

ST 16-0009-GIL 02/04/2016 MISCELLANEOUS

Municipal gas taxes imposed under the authority provided in Section 8-11-2 of the Illinois Municipal Code (65 ILCS 5/8-11-2) are not administered by the Department of Revenue. (This is a GIL.)

February 4, 2016

Dear Xxxxx:

This letter is in response to your letter dated October 23, 2015, 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 who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department’s regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter (“GIL”) is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.tax.illinois.gov to review regulations, letter rulings and other types of information relevant to your inquiry.

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

ABC is writing the Illinois Department of Revenue (“IDOR”) under the Illinois Administrative Code Title 2: Governmental Organization, Section 1200.120, entitled General Information Letters.

BACKGROUND

Who is ABC: ABC is a utility tax auditor organized as an Illinois corporation. ABC reviews the collection of municipal utility taxes, franchise fees or user fees collected by natural gas, electricity and cable utilities on behalf of municipalities within Illinois.

Basis of Inquiry: ABCs’ inquiry is on behalf of municipal clients who have lost significant tax revenues due to deregulation of natural gas. Deregulation has given businesses and residents the ability to switch to third-party suppliers of natural gas. The loss in tax revenues is due to

third-party sellers of natural gas asserting that their sales are made in “interstate commerce”, and therefore not subject to municipal taxation or taxation by the State of Illinois in some cases.

Overview

It is ABCs’ contention that today’s sales of natural gas by new unregulated “third-party suppliers” are not interstate sales of natural gas, but rather local sales subject to both State and municipal taxation. Due to the history of deregulation and the changes that have occurred since the inception of deregulation in 1997, set forth herein, ABC believes that unregulated third-party suppliers are avoiding local and State taxation due to a legal fiction that has been largely disqualified by the changes in natural gas delivery over time in Illinois, the nexus of Illinois of unregulated third-party suppliers selling gas, the more recent laws affecting internet retail sales and the Illinois Supreme Court’s *Hartney* decision (2013 IL 115130) preventing avoidance of tax on local sales.

FACTS

Municipal Utility Tax (“MUT”): Many municipalities in Illinois impose a tax on sales of natural gas in an amount equal to a percentage of sales. Typically, for natural gas, the percentage tax is imposed on gross receipts of sales. The majority of gas tax rates are 5%. This tax is permissible by law pursuant to the Illinois Municipal Code as follows:

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(65 ILCS 5/8-11/2) (from Ch.24, par. 8-11-2)

Sec. 8-11-2. The corporate authorities of an municipality may tax any or all of the following occupations or privileges:

- 1. (Blank).*
- 2. Persons engaged in the business of distributing supplying, furnishing, or selling gas for use or consumption within the corporate limits of a municipality of 500,000 or fewer population, and not for resale, at a rate not to exceed 5% of the gross receipts therefrom.*

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A sample ordinance establishing a MUT is enclosed for review and consideration in formulating IDOR’s response to questions posted by ABC at the end.

The following discussion provides background information to assist IDOR in opining on whether sales of natural gas are interstate commerce or local sales.

DISCUSSION:

DEREGULATION AND MUNICIPAL NATURAL GAS TAXES

Deregulation in Illinois can be broken into two time periods: Pre-1997 and 1997 thereafter.

Pre-1997

Prior to 1997, deregulation of natural gas in Illinois benefited only commercial and industrial businesses (shippers). Larger companies purchased natural gas at points in STATE 1, STATE 2 and STATE 3 often referred to as “wellhead purchases”¹. Wellhead purchases are purchases where title of natural gas passes from the shipper at the wellhead to the interstate pipeline for redelivery to the local distribution company (LDC) in Illinois² (See accompanying chart showing Components of Distribution) The interstate pipeline takes possession and control of the gas being shipped at the wellhead. Below is language directly from an interstate pipeline’s tariff. (See specifically language in yellow).

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Natural Gas Pipeline Company of America LLC FERC Gas
Tariff
Original Sheet No. 480 Seventh Revised Volume
No. 1

GENERAL TERMS AND CONDITIONS

28. POSSESSION OF GAS, TITLE AND RESPONSIBILITY

Shipper warrants that it will at the time of delivery to Natural have good title to all gas so delivered free and clear of all liens, encumbrances and claims whatsoever. As between Shipper and Natural, Shipper shall be deemed to be in control and possession of gas and responsible therefor and shall hold Natural harmless of and from any damage or injury caused thereby until the gas shall have been delivered to Natural at the Receipt Point(s) after which Natural shall be deemed to be in control and possession of such gas until its delivery to Shipper or for Shipper’s account at the Delivery Point(s) and while in such possession Natural shall be responsible therefor and hold Shipper harmless of and from any damage or injury caused thereby. Natural shall have no responsibility with respect to any gas on account of anything

¹ Alternatively referred to as receipt point in interstate tariff.

² UTILITY CO. 1, UTILITY CO. 2, UTILITY CO. 3, and UTILITY CO. 4 are the primary companies in Illinois referred to as LDC’s and are the primary utilities where a tax uncertainty exists.

which may be done, happen or arise with respect to said gas until it is received by Natural. Shipper shall have no responsibility with respect to said gas until it is received by Natural. Shipper shall have no responsibility with respect to said gas after its receipt by Natural on account of anything which may be done, happen or arise with respect to said gas after such receipt until its delivery to Shipper, or for Shipper's account, at the Delivery Point(s). The point of the division of responsibility shall be the point of interconnection between the facilities of Natural and Shipper, or their respective agents, at the Receipt or Delivery Point(s), as applicable. The foregoing provisions of the Section shall not relieve either party from responsibility for acts of gross negligence or willful misconduct of such party, its agents or employees.

Issued by: Bruce H. Newsome, Vice President
Issued on April 18, 2008 Effective on April 18, 2008

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1997 AND THEREAFTER

Beginning in 1997, deregulation expanded to allow residential consumers the opportunity to purchase gas from suppliers other than their LDC. But instead of residential customers purchasing gas at the wellhead like businesses had done pre-1997, these new consumers purchased gas at points in Illinois called city-gate³ and simply used the LDC to transport the gas to their gas meter or "burner-tip". And instead of purchasing gas from actual producers⁴ of natural gas at the wellhead, residential consumers purchased gas from third-party suppliers. In most cases, third party suppliers became the entity that actually shipped the gas in the interstate pipeline to be delivered to the city-gate. This practice of purchasing gas at the city-gate from third-party suppliers became standard practice for all consumers post-1997.

Today, with the onset of full-blown deregulation, over 25 third-party suppliers have entered the marketplace to sell gas to local residents, businesses and industrials, thus displacing the sales of natural gas by the LDC. From our investigation, no sales to businesses or residents are made by producers or third-parties at the wellhead.

Historically, given a utility's local presence, it collected a MUT where required by law and remitted same to the applicable municipality. However, these new companies operating in a deregulated market have not collected a MUT given the manner in which delivery and title have been separated. These new players claim to operate under a custom and practice where third-party sales are sales made in interstate commerce, and thus they claim to not be subject to a MUT based on federal law. The

³ In interstate pipeline tariffs point also referred to as delivery point.

⁴ Companies that drill natural gas wells and own the production

Delivery Point. Any measurement required to determine deliveries to the Company of Shipper-owned gas at each Receipt Point shall be done by the Transporter in accordance with the terms of the Transporter's currently effective tariff, on file with either the Federal Energy Regulatory Commission or the Illinois Commerce Commission, as applicable and metering practices applicable to deliveries to the Company. The Shipper shall hold title to the gas delivered under this rate at all times. The Company shall be deemed to be in control and possession of the gas deliverable to the Shipper after its receipt by the Company at the Receipt Point until its delivery to the Shipper at the final Delivery Point. The Shipper shall be deemed to be in control and possession of such gas at all times at and prior to receipt at the Receipt Point, and at and after delivery to the final Delivery Point. In no event shall the Company be required to take any action, engage in any activity or provide any service that would cause the Company to become subject to the jurisdiction of the Federal Energy Regulatory Commission or to lose its exemption from federal Energy Regulatory Commission jurisdiction pursuant to Section 1(b) or 1(c) or the Natural Gas Act (15 U.S.C. 717(b), 717(c)).

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DISCUSSION
NATURAL GAS SALES AND INTERSTATE COMMERCE

The issue at hand is whether third-party sales of natural gas purportedly made within interstate commerce, are subject to State and local government taxation. Using background from above, below is a summation of our rationale whereby it seems apparent that third-party sales could and should be taxed because they fail to meet the test for a sale that would be purely interstate in nature.

- a. **4-Prong Test:** The Supreme Court in *Complete Auto Transit, Inc, V. Brady*, 430 U.S. (1977) developed a 4-prong test to establish whether a transaction is subject to State and local taxation. The 4-prong test is comprised of the following tests:
 - i. **Nexus with the Taxing State:** Nearly all third-party gas suppliers have sales staff, operations staff, offices and agents residing in the marketplace creating “substantial nexus” to the State, as defined by the United States Supreme Court in *Nation Bellas Hess, Inc. v Illinois Department of Revenue*, 366 U.S 753 (1967) wherein the Court ruled that a nexus required an in-state physical presence.

- ii. **Tax must be fairly apportioned:** The tax would be fairly apportioned if applied to all natural gas sales because the rate of taxation is identical on all terms of gas sold in the State or local jurisdiction regardless of the entity actually making the sales at retail.
- iii. **Does the tax discriminate against interstate commerce:** Assuming third-party sales are interstate commerce, there is no discrimination between third-party sales and sales by an LDC. To the contrary, sales tax does not discriminate against interstate commerce, as third-party sales, for purposes of this discussion, are not taxed when sold, but are taxed when sold by an LDC. Each business entity purchases their gas identically, yet the third-party escapes the tax simply by separating the title to the gas and the delivery of gas. The avoidance of the tax is done contractually for the sole purpose of avoiding any taxation, and thus is a pure legal fiction serving no other purpose. No discrimination would exist with the imposition of a State or local tax on third-party suppliers. Imposition of a local sales tax levels the playing field between intrastate sales and interstate sales.
- iv. **Tax is fairly related to the State:** Clearly, one gas enters into the State of Illinois or the local municipalities, the interstate pipeline enjoys the services of the State and local municipality in terms of police, fire, and other emergency services.

We believe it is clear that sales made by third-party suppliers in Illinois meet the 4-prong test and thus allow municipalities and the State to impose gross receipts taxes on sales of natural gas.

- b. **Pipeline Tariffs-Physical Delivery:** From our vantage point, it appears that custom and practice, not the physical delivery components set forth in interstate tariffs or local distribution tariffs, have resulted in third-party gas sales being characterized as sales occurring in “interstate commerce”; and therefore, not subject to local taxation pursuant to the Commerce Clause. Moreover, it appears regardless of whether it’s impossible to physically pass title of natural gas outside the State, municipal utility taxes have gone uncollected based on what appears to be practices prior to 1997. Below is the physical chain of custody of a natural gas sale which clearly makes it impossible to pass title outside the State and makes the sales local sale in nature.
 - i. Examining FERC Gas Tariffs for XYZ the primary interstate pipeline serving the State of Illinois (see page 3 for actual pertinent tariff language), state XYZ has control and

possession of gas once the gas enters their system (wellhead) (receipt point) and XYZ returns possession at the interconnection between it and the local distribution company (city-gate) (delivery point). Given this, it would be impossible to pass title of gas flowing through XYZ's pipe outside Illinois as has been contractually custom and practice in many cases.

- ii. Illinois Commerce gas Tariffs for UTILITY 1, the largest LDC in the State of Illinois, state the LDC takes control and possession of the gas at the delivery point (city-gate) (receipt point) from XYZ and returns the gas at the meter (burner-tip) (delivery point) at the consumer's physical location. Again it would seem impossible to pass title outside the State to be considered interstate in nature.
- c. **IDOR Definition of Transactions in Interstate Commerce:** Based on statues governing IDOR's assessment of taxation on natural gas current practices at the State of municipal level are not sales in interstate commerce. Below is specific statute:

TITLE 86: REVENUE
CHAPTER I: DEPARTMENT OF REVENUE
PART 470 GAS REVENUE TAX ACT
SECTION 470.155 TRANSACTIONS IN INTERSTATE COMMERCE

Section 470.155 Transactions on Interstate Commerce

- a) The tax is not imposed upon any taxpayer with respect to any transaction in interstate commerce to the extent that such transactions may not, under the Constitution and statutes of the United States, be made the subject of taxation by this State.
- b) Insofar as the tax is imposed upon persons distributing, supplying, furnishing or selling gas for use or consumption and not for resale, the following general principles will apply in determining whether or not transactions are in interstate commerce:
- c) Where a taxpayer delivers gas through continuous mains, lines or pipes from a point in Illinois to a point outside of Illinois, such transactions are in interstate commerce, and the taxpayer is not liable for tax with respect to gross receipts therefrom.
- d) Where a taxpayer not engaged in business in this State delivers gas through continuous mains, lines or pipes from a point outside of Illinois to a point within Illinois, the transaction is in interstate commerce, and the taxpayer is not liable for tax with

respect to his receipts therefrom. However, if such company is engaged in the business in Illinois of distributing, supplying, furnishing or selling gas brought within this State for use or consumption and not for resale, such transactions do not constitute interstate commerce, and the tax will apply.

- e) Where a taxpayer delivers gas through continuous mains, lines or pipes from one point in Illinois to a second point within Illinois, the transaction is not in interstate commerce, and the taxpayer will be liable for tax with respect to his receipts therefrom. This rule applies irrespective of the fact that a portion of the continuous mains, lines or pipes of the taxpayer through which gas passes are situated outside Illinois.

- f) Where a taxpayer distributes supplies, furnishes or sells gas to a single customer under a contract calling for the delivery of gas partly within Illinois and partly outside of Illinois, the taxpayer is liable for tax with respect to that portion of gross receipts from the contract accruing from service furnished within this State.

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In 2015, from ABC's vantage point, most (if not all) of the third-party sales of natural gas in Illinois are made by companies or their agents having a physical presence in Illinois. The ABC Utility Services believes these sales have substantial and/or attributional nexus with State and local governments. Passing title outside the State (and, by extension, outside the municipality) is simply a legal fiction created to avoid taxation and does not seem possible given pipeline tariffs or the physical location of sale.

QUESTIONS

1. Are out-of-state third-party suppliers subject to State and municipal tax on sales of natural gas?

2. Given the above facts, would natural gas sales, where physical possession and title pass to an end-use customer at the city-gate, be considered sales made within Illinois for taxation purposes?

3. If an entity making a sale of natural gas to end-users in Illinois has a substantial nexus in Illinois (as defined by the 4-prong test), would the sale be considered local in nature regardless of where contractual title passed to the end-user, i.e. wellhead, city-gate or burner-tip?

4. Would State definitions of interstate commerce be the same for municipalities in Illinois as set forth in the Gas Revenue Tax Act?
5. Are there other considerations that IDOR would suggest to determine the location (for taxation purposes) of a natural gas sale?
6. Do IDOR's post-*Hartney* (2013 IL 115130) regulations affect IDOR's analysis of this matter?

DEPARTMENT'S RESPONSE:

The provisions of 86 Ill. Adm. Code 470.110 implement the Gas Revenue Tax Act. 35 ILCS 615. The Gas Revenue Tax Act is a State-wide tax administered by the Department. Tax revenues received by the Department are deposited into the State General Revenue Fund. Section 2 of the Act imposes a tax upon persons engaged in the business of distributing, supplying, furnishing or selling gas to persons for use or consumption and not for resale at the rate of 2.4 cents per therm or 5% of the gross receipts received from each customer from such business, whichever is the lower rate. 35 ILCS 615/2.

The Gas Use Tax Law imposes a State-wide tax on the privilege of using in this State gas obtained in a purchase of out-of-state gas at the rate of 2.4 cents per therm or 5% of the purchase price for the billing period, whichever is the lower rate. 35 ILCS 173/5-10; 86 Ill. Adm. Code 471.105.

Section 8-11-2 of the Illinois Municipal Code (65 ILCS 5/8-11-2) is not administered by the Department of Revenue; it is administered by municipalities that elect to impose a gas occupation tax. The Department has no authority or jurisdiction to provide guidance in regards to municipally-administered taxes imposed under this section of the Illinois Municipal Code. The local tax is in addition to any tax imposed by the State.

As noted above, the purpose of a GIL is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. The Department cannot provide guidance on hypothetical transactions.

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

Very truly yours,

Richard S. Wolters

RSW:bkl