ST 14-0050-GIL 10/31/14 Local Taxes
This letter explains how to determine the local tax rate applicable to conditional sales leasing transactions. (See 86 Ill. Adm. Code 220.115.) (This is a GIL.)

October 31, 2014

Dear xxx:

This letter is in response to your letter dated July 30, 2014, in which you request 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 that 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 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:

> Since effective date of the new sourcing regulations xxx has collected comments and questions from industry regarding the Department's regulations. The following questions from industry members are offered as evidencing continued uncertainty. XXX requests response in a General Information Letter providing guidance to implementation in the marketplace:
>
> **General Questions**
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> 1. Will lessors continue to be allowed to provide resale exemption certificates to their vendors reflecting a purchase for resale in respect to a conditional sales agreement?
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> 2. The new rule only makes mention of 'a lease with a dollar or other nominal option to purchase' shall be considered a conditional sale. This simplified reference is silent with regards to other time payment agreements that could also be considered conditional sales and raises the following questions:
>
>   a. Will leases with a mandatory end of lease purchase (i.e. balloon payment, PUT) also be considered a conditional sale for purposes of applying §(d)(4) of the rule? Stated otherwise, if lessors are guaranteed at the time of entering into a lease that the leased property will be sold, will such lease agreements be considered a conditional sale for purposes of applying §(d)(4)?

b. Will other time payment agreements entered into by the seller and purchaser, such as installment sales and equipment finance agreements, also be considered conditional sales for purposes of applying §(d)(4)?

3. With respect to determining the appropriate rate of tax to apply to a sale at the time the conditional sales agreement is entered into by the parties.

4. Lessors who enter into conditional sales may not hold the inventory that they are selling. In cases where the lessor is drop-shipping property from its suppliers or where the property has to be specially manufactured, the conditional sales agreement is often entered into prior to the location of the property being known by the parties. Consequently, we urge the IDOR to adopt simple rules using the ultimate destination of the property (end-users location) as the determining or safe-harbor factor in the taxation of the property being sold through a conditional sales agreement. Here are some scenarios that could lead to significant confusion among retailers if not made clear by the Department:

5. A lessor and its customer enter into a conditional sales agreement prior to the manufacture of the property subject to the agreement. Would the Department of Revenue then default to a rate of tax determined from the location of the site of manufacturing (even if out of state), the lessor's location (even if out of state), or the ultimate destination of the property being acquired by the customer in Illinois? What if all three sites were in Illinois, would your answer change? What if the lessor records are inconclusive as to the location where the property is being manufactured?

6. A lessor and its customer enter into a conditional sales agreement prior to the lessor's ordering of the property from a third-party vendor. Would the Department of Revenue then default to using a rate of tax determined from the location of the site of shipment FOB origin (even after having been required to issue a resale exemption certificate), the lessor's location (even if out of state), or the ultimate destination of the property being acquired by the customer in Illinois? If FOB origin is determined to be the correct answer, lessors should not be required to provide resale exemption certificates to their vendors, as they are under current regulations. Would your answer change if the conditional sales agreement is conditioned upon the lessee's receipt and final acceptance of the property covered by the agreement (i.e. Sale on approval 810 ILCS 5/2-326)?

7. A lessor and its customer enter into a conditional sales agreement after the lessor ordered the property from its third-party vendor. Would the Department of Revenue then default to using a rate of tax determined from the location of the site of shipment FOB origin (even after having been required to issue a resale exemption certificate), the rate of tax determined from the location of the property while in transit by common carrier if the property had already shipped, the lessor's

location (even if out of state), or the ultimate destination of the property being acquired by the customer in Illinois?

8. A lessor emails its customer a conditional sales agreement just prior to authorizing the shipment of the property out of lessor's warehouse to the customer. The property arrives at the customer's location just before the customer executes and returns the signed conditional sales agreement to the lessor. The lessor charges ROT based upon the location of the property at the customer. Has the lessor chosen the correct tax jurisdiction under the new regulations?

9. A lessor and its customer enter into an unconditional interim funding agreement for property that will be temporarily located at a logistics/configuration/staging center prior to distribution to various locations of the customer. When the property is received by the customer at its ultimate destination, the interim funding agreement terms convert into a conditional sale. Will the temporary location of the property at time of entering into the interim funding agreement be the correct location for sourcing? Or will the receipt of the property by the customer at the time the agreement converts into a conditional be the correct location for sourcing? Would this answer change if the interim funding agreement was conditioned on final receipt and acceptance by the customer under the conditional sale?

10. Under any of the above scenarios could the Department of Revenue envision the lessor/retailer defaulting back into the jurisdictional analysis required under Regulations Section 220.115(c)(1)?

Timing of Tax Liability Questions

1. The difference between the moment in which a conditional sales agreement is entered into and the moment in which such property is delivered and first invoiced to the customer can be substantial at times. Will the Department require ROT to be collected and remitted by the lessor prior to the time of delivery of the property and invoicing? Can the Department confirm that the contractual lease period and the rentals due thereunder determine the time of sale and for filing and remittance of tax rather than the date a conditional sales agreement is entered into?

2. If a lessor does an outright sale of the conditional sales agreement and is obligated to report the receipts of the sale pursuant to 130.1960(c), are the additional receipts sourced to the location of the property at the time of selling the agreement? Or are they sourced to the location of the property at the time of entering into the conditional sales agreement with the customer? Will the Department defer to any provisions of Illinois Uniform Commercial Code such as "Sale on approval" at 810 ILCS 5/2-326 or "Passing of title" at 810 ILCS 5/2-401, for purposes of determining when the conditional sale agreement is entered into?

DEPARTMENT'S RESPONSE:

I. The Sourcing Rules

The Department adopted its final sourcing rules on June 25, 2014. The rules implement retailers' occupation tax statutes, which allow municipalities, counties and other municipal corporations to impose taxes on persons "engaged in the business of selling" in their jurisdictions. *See, e.g.*, 55 ILCS 5/5-1006 (authorizing counties to impose retailers' occupation tax on persons "engaged in the business of selling" within the county); 70 ILCS 3615/4.03(e) (authorizing the Regional Transportation Authority to impose a tax on persons "engaged in the business of selling" within a six-county region).

The Illinois Supreme Court held in *Hartney Fuel Oil Co. v. Hamer* that determining whether a seller is "engaged in the business of selling" in a particular jurisdiction within the meaning of the retailers' occupation tax acts requires an analysis of where the retailer engages in the "composite of activities" that comprise its business. 2013 IL 115130 ¶¶ 32-36.

The local sourcing rules recently adopted by the Department provide guidance and direction to retailers and local taxing jurisdictions in applying the statute and case law, which require a fact-specific analysis.

The sourcing rules are divided into four parts. The first part provides relevant definitions. *See, e.g.*, 86 Ill. Adm. Code 220.115(a). Next, the regulations set forth the legal standard derived from the statutory language and case law interpreting that language. *Id.* § 220.115(b). Subsection (c) then applies that legal standard to retailers conducting selling activities in multiple jurisdictions. *Id.* § 220.115(c). In particular, subsection (c) identifies those selling activities generally most important to the business of selling and explains the combination of selling activities that comprise the business of selling in a particular location. *Id.* § 220.115(c)(1)-(c)(6). Lastly, subsection (d) recognizes that certain selling operations "with unique, complicated or widely dispersed selling activities" do not fit within traditional retail models. For certain retailers that meet this standard, subsection (d) provides "administrative shortcuts that balance the administrative difficulties presented by certain selling operations against the need for accurate tax assessment." 86 Ill. Adm. Code 220.115 (d)(1).

II. Subsection (d)(4): Leases with an Option to Purchase.

Subsection (d)(4) is an "administrative shortcut" for a particular type of sale: "Leases with an Option to Purchase." The rule provides:

> Leases with an Option to Purchase. A lease with a dollar or other nominal option to purchase is considered to be a conditional sale subject to retailers' occupation tax. (See 86 Ill. Adm. Code 130.2010(a)). Persons selling tangible personal property to a nominal lessee or bailee for use or consumption under a conditional sales agreement are presumed to be engaged in the business of selling at the

> physical location of the property at the time the parties entered into the conditional sales agreement.

Your letter inquired about the application of this provision in various factual circumstances. It is beyond the scope of a GIL to provide specific answers to hypothetical questions. However, the following principles inform the meaning and application of subsection (d)(4).

First, the local sourcing rules recently adopted by the Department of Revenue implement Illinois' retail occupation tax acts, or ROTAs. The ROTAs, in turn, fit within a larger category of sales taxes commonly referred to as "origin sourcing" statutes. Origin sourcing statutes are distinguishable from "destination sourcing" statutes. Generally, under an origin sourcing statute, the seller incurs tax at its location while under a destination sourcing regime, tax is incurred where the property is delivered or used by a purchaser. *See Automatic Voting Machs. v. Daley*, 409 Ill. 438, 447 (1951); *Ex-Cell-O Corp. v. McKibbin*, 383 Ill. 316, 321 (1943). Because Illinois has chosen origin sourcing over destination sourcing, the Department cannot, as your letter suggests, adopt "rules using the ultimate destination of the property . . . as the determining . . . factor in the taxation of property being sold through a conditional sales agreement."

Second, the rules adopted on June 25, 2014 address only the issue of sourcing; that is, which local jurisdictions, if any, have authority to tax which retailers. The rules do not modify, alter, or otherwise affect the definition of a "conditional sale" as provided elsewhere in Illinois law. Nor do the sourcing rules impact any rules and practices governing taxation of conditional sales unrelated to sourcing. Because the sourcing rules did not impact the use of retail exemption certificates, the meaning of "conditional sale," or the timing of tax payments, questions related to these issues are beyond the scope of this GIL. With respect to issues unrelated to sourcing, taxpayers should continue to follow the practices and procedures they followed before issuance of the local sourcing rules.

Third, subsection (d)(4) provides an administrative "shortcut" in the form of a presumption. Under subsection (d)(4), a retailer may presume that, if certain criteria are met, it is engaged in the business of selling at the location where the property was located. However, if the criteria in subsection (d)(4) are not met, the presumption does not apply. The retailer is not entitled to the "shortcut," and – if no other "shortcut" in subsection (d) applies – it must determine where it is engaged in the business of selling by identifying and applying the primary and secondary selling activities listed in subsection (c). *See also* 86 Ill. Adm. Code 220.115 (c)(2), (c)(4).

Fourth, for the presumption in subsection (d)(4) to apply, two conditions must be met. First, the sale must be made under a conditional sales agreement. Second, the property sold must be under the possession or control of the seller "at the time the parties enter into the conditional sales agreement." When these conditions are met, the seller may source the sale to the location of the property at the time of the agreement.

As to the first criteria, whether an agreement is a conditional sales agreement is based on the guidance provided in 86 Ill. Adm. Code 130.2010(a) and other sources of Illinois law. The June 25, 2014 rules only provide guidance on where to source a conditional sale, not on whether a particular agreement is a conditional sale.

The second criteria – the "time the parties entered into the sales agreement" – is fact-specific and dependent on the terms of the agreement and the intent of the parties. Because the parties largely control the timing of their agreement, it is not possible to provide guidance in advance on when two contracting parties have entered into a conditional sales agreement. Rather, the "time the parties entered into the conditional sales agreement" will depend on the terms of the agreement.

If these two conditions are not met, subsection (d)(4) does not apply and the seller must determine where it is engaged in the business of selling under subsection (c) of the rules. As noted above, subsection (c) uses a "composite of selling activities" approach to source sales to the location of the seller at the time of the sale as required by Illinois law. *Hartney Fuel Oil Co. v. Hamer*, 2013 IL 115130.

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

Very truly yours,

Paul Berks
Deputy General Counsel

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