ILLINOIS TAX FACTS

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Illinois Taxation of Retail Sales: A Primer and Some Problems

By Dr. Natalie Davila

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Overview

As internet sales continue to blossom, the evolving way that Illinoisans purchase goods has major implications for units of local government, an annual revenue loss that we estimate could be $635 million today, around 11.6 percent of total local sales and use tax.

Introduction

As a result of revenue forecasting work I have been doing for the Illinois Municipal League I began to wonder what role, if any, the increasing rate of growth in on-line sales plays in the distribution of Retailers' Occupation Tax and Use Tax to Illinois municipalities. Online sales now account for at least 8.5 percent of total retail sales in the US, so the impact could be significant.[1] Answering this question requires an understanding of Illinois' tax structure generally and how sourcing rules and local sales tax authorization impact sales and use taxes distributed to units of local government. This article attempts to demonstrate not only that internet sales have made things more complicated but also that they have eroded overall total revenue to and shifted revenue among local governments.

TAXPAYERS' FEDERATION OF ILLINOIS

NOTES FROM THE INSIDE. . .

By Carol S. Portman

The growing popularity of online shopping has revolutionized the retail world. One side effect: the push by states to collect sales tax on internet sales. For nearly two decades pundits have been bemoaning the growth of untaxed online sales, and many states have responded with creative approaches to collecting taxes. Those state efforts, together with the recent trend of online retailers acquiring in-state presence (and thereby subjecting their sales to tax), has slowed the erosion of state taxes.

However, as Natalie Davila points out in this edition of *Tax Facts*, this is less true for Illinois' local taxes. When a retailer sells a $100 coat at an Illinois store, the state gets $5.00 in sales tax and local governments receive, on average, $3.64 in sales taxes. When the same coat is sold online for the same $100, the state still gets $5.00, but local governments typically get only $1.25 (if tax is collected at all).

Natalie discusses other complexities associated with Illinois' sales tax system – determining where a sale occurs (not as easy as it sounds), determining whether sales tax or use tax applies, and the resulting differences in distributions to local governments.

The financial impact is striking. Natalie's $635 million estimate of the potential loss to local governments (almost 12 percent of local sales taxes) is almost three times her $215 million estimate of state government's loss from uncollected tax. I expect we will hear more about this -- from local governments – but the solutions won't be easy. (For example—local use tax has superficial appeal, but would create more chaos.)

To put these issues in context it is important to first briefly discuss Illinois' current sales tax system, by way of illustrating how the world has changed since 1932 when the ROT was first enacted. The changing nature of what we buy and how we buy it, along with the ability of local governments to levy their own local ROT, has led to a wide range in rates. This means there is no statewide "tax climate" but rather individual local tax climates. Such wide differences have led to economic distortions as taxpayers alter their behavior to minimize tax liability– hence violating one of the most important guiding principles of good tax policy. These problems are then exacerbated by how taxes associated with online purchases are levied and distributed.

Antiquated Retail Sales Tax Structure

Brief Description: Illinois does not have a true sales tax on retail sales.[2] Rather, Illinois sales tax is actually comprised of four different taxes: the Retailers' Occupation Tax (ROT) and its complement the Use Tax (UT), the Service Occupation Tax (SOT) and its complement the Service Use Tax (SUT). The ROT is imposed on Illinois retailers on the gross receipts from sales of tangible personal property. The UT, added in 1955, is a tax on the privilege of using tangible personal property in the state. The purpose of the UT is to protect in-state retailers from unfair competition from out-of-state retailers who are not subject to the ROT. In a normal over-the-counter sale an Illinois retailer collects and remits ROT. If that same Illinois retailer makes a remote sale (via catalog or internet), the retailer collects and remits UT. It is less straightforward when Illinois cannot compel the retailer to collect tax, most typically when an out-of-state internet seller or catalog company has no physical presence in Illinois (the technical legal term is "nexus"). In such cases the purchaser is supposed to self-assess the UT and remit it to the State. The SOT and SUT have the same relationship to each other as do the ROT and the UT, but apply to tangible personal property transferred within the course of performing a service. There are other complications involving the SOT and SUT, but this paper will focus on the ROT and the UT.

Rate History: Illinois' Retailers' Occupation Tax was first enacted in 1932 as a way to cover costs associated with the estimated 1,200,000 persons or nearly one-sixth of the population of the state that by March 1933 were dependent on State and local governments for the very necessities of life.[3] A 2 percent Retailers' Occupation Tax Act became effective July 1, 1933. This rate was increased several times and currently stands at 6.25 percent for general merchandise and 1 percent for groceries, drugs, and medical appliances. (The other taxes in the state sales tax structure—UT, SOT, and SUT—are applied at the same rate as the ROT.) A sales tax reform initiative in 1990 incorporated what was then 1.25 percent in locally imposed (but state-wide) taxes into the state tax structure, and boosted the state ROT and its complementary UT from 5 to 6.25 for general merchandise. The increased revenues from the state rate increase from 5.00 to 6.25 percent were distributed (mostly) to local governments.

ILLINOIS SALES TAX RATE HISTORY

YEAR	STATE ROT	STATE USE TAX	STATEWIDE LOCAL ROT
1933	2%	0	0
1935	3%	0	0
1955	3%	3%	1%*
1959	3%	3%	1%*
1969	4%	4%	1%
1984	5%	5%	1%
1986	5%	5%	1.25%
1990**	6.25%	6.25%	0

* Municipal Retailers Occupation Tax authorized in 1955; County Retailers Occupation Tax authorized in 1959 ,
** The 1990 Sales Tax Reform converted the 1.25 percent local ROT taxes into a state tax, thereby adding a complementary Use Tax.

Over time, many units of local government have been given authority to piggyback onto the state sales tax system administered by the Department of Revenue, even after the 1990 "reform" efforts. These additions have been made to the local ROT rate, but none of the add-on local taxes has a complementary UT. The population-weighted average combined state and local 2016 sales tax (ROT) rate in Illinois is estimated at 8.64 percent,[4] well above the state base rate of 6.25%.

Combined with Increasingly Complex Tax Administration

The processes of collecting, accounting for, and administering the entire sales tax system, for both retailers and the Department of Revenue, have become increasingly more complicated as our economy has evolved. In particular, the disparity of tax rates described above combined with local sourcing rules and the question of

AUTHORIZED LOCAL SALES TAXES	
1955	Municipalities
1959	Counties
1979	RTA
1980	Metro East
1986	DuPage Water Commission
1986	County Supplementary
1990	Sales Tax Reform
1990	Home Rule Common Base
1994	Non-Home Rule Municipalities
1998	County Public Safety
2001	Metro East Park and Recreation
2005	Business Districts/Special Service Areas
2008	County School Facility
2009	County Flood Prevention

whether ROT or UT applies impacts how ROT and UT get distributed to units of local government.

Sourcing: "Sourcing" for sales tax purposes determines where a sale occurs, which in turn determines which local government gets the local share of the state sales tax, and which local tax applies (if any). Illinois is an origin rather than destination sourcing state, which means the applicable tax rate is where the purchase originates and not its final destination. This is significant only for local governments, as state government always receives the 5 percent state component of the ROT and UT. When combined with the wide disparity of local sales tax rates throughout the state, origin sourcing exerts significant influence on the behavior of both the retailer and purchaser. This issue was highlighted in a recent dispute between Hartney Fuel Oil and the Illinois Department of Revenue (IDOR), which went all the way to the Illinois Supreme Court. Hartney had set up an operation to accept orders in a low-tax jurisdiction, effectively moving sales that would have otherwise been taxed at a higher rate to the low-rate jurisdiction. The order acceptance operations benefitted the seller, the purchaser and the jurisdiction where they were set up, but hurt the location where the sales would otherwise have been sourced. The case was even more controversial because, as a condition of setting up the order acceptance operations, the local government agreed to rebate to Hartney a portion of the new local sales tax it received because of Hartney's activities there. The Illinois Supreme Court held that the IDOR rules did indeed source sales to Hartney's order acceptance operation, but that the rules were inconsistent with the underlying statute. IDOR has promulgated new rules, but it is almost impossible to prevent fights between local taxing jurisdictions when the stakes—lower tax bills for the customer and higher tax revenues for the governments—are so high. Another example of the interaction of Illinois' sourcing rules and wide range of rates impacting behavior, this time on the consumer side, is when someone who lives in a higher tax jurisdiction travels to a lower tax jurisdiction to buy a sofa. Whether or not the sofa is delivered by the vendor, the applicable tax rate is based on the store's location.

As illustrated above, Illinois' significant disparities in local sales tax rates (ranging from 0 percent to 4.0 percent) can lead to distorted economic activity. Everything else being equal, as long as this disparity exists, taxpayers will try to find a way to conduct the selling activity (if Illinois remains origin sourcing) or the receipt of the property (if Illinois moves to destination sourcing) in a low-tax jurisdiction. As long as there are significant differences in local sales tax rates, there will be attempts to source sales to low rate jurisdictions.

ROT v. Use Tax: When we combine this sourcing issue with the question of whether ROT or UT applies and how the local 1.25 percent share of the 6.25 percent state-wide tax is distributed, the situation becomes even more complex. (And, as described in more detail below, has the potential to result in significant loss of total revenue to local governments and differing distributions of existing tax receipts.)

When, under the relevant sourcing rules, a sale occurs within the state, ROT applies and because the retailer has a presence and makes sales here, it is also collecting and remitting tax. If, on the other hand, the sale itself does not occur in Illinois, but the item purchased is used in the state (shipped in or brought here by the purchaser), then UT applies, and compliance is spottier. Internet and other remote sellers that have nexus in Illinois (and many do) must collect the state-imposed 6.25 percent use tax on sales shipped into Illinois. For sales by retailers that do not meet the nexus test (and there are many of these as well), payment of use tax to IDOR becomes the responsibility of the consumer. UT self-assessment historically has had a low compliance rate for individuals.[5]

One recent development highlights the complexity of Illinois' taxing situation. Amazon, the country's largest internet retailer, now has physical nexus in Illinois and is now collecting tax on its sales to consumers in Illinois.[6] If the good is delivered from a fulfillment center located in Illinois to an Illinois consumer, ROT applies, at the total state rate plus any applicable local ROT rate where the fulfillment center is located. This ROT rate may differ, and be significantly higher, than the rate applied to goods shipped from a fulfillment center located out-of-state. In that situation, only the 6.25 percent UT rate applies. In other words remote sellers must recognize where an item sold is located before determining the appropriate tax rate.

Use Tax Distribution: In a nutshell, the local component of ROT goes to the jurisdiction where the sale is sourced, and the local component of UT is distributed as follows.

- 20 percent City of Chicago
- 10 percent Regional Transportation Authority
- 0.6 percent Metro-East Mass Transit District
- $37.8 million (annually) Build Illinois Fund
- Balance to municipalities (other than Chicago) and counties based on population

When an internet seller already collecting Illinois tax opens a fulfillment center in Illinois, the tax due on sales made through that location changes from UT to ROT, and the local component of the tax collected goes to the county and municipality where the facility is located. Such factors need to be accounted for when developing an estimate of the overall tax impact of internet sales.

Along with a Growing Digital Economy

While the purpose of this article is not to discuss in detail recent trends in online purchasing versus traditional bricks and mortar purchasing, it is important to note that online retail purchasing is growing at a rate almost double that of traditional purchases. This trend is significant with regard to how taxes get distributed to units of local government here in Illinois. The following discussion picks up from an article published by the Better Government Association in May 2017 that was the first to highlight this issue.[7]

Resulting in Significant Tax Loss and Redistribution

We want to get some idea of how our evolving way of making purchases has impacted both state and local government in Illinois. Our first step is to develop an updated "degree of magnitude" estimate for state revenue loss associated with internet sales--those sales upon which no tax is being paid. This will be followed by developing an estimate of associated local ROT or UT revenue loss and redistribution.

The first study of estimated Illinois sales tax loss due to e-commerce that I am familiar with was conducted by Fox and Bruce in 2000.[8] For Illinois state and local tax loss due to e-commerce the authors forecasted $844.8 million in 2003.[9] The authors performed periodic updates and the estimates changed significantly. The latest estimate, published in 2009, where they estimated the combined state and local loss in Illinois to be $343.7 million in 2008, growing to $506.8 million in 2012.

Given the wide variation in these estimates, while I was the Research Director at IDOR we undertook a project to review the authors' methodology and update the Fox and Bruce estimates. Our goal in conducting this research was to develop a methodology that we felt was sound and that we could explain and justify to policy makers. Too often we heard states talk about very large, and in our opinion, unrealistic estimates of tax loss due to online sales. Our results, published in 2009, yielded a FY2009 state tax loss of around $150 million at the 5 percent rate (this translates into a state and local estimate, using the full 6.25 percent, of $187.5 million), much less than the often cited estimates at the time.[10] A 2011 update yielded a state estimated loss in revenue due to e-commerce of around $200m ($250 million in state and local tax loss) in FY2013.

Can we resolve this wide disparity in revenue estimates? Not completely, but there is one thing that needs to be accounted for. The Bruce and Fox studies combine state and local e-commerce tax loss. If we ratchet down their estimates to only account for the state 5 percent component and use their most conservative estimate for FY2011 we generate an estimate of $360 million compared with the IDOR estimate of $150 million. Alternatively, using the methodology employed by California and adjusting for Illinois population and tax rate yields a FY2011 state estimate of $210 million, very close to the IDOR estimate.[11]

In order to measure the distributional impact of the current UT collection and non-collection on local governments we start with a FY2011 state estimate of $210 million. We do this not to get into a debate about what is the "right" estimate but to take the median estimate to analyze how the situation has evolved since that time and what these developments mean for estimates of tax loss and distribution of ROT and UT in Illinois. The same methodology could be applied to either the Bruce and Fox estimates or the published IDOR estimates.

In any event, clearly all the above estimates are out-of-date. Since these studies were conducted the e-commerce industry and associated tax administration have continued to evolve. Internet sales have grown at double digits compared with single digit growth in bricks and mortar sales. At the same time, more internet retailers have developed physical nexus and have started collecting and remitting ROT and UT. Since 2005 combined ROT/UT revenues have grown in Illinois by 25 percent while UT collections have increased by 150 percent.

Estimating E-Commerce Effect on Local Revenues. Based on estimates for e-commerce from the Census Bureau, e-commerce accounted for 8.5 percent of total retail sales in the first quarter 2017, compared with 4.7 percent for the same period 2011.[12] The annual growth rate has averaged 15.1 percent. A major development since 2011 is that Amazon now has a physical presence in Illinois and is collecting tax from Illinois residents.[13] Amazon's growth has significantly surpassed the average for the industry, averaging almost 25 percent on an annual basis. Current estimates suggest that Amazon accounts for 43 percent of US online retail sales.[14] We estimate that there has been an annual increase of some $200 million in state and $52 million in local UT collected as a result of Amazon establishing nexus and collecting tax in the state (along with Illinois' adoption of click-through nexus legislation and associated rules), so we have not seen a huge increase in tax loss between 2011 and current tax collections.

Combining the two factors – increasing levels of e-commerce sales where tax compliance is uncertain with the fact that the e-commerce giant Amazon has begun collecting and remitting Illinois tax -- yields an estimate for 2016 state tax loss of $215 million for the state 5 percent portion (comparable to the 2011 state loss estimate of $210 million). The corresponding local tax loss (looking only at the 1.25 percent local component of the UT) is estimated at $54 million

The calculation above focuses only on revenue loss associated with remote sales on which UT is not collected or paid. While this is one source of downward pressure on local government ROT and UT, as the digital economy continues to expand a larger and larger percentage of sales are being taxed at the 6.25 percent UT rate, rather than the average 8.64 percent ROT rate for traditional bricks and mortar sales. Think of it this way: if an Illinois resident bought a $100 jacket at an Illinois department store, the state would receive $5.00 in tax and local governments (on average) would receive $3.64. If the Illinois resident buys the same $100 jacket online from an e-commerce retailer who collects Illinois UT, the state would receive $5.00 in tax and local governments would receive $1.25. Local governments are losing ROT and UT revenue in the following ways.

1. Current annual local UT receipts are $250 million. If these purchases were subject to the average state and local ROT rate of 8.64 percent rather than the UT rate of 6.25 percent, local governments would receive an addition $480 million annually.
2. Local UT on remote sales on which tax is not being collected/paid is estimated at $54 million at the 6.25 percent rate. If these purchases were subject to average state and local ROT rate of 8.64 percent, local governments would receive in excess of $155 million annually.

Finally, a less commonly discussed tax impact of the recent trend of internet sellers opening fulfillment centers in Illinois is the distributional shift among local jurisdictions. As described above, items shipped from Illinois fulfillment centers to Illinois residents are subject to ROT, not UT. As noted above, a switch from UT to ROT does not impact the magnitude of state revenue (the 5 percent of the 6.25 percent) in any way, if the seller was already collecting tax. However, it changes how tax collections are distributed to municipalities. Winners in this new world are those municipalities that house a fulfillment center, who get the full 1.25 percent, plus any local ROT imposed by the jurisdiction, while losers are all other municipalities in the state, who would have shared in the 1.25 percent if it were a UT transaction. At the time of writing, we do not have data to estimate the consequences of this shift.

Conclusion

While online sales continue to grow at a much higher rate than traditional bricks and mortar retail sales, how things will end up in the long run is much less certain.[15] [16] However, what we do know is that in Illinois this industry-in-transition is having significant impacts on how much tax and what kind of tax is being collected and distributed to local governments. Local governments are losing out to the tune of $54 million due to uncollected tax. In addition, the UT tax rate is 1.25 percent compared with an average local ROT rate of 3.64 percent, which translates into downward pressure on local receipts of $100

Illinois Tax Facts

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million. In addition, local governments are losing $480 million compared to what they would be receiving if current UT tax compliant sales were taxed at the average local ROT rate. This leads to a total theoretical loss to local governments in excess of $635 million. Finally, all municipalities benefit from collection of UT from online sales. If, because of changes in business practices, the tax collected now becomes ROT, only those municipalities which house a fulfillment center benefit.

ENDNOTES

1 https://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf
2 Note that sales and use tax applies to many business-to-business transactions. However, the focus of this report is on business-to-consumer transactions.
3 The Illinois Sales Tax (retailers' Occupation Tax): Why It Was Enacted and What It Has Accomplished, Department of Finance of the State of Illinois, http://www.idaillinois.org/cdm/ref/collection/isl/id/41374
4 https://files.taxfoundation.org/legacy/docs/LOST2016-01_0.png
5 See "Illinois Use Tax Collection: One Small Step, But in Which Direction?", January/February 2015 *Tax Facts*, http://www.illinoistax.org/app/webroot/userfiles/file/2015%20Research%20Reports/2015%201%20IFPC%20Research%20Report.PDF
6 http://www.chicagotribune.com/business/ct-amazon-romeoville-distribution-center-opening-0609-biz-20170608-story.html
7 http://www.bettergov.org/news/why-the-online-threat-to-big-retail-means-bigger-holes-in-illinois-budgets
8 Bruce, Donald, and William F. Fox. "E-Commerce in the Context of Declining State Sales Tax Bases." National Tax Journal. Vol. 53, No. 4 (December 2000, Part 3), pp. 1373-1388. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=251107
9 https://www.ntanet.org/NTJ/53/4/ntj-v53n04p1373-90-commerce-context-declining-state.pdf
10 Based on recent feedback from IDOR, they believe that their estimates may need to be revised upward by up to 30 percent due to the availability of more detailed data that suggests an initial undercounting of sales by smaller internet vendors. If we made this adjustment we would come up with an estimate that is comparable to the estimate that uses the California methodology
11 https://www.boe.ca.gov/legdiv/pdf/e-commerce-11-10.pdf
12 https://www.census.gov/retail/index.html
13 http://www.chicagotribune.com/business/ct-amazon-sales-tax-illinois-0124-biz-2-20150123-story.html
14 http://www.businessinsider.com/amazon-accounts-for-43-of-us-online-retail-sales-2017-2
15 http://www.businessinsider.com/9-retailers-with-poor-expected-earnings-for-2017-2017-4/#7-ulta-salon-cosmetics-and-fragrance-3
16 https://seekingalpha.com/article/4076089-brick-mortar-retail-dead-believe-critics

The following three charts were from a presentation that Natalie Davila and Mike Lipsman, of the Strategic Economics Group, made to the Federation of Tax Administrator's recent research conference. They shed additional light on Illinois' sales tax collections over time and in comparison with the rest of the country.

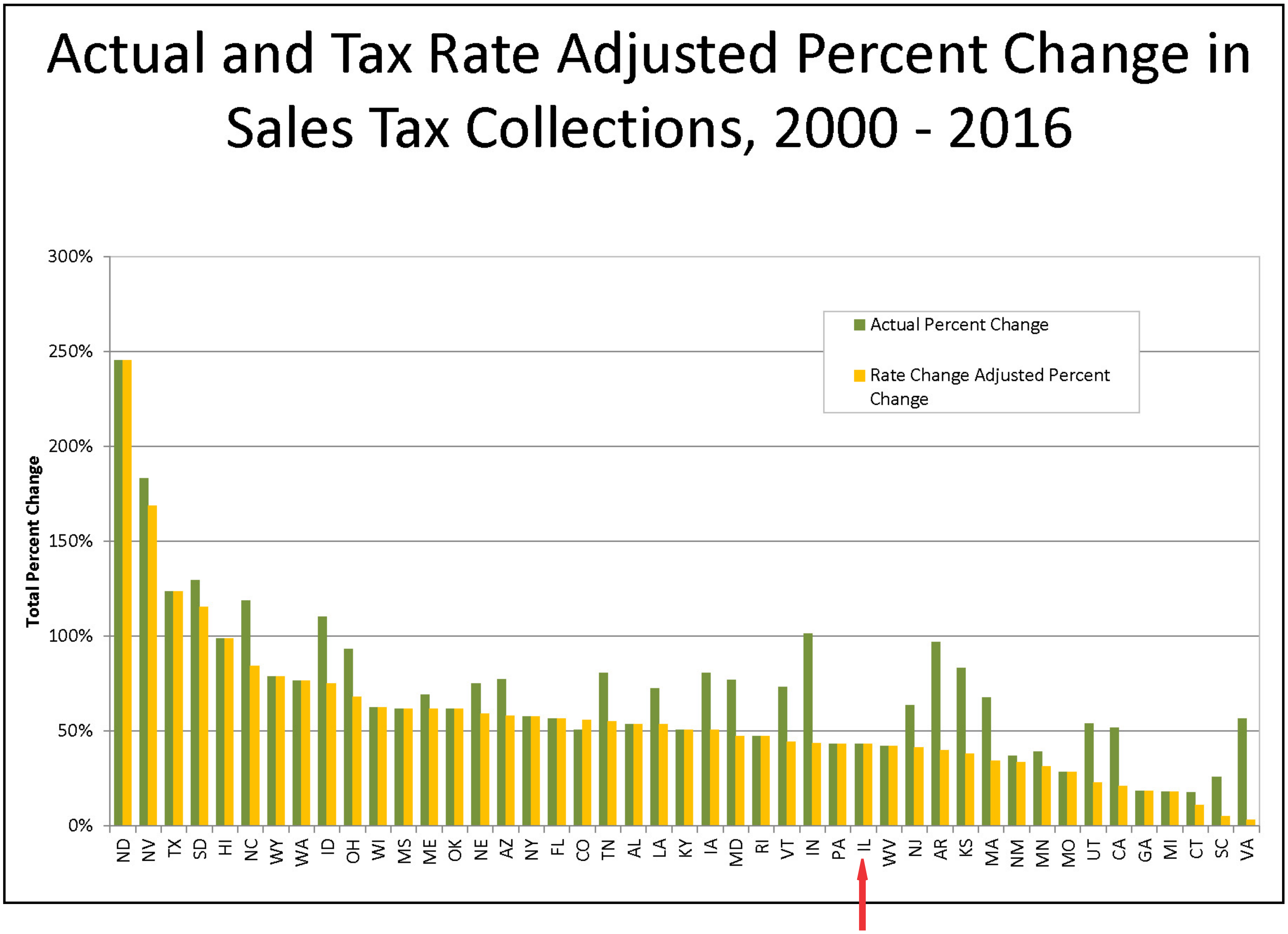

Figure 1 shows the growth in sales tax collections in each state over the last 17 years. The green bar is the raw percentage increase in collections. The yellow bar accounts for increases in the tax rate, so it shows what the growth in sales tax collections would have been if there had been no changes to the sales tax rate. The data is just for state collections and Illinois has not increased its rate since 2000, so the bars are the same.

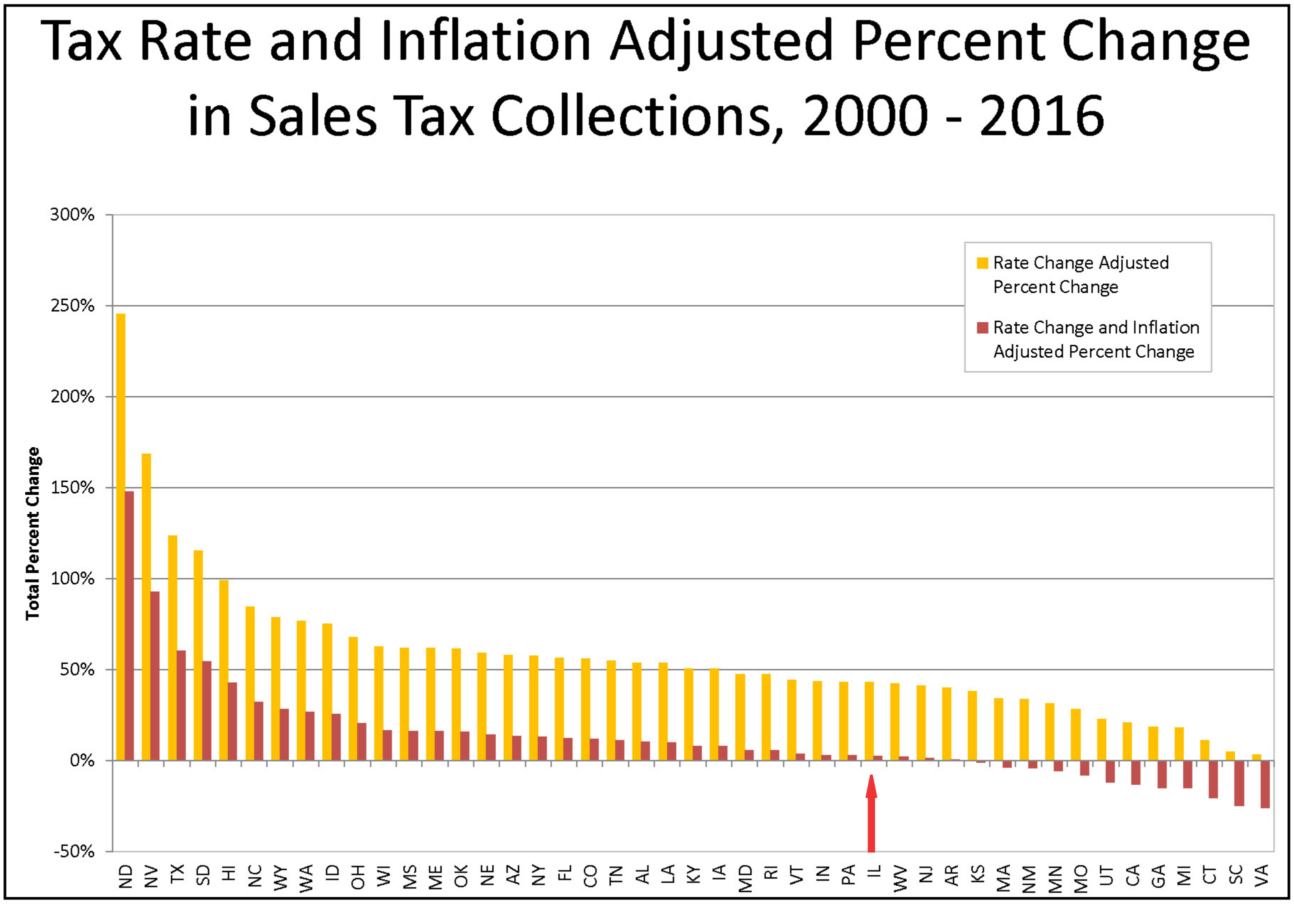

Figure 2 is similar to Figure 1, but it also takes inflation into account. The red bar also adjusts for changes in the tax rate. This shows that a number of states have seen their sales tax base decline or stay flat once inflation and tax rate changes have been accounted for. Illinois has hardly seen any growth in its sales tax base.

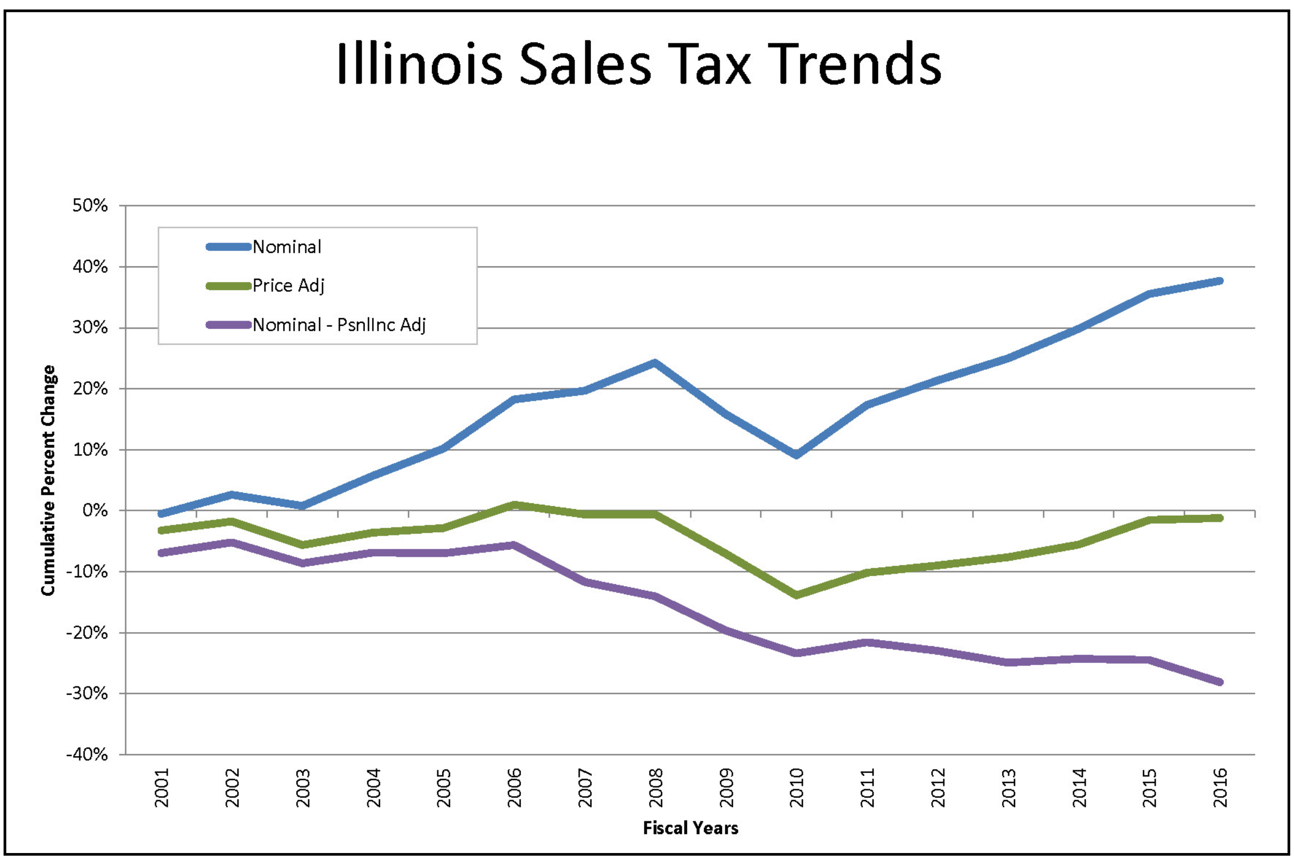

Figure 3 shows the growth of sales tax collections in Illinois over time. The purple line adjusts collections for inflation and personal income growth. This means that the sales tax base has grown 28 percent less than personal income during this period.

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