Don't Bury Your Head in the Sand: Illinois Court Rulings on Use Tax for Shipping Charges

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Taxpayers responsible for collecting and remitting use tax in Illinois should take comfort in some recent court rulings. Taxpayers typically face a significant burden when attempting to comply with sales and use tax responsibilities. The task of staying abreast of state and local rules is challenging. Making matters worse, a number of taxpayers faced legal action from third parties seeking monetary recovery for themselves and the state under the Illinois False Claims Act. What should taxpayers do? The recent rulings indicate taxpayers avoid liability under the Illinois False Claims Act when they don't bury their head in the sand with respect to Illinois use tax responsibilities.

In early 2016, the Illinois Department of Revenue ("IDOR") amended regulations to clarify when transportation and delivery charges are part of "gross receipts" subject to the state's Retailers' Occupation Tax or the Use Tax Act, and to conform to the Illinois Supreme Court's decision in Kean v. Wal-Mart Stores, Inc. The updated regulations state delivery charges are part of the gross receipts when there is an "inseparable link" between the sale of tangible personal property and its delivery. The regulations go on to provide 19 examples of circumstances creating or failing to create an inseparable link. The prior lack of clear guidance resulted in several cases being litigated. The amended shipping and handling regulations should provide taxpayers with clearer guidance and conform to the Illinois Supreme Court's ruling in Kean.

National Business Furniture, LLC—background

In State of Illinois ex rel. Schad, Diamond & Shedden, P.C. v. National Business Furniture, LLC, (one of more than 200 cases filed by the same relator), the Illinois Appellate Court focused on the confusion over the imposition of use taxes on shipping charges. In the original claim, a law firm, seeking a payout as a whistleblower, alleged that National Business Furniture, LLC (NBF) knowingly failed to collect and remit use
tax on shipping charges for Internet and catalog sales made to Illinois residents, and that NBF was liable for civil penalties, triple damages, and attorneys fees under the Illinois False Claims Act.

Under that Illinois law, the plaintiff, referred to as the "relator," is considered a party to the action and is entitled to a percentage of the proceeds or settlement if the suit is successful. Following a bench trial, the trial court judge entered judgment in NBF’s favor and found the relator failed to prove the defendant knowingly concealed or avoided an established duty to pay the state of Illinois.

During the relevant time period, section 130.415 of the Illinois Administrative Code provided that the determination of whether or not a use tax must be collected on shipping charges depended on whether the charges are "included in the selling price of the property," which was not necessarily determined by whether the charges were separately billed. The amended regulations noted above were not yet effective.

If shipping charges were separately contracted for, then they were not considered part of the selling price and were not subject to use tax. The lack of a separate contract did not imply shipping charges were "included in the selling price." Providing the purchaser with the option of picking up the merchandise at the seller’s warehouse or "having delivery made by the seller for the agreed purchase price plus an ascertained or ascertainable delivery charge" constituted sufficient evidence that the delivery charges were not "included in the selling price” of the property.

NBF is a Wisconsin-based company that sells office furniture and supplies to customers located throughout the country using one of four distribution channels:

1. in-person visits from sales representatives,
2. catalog orders,
3. toll-free telephone line orders, and
4. website orders.

No retail locations or warehouse locations were located in Illinois. NBF relied on drop shipments from unrelated third-party manufacturers. Those third parties directly shipped merchandise to customers. In almost all cases, items were shipped and delivered to customers.

NBF did not prepare separate written contracts regarding delivery. Customers could typically select the type of delivery and pay a shipping charge separately stated on an invoice or order confirmation. Customers making telephone orders could alternatively arrange for delivery using their own accounts with third-party
shipping companies and then be charged nothing for shipping. NBF’s customary practice was to collect and remit use tax on merchandise totals but not on shipping charges. This practice was reflected on customer invoices and order confirmations.

The suit against NBF alleged that there was a "clear duty to collect use tax on shipping charges" and that NBF knowingly made, used, or caused to be made or used false records or statements to conceal, avoid, or decrease its obligation to pay or transmit money to the state of Illinois. The plaintiff law firm's basis for alleging a "knowing" violation of the statute was the fact that one of its employees was able to purchase goods from the website without being charged sales tax. To bring the suit within the False Claims Act, the suit claimed the target knowingly concealed, or knowingly and improperly avoided or decreased its obligation to pay.

During the two-day bench trial, a number of witnesses were questioned regarding when and how NBF implemented its use tax policy and what mechanisms NBF had in place for complying with multiple state and municipal tax laws. The court noted that NBF relied on its own tax analysis of the relevant issue, its examination history with IDOR, third-party software to calculate the relevant taxes, and a third-party accounting firm to prepare the relevant tax returns.

*National Business Furniture, LLC—reckless disregard*

The requirements of a claim under the False Claims Act does not require a specific intent to defraud the state. Instead, only a showing of knowing concealment or improper avoidance of an obligation to pay the state is needed. A party has knowingly concealed or avoided an obligation to pay when it has actual knowledge or acts with "reckless disregard" of the obligation.

The Appellate Court opinion spends a significant amount of time attempting to define what constitutes "reckless disregard" and offers a number of potential definitions:

1. Failure to make such inquiry as would be reasonable and prudent to conduct under the circumstances, which is a limited duty to inquire as opposed to a burdensome obligation.
2. Gross negligence.
3. An extreme version of ordinary negligence.
4. An aggravated form of gross negligence.
5. Gross negligence-plus.
6. A state of mind lying "on a continuum between gross negligence and intentional harm."
7. The ostrich-type situation where an individual has buried his head in the sand and failed to make simple inquiries.

8. Ignoring obvious warning signs and refusing to learn of information which, in the exercise of prudent judgment, should be discovered.

While the Appellate Court offered up a number of potential definitions, it is difficult to ignore the analogy of an ostrich burying its head in the sand, and the court does not disappoint in its analysis. "Relator instead needed to prove that defendant ignored obvious warning signs, buried its head in the sand, and refused to learn information from which its duty to pay money to the State would have been obvious." The Appellate Court found that NBF did not bury its head in the sand. Instead, it relied on (1) its own interpretation of the relevant statutes and guidance, and (2) its prior history of IDOR examinations.

Ultimately, the Appellate Court found "reasonable minds could disagree regarding whether the defendant had a duty to collect and remit use tax on shipping charges." Therefore, NBF did not act recklessly or simply bury its head in the sand while ignoring an obligation to collect and remit use tax on shipping charges. In order to recover damages, the relator needed to prove but failed to "prove that defendant ignored obvious warning signs, buried its head in the sand, and refused to learn information from which its duty to pay money to the State would have been obvious."7

**Treasury Wine Estates**—reliance on third parties

Reliance on a third party was recently analyzed in a different case. On August 30, 2016, Cook County Circuit Court Judge Thomas Mulroy ruled in favor of Treasury Wine Estates in another Illinois False Claims Act filed on the state's behalf by a relator.8 The ruling held that the relator failed to prove Treasury Wine Estates knowingly violated the Illinois False Claims Act or that it acted with reckless disregard of an Illinois tax collection and remittance obligation. Consistent with National Business Furniture, LLC, the court analyzed the issue using a reckless disregard standard and similarly describes the standard as impacting taxpayers who "intentionally close their eyes, hide their heads in the proverbial sand, and do not make simple inquiries."

Treasury Wine Estates outsourced its tax compliance to a third party. The ruling states: "Defendant relied on its consultants to do the job for which they were hired, to do the right thing and be acquainted with Illinois sales tax law. Defendant relied on its preparers' expertise, experience in the field and representations to ensure its ST-1 forms were accurate. Defendant was faced with the task of filing hundreds of tax returns in many states which have different and conflicting laws. Defendant did what a prudent business would do: it
asked for help with navigating the murky waters of Illinois tax law and the challenging task of correctly preparing an Illinois sales tax return. Defendant did not intend to defraud Illinois; it intended to do what Illinois law required and sought expert help to do it. Defendant was not required to check the work of its consultants by seeking advice from other professionals. Defendant was prudent when it sought and paid for advice from companies experienced in its industry and experienced in state tax preparation work."

Conclusion

Taxpayers in Illinois should review the amended guidance from IDOR, update and document tax return filing positions, and ensure positions are disclosed on use tax returns and during IDOR examinations. Alternatively, taxpayers should seek assistance from qualified tax professionals to perform these items. Both conservative and aggressive positions have been subject to litigation. However, there is good news. Taxpayers who do not bury their heads in the proverbial sand should be spared.

1 40 Ill. Reg. 6130, 6143 (eff. Apr. 1, 2016).

2 235 Ill. 2d 351 (2009).

3 2016 Ill. App (1st Div.) 150526.


7 Citing Ervin, 370 F. Supp. 2d at 41-42.