



## Illinois Department of Revenue

Legal Services Office 5-500  
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### Department of Revenue Response to Comments on Local Sourcing Regulations

1) Heading of the Part and Code Citations:

- A. Home Rule County Retailers Occupation Tax
- B. Home Rule Municipal Retailers Occupation Tax
- C. Regional Transportation Authority Retailers Occupation Tax
- D. Metro-East Mass Transit District Retailers Occupation Tax
- E. Metro-East Park and Recreation District Retailers Occupation Tax
- F. County Water Commission Retailers Occupation Tax
- G. Special County Retailers Occupation Tax
- H. Salem Civic Center Retailers Occupation Tax
- I. Non-Home Rule Municipal Retailers Occupation Tax
- J. County Motor Fuel Tax,

2) Code Citations

- A. 86 Ill. Admin Code 220
- B. 86 Ill. Admin Code 270
- C. 86 Ill. Admin Code 320
- D. 86 Ill. Admin Code 370
- E. 86 Ill. Admin Code 395
- F. 86 Ill. Admin Code 630
- G. 86 Ill. Admin Code 670
- H. 86 Ill. Admin Code 690
- I. 86 Ill. Admin Code 693
- J. 86 Ill. Admin Code 695

3) Section Number

- A. 220.115
- B. 270.115
- C. 320.115
- D. 370.115
- E. 395.115
- F. 630.120
- G. 670.115
- H. 690.115
- I. 693.115
- J. 695.115

## Background

On November 21, 2013, the Illinois Supreme Court decided *Hartney Fuel Oil Company v. Hamer*, 2013 IL 115130 (attached as Exhibit A). The *Hartney* decision expressly invalidated three Department of Revenue (“Department”) regulations governing allocation of local sales taxes, and effectively invalidated seven other rules that contained the same terms as the three regulations at issue in the case. On January 22, 2014, the Department filed emergency rules to fill the legal void governing sales tax allocation that was created by the Supreme Court’s decision. The Joint Committee on Administrative Rules (JCAR) considered the emergency rules at a hearing on March 19, 2014 and did not object to them. The emergency rules expire on June 20, 2014. See 5 ILCS 100/5-45 (c) (emergency rules effective for not longer than 150 days).

On March 21, 2014, the Department proposed permanent rules (“Proposed Rules”) substantively similar to the emergency rules, to govern allocation of local retailer occupation taxes.<sup>1</sup> The Proposed Rules were subject to a 45 day comment period under 5 ILCS 100/5-40(b), which concluded on May 5, 2014.

The Department received thirty-one written comments from twenty-one separate organizations, including local taxing jurisdictions, businesses and groups representing various Illinois retailers and taxpayers. The Department held public hearings on December 12, 2013 and March 21, 2014 to receive oral comments. The Department also conducted four working group meetings with representatives of local taxing jurisdictions and business groups. The administrative record includes:

- all the written comments submitted to the Department;
- a transcript of the March 21, 2014 public hearing;
- a summary of the Department’s testimony at the March 19, 2014 JCAR hearing
- summaries of all working group meetings; and,
- summaries of oral comments submitted to Department employees.

The full administrative record is available on the Department’s website at <http://www.revenue.state.il.us/News/HartneyDecision.htm>.

Having reviewed and evaluated all “criticisms, suggestions and comments” provided, see 1 Ill. Admin. Code § 220.600(a)(9)(B), the Department commences the Second Notice Period by submitting this analysis of the comments received and summary of changes to the Proposed

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<sup>1</sup> The Department initially filed its Proposed Rules on January 22, 2014. However, the Proposed Rules inadvertently included a provision the Department intended to omit from the rules, so, based on the recommendation of JCAR staff, the Department re-filed the Proposed Rules on March 10, 2014.

Rules. The Department's modified, proposed permanent rules ("Final Rules") are attached as **Exhibit B** and separately submitted for review by JCAR.<sup>2</sup>

### **Response to Comments and Summary of Changes to Proposed Rules**

There are three significant changes from the Proposed Rules to the Final Rules. First, the relative weight and importance of the Primary and Secondary Selling Activities is more precise. Second, the Final Rules include certain presumptions for retailers with unique selling operations, including leasing/finance companies and Internet sellers. Third, the Final Rules clarify that the "composite of selling activities" test applies equally to intrastate and interstate retailers.

The substance of, and rationale, for each of these changes is explained in detail below.

#### **I. Primary and Secondary Selling Activities**

The most common comments and suggestions on the Proposed Rules related to the division of selling activities into two tiers ("Primary" and "Secondary"), reflecting the relative importance of the selling activities to the determination of where a retailer was engaged in the business of selling.

##### **A. Summary of Criticisms of Primary/Secondary Selling Activities in Proposed Rules.**

On one hand, several comments argued that the division between Primary and Secondary Selling Activities in the Proposed Rules did not go far enough in assigning weight and importance to each relevant selling activity. *See, e.g.*, May 4, 2014 Comment submitted by the Illinois Chamber of Commerce ("The primary factor/secondary factor test outlined in the proposed amendments creates uncertainty for retailers because it does not indicate how important each factor is in determining a sale location, or how many factors must occur in a selling location in order for a retailer to be deemed 'engaged in the business of selling' in that location."); *see also* March 21, 2014 Testimony on Behalf of City of Kankakee ("Kankakee requests that the Department revise its proposed regulations to provide clear, objective standards for retailers to follow, rather than the subjective nine-factor consideration currently set forth in the proposed regulations."). One component of the argument that the Proposed Rules were indeterminate was that they did not provide a clear, objective method to identify the location of the business of selling when the Primary and Secondary Selling Activities were evenly split or ambiguous. *See, e.g.*, March 21, 2014 Comments of the Taxpayers Federation of Illinois (criticizing the Primary and Secondary selling activities for lacking a "tie-breaking mechanism").

On the other hand, several comments rejected the argument that the division between Primary and Secondary Selling Activities was indeterminate. These comments complained, however, that distinguishing among selling activities – that is, identifying some as more

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<sup>2</sup> Attached as Exhibit B is the proposed Final Rule governing the Home Rule County Retailer's Occupation Tax, 86 Ill. Admin. Reg § 220.115. Identical changes have been made to all ten regulations invalidated in *Hartney* and submitted for second notice.

important than other – unnecessarily and improperly narrowed the inquiry into a retailer’s business of selling. Statement of the Regional Transportation Authority (“RTA”) at 7 (“Elevating any small number of factors above all others leads at best to arbitrary results that do not necessarily correspond with a retailer’s business reality and, at worst, to new combinations of sham business practices to improperly avoid local retailers’ occupation tax.”). Contrary to those that took issue with the regulations as too broad, the RTA and other local taxing jurisdictions advocated an “open-ended” inquiry that would permit consideration of “elements of a retailer’s business of selling that are not” identified as Primary or Secondary Selling Activities. *Id.* at 12-13.

Although the criticisms of the Proposed Rules come from opposite perspectives, both have some merit. The Department agrees that retailers in Illinois must have confidence that they are charging the correct tax rate and remitting the taxes properly due. This is particularly important for the retailers’ occupation tax because that tax is collected from the customer at the time of a sale. Thus, any uncertainty about the proper tax rate will result in a deficiency that the retailer likely cannot recoup by passing it on to the customer. March 21, 2014 Testimony of Robert Karr on behalf of the Illinois Retail Merchants Association (retailers must make a determination at the time of sale as to what jurisdiction’s ROTA applies). At the same time, the *Hartney* decision makes clear that the rules cannot sacrifice fidelity to the statute’s purpose in favor of easy administration for retailers. Under *Hartney*, the statute requires a fact-specific test that considers each retailer’s selling operation and links retailer’s occupation taxes to the provision of municipal services.

The Final Rules reflect changes intended to address these competing concerns.

#### **B. Modifications to Primary/Secondary Activities.**

The Final Rules modify the Primary Selling Activities and clarify their significance and weight. There are five, rather than four, Primary Selling Activities in the Final Rules. **Ex. B** § 220.115(c)(1). A retailer conducting any three Primary Selling Activities in a single jurisdiction in Illinois is engaged in the business of selling in that jurisdiction. **Ex. B** § 220.115(c)(2); *see also* March 17, 2014 Comments of the Village of Channahon at 9 (“the presence of three of the five following factors within a county shall be sufficient to source a sale to such county”) *and* March 21, 2014 Statement on behalf of the City of Kankakee at 2 (“one possible solution would be to expand the primary factors to five factors and to provide that the presence of two or three of the five factors be sufficient to source a sale”). The five Primary Selling Activities in the Final Rules are: sales personnel, the sales agreement, payment terms, inventory and headquarters. A retailer is engaged in the business of selling in the jurisdiction in which three of these Selling Activities occur.

The Primary Selling Activities were chosen because, as a general matter, they reflect genuine selling activity *and* invoke the need for government services. *See, e.g.*, Statement of the RTA at 7 (“[T]he most important selling activities for a particular retailer are those that best determine where it benefitted from services provided by local governments.”); March 21, 2014 Testimony of Mayor Barrett Pedersen, Franklin Park (discussing taxpayer that sourced its sales to a satellite office pre-*Hartney*, forcing Franklin Park to “provide the company with everything

from fire protection to street maintenance without collecting any sales tax to help pay for those services”). The location of sales personnel, inventory, and a seller’s headquarters all are Primary Selling Activities under the Final Rules because these activities are critical to the “occupation of selling,” *and* they generally occur at locations that invoke government services and protections.

The Final Rules also clarify how retailers that disperse Primary Selling Activities through multiple jurisdictions should apply the Secondary Selling Activities to determine where they are engaged in the business of selling. Such a retailer should pay the ROT in the jurisdiction in which its inventory is located or where it maintains its headquarters, depending on which location is the location of more Selling Activities, considering both Primary and Secondary Selling Activities. **Ex. B** § 220.115(c)(5). This approach is intended to provide a clear, definitive answer as to where retailers with dispersed Selling Activities are engaged in the business of selling. At the same time, this rule ensures that sales ultimately are sourced to a jurisdiction where legitimate Selling Activities take place.

Lastly, the Final Rules include a tiebreaker for retailers with Selling Activities evenly dispersed between the location of their inventory and their headquarters. These retailers should source to their headquarters unless there is clear and convincing evidence that a different location is proper. *Id.* § 220.115(c)(6). In other words, if all other factors are equal, a company’s headquarters best reflects where it is engaged in the business of selling because the most selling activities likely occur there.

In sum, the Final Rules include three changes that address concerns that the Proposed Rules did not provide sufficient certainty as to the proper jurisdiction in which to source sales. First, under the Final Rules, a retailer is engaged in the business of selling in the location where it engages in at least three of five Primary Selling Activities. If there is no such location, a retailer is engaged in the business of selling where it keeps inventory or where it maintains a headquarters, whichever location is where more Selling Activity takes place. If Selling Activities are evenly split between those locations, retailers presumptively should source their sales to the location of their headquarters. These modifications from the Proposed Rules improve the rule’s clarity, and ease its administration, while maintaining consistency with the underlying purpose of ROTA to allow local governments to tax those retailers that engage in business in their jurisdictions.

## **II. The Final Rules Provide Special Presumptions for Some Sellers.**

Although the Primary and Secondary Selling Activities are common to numerous diverse retailers, they are not universal. There are some retail operations for which the Primary and Secondary Selling Activities are a poor fit, such that applying them to certain retailers would lead to odd or anomalous results. Because these retailers may not be able to apply the “composite of selling activities” test to their operations, subsection (d) of the Final Rules addresses this issue by providing legal presumptions to facilitate and streamline application of the regulations to certain unique retail operations.

For example, certain finance instruments that closely resemble leases are considered “conditional sales” under Illinois law. 86 Ill. Admin. Code § 130.2010. Consequently, leasing

and finance companies that finance the purchase of equipment through “conditional sales” are considered retailers under Illinois law. *Id.* Though considered retailers in this limited circumstance, finance companies are not organized like retailers. Consequently, they engage in few traditional Selling Activities. Statement of the Equipment Leasing and Financing Association (“ELFA”) at 3-4. The principle activities of finance companies are not negotiating and entering into sales agreements, or procuring and storing inventory. Rather, their principle activities are assessing credit and determining interest rates. *Id.* at 2 (“[C]redit review and credit approval become the most significant activity in pricing and approving a customer’s choice of financing under conditional sales type leases.”).

Because finance companies are not engaged in traditional retail Selling Activity, it is difficult to apply the composite of selling activities test to their operations. In consultation with representatives of the leasing and financing industry, the Department concluded that the location of the equipment that secures continuing payments to the finance company is the best gauge of where these retailers are engaged in the business of selling. Thus, the Final Rules include a presumption that retailers engaged in the business of selling through conditional sales finance arrangements are engaged in the business of selling where the equipment is located when the sale is made. Ex. B §220.115 (d)(4).

Similarly, retail sales over the Internet generally do not include the same Selling Activities as traditional retail sales. For example, Internet-based sales involve few salespeople because “in the electronic commerce industry . . . such personnel do not negotiate and bind the seller.” March 17, 2014 Comments of PriceWaterhouseCoopers LLP at 1. Moreover, in electronic commerce, order acceptance and payment arrangements are fully automated, independent of human intervention, occur in any location, and generally not critical to the organization of the business of selling. *Id.* (“Servers that host the website and process orders and credit card information . . . are automated in nature and require de minimus intervention by employees.”). Because the business of selling over the Internet relies on few Selling Activities, and disperses those Selling Activities among remote, often unoccupied, locations, the “composite of selling activities” test may be particularly difficult to apply to Internet sales. March 21, 2014 Testimony of Robert Karr on behalf of the Illinois Retail Merchants Association (explaining difficulty of applying Primary Selling Activities to Internet transactions); March 17, 2014 Statement of PriceWaterhouseCoopers LLP at 2 (“Because the business operations of an electronic commerce company vary greatly from traditional brick and mortar stores, there is difficulty applying the primary and secondary factors as written.”).

For this reason, the Final Rules presume that the predominant Selling Activities in an Internet sale occur outside the State, and are subject to the Illinois Use Tax Act. Ex. B § 220.115 (d)(1). This presumption is overcome if (a) the retailer ships tangible personal property from inventory located in Illinois, *see* May 5, 2014 Statement of ReedSmith at 2 (proposing that “internet-based retailer will source its sales . . . to the location of the inventory at the time of the sale”), or (b) the tangible personal property purchased on-line is picked up at a retail location in Illinois; or (c) there is clear and convincing evidence that the retailer’s predominant Selling Activities occur in Illinois.

There are two other special rules in subsection (d) of the Final Rules. They provide (1) that a retailer with inventory in the State should pay the ROTA at the location of the inventory; and (2) that coal and other minerals should be sourced to the location where they are extracted from the earth. Ex. B § 220.115 (d)(2), (d)(5). Both of these rules were in the regulations before the Supreme Court issued its decision in *Hartney*. Both rules have either legislative or judicial support, *see* 30 ILCS 105/6z-18 (statute stating that retail sales of coal should be sourced where extracted from earth) and *Chemed Corp. Inc. v. Dep't of Revenue*, 186 Ill. App. 3d 402 (4th Dist. 1989) (upholding inventory rule). Neither rule was specifically at issue or addressed in *Hartney*. And there were no comments criticizing the substance of these rules. Consequently, the Final Rules, like the Emergency Rules, the Proposed Rules, and the law before the Supreme Court decided *Hartney* contain these provisions related to coal and other minerals and to inventory delivered from a location in the State to a customer in the State.

### **III. The Composite of Selling Activities Test Applies to Both Intrastate and Interstate Retailers.**

In *Hartney*, the taxpayer conducted all of its Selling Activities in one location in Illinois, but accepted purchase orders for its sales in a separate jurisdiction in Illinois. The Court held that under the relevant ROTAs, *Hartney* should have paid in the jurisdiction where it conducted its Selling Activities, not where it accepted purchase orders. Because *Hartney* involved an *intrastate* conflict, the Court was not required to decide how a retailer with *interstate* Selling Activities should determine where it was engaged in the business of selling. The Proposed Rules were ambiguous on whether they applied only to retailers with multiple Selling Activities in Illinois (like *Hartney*), or whether the same weighing and comparing of Selling Activities applied to retailers with Selling Activities inside and outside the State.

The Final Rules clarify that the same legal standard applies to both intrastate and interstate retailers. A “retailer is engaged in the business of selling in the taxing jurisdiction where its predominant and most important Selling Activities take place,” regardless of whether those activities are inside or outside of Illinois. Ex. B § 220.115(b)(7); *see also id.* at § 220.115(c)(2) (“A retailer engaging in three or more Primary Selling Activities outside the State shall collect and remit tax to the State to the extent required by the Illinois Use Tax Act.”).

This clarification rejects in large part a proposal by the Village of Channahon that the Department limit the regulations to retailers with Selling Activities in jurisdictions in Illinois. May 5, 2014 Statement submitted on behalf of the Village of Channahon. Under Channahon’s proposal, acceptance of a purchase order – which the Supreme Court specifically found insufficient to support retailer’s occupation tax when more significant Selling Activities occurred in another Illinois jurisdiction – would be sufficient to support the tax if the retailers’ other activities were outside the State. *Id.* at 1 (“[F]or purposes of the State ROT, it is only necessary to determine that there is enough activity in the State to justify imposition of the State ROT. And, under such an interpretation, it could be determined that acceptance is enough to impose the State ROT.”). The Department rejects this proposal for both legal and policy reasons.

As a legal matter, Channahon’s interpretation is not consistent with the rationale of *Hartney*, or the decisions on which the Court relied in *Hartney*. The linchpin of the *Hartney*

decision was that the local ROTAs must be construed to be consistent with the State ROTA. *Hartney*, 2013 115130 ¶¶ 32-33. The Court pointed out that seventy years of precedent had established that the statutory phrase “engaged in the business of selling at retail” required a fact intensive analysis of the composite of many activities comprising the retailer’s business. *Id.* ¶¶ 30-34. Under this analysis, the Court noted that “some combinations of activities within the state are insufficient for the retail occupation tax to apply.” *Id.* ¶ 31 (citing *Automatic Voting Mach. Corp. v. Daley*, 409 Ill. 438, 447 (1951)). Thus, Channahon’s request that the Department enforce the ROTAs against retailers with predominant Selling Activities outside Illinois is inconsistent with numerous decisions of the Illinois Supreme Court. *See Ex-Cell-O Corp. v. McKibbin*, 383 Ill. 316, 321-22 (1943); *Hartney*, 2013 115130 ¶ 33. Rather, retailers with predominant Selling Activities in a location outside the State, but some Selling Activities in the State, are subject to the Use Tax Act, not the ROTAs.

Channahon’s policy arguments in support of its proposal are unconvincing. Channahon asserts that because it is “impractical to rely on consumers paying use taxes,” the State should maximize revenue by requiring retailers with any Selling Activity in the State to collect under the ROTA, rather than the Use Tax Act. May 5, 2014 Statement submitted on behalf of the Village of Channahon at 3. However, all retailers with a physical presence in Illinois are subject to registration, collection and payment requirements under the Use Tax Act that are identical to the requirements under ROTA. 35 ILCS 105/3-45 (“The tax imposed by this Act shall be collected from the purchaser by a retailer maintaining a place of business in this State . . .”). Retailers are not more likely to ignore their statutory obligation under the Use Tax Act than they are to ignore ROTA’s requirements because the penalties for doing so are the same. Thus, applying the composite of Selling Activities test to multi-state retailers does not require the State to depend on consumers to remit use taxes. Rather, it merely requires retailers to register, collect and remit in accordance with the Use Tax Act, rather than the ROTA.

Similarly, Channahon’s concern that Illinois’s collection of Use Tax will be subject to offset for taxes paid in other states is incorrect. May 5, 2014 Statement submitted on behalf of the Village of Channahon at 3-4. The Use Tax Act requires the State to set off taxes “properly due and paid” to another State from the Use Tax owed to Illinois. 35 ILCS 105/3-55(d). But there are no taxes properly due in another state for sales made in Illinois to Illinois customers for use in Illinois. So there will be no reduction of the Use Tax due from out-of-state retailers that make sales to customers in Illinois. The rules promulgated in response to *Hartney* apply only to Illinois sales.

Lastly, Channahon asserts that “revenues to local municipalities will not be jeopardized if the focus is only on activities conducted in Illinois.” May 5, 2014 Statement submitted on behalf of the Village of Channahon at 4. This is not accurate. Twenty percent of revenue derived from Illinois’ 6.25% Use Tax is deposited into the State and Local Sales Tax Reform Fund. 35 ILCS 105/9. It is distributed as follows: 20% to the City of Chicago, 10% to the Regional Transportation Authority; several transfers are made to the Madison County Mass Transit District and the Build Illinois Fund; and the remainder is transferred to the Local Government Distributive Fund. *See* 30 ILCS 105/6z-17. Monies transferred to the Local Government Distributive Fund are distributed to local governments, not including the City of Chicago, based on population. 30 ILCS 115/2.

By contrast, 20% of the State ROT goes to the local taxing jurisdictions where the retailer was engaged in the business of selling. Consequently, the effect of Channahon's proposal would be to transfer the use tax revenues equitably shared by all local governments in Illinois to the few local jurisdictions where out-of-state retailers establish order acceptance facilities like the one condemned by the Court in *Hartney*.

In short, fair tax policy counsels against accepting Channahon's proposal. The Final Rules expressly provide for a uniform standard for determining where a retailer is engaged in the business of selling, which applies to in-state and out-of-state businesses equally.

#### **IV. Other Changes from the Emergency Rules and Proposed Rules to the Final Rules**

In addition to the three significant changes discussed above, the Final Rules also include other less substantial changes, which are listed here with brief explanations.

- The provision in the Proposed Rules entitled "Order Acceptance Not Doing Business in the County" was removed because it was redundant and confusing. *See* Statement of the RTA at 7-8 (arguing that provision was confusing and duplicative and suggesting "[t]he simplest solution would be to simply delete this section in its entirety as redundant").
- The provision in the Emergency Rules entitled "Long Term or Blanket Contracts," which was omitted from the Proposed Rules, is not contained in the Final Rules. That "Long Term or Blanket Contracts" provision permitted a retailer to source sales to the place where it accepted orders. This provision is contrary to the decision in *Hartney*. *See* Statement of the RTA at 5.

Respectfully Submitted,

/s/ Paul Berks

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