

Illinois income tax nexus established by attributional nexus and sales tax registration, P.L. 86-272 protections exceeded

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In brief

An Illinois Administrative Law Judge (ALJ) found that an out-of-state company had Illinois income tax nexus due to the in-state activities of third-parties and because of its sales tax registration with the state. The ALJ's reliance on attributional nexus is a rare application of such a concept for income tax purposes. While this unusual decision has no precedential authority, out-of-state taxpayers should be aware of the potential for Illinois to argue that income tax nexus may exist based on in-state activities of third-parties or merely because of registering for collection of sales tax. [[*Department of Revenue v. ABC Company*](#), Illinois Office of Administrative Hearings, No. IT 13-05 (8/2/13, released November 2013)]

In detail

Facts

During the 2005 and 2006 tax years, Parent Corporation filed Illinois income tax returns as the reporting taxpayer for a group of four related corporations conducting a single unitary business, including Taxpayer. During the years at issue, Parent was a global network marketing company that sold weight management, nutritional supplement, and personal care products (Products). Parent distributed Products through a network marketing organization composed of independent Distributors. Distributors were individuals who generally sold

products in their private homes, in the homes of potential retail purchasers, or in other non-traditional retail settings.

Parent provided training services at live events to Distributors. Taxpayer sold and distributed Products to Distributors for resale to ultimate consumers in locations that included Illinois.

Distributors' earnings were derived from selling Products at a markup. Distributors also earned royalties or bonuses depending on their performance or establishment of their own sales organizations.

Pursuant to an agreement with the Department, Taxpayer filed

Illinois Retailers' Occupation Tax (sales tax) returns, reporting and paying tax on Products sold in Illinois by Illinois Distributors.

Parent did not include Taxpayer's sales in the group's Illinois sales factor numerator

On its 2005 and 2006 Illinois corporate tax returns, Parent did not include Taxpayer's Illinois sales in the unitary group's Illinois sales factor numerator, taking the position that Taxpayer was not subject to Illinois income tax. On audit, the Department asserted that Taxpayer's Illinois sales should

have been in the Illinois numerator of Parent's unitary Illinois income tax return.

The two issues identified by the ALJ on protest were: (1) whether Taxpayer had nexus with Illinois; and, if so, (2) whether Illinois was precluded by P.L. 86-272 from levying income tax on Taxpayer for those years. The ALJ ruled that Taxpayer had nexus with Illinois both as a result of its Distributors' activities in the state and because of its own activities. The ALJ further found that P.L. 86-272 protection was exceeded.

Distributors' Illinois physical presence were attributed to Taxpayer

Taxpayer asserted that it had no income tax nexus with Illinois because it had no physical presence there and because the Illinois Distributors could not be treated as agents necessary for maintaining a market in the state. The ALJ surveyed several US Supreme Court decisions and concluded that "a foreign corporation may be considered 'physically present' in a state because of the physical presence of independent contractors who are soliciting orders for the seller's goods."

The ALJ noted the following in his support for finding that Illinois Distributors created nexus for Taxpayer:

- Taxpayer contracted with thousands of Illinois Distributors, which far exceeded the ten Florida wholesalers the US Supreme Court found created nexus in *Scripto v. Carson*.
- Taxpayer agreed to pay Distributors for production bonuses for their increasing success at selling Product in Illinois. The ALJ found that Taxpayer's "bonus and other
- Taxpayer characterized Distributors as its final customers acting in their own self-interest because Distributors purchase Products before selling them to ultimate customers. The ALJ found that such characterization focused on just one part of the whole activities of Parent group's single unitary business. For example, Parent's "single, unitary business includes a chain of distribution that . . . [includes] the retail sale of such Products by Distributors to the intended, ultimate, retail customer."
- Taxpayer does not sell its Products in retail stores. The marketplace for its Products is generally the private home of the Distributor. Accordingly, Distributors are not 'strangers' to Taxpayer.
- A Distributor acts on behalf of Taxpayer as its agent by fulfilling Taxpayer's money-back guarantee to retail purchasers. "Illinois Distributors' physical presence and activities in Illinois are necessary for maintaining Taxpayer's market in Illinois, and for protecting [Taxpayer's] interests."
- Distributors also protect Taxpayer's interest by agreeing to enhance Taxpayer's reputation and to protect its business and trade secrets.
- Parent exercises control over Distributors through a set of rules Distributors are required to follow.

The ALJ concluded that Taxpayer:

"purposefully directed significant sales of Products to

thousands of Illinois Distributors, who agreed to promote and sell Products, at retail, in Illinois, and who were required to act as Taxpayer's agent for purposes of fulfilling Taxpayer's guarantee to retail customers. . . . Those activities created sufficient minimum contacts between Taxpayer and Illinois, for Illinois to impose a tax on Taxpayer for the privilege of earning income there."

Taxpayer had income tax nexus with Illinois due to its sales tax registration

The ALJ found "generally a person who exercises the privilege of engaging in the occupation of making retail sales in Illinois is also exercising the privilege of earning or receiving income in Illinois. Persons who exercise the privilege of earning or receiving income in Illinois are subject to the tax imposed by [the Illinois Income Tax Act]." The ALJ concluded that Taxpayer submitted itself to the taxing and regulatory authority of Illinois when it registered with the Department and agreed to file Illinois returns to collect and remit Illinois sales tax from Illinois Distributors. In doing so, Parent established significant, continuing, and direct contacts with Illinois.

The ALJ rejected Taxpayer's argument that it volunteered to register as a seller solely as an accommodation for the Department and therefore such action should not equate to nexus-creating contact with Illinois. The ALJ found that Taxpayer approached the Department and requested that it be allowed to pay sales tax on behalf of the Distributors. Taxpayer benefitted from its agreement because it did not have to collect, account for, or pay Illinois use tax on sales to Illinois Distributors who purchased Products for personal use. Additionally, the ALJ

found that it was not unreasonable to infer that Taxpayer agreed to pay Illinois Distributors' sales tax liabilities because they were acting on Taxpayer's behalf.

Regardless of Taxpayer's reason for doing so, the ALJ found that Taxpayer registered with the Department and for more than 20 years filed Illinois sales tax returns and paid Illinois sales tax to the Department. The ALJ held that "[g]iven those undisputed facts, it is much too late for [Taxpayer] to complain that it lacks minimum contacts with Illinois sufficient for Illinois to tax it."

Distributors' Illinois activities exceeded P.L. 86-272 protection

The ALJ determined that Distributors were 'representatives' of Taxpayer for purposes of P.L. 86-272 and that their Illinois activities exceeded mere solicitation of sales for reasons including:

- Distributors were making sales in Illinois. Order forms did not have to be sent outside of Illinois for approval or rejection and Distributors accepted customers' orders and delivered Products to customers.
- Distributors were required to fulfill all aspects of Taxpayer's guarantee to retail purchasers, including accepting product returns, providing customers with replacement Products, and providing customers with refunds.

Because Distributors' Illinois activities exceeded mere solicitation of sales, such activities were not protected by P.L. 86-272.

The takeaway

It must be pointed out this this decision has no precedential authority. While the opinion is not clear, it appears that either Taxpayer's

own activities (registering for sales tax) or the activities of its Distributors would have independently satisfied nexus requirements. Taxpayers should be aware of the following issues.

The ALJ concludes that Taxpayer's filing and registering for sales tax purposes equates to establishing income tax nexus. We are unaware of any published Illinois guidance that results in a similar conclusion.

The decision notes US Commerce Clause considerations early in the opinion. For example, the ALJ quotes the following from *Quill*: "the 'substantial nexus' requirement is not, like due process' 'minimum contacts' requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce." However, the opinion's conclusion, especially as it relates to Taxpayer's own Illinois activities, does not appear to apply a substantial nexus test; rather, the opinion provides that Taxpayer 'purposefully directed' sales to Illinois and that Taxpayer's substantial contacts were sufficient to give it 'fair notice' that the Department might claim that Taxpayer was exercising the privilege of earning income in Illinois and that it doesn't "offend traditional notions of fair play and substantial justice" for the Department to impose income tax on Taxpayer. These all articulate due process concepts, not commerce clause concerns. It is unknown whether a court would apply stricter requirements and come to a different conclusion.

Although there are numerous attributional nexus decisions across the states addressing sales tax nexus in which the out-of-state entity is directly selling to the in-state customer, this Illinois ALJ decision provides a rare application of attributional nexus in the area of income tax. It is interesting that the ALJ focused on connections that

indirectly involved Taxpayer, such as characterizing Distributors as part of Parent's unitary group (the "single, unitary business includes a chain of distribution that . . . [includes] the retail sale of such Products by Distributors to the intended, ultimate, retail customer."), though there was no serious discussion of whether Distributors in fact satisfied all elements of a unitary relationship (e.g., ownership).

The requirements established and satisfied in this decision suggest a questionably low threshold of connections needed to establish attributional nexus, particularly when the Illinois actors could be viewed as final customers of the taxpayer. Consider an out-of-state food manufacturer selling to Illinois grocery stores. The manufacturer would have knowledge that its products are being sold to Illinois customers and therefore would be purposefully directing significant products to Illinois customers. The manufacturer could provide the grocery store with additional revenue in terms of volume discounts based on performance. The manufacturer could impose certain conditions on the grocery store – such as where and how to display its products. The grocery store could accept returns on damaged or undesirable items. It would be extraordinary to conclude that the food manufacturer has nexus with Illinois to justify the imposition of income tax. A connection that satisfies due process may exist, but not one that satisfies commerce clause concerns.

Another factor to consider here is the impact on throwback. If the Department is asserting nexus in this situation, companies should carefully consider whether to throw back sales to their origination states when shipping product to Illinois under a similar fact pattern. Overpaying one state and having exposure in another

is a no-win situation for taxpayers in a nexus situation, since the statutes of limitation on a non-filer may never close, while a statute to claim a refund on an overpayment would limit the look back period.

Let's talk

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