

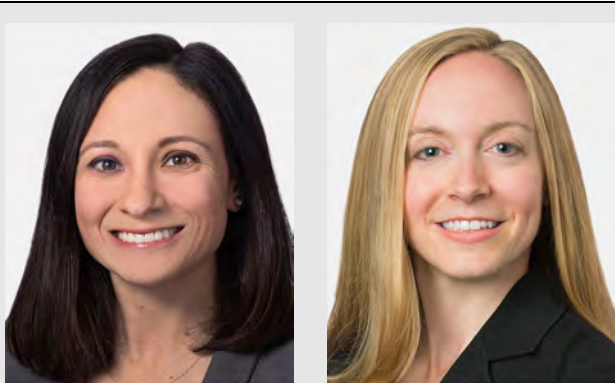
The Illinois Sales Tax: Origin Sourcing in a Destination World

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In this installment of SALT Insights, Ferrante and George argue that recent attempts by the Illinois General Assembly and Department of Revenue to amend state law in accordance with *Wayfair* have only complicated existing issues with the state's sales and use tax system.

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Most companies now have firsthand experience grappling with and attempting to implement changes under *Wayfair*.¹ Understanding the new legal and regulatory landscape in each jurisdiction, executing it in practice, and then supporting and defending one's position when contested are fraught with complex, unexpected challenges.

¹ *South Dakota v. Wayfair Inc.*, 585 U.S. ___, 138 S. Ct. 2080 (2018).

These challenges are perhaps most evident in Illinois.² Earlier this year, the Illinois Department of Revenue adopted further *Wayfair*-related amendments to its sales and use tax rules.³

While not surprising, the amendments do highlight a fundamental concern regarding the structure and nature of Illinois's sales and use tax scheme: Applying *Wayfair* destination-sourcing rules under an origin-sourcing body of law is a minefield.

Background on Illinois Sales and Use Taxes

Illinois's sales tax, referred to as the retailers' occupation tax (ROT), is not a true sales tax. Rather, it is an occupation tax imposed on the occupation of retailing — that is, on retailers engaging in the business of selling at retail⁴ — rather than on the sale itself. Therefore, the ROT is by its nature origin-based, looking to where retailing occurs rather than where a sale is shipped or delivered. Like other states, Illinois has a typical use tax — imposed at the same rate as its sales tax — that generally applies to out-of-state sales shipped into Illinois and not subject to sales tax.

The state allows some local jurisdictions to impose a local ROT in addition to the 6.25 percent state ROT. Illinois does not impose a local use tax. Therefore, assuming nexus exists, an out-of-state retailer shipping a product to a Chicago customer would have been subject to only a 6.25 percent state use tax on the sale. But the same retailer

² See, e.g., Lauren A. Ferrante, David C. Blum, and Stefi N. George, "Wayfair's Stealthy Creep Continues to Peer-to-Peer Car Sharing," *Tax Notes State*, Jan. 2, 2023, p. 55.

³ 47 Ill. Reg. 2,508-2,880 (Feb. 24, 2023), at 2719; 47 Ill. Reg. 1,742-2,210 (Feb. 10, 2023), at 2116, 2142.

⁴ 35 ILCS 120/2(a).

operating out of Chicago selling the same product to the same customer would be subject to a higher tax rate because of the 6.25 percent state ROT and the local ROT, which can hover around 4 percent.

Under the latter example, even in-state retailers experienced a stark rate differential depending on where their selling operations were; for instance, Chicago retailers are subject to a higher local ROT rate than Champaign, Illinois, retailers. Ten years ago, this intrastate rate differential led to the Illinois Supreme Court's *Hartney Fuel Oil* ruling,⁵ which invalidated the DOR's bright-line, single-factor order acceptance rule for sourcing intrastate sales because it belied a totality of the selling-activities standard established by ROT statutory and case law.⁶

Five years after *Hartney* affirmed origin-based sourcing, the U.S. Supreme Court in *Wayfair* upheld a state law requiring an out-of-state seller to collect sales tax on its sales for delivery into the state when specific dollar or transaction thresholds are met. This prompted Illinois — and most other states with a sales tax — to enact conforming legislation; however, because of its unique approach to sales tax, Illinois's enactment of *Wayfair* rules is more problematic for sellers than similar laws in other states.

Inconsistent Sourcing Patchwork

Illinois's approach to *Wayfair* creates an inconsistent patchwork of sourcing methods that results in disparate treatment of sellers. Among other changes, the General Assembly amended both the ROT and use tax regimes to apply *Wayfair* thresholds to these taxes, thus making the threshold dollar or transaction-volume sales

to customers in Illinois sufficient to constitute engaging in the occupation of retailing, even if the retailer is not physically present in the state.⁷ Thus, the *Wayfair* legislation incorporates destination sourcing into an origin-sourcing tax system that is otherwise left largely intact. The origin sourcing is most apparent in that the plain language of the ROT remains an occupation tax imposed on the occupation of retailing, and various statutory and regulatory amendments in prior years have maintained origin sourcing for some types of retailers (including marketplace facilitators and marketplace sellers) making sales through various means (that is, in-person or via the internet).⁸

For instance, while destination sourcing applies to source local ROT for sales made by a retailer without an Illinois physical presence and for third-party sales facilitated by a marketplace facilitator,⁹ origin sourcing applies to source local ROT for first-party sales made by a marketplace facilitator fulfilled from in-state inventory,¹⁰ and only state use tax applies to source sales made by a retailer with an Illinois physical presence whose selling activities occur outside Illinois.¹¹ This disparate treatment among sellers for the same sales — based on in-state presence and how sales are made — results in different tax rates and a strong case for constitutional violations.

The *Wayfair* Court affirmed the long-standing constitutional principles that circumscribe state tax laws: "First, state regulations may not discriminate against interstate commerce; and second, States may not impose undue burdens on interstate commerce. State laws that discriminate against interstate commerce face 'a virtually per se rule of invalidity.'"¹²

Here, Illinois treats in-state and out-of-state commerce differently by applying a different

⁵ *Hartney Fuel Oil Co. v. Hamer*, 2013 IL 115130 (Nov. 21, 2013).

⁶ See *Hartney*, 2013 IL 115130, para. 36: "Taking these two conclusions about the plain meaning of the business of selling and legislative intent together, then, the local ROT Acts were enacted to allow local jurisdictions to tax the composite of selling activities taking place within their jurisdictions, collecting taxes in relation to services enjoyed by the retailer."

Despite striking down the DOR's order-acceptance rule for sourcing local sales, the supreme court nonetheless held that the taxpayer was entitled to abatement of additional tax and penalties under the Taxpayers' Bill of Rights Act because it relied on erroneous DOR guidance. *Id.* at paras. 67-68. Interestingly, only one month before issuing its *Hartney* ruling, the court likewise struck down the state's click-through nexus law on grounds that it discriminated against online commerce in favor of offline commerce in violation of the Internet Tax Freedom Act. See *Performance Marketing Association Inc. v. Hamer*, 2013 IL 114496 (Oct. 18, 2013).

⁷ See, e.g., 35 ILCS 120/2(b), 120/1; 86 Ill. Admin. Code section 131.115.

⁸ See, e.g., 35 ILCS 120/2-12; 86 Ill. Admin. Code section 131.107.

⁹ Based on Illinois population, many of those sales would presumably be sourced to Chicago, which has a high ROT rate. See, e.g., 86 Ill. Admin. Code section 131.107(a)(1), (2).

¹⁰ *Id.* at section 131.107(a)(3).

¹¹ *Id.* at section 131.107(a)(4).

¹² *Wayfair*, 138 S. Ct. at 2091 (citation omitted).

sourcing rule and thus tax rate to remote retailers (destination sourcing)¹³ and other types of retailers that maintain some Illinois physical presence (either origin sourcing or use tax).¹⁴ Also, the DOR's tax compliance process to report sales subject to destination sourcing is onerous and cumbersome, imposing a heavier and more costly administrative burden on interstate commerce.¹⁵ Both of these aspects of the state's *Wayfair* law and guidance raise constitutionality questions because they appear to blatantly discriminate against interstate commerce and impose an undue burden. When the Supreme Court in *Wayfair* sanctioned economic nexus, it clearly did not have in mind this type of regime of questionable constitutionality.

Ironically, these disparities and deficiencies are the result of the enactment of Illinois's Leveling the Playing Field legislation, an attempt to equalize the sales and use tax rate paid by in-state and remote retailers.¹⁶ Though it is an attempt to address the disparity, the state's origin sourcing is unintentionally reminiscent of the pre-*Hartney* days for being easily manipulable for some nimble sellers (that is, an out-of-state seller storing its inventory in downstate Illinois) — clearly the opposite of the intended result.

Exacerbating Existing Problems

Rather than resolving this existing disparity, the DOR's most recent amendments have exacerbated Illinois's already problematic sales and use tax system. For instance, the amendments mimic the *Wayfair* legislation by deeming the "business of selling" to be determined by where sales are shipped or delivered (contrary to the nature of the tax and decades of case law) and describing a complex decision-making web of destination sourcing and origin sourcing, depending on the circumstances.

Wayfair-related actions and inactions of both the legislature and DOR have led to a rewrite of Illinois laws and rules that purport to conform with a typical, destination-based sales tax. But these efforts have been unsuccessful, resulting in a legally fraught patchwork of statutory and regulatory amendments that attempt to squeeze a square peg (that is, occupation tax imposed on the occupation of retailing) into a round hole (that is, a true sales tax imposed on the sale destination). Until this scheme is successfully challenged, businesses will have to contend with it. This regime goes far beyond what the U.S. Supreme Court appears to have intended when it overturned the physical presence nexus standard in *Wayfair*. ■

¹³ See 86 Ill. Admin. Code sections 131.105, 171.107(a)(4).

¹⁴ *Id.* at section 131.107(a)(4).

¹⁵ See Illinois DOR, Destination-Based Sales Tax Assistance Effective January 1, 2021.

¹⁶ Public Acts 101-0031 and 101-0604, Illinois General Assembly (effective Jan. 1, 2021); see also the Illinois DOR webpage, including a "Leveling the Playing Field" flowchart that depicts the tax rate differential discussed in the text.