who sells like-kind property apart from their sale of items no longer needed for their rental inventory incurs Retailers' Occupation Tax on all retail sales of that property including sales of items no longer needed for their rental inventory. This is true because a person who is engaged in the business of selling tangible personal property cannot make an isolated or occasional sale of like-kind tangible personal property.

For example, a lessor of computer equipment who also maintains a sales inventory of computer equipment incurs Retailers' Occupation Tax liability whenever they make retail sales of computer equipment, including sales of computer equipment no longer needed in their rental inventory. The result would be the same even if the lessor/seller did not maintain a separate sales inventory, as such, but offered computer equipment for sale apart from items coming off lease that are no longer needed for their rental inventory. This would be the case where the lessor advertised or otherwise held themselves out as a supplier of computer equipment apart from the items coming off lease and no longer needed for their rental inventory. In this situation, the lessor/seller would incur Retailers' Occupation Tax liability on all sales of computer equipment for use or consumption and must collect the complementary Use Tax from their customers.

Credit for Previously Paid Taxes

A lessor who incurs Retailers' Occupation Tax liability on the sale of an item can take a credit against that liability for any Use Tax and any local Retailers' Occupation Tax reimbursements they paid to a supplier registered to collect Illinois tax when they purchased that item. However, this credit cannot exceed the amount of Retailers' Occupation Tax incurred by the lessor/retailer when they sell the item.

If a lessor filed a return and paid the tax directly to the Department, the lessor must file a claim to recover it. However, this claim cannot exceed the amount of Retailers' Occupation Tax incurred by the lessor/retailer when they sell the item.

The credit is available to all lessors who are required to pay Retailers' Occupation Tax when selling an item after having used that item for rental purposes, including lessors of motor vehicles. The credit is available to all lessors (and renters) of motor vehicles who incur Retailers' Occupation Tax liability on sales so long as Use Tax was paid to an Illinois retailer when the lessor (or renter) purchased the motor vehicle being sold. If the lessor (or renter) did not pay Use Tax to an Illinois dealer when they purchased the motor vehicle being sold but, instead, filed a return and paid the tax directly to the Department, the credit is not available, and it must not be taken. (If the lessor filed a return and paid

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the tax directly to the Department, the lessor must file a claim to recover it. See 86 Ill. Adm. Code 130.1501.)

When an item that was purchased for lease on or after January 1, 2015, is sold, this credit cannot be claimed if the selling price reported on the original Form ST-556-LSE or Form RUT-25-LSE was the amount due under the lease contract. The credit can only be claimed if the selling price reported was equal to the actual selling price. (See the definition of “selling price” in Section 1 of the Retailers’ Occupation Tax Act (35 ILCS 120/1).

When the credit is claimed, the lessor/seller must retain documentation demonstrating that Use Tax was paid to a supplier registered to collect Illinois tax when they purchased the item being sold and in what amount. A paid receipt from the supplier for the item on which the credit is being claimed showing the amount of Use Tax paid as a separate item is sufficient to document the credit for all items other than motor vehicles.

There is no credit available for taxes paid by a rentor under the Automobile Renting Occupation and Use Tax Act [35 ILCS 155].

Leasing

Those who lease the use of automobiles under lease terms of more than one year or lease furniture, bus tires, costumes, towels, linens, or other tangible personal property to others, are not engaged in the business of selling tangible personal property to purchasers for use or consumption within the meaning of the Retailers' Occupation Tax Act. These leases are not subject to Retailer's Occupation Tax. This will apply to [true leases](#), but it will not apply to [conditional sales contracts](#) as defined above.

However, such lessors (not being resellers) are users of the property and are subject to the Use Tax when purchasing tangible personal property which they lease to others.

Out of State Leasing Company

Illinois law provides that property that is used in Illinois becomes subject to Illinois Use Tax upon its first entry into Illinois. If a piece of equipment is purchased and used in another state and then leased or rented in Illinois, it is subject to Use Tax based upon the depreciated value with credit given for tax properly paid (includes rental tax) to the other state.

Repair Parts consumed in Illinois on leased equipment being repaired in Illinois are subject to tax.

Conditional Sales of Leased Property

When a lessor makes a conditional sale of tangible personal property to a customer, the lessor is acting as a retailer. The lessor may purchase the property using a Certificate of Resale. When the lessor sells the property, they incur Retailers' Occupation Tax based upon the monthly payments as they are received. In this situation, the customer does incur the corresponding Use Tax liability and the amount of tax should be separately stated and identified as tax on the customer's monthly bill.

When retailers sell intangible personal property along with tangible personal property transferred in leases, the books and records of the retailers must separate the price of the intangible personal property from the price of the tangible personal property of the lease, or the full amount will be subject to Retailers' Occupation Tax. See 86 Ill. Adm. Code 130.220(c).

Rental Purchase Agreement Occupation and Use Tax

The Rental Purchase Agreement Occupation Tax is imposed on the gross receipts received on or after January 1, 2018, from the renting of tangible personal property under a rental purchase agreement. "Renting" is considered any transfer of the possession or right to possession of merchandise to a user for a valuable consideration under a rental purchase agreement. Gross receipts include the total rental price or leasing price but do not include receipts received for delivery, reinstatement, processing, waiver, or club program fees.

A "rental purchase agreement" is an agreement for the use of merchandise by a consumer for personal, family, or household purposes for an initial period of four months or less that is automatically renewable with each payment after the initial period and that permits the consumer to

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become the owner of the merchandise. These transactions are governed by the Rental-Purchase Agreement Act, 815 ILCS 655/0.01 et seq.

A business must pay the Rental Purchase Agreement Occupation Tax if, in the ordinary course of their business, they regularly lease, offer to lease, or arrange for the leasing of merchandise under a rental purchase agreement, an arrangement typically known as a “rent-to-own” transaction. The business also must pay this tax if they have been assigned an interest in a rental purchase agreement.

When merchants do not collect Rental Purchase Agreement Occupation and Use tax, it will be up to the purchaser to file form ST-244, Rental Purchase Agreement Use Tax Return, to report and pay the Rental Purchase Agreement Use Tax. Illinois law requires Form ST-244 to be filed and the tax liability paid electronically.

See the Rental Purchase Agreement Occupation and Use Tax Act, 35 ILCS 180/1 for more information.

Exempt Organizations as Lessees

In a true lease (not in a conditional sales contract), the lessor is considered the end user of the property and the fact that the lessee is a tax-exempt user (i.e., government, hospitals, and other non-profit organizations) does not exempt the sale to and purchase by the lessor from Retailers' Occupation Tax or Use Tax. The Illinois Supreme Court in *TELCO LEASING V. ALLPHIN* 63 Ill.2d 305, 347 N.E.2d 729, 1976 noted that the term user in its statutory sense encompasses the utilization of property for profit-making purposes by means of leasing. See the definition at 86 Ill. Adm. Code 150.201. This is true whether the exempt organization issues the purchase order to a supplier or to the leasing corporation. This was upheld in *CONTINENTAL ILLINOIS LEASING CORP. AND ST. MARY OF NAZARETH HOSPITAL V. ILLINOIS DEPT. OF REVENUE*, 108 Ill. App. 3d 583,439 N.E.2d 118, 1982.

Exempt Hospitals

Reference:

86 Ill. Adm. Code 130.2011

Effective January 1, 1996, through December 31, 2000, and on and after August 2, 2001, sales of computers and communications equipment utilized for any hospital purpose and sales of equipment used in the diagnosis, analysis, or treatment of hospital patients that are sold to persons who lease those items to exempt hospitals are not subject to Retailers' Occupation Tax. The exemption is available, provided that:

- The computers and communications equipment and other equipment described above must all be purchased for lease to a tax-exempt hospital under a lease that has been executed or is in effect at the time of purchase;
- The lease must be for a period of one year or longer; and
- The lease must be to a hospital that has an active tax exemption identification number issued by the Department under Section 1g of the Retailers' Occupation Tax Act (see Section 130.2007)

The purchaser or service customer must give the seller (retailer) or serviceman a certification stating that the computer or other communications equipment and equipment used in the diagnosis, analysis, or treatment of hospital patients is being purchased for lease to a tax-exempt hospital under a lease for a period of one year or longer executed or in effect at the time of the purchase. The retailer or serviceman must retain the certification in their books and records to properly document the exemption.

Under the Use Tax Act regulation 86 Ill. Adm Code 150.331(e), if computers or other equipment are purchased by a lessor and the computers or other equipment are used in a manner that does not qualify for the exemption or are used in any other non-exempt manner, the lessor is liable for the appropriate tax imposed under the Use Tax Act. Computers or other equipment being leased under qualifying leases that were entered into between January 1, 1996, and December 31, 2000, continue to be exempt after January 1, 2001, until such time as the computers or other equipment is no longer

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being leased under those qualifying leases or is used in any other non-qualifying manner. If the computers or other equipment is no longer leased in an exempt manner or is used in any other non-exempt manner, the amount of Use Tax liability incurred by the lessor is based on the fair market value of the computers or other equipment at the time the non-qualifying use occurred.

Governmental Bodies**Reference:**

86 Ill. Adm. Code 130.2012

Effective January 1, 1996, through December 31, 2000, and on and after August 2, 2001, sales of tangible personal property to a lessor who leases that property to a governmental body are not subject to Retailers' Occupation Tax. The exemption is available, provided that:

- The tangible personal property must be purchased for lease to a governmental body under a lease that has been executed or is in effect at the time of purchase;
- The lease must be for a period of one year or longer; and
- The lease must be to a governmental body that has an active tax exemption identification number issued by the Department under Section 1g of the Retailers' Occupation Tax Act (see Section 130.2007).

The purchaser or service customer must give the seller or serviceman a certification stating that the property is being purchased for lease to a governmental body, under a lease of one year or longer executed or in effect at the time of the purchase.

Under the Use Tax Act regulations 86 Ill. Adm Code 150.332, if the property is purchased by a lessor under the provisions of this Section 150.332(c) and the property is used in a manner that does not qualify for the exemption or is used in any other non-exempt manner, the lessor is liable for the appropriate tax imposed under the Use Tax Act. The property being leased under qualifying leases that were entered into between January 1, 1996, and December 31, 2000, continue to be exempt after January 1, 2001, until such time as the property is no longer being leased under those qualifying leases or are used in any other non-qualifying manner. If the property is no longer leased in an exempt manner or is used in any other non-exempt manner, the amount of Use Tax liability incurred by the lessor is based on the fair market value of the property at the time the non-qualifying use occurred.

Resale Certificates**Reference:**

86 Ill. Adm. Code 130.1405

A leasing company is prohibited from giving a resale certificate on a true lease transaction. Likewise, a leasing company may not indicate to the vendor that the leasing company will direct-pay or self-assess the tax. By self-assessing the Use Tax, the leasing company is avoiding the local taxes if the purchase would otherwise be subject to Retailers' Occupation Tax. The vendor will claim they took

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the resale certificate in "good faith" from the leasing company. The Illinois Retailers' Occupation Tax Act provides criminal penalties for anyone who knowingly gives its vendor a resale certificate on a taxable transaction. (Refer to 86 Ill. Adm. Code 130.910(c)). It is rare that a leasing company will purchase equipment until all the lease terms have been agreed to between the company and its customers. If a situation is encountered where leasing companies are providing resale certificates to their vendors, the Auditor will inform the Revenue Audit Supervisor. A letter bearing the supervisor's signature should be sent requesting the taxpayer cease this practice.

If the lessor is selling an item which is no longer being rented, they may accept a resale certificate from the purchaser if that purchaser is a retailer in the business of selling the same items.

Other Exemptions

Lessors may purchase items tax free to be leased under a true lease agreement when those items as defined by 86 Ill. Adm Code 130.2010 qualify for; manufacturing machinery and equipment, farm machinery and equipment, or graphic arts machinery and equipment (NOTE: beginning on July 1, 2017, the manufacturing machinery and equipment exemption was expanded to include graphic arts machinery and equipment (see 86 Ill. Adm. Code 130.330(g)).

Farm Machinery and Equipment Exemption

Reference:

86 Ill. Adm. Code 130.305

Farm machinery and equipment purchased for lease to be used by the lessee primarily in production agriculture as defined by 86 Ill. Adm Code 130.305(b) or in state or federal agricultural programs qualifies for the exemption. The lessor purchasing such equipment must certify that the equipment will be used in an exempt manner. Should a purchaser-lessor subsequently lease the machinery or equipment to a lessee who does not use it in a manner that would qualify directly for the exemption, the purchaser-lessor will become liable for the tax from which they were previously exempt.

The exemption applies only to items of farm machinery and equipment, either new or used, certified by the purchaser to be used primarily for production agriculture or state or federal agricultural programs, and including machinery and equipment purchased for lease. Included in this exemption are implements of husbandry defined in Section 1-130 of the Illinois Vehicle Code. Examples are fertilizer spreaders and nurse wagons required to be registered under Section 3-809 of the Illinois Vehicle Code. Excluded from this exemption are other motor vehicles required to be registered pursuant to the Illinois Vehicle Code.

Manufacturing Machinery and Equipment Exemption

Reference:

86 Ill. Adm. Code 130.330

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.

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The exemption applies whether the sale or lease is made directly by the manufacturer or some other person. In certain cases, purchases of machinery and equipment by a lessor will be exempt even though that lessor does not themselves employ the machinery and equipment in an exempt manner.

For this exemption to apply, the purchaser need not employ the exempt machinery or equipment in manufacturing. If the purchaser leases that machinery or equipment to a lessee-manufacturer who uses it in an exempt manner, the sale to the purchaser-lessor will be exempt from tax. A supplier may exclude such sales from their taxable gross receipts if the purchaser/lessor provides to them a properly completed exemption certificate and the information contained therein would support an exemption if the sale were made directly to the lessee-manufacturer. Should a purchaser-lessor subsequently lease the machinery or equipment to a lessee who does not use it in a manner that would qualify directly for the exemption, the purchaser-lessor will become liable for the tax from which they were previously exempt.

Until July 1, 2017, the printing process was not commonly regarded as manufacturing. Therefore, machinery and equipment used in any printing application did not qualify for the exemption. This includes graphic arts, newspapers or books, as well as other industrial or commercial applications. Beginning July 1, 2017, with the enactment of Public Act 100-0022 the exemption includes machinery and equipment used in graphic arts production.

Effective July 1, 2019, the manufacturing machinery and equipment exemption includes production-related tangible personal property. See 86 Ill. Adm. Code 130.330 for more information.

Graphic Arts Machinery and Equipment Exemption

Reference:

86 Ill. Adm. Code 130.325

Through June 30, 2003, and beginning again on September 1, 2004 through August 30, 2014, the Retailers' Occupation Tax does not apply to the sale of machinery and equipment to be used primarily in graphic arts production, including repair and replacement parts, both new and used and including that manufactured on special order. The exemption extends to purchases by lessors who will lease the property for use primarily in graphic arts production. Taxpayers must certify the use of the equipment they are purchasing to their suppliers. Beginning July 1, 2017, the manufacturing machinery and equipment exemption was expanded to include graphic arts machinery. See 86 Ill. Adm. Code 130.330(g)).

Manufacturers

Many manufacturers in addition to selling equipment will also lease equipment to customers. This should be discussed with the taxpayer at the initial conference when planning the scope of the audit. Additional sources to examine are the Federal 1120 rental income or other income amounts, the annual reports and Schedule 10-K. The material cost price of the tangible personal property which went into the leased equipment is the basis upon which Use Tax will be computed. The taxpayer will self-assess the Use Tax and report it on the ST-1.

Until June 30, 2008, the leasing of motor vehicles by motor vehicle manufacturers to their employees was within the interim use exemption if the leased motor vehicles were carried as inventory on the books of the manufacturers or were otherwise available for sale during the lease period. Beginning on July 1, 2008, and thereafter, a manufacturer may claim the interim use exemption for tangible personal property leased to its employees, or otherwise used by its employees, only when the manufacturer is registered as a retailer and the use of that property would qualify under all the requirements stated in 86 Ill. Adm. Code 150.306.

Equipment Transferred into Illinois

Leased property may be moved from state to state in the middle of a lease contract. A lessee may close a plant, consolidate a department, or go out of business making it necessary to relocate leased equipment. Use Tax is due on equipment moved into Illinois. In this situation, the Use Tax must be self-assessed and paid on a return filed for the month in which the item was moved into Illinois. The Use Tax base is reduced by straight-line depreciation as set out in 86 Ill. Adm. Code 150.110. The depreciation credit is based on a straight-line formula covering the useful life of the property. Credit for taxes properly paid to another state should be given. This includes another state's rental receipts tax properly paid by the lessor.

Sales of Leased Property

At the end of a contract term, the lessor may dispose of leased property by selling it to the lessee. The price may have been set in the lease contract, negotiated, or set by an arbitrator. The lessee may or may not be contractually bound to purchase the equipment.

The sale proceeds are subject to Retailers' Occupation Tax (state and local) when the leasing company is also in the business of selling such equipment at retail. If the lessor sells the equipment to someone other than the lessee, those sales would also be subject to Retailers' Occupation Tax unless exempt for resale, interstate commerce, etc. A lessor who incurs a Retailers' Occupation Tax liability on the sale of an item can take a credit against that liability for any Use Tax and any local Retailers' Occupation Tax reimbursements that the lessor paid to a supplier registered to collect Illinois tax when the lessor purchased that particular item. However, this credit cannot exceed the amount of Retailers' Occupation Tax incurred by the lessor/retailer when the lessor/retailer sells the item. Lessors that self-assessed Use Tax instead of paying their supplier, can recover their previously paid tax by filing a claim for credit, provided the statute of limitations to do so is still open. (86 Ill. Adm. Code 130.2013)

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When an out-of-state leasing company make sales into Illinois themselves or through a marketplace tax may be due. See Chapter 7 more information on this topic.

Occasional Sales of Leased Property – Non-Vehicle

Leasing companies that do not hold themselves out as sellers of used equipment and who do not make sales of new equipment may be making occasional sales when selling off previously leased equipment. Retailers' Occupation Tax is not due on such occasional sales. The decision of whether a leasing company's sales are occasional or subject to Retailers' Occupation Tax and local taxes will usually depend upon examples of circumstantial evidence shown below.

Leasing companies cannot claim their sales of off-lease equipment are occasional sales if they:

1. Also have conditional sales contracts.
2. Have purchase options, early buyouts, and other sales terms in the lease contract.

Lessors who utilize both conditional sales agreements and true leases cannot claim the occasional sale exemption when the equipment from their true leases come off lease. Due to retail sales of equipment through their conditional sales agreements, they are engaged in the business of selling equipment at retail. Persons who are engaged in the business of selling equipment at retail cannot claim the occasional sale exemption when they sell the same type of equipment coming off a true lease.

The occasional sale exemption applies only to sales of tangible personal property by persons who are not engaged in the business of selling tangible personal property of that kind. This exemption is commonly claimed, for instance, when a business exclusively engaged in leasing tangible personal property under true leases sells equipment that comes off lease.

The burden will be on the auditor to gather documentation to refute the taxpayer's claim that the sales were occasional.

Occasional Sales Motor Vehicles, Aircraft, Watercraft

Per 86 Ill. Adm. Code 130.111, any person engaged in the business of leasing or renting motor vehicles, trailers, aircraft, or watercraft, to others and who, in connection therewith, sells any used motor vehicle, trailer, aircraft or watercraft, to a purchaser or lessor for use and not for resale is a retailer selling tangible personal property at retail to the extent of the value of the vehicle, trailer, aircraft, or watercraft sold. **THIS MEANS THAT THE SALE OF MOTOR VEHICLES, TRAILERS, AIRCRAFT, AND WATERCRAFT BY A LESSOR IS NOT AN OCCASIONAL OR ISOLATED SALE.**

Sales of Tangible Personal Property Encumbered by a Lease

Effective January 11, 1993, 86 Ill. Adm. Code 130.220 was amended by adding subsection (c) as follows:

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"All gross receipts received from the sale of tangible personal property at retail, whether or not encumbered by leases or other rights vested in third parties, are presumed to be subject to Retailers' Occupation Tax. No deduction will be permitted for any value attributable to intangible property or rights transferred in a sale of tangible personal property at retail if there is not clear evidence from the books and records of the retailer that the sale of such intangible property has been contracted for separately from the sale of the tangible personal property. In no event will the combined sale of tangible and intangible property be permitted to reduce the tax base of the tangible personal property being sold below the fair market value of similar tangible personal property sold separately."

When examining the tax consequences of a sale of tangible personal property encumbered by a lease it is often necessary to examine the entire series of transactions surrounding that sale. This will help the auditor develop a clear understanding of the transaction under audit.

In the following example, a computer is first purchased by Company A, then leased by Company A to Company C, and ultimately sold to Company B while still encumbered by the lease.

EXAMPLE:

Company A (Co. A) is in the business of leasing and selling computer equipment.

Company B (Co. B) is a financial organization that purchases computer equipment, encumbered by a lease, for purposes of obtaining the lease stream.

Company C (Co. C), the lessee of the equipment, has physical possession of the equipment and is using it in their business.

1. Co. B informs Co. A that they are in the market to purchase a lease stream. (Co. B will also be purchasing the equipment from Co. A as part of the deal.)
2. Co. B puts Co. C, a potential lessee, in touch with Co. A.
3. Co. A purchases the computer equipment from a manufacturer.
4. Co. A leases the equipment to Co. C.
5. Co. A then sells the computer equipment encumbered by the lease to Co. B. Title to the property and the right to receive the rental payments pass from Co. A to Co. B.

The order or way these events occur will vary among taxpayers. A specific taxpayer may also treat individual transactions differently. Transactions may occur simultaneously, or the equipment may be leased for a period before being sold.

Company A

Generally, the Department has treated a lessor of tangible personal property as the user of the property. Use Tax would be due on the purchase of such property. An exception to this rule is where an interim use of the property can be demonstrated. This exception would apply to Co. A under the following circumstances. If Co. A is primarily (over 50%) in the business of selling tangible personal property (THIS INCLUDES THE SALE OF LEASES) they may give their supplier a resale certificate. This allows Co. A to purchase the property for resale tax free, claiming an interim use of the property as a basis for doing so. This is authorized under 86 Ill. Adm. Code 150.306(a) which states:

- (1) Tangible personal property purchased by a retailer for resale and used by the retailer or their agents prior to its ultimate sale at retail, is exempt from Use Tax, provided that the tangible personal property is carried as inventory on the books of the retailer or is otherwise available for sale during the interim use period.
- (2) The leasing of tangible personal property by persons who are PRIMARILY (emphasis added) engaged in the business of selling such property at retail is within the interim use exemption if such property is carried as inventory on the books of the retailer or is otherwise available for sale during the lease period.

Under these circumstances, Co. A is considered a retailer, albeit in a nontraditional sense. This is evident in the fact that to make a sale, Co. A must first enter into a lease. As a lessor, Co. A is considered to have made a use of the property. This use, however, is an interim use. The Department will allow the Interim Use Exemption only when it can be shown that Co. A is primarily (over 50%) in the business of selling tangible personal property.

In situations where Co. A is claiming an interim use exclusion, the auditor will have to reasonably decide what constitutes being primarily engaged in the business of selling tangible personal property.

In situations where Co. A is not primarily engaged in the business of selling tangible personal property, Use Tax will be due on the purchase of computers that will be leased before they are sold either independently or as part of a sale of an encumbered lease.

Company B

If the Use Tax is charged, Co. B must pay it to Co. A.

If Use Tax is self-assessed by Co. B, it must be computed based on the instructions contained in 86 Ill. Adm. Code 130.220(c).

If Co. B is registered and intends to resell the equipment encumbered by the lease, they may give Co. A a resale certificate.

If Co. B is unregistered, they may obtain a reseller's number if all their sales are sales for resale or otherwise tax exempt.

Company C

If Co. C, the lessee, does not take title to the property they would not incur any tax liability on the transaction.

Referencing the above EXAMPLE, it would not be uncommon to find that Co. B. resells part or all the tangible personal property, encumbered by leases, purchased from Co. A. In fact, the tangible personal property encumbered by leases may be resold several times before the final sale is made and the tax is measured. The tax base may be greatly reduced by that time. Conceivably, there may not be a tax base. If the sales are made in interstate commerce or to an exempt purchaser, no tax would be due, provided that the sellers obtain properly completed exemption certificates.

Sale/Lease Back Transaction

In sale/leaseback situations, typically customer A purchases equipment from retailer B, and then sells it to lessor C who leases the equipment back to customer A. Customer A has paid tax when purchasing the equipment in the first transaction under a taxable retail sale and the second transaction (customer A's sale to lessor C) is a nontaxable occasional sale so long as A is not otherwise in the business of selling like-kind property. The third transaction (the leaseback of the equipment from lessor C to customer A) is not taxable because, as noted above, Illinois does not impose a sales/use tax on rental receipts except for automobiles rented for a period of one year or less. In general, no special documentation is required for any of the sale/leaseback transactions. See Ill. Adm. Code 130.110 (e).

In transaction 1 (sale from retailer B to customer A), retailer B would include the gross proceeds from its sale to customer A on its monthly sales tax returns and customer A would retain an invoice showing it paid tax to retailer B. In transaction 2 (sale from customer A to lessor C), it may be wise to document, on the invoice to lessor C, the fact that customer A is not otherwise in the business of selling like-kind equipment and that the sale is a nontaxable occasional sale. Transaction 3 (leaseback from lessor C to customer A) requires no documentation because rental receipts under true leases are not subject to Illinois sales tax liability (again, except automobiles rented for one year or less and tangible personal property rented under a rental purchase agreement ("rent-to-own" transactions)).

The sale/leaseback transaction is not generally used with a conditional sale because there is no statutory mechanism to provide a credit for tax customer A properly paid in its previous purchase from retailer B. If a sale/leaseback is used in conjunction with a conditional sale, tax will be due when lessor C conditionally sells the equipment back to customer A. To avoid this result customer A would need to lease the equipment from lessor C under a true lease rather than a conditional sale.

Sale/leaseback transactions do not generally involve conditional sales. However, if a sale/leaseback transaction involves a conditional sale, then the Lessee would purchase the item for resale and give the vendor a resale certificate. When the Lessor purchases the item from the Lessee, the Lessor would give the Lessee a retail certificate because at the time of the purchase, the Lessor knows they will be selling the item back to the Lessee and, thus, the Lessor would owe Retailers' Occupation Tax on its gross receipts from the sale of the item back to the Lessee.

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If the transaction is neither a true lease nor a conditional sale involving a sale/leaseback situation, but, instead, is simply a transaction involving a debt financing instrument and no ownership transfers from the Lessee to the Lessor, then generally no tax liability exists on that transaction. In those situations, the Lessee normally purchases the equipment from the vendor, pays tax on the purchase price, and obtains title to the property. The Lessor obtains a priority security interest in the property as a condition of making the lease/loan to the Lessee.

Credit for Previously Paid Tax

Lessors whose only sales are sales of items coming off lease that are no longer needed for their rental inventory incur no Retailers' Occupation Tax liability on those sales. These would be considered occasional sales. There is no tax liability and no credit for previously paid tax.

Lessors who are otherwise engaged in the business of selling like-kind property incur Retailers' Occupation Tax liability on all sales, including sales of items coming off lease that are no longer needed for their rental inventories. Lessors would take the credit for previously paid tax on these items on their ST-1 return.

If a lessor filed a return (self-assessed) and paid the tax directly to the Illinois Department of Revenue, the lessor must file a claim to recover it. However, this claim cannot exceed the amount of Retailers' Occupation Tax incurred by the lessor/retailer when they sell the item.

- A lessor who makes no retail sales and whose only sales are sales of items coming off lease that are no longer needed for their rental inventory incurs no Retailers' Occupation Tax liability on those sales.
- Lessors who are otherwise engaged in the business of selling like-kind property incur Retailers' Occupation Tax liability on all sales, including sales of items coming off lease that are no longer needed for their rental inventories.
- Lessors and renters of automobiles incur Retailers' Occupation Tax liability when they make retail sales of passenger cars coming off lease that are no longer needed for their rental inventories.
- Lessors and renters of aircraft and watercraft incur Retailers' Occupation Tax liability when they make retail sales of aircraft and watercraft coming off lease that are no longer needed for their rental inventories.

- **Exemptions**

The following exemptions may be allowed when tangible personal property is purchased by a lessor who will either rent out or lease the tangible personal property to someone else:

- Manufacturing Machinery and Equipment exemption,
- Graphic Arts Machinery and Equipment exemption (now included as part of the Manufacturing Machinery and Equipment exemption),
- Farm Machinery and Equipment exemption,
- Leasing of computer equipment and diagnostic equipment to exempt hospitals
- Leasing of tangible personal property to government bodies
- Leasing of tangible personal property to exempt organizations under a conditional lease

- **Credit for Previously Paid Tax**

- A lessor who incurs Retailers' Occupation Tax liability on the sale of an item can take a credit against that liability for any Use Tax and any local Retailers' Occupation Tax reimbursements they paid to a supplier registered to collect Illinois tax when they purchased that item. However, this credit cannot exceed the amount of Retailers' Occupation Tax incurred by the lessor/retailer when they sell the item.
- If a lessor filed a return (self-assessed) and paid the tax directly to the Illinois Department of Revenue, the lessor must file a claim to recover it. However, this claim cannot exceed the amount of Retailers' Occupation Tax incurred by the lessor/retailer when they sell the item.
- There is no credit available for taxes paid by a renter under the Automobile Renting Occupation and Use Tax Act [35 ILCS 155].
- When an item that was purchased for lease on or after January 1, 2015, is sold, this credit cannot be claimed if the selling price reported on the original Form ST-556-LSE or Form RUT-

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25-LSE was the amount due under the lease contract. The credit can only be claimed if the selling price reported was equal to the actual selling price.

- Documentation to Support the Credit

When the credit is claimed, the lessor/seller must retain documentation demonstrating that Use Tax was paid to a supplier registered to collect Illinois tax when they purchased the item being sold and in what amount. A paid receipt from the supplier for the item on which the credit is being claimed showing the amount of Use Tax paid as a separate item is sufficient to document the credit for all items other than motor vehicles.

For motor vehicles, the credit is to be documented by a copy of the transaction reporting return ST-556 filed by the Illinois dealer from whom the lessor purchased the motor vehicle. That transaction reporting return will show the amount of Use Tax that the lessor paid to the Illinois dealer.

Situations may be encountered where a taxpayer has collected tax on rental receipts and has remitted this erroneously collected tax to the Department instead of paying Use Tax on the item being rented. The controlling factor in determining whether to give the taxpayer credit for the erroneous tax payment lies in the specific language of the contract with the lessee. A contractual agreement must be present between the lessor and lessee containing a specific reimbursement provision. The timing and manner of Use Tax payment must be specifically provided for in the same agreement.

Although there is NO statutory right for reimbursement of Use Taxes from a lessee, a lessor can achieve the same result contractually via the lease agreement. This is accomplished by requiring lessees to bear the expense of Use Tax imposed or to reimburse the lessor for any Use Tax liability incurred. Payment of the Use Tax liability may be incorporated into the amount charged as rental and spread over the period of the lease or stated as a separate charge that is due at the beginning of the lease. The manner and timing of payment should be negotiated between the parties, and the **SPECIFIC LANGUAGE OF THE CONTRACT** determines whether the lessee has an obligation to reimburse the lessor for the Use Tax.

Therefore, if taxpayers collect tax on rental receipts, pay that money to the Department on their returns, and have contractual agreements with the lessees which state that they are reimbursing themselves for Use Tax liability, they should be given credit for these payments against any Use Tax liability established in an audit. Auditors must check for over collection of tax on rental receipts. If the tax collected on rental receipts is more than the Use Tax liability, it should be picked up the same as all other over collections of tax.

For example, a lessor of tangible personal property who paid Use Tax up front upon acquisition of the rental property collects an amount described in the rental statements as a "tax" from lessees. Because the lease contract payment amounts do not generate a tax, the amounts collected as a "tax" are a collection of tax on nontaxable receipts and the lessee has a legal right to claim a refund of that amount. The exception would be if the receipts are subject to Rental Purchase Agreement Occupation and Use Tax (See the [RENTAL PURCHASE AGREEMENT OCCUPATION AND USE TAX](#) section above). If the amount is not refunded, the taxpayer must pay the amount to the Department. (See *JOHN NOTTOLI, INC. V. DEPARTMENT OF REVENUE*, (272 Ill. App. 3d 822, 651 N.E. 2d 148, (2007).)