
Illinois Supreme Court invalidates local sales sourcing regulations on a prospective basis, taxpayer allowed to rely on flawed rule

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In brief

The Illinois Supreme Court found invalid Illinois regulations providing that the situs of local sales tax occurs at the place where purchase orders are accepted. The court reasoned that the regulations impermissibly narrowed state statutes by failing to provide for a fact-intensive inquiry. However, under the Illinois Taxpayers' Bill of Rights, the Department is bound by its flawed interpretation of the law in effect at the time. Therefore, the Department was required to abate the liability and penalties of a taxpayer that acted consistently with the regulations and sourced local sales tax to the location where it accepted orders.

This decision raises many unanswered questions for taxpayers going forward. Additionally, taxpayers facing sham transaction arguments from the Department may find this case instructive regarding the level of business activity the Illinois Supreme Court views as having 'economic substance.' [[*Hartney Fuel Oil v. Hamer*](#), Ill. Sup. Ct., Docket Nos. 115130, 115131 (11/21/13)]

In detail

During the years at issue, Hartney Fuel Oil Co. (Hartney) purchased fuel oil from large fuel suppliers and sold it to customers such as railroads, trucking companies, gas stations, and other fuel distributors. During the audit period, Hartney maintained its corporate headquarters in Forest View, Illinois. From its Forest View office, Hartney would set fuel prices, cultivate customer relationships, and handle administrative tasks like

billing and accounting. Each night, Hartney staff there would communicate fuel prices for the following day to prospective customers.

In addition to its home office, Hartney had a sales office location in Mark, Illinois where it contracted with a third party sales representative to take fuel orders. Hartney paid a flat fee of \$1,000 per month for a nonexclusive lease of property and the services of a clerk at the Mark location.

There were two types of sales transactions processed at the Mark sales office: (1) daily purchase orders and (2) long-term purchase orders. Daily purchase orders came from established customers. The sales representative generally accepted a customer's order on the spot and arranged delivery. For activity reviewed during the audit period, the representative did not need order approval from Hartney's Forest View headquarters.

Long-term purchase orders came from customers that executed long-term requirements contracts with Hartney. The contracts were negotiated with customers by Hartney's president. The president generally signed contracts and sent them to customers. Customers would send signed agreements to the Mark sales office. If the president had not signed the contract, he would travel to Mark to sign the agreement.

By structuring its sales in this way, Hartney hoped to avoid liability for local sales taxes in Forest View, as well as for the local county and regional transportation taxes. The village of Mark and the county it is located in did not impose these local sales taxes.

Procedural history

Following an audit of activity from January 1, 2005, to June 30, 2007, the Illinois Department of Revenue determined that Hartney's local sales were attributable to the company's Forest View office, rather than the Mark sales office, for purposes of local sales tax. The Department issued a notice of tax liability, which Hartney paid under protest. Hartney then filed for relief in the circuit court of Putnam County. The circuit court, relying on the Department's regulations, found for Hartney. The appellate court affirmed that decision, finding that, although the taxpayer intentionally structured its sales location and procedures to minimize its tax liability, there was nothing in Illinois statutes or regulations that supported a contrary outcome. Click [here](#) for our summary of the appellate court decision.

The Department appealed to the Illinois Supreme Court, where the court ruled that: (1) Illinois statutes generally provide that local situs determination requires a fact-intensive inquiry; (2) Illinois regulations impermissibly narrow

such statutes rather than allow for a fact-intensive inquiry; and (3) despite the invalid regulations, the Illinois Taxpayers' Bill of Rights requires the Department to follow its 'flawed' regulations.

Statutes suggest a fact-intensive inquiry is required

The court reviewed the three applicable state statutes addressing local taxation: (1) the Home Rule County Retailers' Occupation Tax, (2) the Home Rule Municipal Retailers' Occupation Tax, and (3) the Regional Transportation Authority Act. All three statutes impose a retail occupation tax upon all persons engaged in the *business of selling* tangible personal property at retail within the county, municipality, or metropolitan region. However, the court stated that, while the plain language of the statutes requires a fact-intensive inquiry to address the business of selling issue, they "do not fully reveal legislative intent as to the situs of taxation."

Regulations provide that situs occurs where purchase order is accepted

Illinois regulations provide that the seller's acceptance of a purchase order is the most important single factor in the occupation of selling. The regulations outline four occurrences of purchase order acceptance that cause the seller to incur local tax liability.

The court found that the regulations contain 'definitive situs-setting provisions' that conclusively establish tax situs where the purchase order is accepted. The court agreed with the trial and appellate courts that, under the regulations, Hartney accepted its purchase orders in Mark, IL.

Regulations provide an impermissible interpretation of the statute

The court recognized that a regulation cannot narrow or broaden the scope of intended taxation under a taxing statute. A regulation that does so must be held invalid. The court held that the regulations at issue impermissibly narrow the local taxing statutes for two reasons. First, the regulations do not amply prescribe the fact-intensive inquiry required by the statutes. Second, they constrict the scope of intended taxation by allowing for only one potentially minor step in the business of selling (i.e., acceptance of a purchase order) to conclusively determine tax situs.

The court noted that Hartney conducted the bulk of its selling activity in Forest View. It carried out all of its marketing efforts, maintained inventory, set prices, and cultivated sales relationships there. Hartney began routing its purchase orders through a separate sales office in Mark exclusively for the purpose of tax planning. Although the clerk in Mark could bind Hartney, the clerk did not participate in any other aspect of the business of selling. The shift from Forest View to Mark removed Hartney from the retail occupation tax rolls of Forest View, Cook County, and the Regional Transportation Authority. However, according to the court, Hartney was still able to benefit from services offered by the local governments.

The court found the regulations were "too inconsistent with the statutes and case law to stand."

Department required to follow its regulations

Illinois law provides that a taxing agency is bound to its own flawed interpretation of the law. Specifically, the Illinois Taxpayers' Bill of Rights Act imposed on the Department the

duty to “abate taxes and penalties assessed based upon erroneous written information or advice given by the Department.” The court found that Hartney acted consistently with the Department’s regulations. Accordingly, because of the Department’s erroneous regulations, the court found that the Department must abate Hartney’s local sales tax liabilities and penalties.

Takeaway

The Illinois Supreme Court’s decision raises many unanswered questions for taxpayers going forward. How does this decision impact existing litigation

on local sales tax sourcing? What is the proper test for determining situs? How does one determine situs between two competing localities? If a fact-intensive inquiry is required, what facts are given weight to determine the location where the business of selling occurs? Will the Department issue new regulations?

Although relegated to a footnote, taxpayers should take note of the court’s statement on the sham transaction doctrine. The court stated that the “sham transaction doctrine is unavailing” because the regulations established that purchase order acceptance determined situs and

stated that Hartney structured its affairs consistent with those regulations. Even though the court provided, within the fact discussion, that Hartney’s sales office was located in Mark, IL “for tax planning purposes,” the court determined that Hartney’s arrangement was “not without economic substance or economic effect.” Taxpayers facing sham transaction arguments from the Department may find this case instructive regarding the level of business activity the Illinois Supreme Court views as having ‘economic substance.’

Let’s talk

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