



TAXPAYERS'
FEDERATION
— OF ILLINOIS —

What's Taxable (and What Isn't) in Today's Evolving Economy?

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Agenda

1. The Basics: Taxable and Nontaxable Transactions
2. Recent Developments – Legislation, Regulations, and Administrative Guidance
3. Recent Developments – Litigation and Exemption Certificate Chaos
4. Best Practices – Documenting the Exempt Transaction

The information herein is to be used for general guidance and should not be relied on for compliance purposes.

The information provided herein is educational in nature and is based on authorities that are subject to change. You should contact your tax adviser regarding application of the information provided to your specific facts and circumstances.



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The Basics: Taxable and Nontaxable Transactions

The Basics: Taxable and Nontaxable Transactions

- **Exclusions** - transactions not included within the state's tax base; **Burden is on the government.**
 - Sales/use taxes are imposed on sales of tangible personal property; not real property or intangible property. But what is “tangible”? – recurring debate across state / local jurisdictions.
 - Some states specifically *exclude* services from tax, e.g., Illinois.
 - What about rented or leased tangible property?
- **Exemptions** - transactions normally subject to tax, but conditions exist which create exemption; **Burden is on the taxpayer.**



The Basics: Taxable and Nontaxable Transactions

Exclusions

- Not surprisingly, every state differs.
- Trap for the unwary – while legal burden is on the government, documentation may still be required to prove on audit that the transaction falls outside the scope of the sales/use tax statute.
- Illinois-specific exclusions:
 - Real property
 - Transportation and delivery charges (quirky rules) (130.415).
 - Store coupons (manufacturer coupons do not reduce the tax base) (130.2115(b)).
 - Discounts (130.420)
 - Installation charges (130.450)
 - Taxes paid 130.435 and 130.445)
 - Mandatory Tips, (see rules for specifics) (130.2145(d))
 - Returns & Bad Debts (quirky rules on bad debts)(130.1960(d))
 - Finance/Interest Charges (130.420)
 - Like-Kind Trade-Ins (130.425)



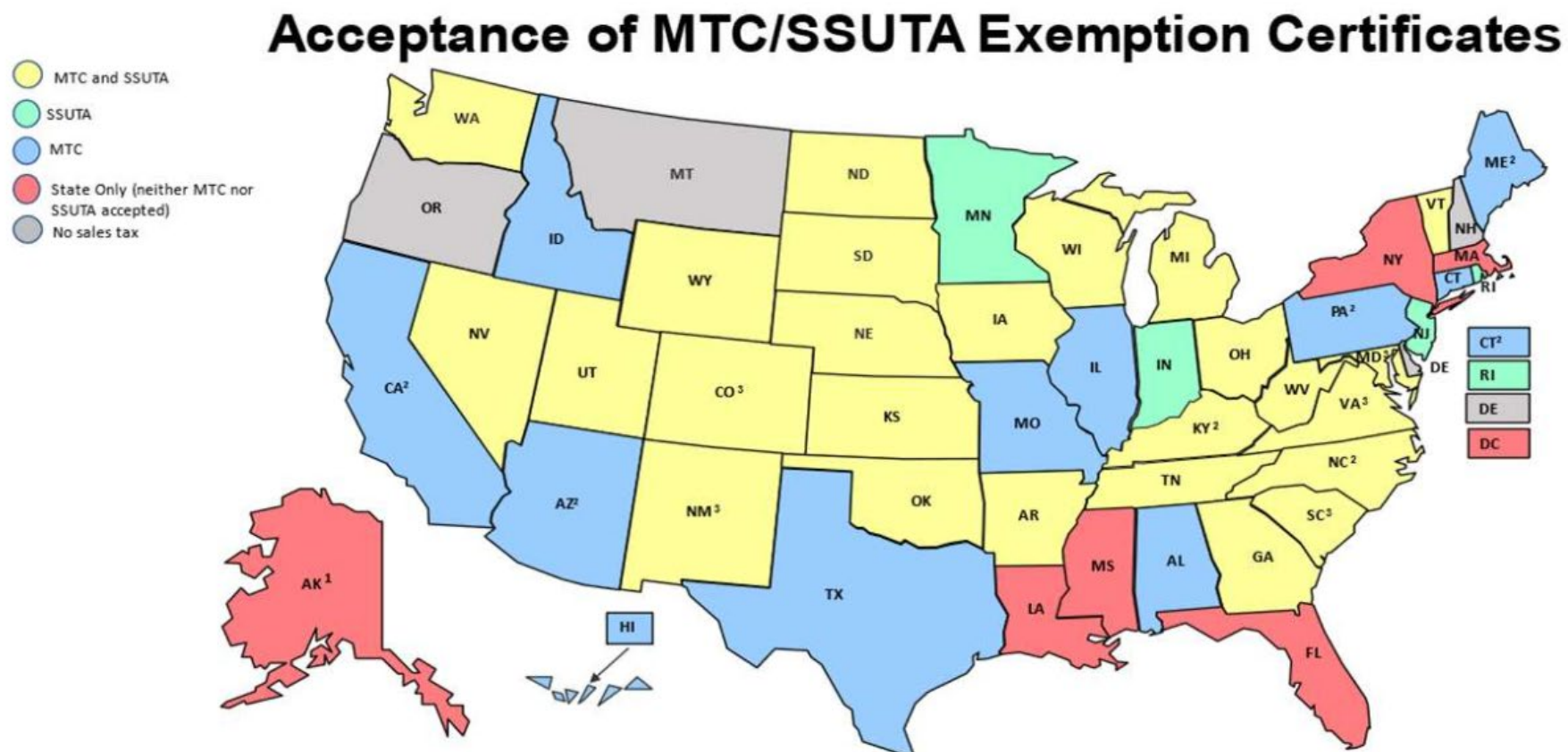
The Basics: Taxable and Nontaxable Transactions

Exemptions

- There are three general types of exemptions: Entity-based exemptions, product-based exemptions, and use-based exemptions.
- Exempt positions must be fully documented to satisfaction of taxing authority. *See, e.g., Ill. Admin. Code 130.810(d)* (“The failure to obtain and keep a Certificate of Resale shall create a presumption that the sale was not a sale for resale. The seller may, however, present other documentary evidence to overcome this presumption.”).
- Documentation can vary depending on specific exemption claimed and applicable state.
 - CRT-61 Certificate of Resale.
 - ST-587 Exemption Certificate (for Manufacturing, Production Agriculture, and Coal and Aggregate Mining).
 - Streamlined Sales Tax Agreement Certificate of Exemption
 - MTC Uniform Certificate
 - R&D Certificate (no IL equivalent)
 - Pollution Control (no IL equivalent)
 - Agricultural (no IL equivalent)
 - Not for profit (no IL equivalent)
 - Direct pay permits – allows purchasers to self-assess use tax on taxable transactions, rather than pay sales tax to vendor. **States differ on types of transactions eligible for direct pay permits.**
 - “Other evidence” accepted?
- True object test – seeks to determine the purchaser’s motive in engaging in the transaction. Did the purchaser intend to buy the TPP or the expertise of the service provider?
- Trap for the unwary – enforcement can also occur through **false claims actions**.



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Source: Council On State Taxation (COST)

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²AZ/CA/CT/KY/ME/NC/PA – Allows limited use of MTC certificate

³CO/MD/NM/SC/VA – Allows limited use of MTC and SSUTA certificates



The Basics: Taxable and Nontaxable Transactions

Entity-Based Exemptions

- Exempt Organizations – IRC Section 501(c)(3)
 - Religious, charitable, educational, governmental (federal, state/local, and government contractors).
 - Federal income tax exemption does not automatically mean state sales/use tax exemption.
 - Purchases by qualifying religious, charitable, educational organizations may be exempt. Recurring retail sales of TPP by such organizations are generally taxable.
 - Any entity eligible for exemption from sales/use tax must have an active identification number, *e.g.*, an “E-number” issued by IL DOR. In Illinois, E-numbers are effective for 5 years.
- IL Education Exemption: narrowly applies to schools providing a traditional curriculum for credit. An entity "organized and operated for the purpose of offering professional, trade or business seminars of short duration, self-improvement or personality development courses, courses which are avocational or recreational in nature ... courses, or courses which do not provide specialized training within a specific vocational or technical field shall not be considered to be organized and operated exclusively for educational purposes." 35 ILCS 120/2h. **Does a karate school qualify? What about an affiliate of public university? What about a non-Illinois university?**
- IL Charitable Exemption: simply being organized as a non-profit is not enough. Must serve charitable purposes. Civic organizations (trade associations) generally not qualified as “charitable.” *The Dept. of Revenue v. ABC Association Taxpayer*, ST No. 17-04 (Apr. 21, 2017). The organization "[m]ust derive its funds mainly from public and private charity." *Methodist Old Peoples Home v. Korzen*, 39 Ill.2d 149 (1968). **Quirky rule – LLCs are not eligible for charitable exemption treatment (although they are eligible for the education exemption).**
- IL Government Exemption: funding must derive from taxpayers directly or indirectly through another governmental agency. If the contract with the governmental unit explicitly requires the contractor to sell those items to the governmental unit, the purchase of those items by the contractor must be structured as purchases for the purpose of resale to the governmental unit. See Ill. Admin. Code 130.2076. **Watch out - certain states tax state and local government.**



The Basics: Taxable and Nontaxable Transactions

Product-Based Exemptions – Retailers Obligation

- Types of product-based exemptions could include (depending on state):
 - Food for home consumption (generally excludes prepared meals).
 - Clothing
 - Prescription drugs (in IL, taxable but may qualify for a reduced tax rate)
 - Medical equipment
 - Newspapers
 - Services (Most states: non-taxable with specifically enumerated exceptions; IL: all services are non-taxable).
 - Custom software (*cf.*, canned software) (IL: licensed software is not a taxable retail sale. See Ill. Admin. Code 130.1935).



The Basics: Taxable and Nontaxable Transactions

Use-Based Exemptions – Purchaser Obligation

- Types of use-based exemptions could include (depending on state):
 - Sales for resale
 - Occasional, isolated, or casual sales
 - Business reorganizations – trap for the unwary: successor liability.
 - Bulk sales
 - Garage or yard sales (note: in IL, occasional sales by non-retailers are *excluded* from sales/use not. See Ill. Admin. Code 130.110(a)).
 - Manufacturing equipment and machinery
 - Pollution control equipment
 - TPP used in the construction or operation of data centers. See Ill. Admin. Code 130.1957.
 - Sales to construction contractors for incorporation into real property
 - Farm chemicals, *e.g.*, used in production agriculture (used to raise crops for sale).
 - Seeds and fertilizer used in production agriculture.
 - Interstate commerce
 - Foreign commerce



The Basics: Taxable and Nontaxable Transactions

Use-Based Exemptions

- Sale for Resale
 - Purchase for resale in same form (*e.g.*, Costco)
 - Purchase and resold in different form (*e.g.*, manufactured or assembled).
 - What about promotional items / giveaways? Examples--
 - Chicago Bulls distribute hats with team logo to first 10,000 fans who enter arena with ticket for the game. Is the team's purchase of the hats from a local vendor a sale for resale or a taxable use by the team?
 - Toys included with purchase of McDonald's Happy Meal? *See McDonald's Restaurants of Mass., Inc. v. MA Commissioner of Rev.*, Case No. C262528 (Apr. 22, 2005).
 - Prizes awarded for "games of skill"? *See Prince v. State Tax Commission*, 366 Mass. 470 (1974).



The Basics: Taxable and Nontaxable Transactions

Use-Based Exemptions

- Sale for Resale
 - **Best practice:** obtain a contemporary resale certificate from every customer to certify transaction is for resale.
 - Certificates are generally valid across states until revoked by the purchaser.
 - Some certificates expire after certain period of time:

State	Expiration Period
Colorado	2 years - expiring at the end of odd-numbered years
Connecticut	Certificate should be renewed every 3 years
Florida	Annual renewal
Illinois	Certificate should be renewed every 3 years
Maine	Annual renewal
Michigan	Expires after 4 years
Minnesota	Certificate should be renewed every 3 years
New Mexico	Expires after 12 years
North Dakota	Certificate should be renewed every 2 years
Oklahoma	Expires after 3 years
South Dakota	Annual renewal
West Virginia	Annual renewal



- Update certificates regularly - especially in these jurisdictions!

The Basics: Taxable and Nontaxable Transactions

Use-Based Exemptions

- Sale for Resale
 - All of certificates require: Name and address of the seller and purchaser, description of purchaser's business, state registration/exemption number, description of property purchased, reason for exemption, signature and date.
 - However, if record of a certificate is not available on audit, do not panic - states often allow introduction of additional documentation. For instance, in Illinois, "other evidence [can] be used to document a sale for resale, when a registration number or resale number and certification to the seller are not provided ..." Such evidence "could include an invoice from the purchaser to his customer showing that the item was actually resold, along with a statement from the purchaser explaining why it had not obtained a resale number and certifying that the purchase was a purchase for resale in Illinois." Ill. Admin. Code 130.1405(d).
 - All evidence is subject to strict scrutiny by the government.



The Basics: Taxable and Nontaxable Transactions

Drop Shipments

Generally, involve 3 parties: one customer, retailer and drop shipper

- Retailer located outside the state and not registered to collect tax sell the product to the consumer
- Drop shipper sells the product to the retailer but ships the product to the consumer on behalf of the retailer. Drop shipper is registered to collect sales tax in consumer state

Out of state resale certificate not accepted

- California
- Connecticut
- District of Columbia
- Hawaii
- Maryland
- Massachusetts
- Mississippi



The Basics – Taxable and Nontaxable Transactions

Good Faith Standards

“Good faith” means that the exemption claimed on and exemption certificate must be:

- Statutorily available on the date of the transaction in the jurisdiction where the transaction is source
- Applicable to the item being purchased, and
- Reasonable for the purchaser’s type of business



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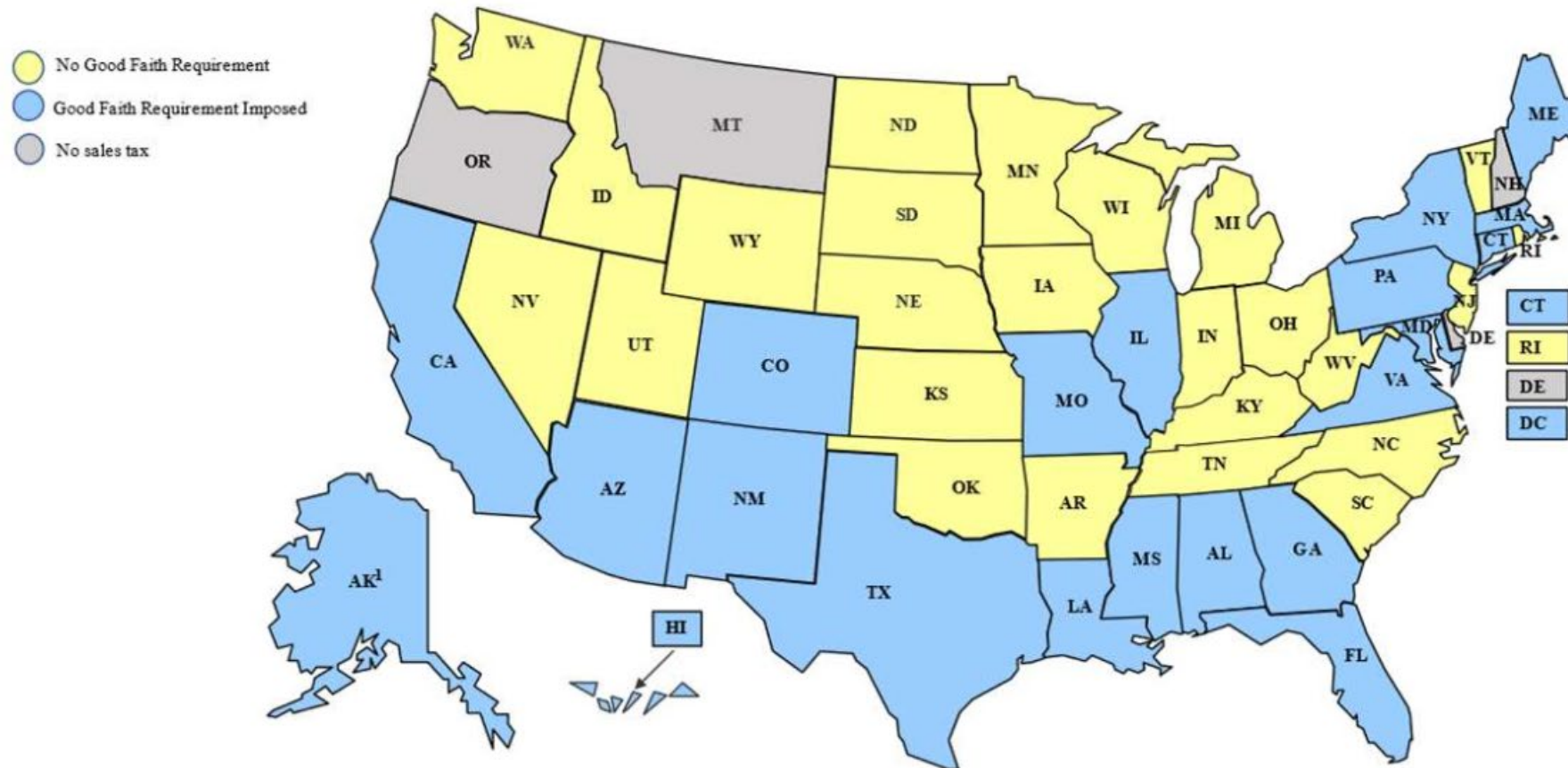
Audit Challenges

California XYZ – The auditor questioned certain sales or netted transactions claimed on your return as sales for resale because they were not supported by a valid resale certificate received in good faith at the time of sale.



The Basics – Taxable and Nontaxable Transactions

Good Faith Requirement on Sellers Accepting Exemption Certificates



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The Basics: Taxable and Nontaxable Transactions

Use-Based Exemptions

- Interstate Commerce
 - Every U.S. jurisdiction exempts sales where the seller ships or delivers tangible personal property to a buyer outside the State.
 - To qualify for the exemption, transaction must be prewired for shipment outside of the state. Temporary storage in state is nontaxable if contract requires delivery to a point outside the state.
 - Property located in Illinois at the time of sale, or subsequently produced in Illinois, that the seller delivers to purchasers outside Illinois by using the seller's own delivery vehicles or by using a common carrier or mail are exempt from the Illinois ROT, SOT, UT and SUT. Ill. Admin. Code 130.605.



The Basics: Taxable and Nontaxable Transactions

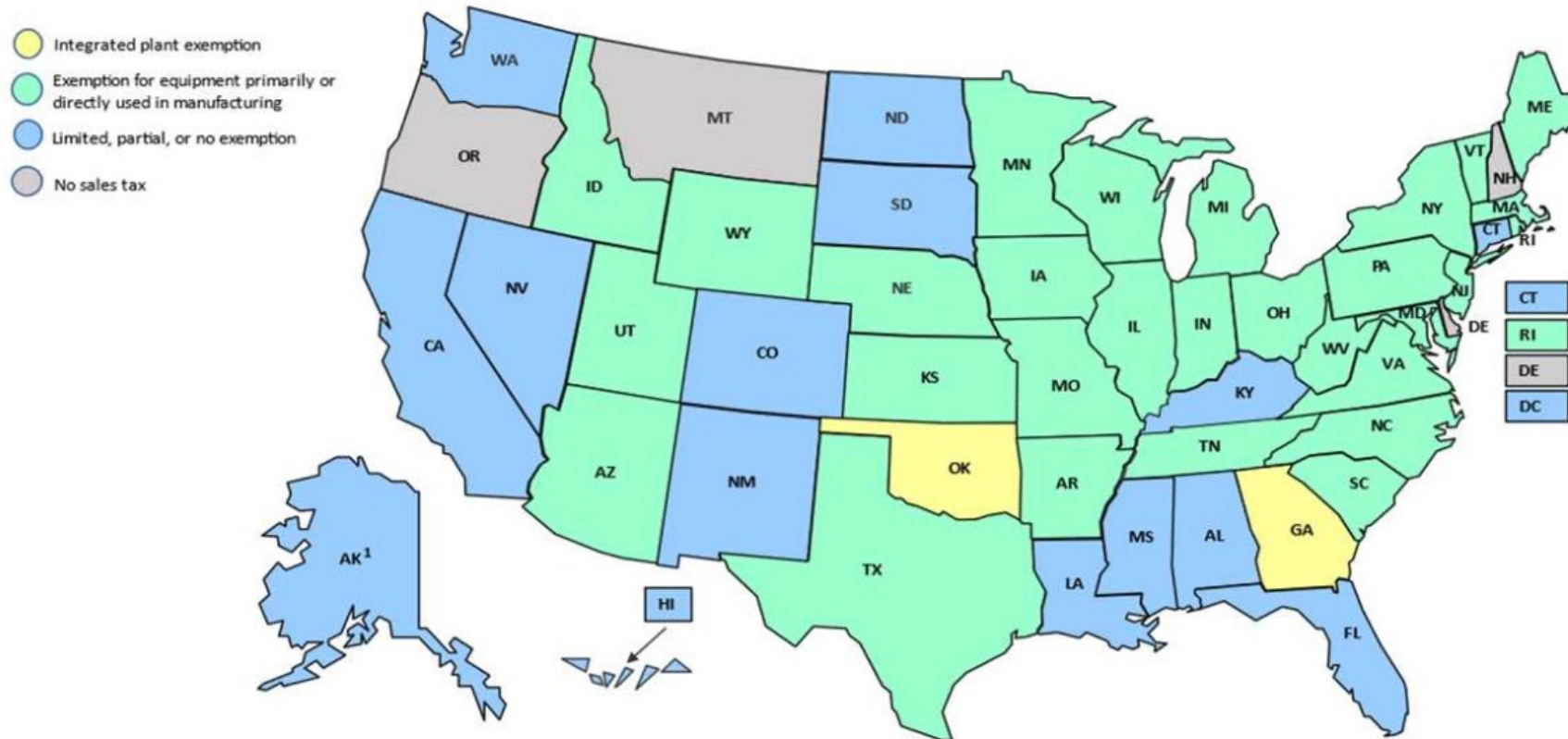
Use-Based Exemptions

- Manufacturing Machinery and Equipment
 - Most states require exempt property to be “used directly” in production.
 - Direct use items typically include raw materials, machinery and tools, repair parts, process-related materials handling equipment (conveyers, etc.), computerized production systems, etc.
 - The exemption also extends to purchased machinery and equipment used in general maintenance or repair of exempt machinery and equipment.
 - In IL, the general rule is purchases of MM&E are exempt if used the purchaser (or lessee of purchaser) primarily in the process of manufacturing or assembling tangible personal property for wholesale or retail sale or lease.
 - An exemption certificate from the purchaser is required, e.g., ST-587 Exemption Certificate (for Manufacturing, Production Agriculture, and Coal and Aggregate Mining).



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Breadth of States' Manufacturing Equipment Exemption



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Recent Developments - Legislation, Regulations, and Administrative Guidance

Illinois – 2023 Sales Tax Letter Rulings

- Product Based - Computer Software
 - ST-23-002-GIL
 - ST-23-007-GIL
 - ST-23-0011-GIL
 - ST-23-0018-GIL
- Product Based – Interstate Commerce
 - ST-23-0013-GIL
 - ST-23-0016-GIL
- Use Based – Manufacturing
 - ST-230003-PLR



Chicago Taxes

Chicago Imposes a 9% Amusement Tax

- Tax was expanded in 2015 to include streaming of video, online video games and movies delivered to mobile devices. See Chicago Muni. Code § 4-156-020 (G.1) – the “Netflix Tax”.
- Sourcing done according Mobile Telecommunications Sourcing Conformity Act, 35 ILCS 638. Uses credit card billing information.
- Illinois court upheld tax in *Labell v. Chicago*.
- Apple sued under the federal Internet Tax Freedom Act (ITFA) but has since settled with Chicago.
- Disputed in other contexts as well. See, e.g., *Wendella Sightseeing Company, Inc. v. The City of Chicago*, 2023 IL App (1st) 211371 (Mar. 14, 2023).



Chicago Taxes

Chicago Imposes a 9% Lease Transaction Tax

- Extremely broad interpretation of taxable “personal property” includes “non-possessory computer leases.”
- Aggressive audit enforcement by Chicago DOF.
- Chicago says the Lease Transaction Tax applies to SaaS, platform as a service, cloud computing, and infrastructure as a service. Personal Property Lease Transaction Tax Ruling No. 12.
 - Arguments against enforcement can include: software is “custom” (narrow definition), if the true object is some other service, or if preempted by federal law (e.g., ITFA).
 - Minimal pushback from the courts ... so far. *See, e.g., Meites v. City of Chicago*, 184 Ill. App. 3d 887 (Ill. App. Ct. 1989) (Lexis legal database search was taxable under the Lease Transaction Tax).



Nationwide Proposed Taxes On Digital Advertising Services and Data

- Proposals across 15 states from 2020 to 2022 would establish new regimes imposing taxes on “Big Tech”; more to come in 2023 and beyond?
- Three categories of tax proposals:
 - 1. Digital Advertising Services**
 - Tax on apportioned gross revenue from digital advertising services
 - Connecticut, Louisiana, Maryland, Massachusetts, Montana, New York, Texas, Washington, West Virginia
 - 2. Social Media Advertising**
 - Tax imposed on social media companies’ gross revenue advertising services or number of users.
 - Arkansas, Connecticut, Indiana
 - 3. “Data Mining” Services**
 - Tax on companies selling personal information or data, akin to a severance tax.
 - DC, Massachusetts, New York, Oregon, Washington, West Virginia



Non-Fungible Tokens

- Some states are beginning to provide guidance --
 - Minnesota: NFTs are taxable when the underlying goods/services are taxable (*e.g.*, music, videogames, admission to sporting events/concerts). Minnesota DOR, Sales Tax Fact Sheet 177 (Aug. 2022).
 - Pennsylvania: NFTs are taxable along with “Computer Hardware, Digital Products, and Streaming Services.” Pennsylvania DOR, Bulletin 2022-48 (Nov. 2022).
 - Washington: Detailed guidance defines an NFT as a unique digital identifier that cannot be copied substituted, or subdivided; that is recorded in a blockchain; and that is used to certify authenticity and ownership of a specific type of product. Washington DOR, “Interim Statement Regarding the Taxability of NonFungible Tokens (NFTs)” (July 1, 2022).
 - Wisconsin: NFTs are taxable when the underlying goods/services are taxable (*e.g.*, music, videogames, admission to sporting events/concerts) (same as Minnesota). Wisconsin DOR, Tax Bulletin No. 219 (Oct. 2022).
- More guidance to come?? Governing board for the Streamlined Sales and Use Tax Agreement to review expansion of taxable “digital codes” to include NFTs that result in transfers of taxable goods/services.





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Recent Developments – Litigation and Exemption Certificate Chaos

Recent Litigation – Digital Goods and Services

- **Maryland: *Comptroller v. Comcast***, Case No. 32 (Jul. 12, 2023). Maryland’s “Digital Advertising Tax” ruled unconstitutional by Anne Arundel County Court. MD Supreme Court overturned ruling, finding that Taxpayer had not exhausted administrative remedies and that a declaratory judgment was not available. Formal opinion issued July 2023 (following May 2023 ruling).
- **Texas: *Apple Inc. v. Hegar***, Case No. No. D-1-GN-20-004108 (pending). Does iCloud and iTunes Match services, allowing customers to access music, photos, videos, calendars and other digital files across multiple devices constitute a taxable data processing service?



Recent Litigation – Digital Goods and Services

- **New York: Matter of Yesware, Inc.**, Case No. 829638, 829639, 829640 (September 29, 2022). An email tracking service, where the taxpayer's proprietary software allowed its clients to track the clients' customers engagement with sales emails (e.g., which clients' emails received responses from the clients' customers and which email links were clicked by the clients' customers), was nontaxable because the "primary function" was neither the software, nor a taxable information service, rather it was a nontaxable "personal or individual" information service because specific client data / engagement information from their respective customers was not fungible and could not be sold to other clients. Compare with *Beeline.com*.
- **New York: Matter of Beeline.com**, Case No. 829516 (Feb. 9, 2023). A vendor management system effectuated through software and which assisted large businesses gather, organize, assemble, and manage their workforce was rendered taxable because the software that effectuated the service was crucial to delivering that service, stating "it is the software that streamlines, automates and integrates the entire bundle of services petitioner is selling." This decision cuts against previous decisions in NYS regarding remotely accessed software and seems to partially rest on the contract language providing that the software was transferred and used by customers. Compare with *Yesware*. Currently under appeal.
- **New York: Matter of Employment Screening Services, LLC**, Case No. 829702 (Oct. 6, 2022): NY imposes sales tax on protective and detective services. NYS DTA determined preparation of screening reports / background checks on potential new hires did not constitute a "protective service." Also not a taxable information services under New York law because the service provides reports that "are tailored and customized based upon the specific applicant, which makes them, by definition, individual and personal in nature." Compare with *Secureworks*.
- **New York: Matter of Secureworks Inc.**, Case No. 828328 (Feb. 17, 2022): IT company's security services are subject to sales tax as protective and detective services under New York Tax Law section 1105(c)(8), which taxes "alarm or protective systems of every nature." Compare with *Employment Screening*.



Exemption Certificate Chaos

- **Indiana: Revenue Ruling 2023-02ST** (Aug. 30, 2023). Company rented equipment to a contractor building a school. Company billed sales tax, contractor refused to pay and provided the school's exemption form. Contractor must issue its own exemption certificate to vendors, and not its exempt customer's certificate.
- **Maryland: *Continental Surfaces, LLC v. MD Comptroller***, Case No. 2445 (May 5, 2016). Sales tax assessment upheld because 1) it could not prove the slabs of silestone it purchased we sold for resale; and 2) on other transactions, it accepted resale certificates from customers who did not resell the slabs but rather used the material to fabricate and install countertops.
- **Mississippi: *Toolpushers Supply Co. v. MS DOR***, Appeal Case No. 2021-SA-01186-COA (Jun. 6, 2023). Toolpushers did not exercise the requisite "good faith" in making the determination at the time of sale that the items at issue it sold to its customers were to a retailer regularly selling or renting that property.



Exemption Certificate Chaos

- **Rhode Island**: *In re: Taxpayer, R.I. Dept. of Rev., Div. of Tax*, Case No. 2022-20 (Dec. 22, 2022). Upheld assessment of sales tax, interest and penalties because the seller received a resale certificate 107 days after the date of the sale rather than at the time of the sale or within 90 days of the sale.
- **Wisconsin**: **Oshkosh Corporation v. Wisconsin Department of Revenue** (Oct. 2022). The issue in this case is whether indirect materials such as office equipment and supplies purchased and used by the taxpayer in fulfillment of their contract with the federal government were purchased for resale to the federal government. Wisconsin Tax Appeals concluded title transfer along in this matter is sufficient to constitute a sale. Circuit Court affirmed and Department of Revenue will not appeal the October 2022 Tax Appeals Commission decision.





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Best Practices – Documenting the Exempt Transaction

Best Practices – Documenting the Exempt Transaction

1. Create a systemized approach to sales/use tax compliance – well before the audit!
2. For every new customer, present an Intake Form to be completed by the customer for purposes of creating a "master profile."
3. Obtain a tax exemption certificate, if applicable (specific instructions must be provided to the field teams advising on the complexities of multistate sales/use tax reporting).
4. First-level review the exemption certificate and ensure accuracy of reported information and flag missing or incorrect data. Establish training process.
5. Second-level review by tax compliance manager to ensure accuracy of information reported.
6. Modernize your records – store all documentation at a centrally located online server accessible by team members across business locations (e.g., Oracle). Do not leave certificates scattered across business locations! Access to records must be easy and immediate!
7. Regularly review records to ensure accuracy. Obtain documentation after-the-fact, if necessary.
8. Establish a exemption certificate refresh cycle.
9. Monitor any updates to customer name changes in master data to ensure certificates are updated
10. Monitor accounts receivable for any routine short payments. May indicate missing tax exemption forms or product taxation errors.
11. Implement any post audit process changes.
12. Establish reliable record retention policy. Most state revenue agencies follow a 3 to 4 year SoL. **Trap for the unwary** - false claims actions can go back 6 years or longer.
13. Regularly review the law in every jurisdiction to ensure compliance is up to speed with practice – hire third-party consultant if this cannot be done in-house.
14. Other suggestions??



Questions?

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