

ILLINOIS STATE TAX DEVELOPMENTS
(Updated as of September 28, 2022)

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I. LEGISLATION

The Illinois House and Senate will reconvene in Springfield during the fall veto session in November 2022. We will provide a legislative update in the spring 2023 outline.

II. NOTEWORTHY NEW REGULATIONS / ADMINISTRATIVE GUIDANCE

A. ADOPTED: Illinois Income Tax Act (Throw-back and Throw-out rules), 46 Ill. Reg. 15317 (Sept. 9, 2022).

Illinois had adopted a regulatory change to its throwback and throw-out rules for sales to foreign countries with treaties with the United States. Under the prior rule, which remains in effect for tax years prior to December 31, 2022, sales of goods to foreign countries can be “thrown-back” to the Illinois numerator of the state’s apportionment formula, and sales of services can be “thrown-out” of the state’s apportionment formula altogether, if the taxpayer is not subject to tax in the foreign country because of a U.S. tax treaty. Under the amended regulation, these sales will no longer be thrown-back or thrown-out of the of the apportionment formula. The rule change is accomplished by amending Ill. Admin. tit., 86 § 100.3200 to remove the Department’s policy that a taxpayer will not be considered “subject to tax” if a treaty exempts its activities in the foreign country from taxation. According to the Department, this amendment aligns Illinois with the Multistate Tax Commission’s model rule on this subject.

NOTE: While this rule change is effective for tax years ending on or after December 31, 2022, there are good arguments to be made that taxpayers are not required to throw-back or throw-out sales to foreign countries where they are exempt from taxation because of a U.S. tax treaty, *before* December 31, 2022. The Department’s rule in effect for tax years prior to December 31, 2022 is arguably invalid because the rule improperly narrows the statutory (35 ILCS 5/303(f)(2)) meaning as to what constitutes “taxable” in another state or country. The rule prior

to December 31, 2022 also arguably violates the Foreign Commerce Clause, because sales made to a purchaser located in a foreign country that has entered into a tax treaty with the United States will be subject to throw-back or throw-out, and therefore treated less favorably than sales made to a purchaser located in a U.S. state that does not impose an income tax or exempts the sales from taxation in the state, because such sales will not be thrown-back to Illinois or thrown-out of the state's apportionment formula. It is also questionable whether this rule change can be applied prospectively, since regulations are interpretations of statutory law, and there has been no statutory change.

- C. PROPOSED RULE: Bulk Sales Reporting, 46 Ill. Reg. 9549 and 9582 (June 10, 2022).** These rulemakings, among other things, amend the state's sales and use tax regulations to incorporate Public Act 100-1171, which changed the requirements for taxpayers making bulk sales effective January 4, 2019. Taxpayers must now provide notice to the Department no later than 10 business days *prior* to the sale or transfer of a business or a bulk of the assets of the business. The old rule required bulk sale notice to be provided no later than 10 business days *after* the sale or transfer.
- D. PROPOSED RULE: Illinois Income Tax Act ("IITA"); 46 Ill. Reg. 12704 (July 29, 2022); Ill. Admin. tit. 86, 100.5020 (one month filing extension for corporations).** This regulatory amendment clarifies when corporations will be allowed one extra month beyond the federal extended filing deadline to file the corporate income tax returns. The IITA provides an automatic six month extension for Illinois income tax returns. The current regulation allows corporations an additional month from the federal extended filing deadline. However, beginning with the 2016 tax year, the IRS moved the federal deadline for many Form 1120 corporate income tax return filers from March 15 to April 15. This federal change had the effect of moving the extended due date from September 15 to October 15, aligning it with the Illinois automatic one-month extension. As a consequence, taxpayers no longer have the extra month to file their Illinois state income tax returns. This rule change will restore the one additional month beyond the federal deadline for corporate income tax returns.

NOTE: Because the Joint Committee on Administrative Rules will not take action on this rule change before the October 15 filing date (extended to October 17, 2022 because the 15th falls on a Saturday), the Department plans to issue a bulletin informing taxpayers they can file one month later (November 15) as if the rule has already been adopted, and will not incur any late filing penalties.

- E. PROPOSED RULE: Use Tax, 46 Ill. Reg. 15021 (Sept. 9, 2022).** This rulemaking amends several regulations regarding local sales taxes to conform current local tax rules with the state’s rules regarding marketplace sourcing under the state’s “Leveling the Playing Field for Illinois Retail Act” to provide greater guidance and clarity for retailers. This rule change also notes that beginning January 1, 2021, retailers without physical presence in Illinois and marketplace facilitators meeting the state’s economic nexus thresholds, are liable for all applicable state and locally-imposed retailers’ occupation taxes (i.e., sales tax) on all sales made to Illinois purchasers and are no longer only mandatory *use tax* collectors.

NOTE: This change from use tax to sales tax could subject Illinois’ Leveling the Playing Field marketplace rules to challenge under the U.S. Supreme Court’s decision in *Dilworth*, 322 U.S. 327 (1944). While, Illinois can impose its use tax on sales shipped to Illinois customers and require out-of-state sellers to collect use tax if they have sufficient economic nexus with Illinois under *Wayfair*, it is questionable whether Illinois, and its many home-rule localities, have transactional sales tax nexus with sales where title transfers outside the state.

III. RECENT CASE LAW AND TAX TRIBUNAL DECISIONS

- A. *Midwest Medical Equip. Solutions, Inc. v. Ill. Dep’t of Rev.*, Case Nos. 17-TT-120, 19-TT-93 and 21-TT-77 (Sept. 6, 2022, Chief ALJ Conway).** The Illinois Independent Tax Tribunal (“Tax Tribunal”) granted the Department’s motion for summary judgment and upheld its notices of tax liability against the taxpayer. The taxpayer claimed that its sales to Managed Care Organizations (“MCOs”) were tax-exempt sales to a government body, and therefore, the Department’s tax assessments should not be upheld.

The taxpayer is a provider of medical items to individuals enrolled in Medicaid. Prior to the audit period years, the State of Illinois had paid the taxpayer directly for items the taxpayer provided to Medicaid enrollees. These sales were tax-exempt sales to a government body because the state paid for the items directly. In 2011, the state began contracting with MCOs to take on the task of administering Medicaid for the state.

The taxpayer argued that the MCOs were intermediaries between the government entity and the taxpayer, and therefore the sales remained exempt from sales tax because the government “ultimately paid for” the items. The Tax Tribunal dismissed this argument, stating that the government exemption applies only when the sale is directly with the government body. The taxpayer also argued that economic substance should trump over form in this instance. The Tax Tribunal held that the doctrine was inapplicable, finding that the MCO contracts explicitly state that MCOs are independent contractors, not agents of the state, MCOs receive payments regardless of whether they provide medical equipment, and the state is not a party to the contract between MCOs and the taxpayer. The Tax Tribunal further determined that even when an agency relationship exists with a government

body, the agent is not necessarily entitled to the government body exemption. The Tax Tribunal moreover noted that because MCOs cannot obtain an E-number from the Department (“E-numbers” are exemption numbers issued by the Department to government bodies and other tax-exempt organizations), MCOs cannot qualify for a sales tax exemption. The Tax Tribunal lastly denied the taxpayer’s request for penalty relief, holding, in part, that there is an established body of case law contrary to the taxpayer’s position.

- B. *Mitutoyo America Corp. v. Ill. Dep’t of Rev., Case No. 21-TT-133 (Sept. 7, 2022, ALJ Barov)*.** The Tax Tribunal granted taxpayer’s motion for summary judgment and ruled against the Department’s interpretation of 5 ILCS 70/1.25, governing proof of mailing. After the taxpayer filed an amended return that was received by the Department six calendar days after the limitations period had expired, the Department asserted that because there was no mailing envelope and no postmark, the date that the amended return was received was controlling. Thus, according to the Department, the amended return was not timely filed. Specifically, the Department argued that 5 ILCS 70/1.25 only allows competent evidence to prove date of mailing when mail is *not received*. In this case, the amended return was received by the Department, but the Department discarded the envelope, so there was no way to verify the envelope’s postmark date.

The Tax Tribunal dismissed the Department’s argument that the state’s proof of mailing subsection (5 ILCS 70/1.25) only applies when mail is not received because it would allow the Department to “avoid the statute’s application simply by discarding or destroying the envelope.” Reading the statute as the Department asserts would “place all risk of mailing on the mailing party, none on the government, and, again, threatens to render the statutory mailing provision meaningless.” The Tax Tribunal also dismissed the Department’s alternative arguments that the only competent evidence to prove the date of mailing is evidence of registered or certified mail, or the taxpayer’s books and records.

To prove proof of mailing, the taxpayer presented an affidavit from the taxpayer’s in-house tax specialist. The affidavit asserted that the affiant personally mailed the amended return on October 15, 2020, one day prior to its due date. While the taxpayer’s normal practice was to file these returns by certified mail, the affiant had deposited the return into a U.S. Post Office mailbox due to the severity of the COVID-19 pandemic at the time. The Tax Tribunal found that the affidavit was credible and consistent with COVID concerns at the time and general mail delivery times. Additionally, the Tax Tribunal noted that while the Department attested to not finding a mailing envelope in the taxpayer’s file, the Department failed to introduce any evidence as to their policy for handling envelopes. The Tax Tribunal addressed the Department’s concern with allowing proof of mailing claim based on an affidavit, by recognizing the highly unusual circumstances surrounding the pandemic.

- C. *PepsiCo Inc. v. Ill. Dep’t of Rev., 16-TT-82; 17-TT-16 (9/12/2022, Chief ALJ Conway)*.** The Tax Tribunal previously ruled on May 4, 2022 against PepsiCo on

the substantive issue as to whether Frito-Lay North American (“FLNA”) qualified as a foreign “80/20,” and therefore must be excluded from PepsiCo’s unitary business group. In reaching its earlier decision, the Tax Tribunal found that the company’s reorganization, which resulted in the removal of FLNA from the unitary business group, lacked economic substance. After the Tax Tribunal’s May 4, 2022 decision, the remaining issue before the Tax Tribunal was whether PepsiCo’s qualified for penalty relief. The Tax Tribunal again ruled against PepsiCo, holding that the taxpayer did not provide sufficient evidence that it acted with ordinary care and prudence.

IV. LETTER RULINGS, BULLETINS AND ANNOUNCEMENTS

- A. **IDOR Audit Manual:** Illinois Department of Revenue’s has released its income tax audit manual on its website at:

<https://www2.illinois.gov/rev/research/publications/AuditManual/Pages/default.aspx>

The sales and miscellaneous tax audit manuals have not yet been released by the Department and no date has been set for their release.

- B. **IT-22-0001-PLR (3/15/2022)**, *Apportionment Insurance Companies*. Taxpayer’s request to change its method of sourcing reinsurance premiums under IITA Section 304(b)(2) was granted by the Department. An insurance company can source premiums based on where the underlying risk is located (look-through approach, which is costly and difficult to figure out for a reinsurer), or based on its premiums written for reinsurance accepted from companies/insurers commercially domiciled in Illinois. To make a switch from the look-through approach to customer location method (or vice-versa), the Department must approve the change via a private letter ruling.
- C. **IT-22-0002-PLR (4/12/2022)**, The Department ruled that a taxpayer who claimed bonus depreciation addition and subtraction modifications under IITA Sections 203(b)(2)(E-10) and (T) must add back the aggregate amount of subtraction modifications claimed on the property in the taxable year of an IRC Section 368(a)(1)(D) corporate reorganization. 35 ILCS § 203(b)(2)(E-11) and 35 ILCS § 203(b)(2)(U) provide an addition and subtraction modification where property, with respect to bonus depreciation modifications have been required, is sold, transferred, abandoned, or otherwise disposed. Since a corporation that is reorganized under IRC § 368(a)(1)(D) is deemed to have contributed all of its assets to the new corporation, the addition and subtraction modifications under 35 ILCS § 203(b)(2)(E-11) and 35 ILCS § 203(b)(2)(U) apply. For the taxable year of its reorganization, the corporation must add back the aggregate amount of subtraction modifications claimed on property under 35 ILCS § 203(b)(2)(T) and is permitted to subtract the amount of the addition modification claimed on property under 35 ILCS § 203(b)(2)(E-10).

- D. **FY 2022-23 Grocery Tax Suspension from July 1, 2022 – June 30, 2023:** Effective July 1, 2022, through June 30, 2023, Public Act 102-0700 requires retailers to notify customers of the suspension of the state one-percent (1%) low rate of sales and use tax on retail sales of groceries. For retailers that cannot include the required statement on their cash register tape, receipt, invoice or sales ticket issued to customers, a clearly visible sign must be posted.
- E. **IDOR Moved Its Chicago Office On June 27, 2022.** The Department's new office address in Chicago is 555 West Monroe, Suite 1100, Chicago, IL 60661

PROVIDERS' BRIEF BIOGRAPHIES

A. **DAVID P. DORNER**

David is a Partner in Reed Smith's State Tax Group. David's primary practice area is tax controversy, including federal and state tax audits, appeals, Illinois Independent Tax Tribunal disputes, administrative hearings, conciliation and mediation conferences and judicial litigation at all levels throughout the United States. Over the past 20 years, David has represented and counseled businesses and individuals on all forms of federal, state and local taxes, including corporate and individual income, franchise, federal excise, sales, use, personal and real property taxes, and he has defended numerous Illinois False Claims Act cases and employee misclassification audits. In addition to tax litigation, David also has substantial experience in the area of taxation of aircraft, railcars, and other transportation-related assets.

B. **JACQUELINE T. NOYES**

Jackie is an associate in Reed Smith's State Tax Group. Jackie focuses her practice on state and local tax issues, including sales and use tax, corporate income, and franchise tax. Jackie has worked with and advised clients in jurisdictions across the country.