THE POTENTIAL IMPACT OF THE STREAMLINED SALES AND USE TAX AGREEMENT ON ILLINOIS

Prepared by
The Civic Federation
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ACKNOWLEDGEMENTS

This report is the culmination of nearly six years of effort by The Civic Federation. It is our attempt to understand and then convey to the public the impact of retail Internet transactions on local government finances. This document has been changed, reviewed, and edited multiple times in our continuing effort to provide the public with the best possible information on state and local tax policy.

Over the last six years, the report has been in many hands. The primary author is Scott Metcalf, our Senior Tax Policy Advisor, has contributed greatly to this project and overseen the evolution of our position. Without his contributions, this report would not have been possible. Lise VanderVoort, the current Research Director of The Civic Federation, has helped shepherd the effort to completion by navigating the report through its final stages.

More importantly, there would be no report but for the contributions of our members. We are extremely grateful to Civic Federation Board member Jim Kranjc, and his colleague Don Sloan from Ryan & Company, for reinvigorating our interest in this report and providing the foundation for the document before you. However, it was Civic Federation Board member Fred Montgomery of Sara Lee who contributed immensely to this document. His expert knowledge of the sales tax system in Illinois, along with his sure and steady guidance, inspired the final product. Thomas Donohoe of McDermott, Will & Emery also contributed to the report by providing a crucial legal viewpoint.

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EXECUTIVE SUMMARY

Introduction

The Streamlined Sales and Use Tax Project ("SSTP") is a national effort to simplify and make uniform the sales and use tax statutes of a majority of states for the purpose of encouraging the taxation of Internet, catalog and other sales by out-of-state retailers. The Project has proposed that member states create a uniform sales tax structure to achieve: tax law simplifications, more efficient administrative procedures, and reduced tax collection burdens. To achieve these objectives, a consortium of states will be formalized through the Streamlined Sales and Use Tax Agreement ("the Agreement"). The changes necessary to join the Agreement would affect the administration of Illinois' sales tax system for all types of retail commerce.

Revenue Estimates

There is widespread disagreement about how much revenue could be generated from taxing the sale of tangible personal property sold over the Internet or by retailers located entirely outside Illinois. Aside from the benefits to multi-state retailers of a simplified and uniform sales tax system across many states, proponents have strongly suggested that the Agreement will result in increased sales tax revenue for states and local governments. However, it is important to keep the potential increase in revenues in the proper perspective when discussing the changes to Illinois' sales tax system, which are necessary to come into compliance with the terms of the Agreement. Some of the reasons for a conservative approach to these projections include:

- The amount of additional revenue for the State of Illinois depends on numerous factors and variables, including:
    - Only the U.S. Congress can grant states the authority to compel out-of-state vendors to collect sales taxes
    - Any additional revenue collected by the State of Illinois must be shared with local governments
    - Many predictions of the growth electronic commerce have been based on inaccurate assumptions
- Numerous Internet retailers who have substantial amounts of sales transactions are already collecting sales taxes
- The vast majority of Internet transactions are not retail sales, and would not be subject to state sales tax
- A significant amount of retail sales are made to businesses that pay complimentary use taxes and are continuously subject to audit
- Despite continuing concern over the potential lost sales tax revenue from Internet sales, Illinois sales tax collections have remained stable over time

Numerous studies have attempted to estimate the amount of additional revenue that Illinois could expect as a result of applying its sales tax to electronic commerce. Three of those studies are reviewed in this report. Each one is discussed in terms of its assumptions, methodology and findings. The projections of each study are listed in the chart below. In order to verify and rationalize those findings, the U.S. Census Bureau's measurements of remote retail trade are used to generate new estimates of the revenue potential of both electronic commerce and remote retail sales in general. Based on the concurrence of two of the three studies examined, and on the new estimates generated in this report, a reasonable estimate of the amount of revenue that the State of Illinois could have generated from taxing electronic commerce and other forms of remote retail transactions in 2001 and 2002 is about $100 million. Electronic commerce by itself would have generated less than $50 million of that amount.

Estimates of State & Local Sales Tax Revenue in Illinois from Remote Retailers & E-Commerce ($ Millions)			
	State Revenue	Local Revenue	Total Revenue
All Remote Retail Sales - 2001			
Civic Federation Estimate	$86	$21	$107
All Remote Retail Sales - 2002			
Civic Federation Estimate	$81	$20	$101
E-Commerce Only - 2001			
Civic Federation Estimate	$20	$5	$25
DMA Study	$45	$11	$56
University of Tennessee	$426	$107	$533
E-Commerce Only - 2002			
Civic Federation Estimate	$23	$6	$28
IL Economic & Fiscal Commission*	$34	$9	$43

Note: Figures may not sum due to rounding

*Midpoint between high and low estimates

Compliance Costs

In addition to the potential sales tax revenue that may be generated from Internet and other remote sales, the Illinois General Assembly must consider the cost of the changes to Illinois' sales tax system, which are necessary to come into compliance with the requirements of the Agreement. In order for Illinois to comply, changes will have to be made in the following areas.

- Sourcing Rules – $42 Million in Local Government Revenues Redistributed

Sourcing Rules determine the location at which a sale is considered to have occurred for the purpose of taxing that sale. For goods that are delivered rather than taken out of a store by the customer, Illinois must change the current practice of taxing sales where the business is located to a new system of taxing sales where the customer takes possession of the goods. The State of Washington's Department of Revenue conducted a study to estimate the extent to which such a change would redistribute sales tax revenues among local governments in Washington. If Illinois can expect the same proportionate amount of redistribution in local sales tax revenue, approximately $42 million can be expected to move between local governments in Illinois.

- Lease Taxes – State Revenue Disrupted, Chicago Revenue Reduced by $100 Million

In general, the State of Illinois does not tax receipts from the lease payments on personal property. Instead, the lessor is considered the end-user of the goods and is taxed on the sales price of the goods when they are purchased. Compliance with the Agreement may require that Illinois begin taxing the lease payments rather than the purchase price of the goods. At the state level, the sales taxes currently collected when a lessor purchases goods would be deferred until taxes are paid on each lease payment for those goods. This deferral of revenues could cause significant, initial revenue shortfalls. Previous studies suggest $18 million would be deferred from leases of computer equipment alone; and a rough estimate of automobile leases indicates that sector of leases alone could result in another $236 million being deferred.

Changes to the taxation of leased property would also affect the City of Chicago's Personal Property Lease Transaction Tax. Currently, Chicago utilizes its home rule authority to tax lease payments at a rate of 6% under a local ordinance that is independent of the sales tax. Because the Agreement requires state and local sales tax bases to be identical by December 31, 2005, the City of Chicago would probably have to repeal its Lease Transaction Tax, at least to the extent that it applies to tangible personal property.

- The Service Occupation Tax and the Service Use Tax

The Service Occupation and Service Use Tax apply to the transfer of tangible personal property incident to the provision of services. Under a rather complicated four-part test, the Service Occupation Tax imposes several different tax liabilities on service providers depending on the nature of their business and their gross receipts. For a number of reasons, two of the four methods of calculating tax liability would have to be eliminated in order for Illinois to comply with the Agreement. It is not possible to project the revenue impact of these changes, but the fiscal impact is not likely to be great. A more important consideration for the Illinois General Assembly is that those service providers who would be negatively impacted by the required changes would likely oppose any attempt to alter the current system. Other service providers are likely to find it difficult or impossible to determine their tax liabilities because changes in sourcing rules would require them to charge taxes based on the locations of their customers. Therefore, the greatest cost of these changes may very well be political rather than fiscal.

- Other Areas for Consideration
    - Tax Rates – Although a lower tax rate for food and drugs is currently allowed under the proposed Agreement, because medical appliances are not exempted from the Agreement's single tax rate requirement, the Illinois General Assembly must either increase the tax rate on medical appliances from 1% to 6.25% or entirely exempt the purchase of medical appliances from taxation.

- Local Taxes – The Agreement also prohibits more than one tax rate per jurisdiction. If substantial compliance with the terms of the Agreement is interpreted to mean that there can be only one sales tax rate within an entire municipality, numerous jurisdictions including the City of Chicago would be forced to increase or decrease tax rates to create uniformity across jurisdictional lines. For example, the DuPage County portion of Chicago has a cumulative tax rate different from the cumulative tax rate of Cook County.
- Uniform Definitions – Changing the definitions of certain items to comply with the requirements of the Agreement could also increase or decrease the tax rate applied to certain items by changing the way in which they are viewed by the state for tax purposes.
- State Audit Function – The introduction of a third-party (known as a Certified Service Provider or CSP) to collect and remit taxes on behalf of vendors also transfers the tax liability of a retailer to a third-party. The financial inability of a CSP to meet the tax liability and the inability of an auditor to directly examine the records of a retailer could lead to abuses and loss of state revenue if not carefully addressed.
- State Level Administration – The Agreement requires state administration of local sales and use taxes. An example is the City of Chicago's 1% Use Tax for Nontitled Personal Property. Transferring the job of administration away from the City could result in delayed distributions of revenue and diminished tax compliance.

Estimates of Potential State & Local Revenue Losses from Compliance with the SSTP Agreement	$ millions
Change to Destination-Based Sourcing*	$42
Change in Taxing Lease Payments**	
Chicago LeaseTax	$100
Computer Leases	$18
Automobile Leases	$236
Change in Taxing Service Occupations	Insufficient Information
Other Areas for Consideration	Insufficient Information
Total Potential Fiscal Impact	$396

* Represents revenue shift. Loss occurs only in certain jurisdictions

** City loss permanent. State loss in first year only.

Conclusion

The results of this analysis indicate a potential for the State of Illinois and the City of Chicago to lose $295 million in the first year from making the changes necessary to join the Streamlined Sales and Use Tax Agreement. Ultimately it is left to the legislature to determine whether the anticipated benefits of coming into compliance with the terms of the Agreement are likely to be outweighed by the costs. However, this analysis strongly indicates that caution and foresight are necessary on the part of the General Assembly to ensure that the State of Illinois and its units of local government do not suffer severe economic dislocations as a result of the proposed changes.

Potential Costs & Benefits of Joining the SSTP Agreement	$ millions
Potential Revenues	
State & Local Sales Tax Revenue 2002	
State Sales Tax Revenue	$81
Local Sales Tax Revenue	$20
Subtotal: Revenues	**$101**
Potential Costs	
Change to Destination Based Sourcing*	$42
Change in Taxing Lease Payments**	
Chicago LeaseTax	$100
Computer Leases	$18
Automobile Leases	$236
Simplifying the Service Occupation Tax	Insufficient Information
Other Areas for Consideration	Insufficient Information
Subtotal: Costs	**$396**
Total Potential Fiscal Impact in the First Year	**-$295**

Note: Figures may not sum due to rounding

* Represents revenue shift. Loss occurs only in certain jurisdictions

** City loss permanent. State loss in first year only.

INTRODUCTION

For as long as there have been sales and use taxes, there have been questions about who must pay them. One important set of questions involves sales by retailers who receive orders and deliver products through communication channels rather than through a store physically located within a state's jurisdiction. On two separate occasions the U.S. Supreme Court has denied a state's request to require retailers with no substantial physical presence in that state to collect use taxes on the retailers' sales to state residents. In both decisions, the Court has held that requiring collection of a use tax by a retailer with no substantial significant physical presence in a state constitutes an unconstitutional burden on interstate commerce.[1] In the more recent decision, the Court indicates that Congress could grant states the authority to compel collection of use taxes by out-of-state retailers. However, Congress has not yet acted to grant that authority.

The development and diffusion of the Internet – a powerful, new communication channel through which vast amounts of business can occur – has heightened the interest in these questions and spawned a movement not only to encourage the voluntary collection of sales taxes by out-of-state retailers, but also to encourage the U.S. Congress to authorize the states to require out-of-state retailers to collect these taxes.

The Streamlined Sales and Use Tax Project ("SSTP") is a national effort to simplify and make uniform the sales and use tax statutes of a majority of states for the purpose of encouraging the taxation of Internet, catalog and other sales from remote locations. Some supporters also believe that uniformity and rationalization of state sales tax laws across the country will generally increase compliance with and respect for the law, not merely facilitate the taxation of remote retail sales. The SSTP has proposed that member states create a uniform sales tax structure to achieve: tax law simplifications, more efficient administrative procedures, and reduced tax collection burdens. To achieve this objective, a consortium of states will be formalized through the Streamlined Sales and Use Tax Agreement ("the Agreement").

The Agreement sets out the conditions states must meet for membership and creates a Governing Board to administer the group. A state can apply for membership only after its laws, rules, regulations, and policies are in "substantial compliance" with each of the requirements.[2] In the case of Illinois, this will require substantial revisions to numerous statutes. These changes would affect the administration of Illinois' tax system for all types of commerce, not just remote sellers.

While simplification and uniformity are desirable goals, policymakers must be aware of the potential for both costs and benefits from such sweeping changes in the tax structure. This report is intended as an initial effort to identify the financial impacts on the State of Illinois and its municipalities of the changes necessary to come into compliance with the

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[1] See *National Bellas Hess, Incorporated v. Department of Revenue for the State of Illinois,* 386 U.S. 753 (1967) and *Quill Corp. V. North Dakota,* 504 U.S. 298 (1992).

[2] David Hardesty, "Streamlined Sales and Use Tax Agreement – Part 1." December 1, 2002. http://www.ecommercetax.com/doc/120102.htm

requirements of the Agreement. It begins with a review of the updated estimates of the amount of state and local tax revenues that could be collected if sales by out-of-state vendors were taxable. It then offers an initial evaluation of the potential fiscal impacts of some of the statutory changes necessary to implement the Agreement in Illinois.

REVENUE ESTIMATES

This section of the report looks at revenue estimates for the taxation of electronic commerce and other forms of remote retail transactions. First, there is a discussion of important issues policymakers should keep in mind when evaluating the amount of additional sales tax revenue that may result from taxing remote retail transactions. Second, three prominent studies of potential sales tax revenue from electronic commerce are discussed. Finally, new revenue estimates are put forward based on the latest information from U.S. Census Bureau's information on electronic commerce and other forms of remote retail sales. The section concludes that the State of Illinois could have realized roughly $100 million of additional revenue in 2001and 2002 from taxing all remote retail sales, and that electronic commerce by itself would have generated less than $50 million of that amount.

Issues for Consideration

General Issues

Four general issues should be kept in mind when evaluating estimates of the revenue potential from Illinois' participation in the Agreement. Although many of these issues can significantly impact the estimated revenue amounts, promoters of Illinois' participation in the Agreement often overlook them.[3]

Congressional Authorization Required

Even if Illinois makes all the necessary changes to its tax laws and is accepted into the Agreement by the other participating states, Illinois will not be able to compel the collection of its taxes by remote retailers unless and until Congress authorizes the states to do so. To date, the U.S. Supreme Court's rulings on the constitutionality of taxing out-of-state retailers preclude states from taxing those merchants. In its most recent decision regarding this issue, the Court stated not only that "Congress has the ultimate power to resolve" the states' ability to tax remote retailers, but also that "Congress is now free to decide whether, when, and to what extent the states" may tax remote retailers.[4] Because the Agreement can in no way circumvent a U.S. Supreme Court ruling or the authority of the U.S. Congress, absent Congressional action, there will be no legal authority for states to compel remote retailers to collect sales and use taxes under the Agreement. For this reason, proponents of the Agreement are clear that membership merely encourages the voluntary collection of taxes by remote retailers until Congress provides states with the necessary grant of authority.

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[3] An important issue regarding changes to Illinois' tax laws, which is also often overlooked, is that compliance with the SSTP Agreement would require Illinois to tax some items that are currently not taxed. For example, changing definitions of certain products or taxing the sale of medical appliances at a rate of 6.25% rather than 1% would generate additional revenue by imposing new or higher taxes on those products. Issues regarding the changes necessary for Illinois to come into compliance with the Agreement are discussed in the second half of this report.

[4] *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992).

SSTP Covers All Remote Sales, Not Just E-Commerce

Should Congress grant the authority, states would be able to compel the collection of taxes on all forms of remote retail sales, not just electronic commerce. The requirement to collect taxes would also apply to mail order, phone and catalog sales. In fact, according to estimates from the U.S. Census Bureau, most retail sales by remote vendors still occur through means other than electronic commerce.[5] Therefore, studies examining only electronic commerce do not account for the full range of sales transactions potentially subject to taxation.

State and Local Sales Tax Distributions

It is also important to remember that, with some minor exceptions, the State of Illinois distributes 20% of its "sales tax"[6] collections to the local governments in which the sales occur.[7] Discussions of the revenue potential for Illinois must distinguish between the state and local portions of sales tax revenue. The State of Illinois itself would only have approximately 80% of any estimated revenues to fund state operations and projects.

Prospective vs. Retrospective Estimates

Finally, there is an important difference between prospective and retrospective revenue estimates. There is great difficulty in acquiring accurate data in a timely manner for all types of economic activity, but especially for electronic commerce. Many studies of electronic commerce project estimates into future years. The estimates of potential revenue amounts from electronic commerce in future years are based on the application of growth rates to estimates of electronic commerce activity from past years. These assumed growth rates are often influenced by a number of factors, which may or may not prove to be accurate. While retrospective estimates may be more than a year old, they are more reliable than prospective estimates, which are based on additional assumptions about future economic behavior.

In addition to these four general issues, there are three more specific considerations that should be taken into account when estimating the amount of additional sales tax revenue that may result from taxing remote retail transactions. First, many remote retailers already collect sales taxes. Second, the majority of electronic commerce would not be taxed under the Agreement. Third, sales tax collections have remained relatively stable throughout the growth of electronic commerce.

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[5] See Appendix A. In 2002, electronic commerce accounted for 28% of all remote retail sales. The total amount of retail transactions conducted via electronic commerce or through mail order houses was $114 billion, while electronic commerce alone accounted for $32 billion. Likewise, electronic commerce accounted for less than 2% of all retail trade in the United States in 2002.

[6] As will be discussed later in this report, the "sales tax" in Illinois is actually a complex combination of use taxes and taxes on the occupation of selling goods at retail.

[7] See Illinois Department of Revenue, Annual Report of Collections and Distributions, Fiscal Year 2002. Local governments receive 20% of the 6.25% general merchandise rate and 100% of the 1% rate on qualifying foods, drugs, and medical appliances. Use Tax collections are not distributed based on the location of the sale. Instead they are distributed based on a formula; one component of that formula distributes the collections based on each local government's relative share of the population.

Many Remote Retailers Already Collect Sales Taxes
Any Internet or catalog retailer who has a "physical presence" in Illinois must collect and remit sales taxes on all Internet or catalog transactions in the state.[8] As the electronic commerce marketplace develops, an increasing amount of business is being conducted by retailers who have both physical store locations and Internet retail sales. Furthermore, those retailers with physical locations in Illinois are increasingly encouraged to collect Illinois sales taxes on their Internet sales.

While often cited as a decision that prohibits states from requiring the collection of sales taxes by out-of-state retailers, the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota* more specifically reaffirms a "bright-line test" for determining whether or not a retailer is required to collect sales taxes.[9] The test revolves around what is referred to as "substantial nexus." The majority decision indicated that the presence of a "small sales force, plant or office" would constitute substantial nexus that must exist before a state can require a retailer to collect and remit sales and use taxes. Thus, the effect of the *Quill* decision is that any retailer with a physical presence in the customer's state can be required to collect that state's sales and use taxes, but an out-of-state retailer without a physical presence cannot.[10]

A growing number of Internet retailers meet this physical-presence test because the retailer also has physical store locations as part of its business and has decided that business considerations require the integration of its Internet and land-based sales operations. Such "multichannel" retailers made 75% of total on-line sales in 2003, up from 54% in 2000 according to Forrester Research.[11] A presence solely on the Internet is no longer the business model being followed by most retailers. Aside from some notable exceptions and a handful of specialty markets, established retail stores and catalog companies increasingly dominate Internet sales.[12] These established retail merchants, who in the past may have complemented traditional brick-and-mortar stores with catalog sales, now follow a business model in which Internet sales comprise a significant portion of their transactions.

In the view of many, this new and increasingly predominant business model, which integrates physical store locations with Internet sales, requires these retailers to collect sales and use taxes. Recently, several major Internet retailers with commonly owned brick-and-mortar locations voluntarily agreed to begin collecting sales tax in 38 states

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8 *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992). See also, "State Taxation of Internet Sales," *Fiscal Focus,* Illinois State Comptroller, June 1999. Available at: http://www.ioc.state.il.us/fiscalfocus/ffmenu.cfm
9 *Quill Corp. v. North Dakota,* ibid.
10 See *Town Crier, Inc. v. Department of Revenue*, 315 Ill. App. 3d 286, 290, 733 N.E.2d 780 (2000).
11 Carrie Johnson, "The Growth of Multichannel Retailing," A Forrester Research, Inc., document prepared for the National Governor's Association and the National Conference of State Legislatures, July 2004. See also: Wall Street Journal, December 8, 2003.
12 Johnson, ibid.

due to customer service concerns.[13] These companies had not been collecting tax on sales made by their Internet divisions. However, the acceptance of returns or exchanges at the brick-and-mortar stores is widely believed to create sufficient nexus between the remote seller and the state to allow the state to compel tax collection by the remote seller. In order to maintain the required legal separation between Internet and physical divisions, companies had been forced to tell customers they were not allowed to return or exchange items purchased on-line to the brick-and-mortar stores. The negative marketplace reaction forced the retailers to give up the tax fight in order to satisfy customers. Forrester Research's recent review of the top 100 retail web sites found that 94% of those retailers collect sales tax for on-line purchases made in states where they have nexus.[14]

Furthermore, whistleblower lawsuits filed in Illinois have also begun to give previously unregistered retailers considerable motivation to register and begin voluntarily collecting the Use Tax.[15] On August 30, 2004, the Illinois State Attorney General filed suit against Target and Wal-Mart with claims that the retailers did not collect sales tax for their web site sales between 1999 and 2002.[16] Attorneys in Illinois have now filed lawsuits against over 60 companies under Illinois' "whistleblower" statute.[17] Whistleblowers argue that targeted companies face triple damages under the whistleblower statutes, if they are found not to be protected by *Quill*; some believe that voluntary compliance is a relatively inexpensive alternative.

Finally, the Illinois Department of Revenue has the authority to enforce the Use Tax against purchasers of taxable retail products. While the Department of Revenue does not enforce the Use Tax against the average consumer, in the case of business consumers a robust audit program does exist. Because business consumers are regularly audited for a number of state taxes, there is every reason to believe that voluntary compliance by businesses is very high.

Vast Majority of Electronic Commerce Would Not Be Taxed

The vast majority of transactions conducted over the Internet would not be taxable because Illinois taxes only *retail* sales of *tangible personal property*.[18] Therefore, transactions in which goods are sold for the purpose of resale are not subject to the sales tax. A system known as Electronic Data Interchange (EDI) handles vast amounts of electronic commerce between businesses over a decades-old system of mainframe computers. If one considers the entire Internet economy, wholesale transactions on EDI constitute the vast majority of electronic commerce transactions. Likewise, Illinois does

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[13] Washington Post, February 7, 2003 Page A01; available at http://www.washingtonpost.com/wp-dyn/articles/A38198-2003Feb6.html and Washington Post, February 6, 2003; available at http://www.washingtonpost.com/wp-dyn/articles/A31210-2003Feb5.html.

[14] Carrie Johnson, "The Growth of Multichannel Retailing," A Forrester Research, Inc., document prepared for the National Governor's Association and the National Conference of State Legislatures, July 2004, p.12.

[15] Whistler-blower lawyer grasps for e-tailer back taxes; Illinois attorney general helps. *Sales & Use Tax Alert*, Vol. XIII, No. 5, March 15, 2003 (CCH Inc.)

[16] Steve Patterson, "State sues Target, Wal-Mart over taxes," Chicago Sun-Times. August 30, 2004, p. 22.

[17] 740 ILCS 175/1 *et.seq.*

[18] 35 ILCS105 and 35 ILCS 120

not tax the sale of intangible goods or services. For example, travel reservations, which accounted for $6.3 billion in electronic commerce during 2002, would not be subject to the Illinois sales tax under the Agreement.[19]

A 1999 Ernst & Young study first pointed out that most electronic commerce would not be subject to sales taxes. It concluded that approximately 80% of e-commerce is business-to-business sales that are either not subject to sales and use taxes or are effectively subject to use tax payments by in-state business purchasers; 63% of the remaining business-to-consumer sales are intangible services, such as travel and financial services, or exempt products, such as groceries and prescription drugs, which generally are not subject to state and local sales and use taxes.[20]

The most recent survey by the U.S. Census Bureau of electronic commerce verifies the assumptions of the Ernst & Young study, and it demonstrates that the Illinois sales tax would not apply to the vast majority of electronic commerce (see Table 1). According to the U.S. Census Bureau's 2002 estimates of electronic commerce, which are discussed in greater detail later in this report, approximately 96% of the total value of electronic commerce transactions occurred within the manufacturing, wholesale and service industries. The retail sale of tangible personal property constituted only 4%.

Table 1
U.S. Census Bureau
2002 E-Commerce Transaction Amounts

	$ millions	
Transaction Types	**Amount**	**Percent of Total**
Total Manufacturing	$751,985	65%
Total Merchant Wholesale Trade	$319,755	28%
Retail Trade	$44,287	4%
Selected Service Industries	$41,463	4%

Note: Figures may not sum due to rounding

Sales Tax Collections Have Remained Stable

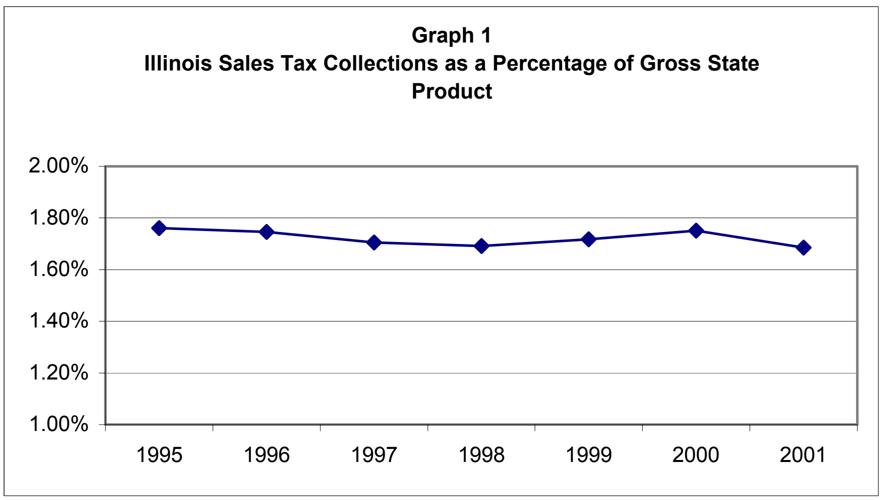
The development of a sense of urgency for the taxing Internet retail sales coincided with the height of the technology bubble in the late 1990s. The rosy projections of seemingly unlimited growth potential of electronic commerce that once fueled dramatic increases in equity markets also increased concern among state and local revenue departments across the nation. Now, even the most ardent supporters of the new economy are making more modest appraisals of future Internet sales growth potential. The University of Tennessee recently revised its estimates of e-commerce downward, citing the experience of the last

[19] E-Stats, US Department of Commerce, April 15, 2004. http://www.census.gov/eos/www/papers/2002/2002finaltext.pdf

[20] Ernst & Young, LP, The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted by the Internet (June 1999).

few years as evidence that "e-commerce has been a less robust channel for transacting goods and services than was estimated when we prepared the earlier estimates."[21]

The Ernst & Young study estimates that 60% of e-commerce purchases of tangible products would otherwise be made by phone or mail, and thus are a substitution, not an addition to remote sales transactions.[22] The study observes that substitution of e-commerce purchases for sales from other remote sellers (e.g., mail order and telemarketers) does not result in reduced sales and use tax. This observation is supported by historical trends in sales and use tax collections both in Illinois and across the country. If an increasing amount of economic activity were indeed escaping sales and use tax through electronic commerce, sales tax revenue as a percentage of total economic activity would be declining. On the contrary, sales and use tax revenues, as a percentage of Illinois' Gross State Product (GSP) for the period 1995 through 2001, has remained stable, as indicated in Graph 1.[23] Although changes in tax rates and exemptions can mask real changes in tax collection trends, it appears unlikely that significant volumes of sales are escaping taxation in Illinois in ever increasing rates.



Graph 2 compares national sales tax revenue figures to Gross Domestic Product (GDP) for the period 1995 through 2002.[24] Although one should use caution in drawing conclusions from general data, annual sales tax revenue appears to grow at a slightly faster pace than retail trade sales throughout most of this period.

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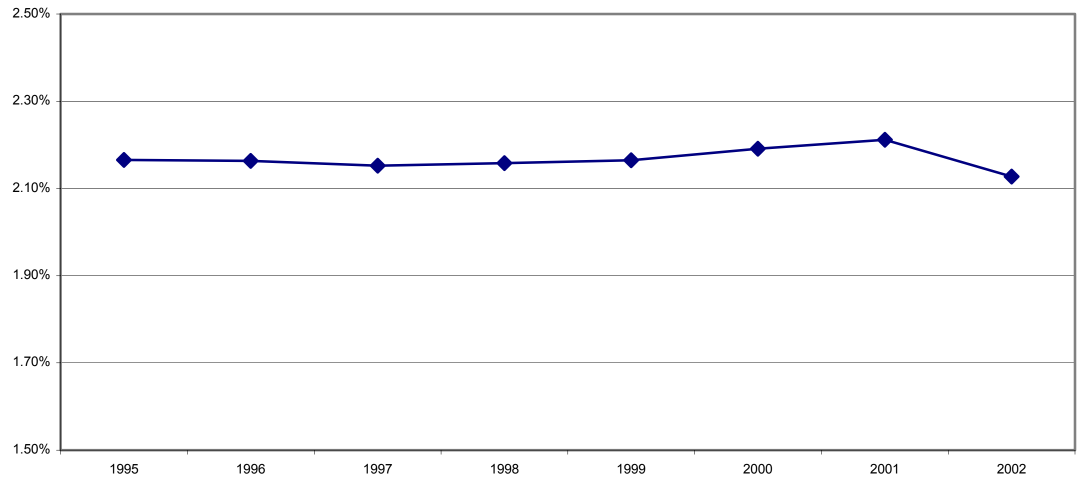
[21] Donald Bruce and William Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Estimates as of July 2004." University of Tennessee Center for Business and Economic Research, July 2004, pg. 1. Available at: http://www.ncsl.org/print/press/Ecommerceupdates.pdf

[22] Robert J. Cline and Thomas S. Neubig, "The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted By the Internet in 1998," Ernst & Young, June 18, 1999.

[23] Gross State Product information taken from the Bureau of Economic Analysis and Sales Tax information from the Illinois Department of Revenue. The most recent year for which information on Illinois' Gross State Product is available is 2001. See Appendix B for detailed charts upon which Graph 1 is based.

[24] Gross Domestic Product information taken from the Bureau of Economic Analysis and Sales Tax information from the U.S. Census Bureau. The most recent year for which state and local combined general sales tax revenue is available is 2002. See Appendix B for detailed charts upon which Graph 2 is based.

Graph 2
US Sales Tax Collections as a Percentage of Gross Domestic Product



Review of Published Estimates

Overview

A variety of studies by different parties have attempted to quantify the amount of revenue states could gain by taxing e-commerce, remote sales or both. While these studies have been primarily conducted on a national level, some do attempt to estimate potential revenues for individual states, including Illinois. The studies focus primarily on electronic commerce, rather than on all remote retail sales; and except for the Illinois Economic & Fiscal Commission, they do not account for sales tax distribution to local governments.

Some of these studies reach dramatically different conclusions on the amount of revenue that could be generated by taxing remote sales. The Congressional Budget Office observes that the different results are in large part due to "uncertainty arising from shortcomings in the data available to quantify uncollected revenue from remote sales."[25] Uncertainty requires researchers to estimate certain factors, and differences in how those factors are estimated can lead to widely divergent results.

The studies surveyed in this section come from three sources: the Illinois Economic & Fiscal Commission, the Center for Business and Economic Research at the University of Tennessee, and the Direct Marketing Association. As noted previously, retrospective estimates are more reliable than prospective estimates because they do not rely on additional assumptions about future economic behavior. For consistency and comparability, the estimates for 2001 are used throughout, with the exception of the

[25] "Economic Issues in Taxing Internet and Mail-Order Sales," Congressional Budget Office, October 2003, pg. 6.

estimates from the Illinois Economic & Fiscal Commission. Because only estimates for 1999 and 2002 are available from the Commission, the 2002 figures are used in this report. For each study there is discussion of the context in which it was written as well as a review of the key components and assumptions of the study. If a study provides no estimates specific to the State of Illinois, a factor of 4.5% is applied to nationwide estimates. This factor is based on Illinois' approximate share of both population and Gross Domestic Product.[26]

Illinois Economic and Fiscal Commission [27]
Published in February 2000 and primarily devoted to providing readers with an overview of Internet taxation issues, this Illinois Economic and Fiscal Commission briefing also provides projections of revenue losses from e-commerce that are specific to Illinois. These estimates are based on a study by Ernst & Young, as well as information from Boston Consulting Group, Forrester Research, and the Chicago Tribune.

The Ernst & Young study upon which these estimates are largely based estimates that 80% of on-line transactions involve wholesale merchandise sold to another business for resale.[28] Wholesale transactions are assumed to be exempt from taxation whether conducted electronically or not. Of the remaining 20%, which are taxable retail sales to consumers, 63% is assumed to be sales of intangible services or tax-exempt products (e.g., food or prescription drugs). The Ernst & Young study also assumes that taxes are already paid on 4% of on-line taxable sales, presumably because the retailer has a physical nexus within the state.[29] The final result is that only 7% of all on-line transactions are assumed to be potentially taxable. To arrive at an amount specific to Illinois, the Illinois Economic and Fiscal Commission report applies a factor of 4.5% to Ernst & Young's national estimates. This factor is based on Illinois' approximate share of national economic activity.

The report provides a range of estimates for Illinois' potential revenue gains (or current revenue losses) to accommodate the speculation upon which the estimates are based, with the high estimate being twice the amount of the low estimate. In 2002 the projected potential revenue ranges from $28.5 million to $57 million. The estimated tax base is presented above by dividing the potential revenue figure by the state tax rate of 6.25%.

The estimates provided at the end of the Commission report also account for Illinois' distribution of sales tax revenues between the state and local governments. Of the 6.25% sales and use tax, 5% is dedicated to the state while 1.25% is distributed to local governments. Therefore, only 80% of the amount shown above, or $22.8 million of the

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[26] See Appendix C for detailed information and calculations.
[27] "A Briefing on: Internet Taxation Issues and Impacts," February 2000. Available at http://www.legis.state.il.us/commission/ecfisc/2000InternetTaxationReport.PDF
[28] Robert J. Cline and Thomas S. Neubig,"The Sky is Not Falling: Why State and Local Revenues Were Not Significantly Impacted By the Internet in 1998," Ernst & Young, June 18, 1999.
[29] As will be discussed later in the report, 4% is likely an underestimate of the current amount of on-line retail activity for which taxes are collected because evolving business models place greater emphasis on the integration of Internet and traditional storefront presences. Furthermore, states including Illinois are expanding efforts to enforce collection of sales taxes under existing physical presence requirements.

low estimate, would go to the State of Illinois. The remaining $5.7 million would be distributed to local governments.

Table 2 IL Economic & Fiscal Commission 2002 Potential IL Sales Tax Revenue from E-Commerce ($ Millions)	Low Estimate	High Estimate
Estimated Sales Tax Base *	$456.0	$912.0
Potential Sales Tax Revenue	**$28.5**	**$57.0**
State Sales Tax Revenue	$22.8	$45.6
Local Sales Tax Revenue	$5.7	$11.4

*Not included in original study. Estimated by dividing Potential Sales Tax Revenue by 6.25%

University of Tennessee Center for Business and Economic Research [30]

The Center for Business and Economic Research at the University of Tennessee published an often-cited study in September 2001. It generates the largest estimates of on-line sales and current revenue losses, based in large part on projections of significant growth in untaxed sales transactions. The estimates are greater than those in other studies due to a much larger estimation of potentially taxable electronic commerce, which resulted from larger estimates of on-line retail trade as well as the inclusion of many more business-to-business transactions.

The University of Tennessee report approaches the topic of e-commerce within the context of a long-term, national trend showing a decline in the sales tax base relative to personal income.[31] It updates estimated revenue losses originally published in 2000 with revised projections from Forrester Research and more recent information about state and local tax structures. The revised estimates increase the previously published revenue loss figures with significantly increased business-to-business e-commerce forecasts from Forrester.[32]

In contrast to other studies, this report assumes that approximately 28% of all on-line transactions in 2001 resulted in tax revenue losses. Nationwide, of the estimated $754.6 billion in on-line transactions, $208.5 billion are classified as resulting in tax revenue loss. The crucial assumption leading to these conclusions is that a large portion of business-to-business transactions (65%) would be subject to taxation. However, it is also important to note that the authors have appropriately reported the figures net of the estimated exempt sales and sales on which tax is already collected – a necessary adjustment that some published reports on this issue have overlooked.

The resulting total sales tax revenue loss for Illinois estimated in this study is $532.9 million. An estimated sales tax base of $8.5 billion was generated by dividing this figure by a tax rate of 6.25%. Of the $533 million in sales tax revenue, $426 million would be distributed to the state and $106 million to local governments.

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[30] "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," September 2001. Available at http://cber.bus.utk.edu/ecomm/ecom0901.pdf. An updated version, published in July 2004 and cited in footnote 21, does not revise the 2001 estimate provided in the September 2001 study. However, it does revise downward its projections for 2003-2008 e-commerce sales and corresponding sales tax revenue.

[31] In addition to the growth in e-commerce, the study attributes this decline to a shift in consumption patterns toward services rather than goods and continuing growth in legislated exemptions from the sales tax.

[32] Forrester Research, Inc. TechStrategy™ Brief: *US eCommerce: The Next Five Years,* August 27, 2002. It is also important to note that Forrester's *retail* e-commerce projections have been sharply reduced since publication of the study. Forrester now predicts that on-line business-to-consumer sales will not reach the $200 billion level until 2007, instead of 2004.

Table 3 University of Tennessee 2001 Potential IL Sales Tax Revenue from E-Commerce	($ Millions)
Estimated Sales Tax Base *	$8,526.0
Potential Sales Tax Revenue	**$532.9**
State Sales Tax Revenue	$426.3
Local Sales Tax Revenue	$106.6

*Not included in original study. Estimated by dividing Potential Sales Tax revenue by 6.25%

The Direct Marketing Association [33]

The Direct Marketing Association (DMA) in a March 2003 report provides much smaller estimates than the University of Tennessee study. Its estimates are more in-line with the estimates from the Illinois Economic & Fiscal Commission. The DMA study provides both an estimate of current revenue loss from e-commerce and a critical analysis of the University of Tennessee Study's findings. The estimates of revenue loss result from the application of a similar methodology to data compiled by the U.S. Census Bureau for 2000 and 2001, rather than projections from Forrester Research. The criticism focuses on the University of Tennessee report's assumptions regarding business-to-business transactions.

In many respects the DMA study uses the same methodology as the University of Tennessee study. However, on an important point the methodologies diverge. The DMA study assumes that a much smaller percentage of business-to-business transactions result in revenue loss. This assumption is based on two interrelated arguments: the inclusion of EDI transactions in the University of Tennessee study, and on high rates of compliance with use tax requirements by businesses. Transactions occurring over the EDI are argued to be primarily for manufacturing purposes and wholesale in nature. Because of the audits to which they are subject, companies are assumed to voluntarily comply with the tax liability requirements at a rate of at least 85%.

The DMA study concludes that in 2001, total U.S. uncollected sales tax from the Internet amounted to approximately $1.9 billion. The author estimates that Illinois' portion of this amount is $56.1 million, or 3% of the U.S. total.[34] Dividing by the state's tax rate of 6.25% yields an estimated tax base of $897.6 million. Potential sales tax revenue from this on-line sales tax base would be distributed between the State of Illinois and local

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[33] Peter Johnson. "A Current Calculation of Uncollected Sales Tax Arising From Internet Growth," The Direct Marketing Association, March 11, 2003.

[34] E-mail from Peter Johnson, December 10, 2003. If one were to use the methodology used elsewhere in this report, namely assuming that Illinois share would be approximately 4.5% based on the state's approximate share of national population and GDP, Illinois share of the $1.9 billion in lost sales tax revenue would be approximately $85 million. However, the author's figures are used in this report because the study provides a specific number for Illinois.

governments. The state would receive 80% or $44.9 million, and local governments would receive 20% or $11.2 million.

Table 4 Direct Marketing Association 2001 Potential IL Sales Tax Revenue from E-Commerce	($ Millions) Author's Estimate	 4.50% Share
Estimated Sales Tax Base *	$897.6	$1,345.5
Potential Sales Tax Revenue	**$56.1**	**$84.1**
State Sales Tax Revenue	$44.9	$67.3
Local Sales Tax Revenue	$11.2	$16.8

*Not included in original study. Estimated by dividing Potential Sales Tax Revenue by 6.25%

Civic Federation Estimates

In order to evaluate the estimates of the preceding studies as well as to provide additional information for policymakers in Illinois, this section uses information from the U.S. Census Bureau to estimate a range of potential sales tax revenue amounts that the State of Illinois could likely expect from the taxation of electronic commerce and other forms of remote retailing.

U.S. Census Bureau Data

The U.S. Census Bureau began developing a methodology for measuring on-line economic activity in 2000. Today, both annual and quarterly estimates of on-line economic activity are available on the Bureau's E-Stats web site.[35] The most recent official E-Stat report available is the 2002 E-Commerce Multi-Sector Report, published in April 2004.

The Bureau collects data through several separate surveys sent to approximately 125,000 plants and firms.[36] The surveys cover the manufacturing, wholesale trade, service, and retail trade industries. However, surveys for different industries use different measurements of economic activity, which are specific to the type of business being conducted. For example, manufacturers are asked for the market value of shipments and retailers are asked for the dollar value of sales. The results are therefore intended only to provide a broad perspective rather than a cumulative total of economic activity across the various sectors of the economy. Each survey asks respondents numerous questions, including the amount of business conducted through electronic means such as an Electronic Data Interchange (EDI) or the Internet. Responses to the survey are then classified according to the 1997 North American Industry Classification System (NAICS)

[35] http://www.census.gov/eos/www/ebusiness614.htm
[36] http://www.census.gov/eos/www/about.html

to create a representative sample of the economic activity occurring throughout the country and across all types of businesses.

Retail electronic commerce is estimated using information from the Monthly Retail Trade Survey. This survey measures economic activity based on the dollar amounts of sales. Therefore, the results are internally consistent in both concept and definition. Data from 19,000 firms is used to create a sample of 11,000 firms representing all segments of retail activity as defined by the NAICS. The electronic commerce report measures the value of goods sold electronically whether over open networks such as the Internet or over proprietary network systems such as a non-Internet EDI. Furthermore, the report provides both the total amount of economic activity and the amount conducted through electronic means for each NAICS code.

The NAICS subdivides retail trade into various categories.[37] The largest category, "Total Retail Trade," represents all subcategories such as sales of motor vehicles and automotive parts. The total amount of retail electronic commerce in 2001 is estimated to be $34.3 billion. "Non-store Retailers" includes a wide range of remote retail operations, including door-to-door solicitation, in-home demonstration, and distribution through vending machines. Non-store retailers constitute $25.8 billion of the total retail sales. The most specific measurement of the economic activity relevant to this discussion is "Electronic Shopping and Mail Order Houses" because it excludes irrelevant transactions such as vending machines. The $25.6 billion of national retail sales by electronic shopping and mail-order houses (NAICS 45411) in 2001 is discussed in more detail below.[38]

NAICS Code 45411 – Electronic Shopping and Mail-Order Houses

The projections of the amount of sales tax revenue that Illinois could reasonably expect from taxing both Internet and other remote sales contained in this section are based on the Census Bureau's estimates from the NAICS category of Electronic Shopping and Mail-Order Houses (45411). There are multiple reasons why using this particular category yields the most accurate results.

While other studies have included business-to-business or manufacturing transactions, the figures categorized by the Census Bureau as manufacturing and merchant wholesale businesses are not analyzed here for several reasons. First, if the goods were not sold to an end-user, Illinois' sale-for-resale exemption would apply. However, the Census data does not specify whether or not the buyer in the wholesale and merchant trade transactions is the end-user. Second, to the extent that businesses are subject to regular audits by the state, compliance with use tax liabilities by companies is assumed to be high enough to warrant exclusion of this category of sales from consideration as new revenues. Finally, the estimates from the manufacturing survey do not use the sales price of the products, but instead represent the market value of the goods shipped to customers; and they are therefore inconsistent with the retail trade estimates.

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[37] A complete listing of the subdivisions can be found at http://www.census.gov/epcd/www/naics.html

[38] See Appendix A. Also available at: http://www.census.gov/eos/www/papers/2001/2001estatstables.pdf.

Within the Retail Trade estimates, the category of "Total Retail Trade" includes too many transactions for it to be used in making projections of potential sales tax revenue. It includes all non-store retailers, motor vehicle and parts dealers, and other subcategories. Because motor vehicles are subject to the sales tax upon registration of the vehicle, these sales are largely subject to taxation under the current sales tax system.

Likewise, the subcategory of "Non-store Retailers" includes transactions, such as door-to-door sales and vending machines, which are not relevant to discussions of Internet and other forms of remote sales. Because such transactions are largely addressed under current Illinois law, Illinois would not see any additional sales tax revenue from them as a result of joining the Agreement.

"Electronic Shopping and Mail Order Houses" is the most specific measurement of the economic activity relevant to this discussion because it removes items that would not be added to the sales tax base under the Agreement. The category includes catalog and mail-order houses as a separate component. It also includes all purely Internet retailers and the "e-commerce business units of 'brick-and-click' retailers, if the e-commerce group operates as a separate unit."[39] In fact, almost all of the "brick-and-click" retailers are included in this category.[40]

Civic Federation Estimates for 2001 and 2002

Several adjustments must be made to the Census Bureau data from NAICS code 45411 to estimate the potential sales tax base Illinois could expect from Internet and other remote retail sales. Initially, Illinois' portion of the national total must be estimated. After Illinois' share of the national total is determined, the next step is to factor out those sales not contributing to additional state revenue, i.e., Illinois' sales transactions that are exempt from taxation, taxed at a lower rate, or currently taxed. These steps are described below.

1. First, to determine Illinois' share of e-commerce nationwide, a factor must be applied to the Census Bureau total. Illinois' share of both population and Gross Domestic Product are roughly the same. Averaging these two proxies for the percentage of national electronic shopping and mail order house transactions results in a factor of 4.55%. This factor is applied to the Census Bureau totals to yield an estimate of Illinois' portion of the sales transactions.

2. Next, the amount of transactions exempt from taxation and the amount of transactions already taxed must be considered. In order to account for these transactions, which would not generate additional sales tax revenue for the State of Illinois, a portion of the estimated sales tax base must be removed from the calculations as follows. For sales of goods exempt from taxation or taxed at a reduced rate (e.g., food and drugs), the estimated Illinois sales tax base is reduced by 15%. This 15% reduction in the sales tax base is similar to the 14% reduction

[39] United States Department of Commerce, U.S. Census Bureau, Economics and Statistics Administration. E-Stats. March 19, 2003. page 4. www.census.gov/estats
[40] ibid.

estimated by Forrester Research and used by the Direct Marketing Association in its study. To verify the accuracy of this factor three additional measurements of exempt or reduced rate goods are provided in Appendix D. First, food, drugs and medical appliances, which account for the largest sales tax exemption amount and are taxed at a rate of 1% rather than 6.25% in Illinois, accounted for approximately 15% of the state's estimated sales tax base in 2001. Second, in addition to providing the total amount of sales transactions for NAICS Code 45411, the Census Bureau also provides estimates for individual types of goods sold within this category. The categories of goods largely exempt from taxation in Illinois represent approximately 12% of total e-commerce transactions and approximately 20% of total remote sales transactions. Finally, results similar to the application of a 15% exemption factor are achieved when the relevant categories are either not taxed or taxed at a lower rate.

3. For sales by remote vendors who also have a physical presence in Illinois, the estimated Illinois sales tax base is reduced by 60% in 2001 and 64% in 2002. These percentages reflect a combination of factors used to estimate remote sales on which tax is already collected in Illinois. The University of Tennessee study assumes that 19% of Internet retail transactions in 2001 were subject to taxation. The Direct Marketing Association study assumes a slightly higher rate of 20% being subject to taxation in 2001. However, Forrester Research estimates that multichannel retailers made 67% of Internet sales in 2001 and 72% of Internet sales in 2002.[41] The increasingly predominant multichannel business model integrates Internet sales into an overall sales strategy with catalogs and physical store locations. Growth of this new business model, in which large Internet retailers also have a physical presence, or "nexus", in Illinois, will offset predicted tax losses from increased retail sales over the Internet. The 19-20% factor used by the University of Tennessee and the Direct Marketing Association is based on projections of growth in Internet retail activity that do not account for actual business activity. Therefore, the Forrester factors of 67% and 72%, which do account for changes in business models, are used as a starting point. These factors are then reduced by 6%, since Forrester Research estimates that 94% of the top 100 Internet retailers collect sales taxes in those states in which they have nexus.[42] In the absence of a factor specifically for retail sales, we used the retailer factor as the best available proxy. Finally, we assumed that 95% of mutlichannel retailers have nexus in Illinois, since the State has a large and diverse retail economy. Thus, the original 67% (2001) and 72% (2002) factors were reduced to 60% and 64%, respectively, representing the assumed percentage of Internet retail sales on which tax is already collected in Illinois.

4. The new Illinois Estimated Sales Tax Base for each year was then multiplied by the State tax rate of 6.25%. In order to include the 15% of sales that are taxed at a reduced rate of 1% (e.g., food and drugs), the calculations in Step 3 above were

[41] Carrie Johnson, "The Growth of Multichannel Retailing," A Forrester Research, Inc., document prepared for the National Governor's Association and the National Conference of State Legislatures, July 2004, p. 9.
[42] Carrie Johnson, p. 12.

applied to 15% of the Illinois Estimated Sales Tax Base and multiplied by a 1% tax rate. The result was then added to the result of Step 3 to constitute the Total Potential State & Local Sales Tax Revenue.

The resulting estimates for 2001 and 2002 are presented in Tables 5 and 6 below. They include both the total amount of remote retail transactions and the total for the subcategory of purely electronic commerce transactions. Total potential state and local revenue from all remote retailers is estimated to be $107 million for 2001, while electronic commerce transactions alone represent $25 million of that amount. These revenue amounts have to be divided between the state and local governments in which the transactions occur. The result is that in 2001 the State of Illinois could have reasonably expected $86 million in additional revenue from the taxation of all forms of remote retailing. Electronic commerce alone constitutes $20 million of that amount.

Table 5
Civic Federation Estimates
2001 Potential IL Sales Tax Revenue from
Remote Sales & E-Commerce

	($ Millions)	
Estimated Sales Tax Base	**Total**	**E-Commerce Only**
U.S.	$109,158	$25,145
Illinois Estimate (4.5% of U.S.)	$4,912	$1,132
Potential Sales Tax Revenue	**Total**	**E-Commerce Only**
State & Local Sales Tax Revenue	**$107**	**$25**
State Sales Tax Revenue	$86	$20
Local Sales Tax Revenue	$21	$5

Note: Figures may not sum due to rounding
Assumptions: 15% pay only 1% sales tax rate, and 60% already remit taxes in IL

On April 15, 2004, the U.S. Census Bureau released its estimates of electronic commerce for 2002. While total sales through mail order houses and electronic commerce increased by 4.9% between 2001 and 2002, electronic commerce by itself increased 28%, from $25 billion to $32 billion. However, when looking at electronic commerce in the context of total retail trade, it remains under 1% of the total. Using the same methodology described above reveals that the state could have expected a total of $101 million from the taxation of all remote sales in 2002, of which $28 million would have been the result of electronic commerce. The 2002 estimate is lower than the 2001 estimate due to the assumed increase in multichannel retail sales from 67% in 2001 to 72% in 2002.

Table 6 Civic Federation Estimates 2002 Potential IL Sales Tax Revenue from Remote Sales & E-Commerce		
	($ Millions)	
Estimated Sales Tax Base	**Total**	**E-Commerce Only**
U.S.	$114,480	$32,191
Illinois Estimate (4.5% of U.S.)	$5,152	$1,449
Potential Sales Tax Revenue	**Total**	**E-Commerce Only**
State & Local Sales Tax Revenue	**$101**	**$28**
State Sales Tax Revenue	$81	$23
Local Sales Tax Revenue	$20	$6

Note: Figures may not sum due to rounding
Assumptions: 15% pay only 1% sales tax rate, and 64% already remit taxes in IL

Conclusions – Potential Revenues

The available information indicates that policy makers in Illinois should be cautious about estimates of the sales tax revenue to be gained from joining the Agreement. There is insufficient evidence to support the popularly held belief that vast amounts of sales tax revenue are being lost due to retail sales on the Internet. Although the amount of retail sales conducted through electronic commerce is increasing at a rapid pace, economic and legal factors mitigate the amount of sales tax revenue to be gained through extending the sales tax to remote vendors.

The argument that sales tax collections are in decline as a result of the growth in electronic commerce should not be accepted at face value. There are many approaches to measuring sales tax collection trends. Other studies have concluded that sales tax collections are declining by looking at collections as a percentage of personal income.[43] When collections are examined as a percentage of Gross State Product and Gross Domestic Product, collections have remained stable during the time of greatest growth in electronic commerce.

There are two important factors that explain why sales tax collections would have remained stable during a time of dramatic increases in electronic commerce: (1) the vast majority of electronic commerce transactions would not have been taxable, and (2) many remote retailers already collect sales taxes. Illinois, as is customary throughout the United States, imposes taxes only on the end user of tangible personal property. The vast majority of transactions conducted by electronic means involve goods used in manufacturing, or goods sold at wholesale for the purpose of reselling those items, or services not involving the transfer of any tangible property. To the extent that any

[43] Donald Bruce and William Fox. "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates, " Center for Business and Economic Research, University of Tennessee, September 2001. Available at http://cber.bus.utk.edu/ecomm/ecom0901.pdf

percentage of those transactions would be subject to sales taxes in Illinois, the state's audit of business tax returns ensures a very high compliance rate. Furthermore, a new business model is becoming dominant in which companies integrate Internet retailing with traditional brick-and-mortar stores. Those merchants who also have a physical presence in the state must collect Illinois sales taxes.

The largest estimates of potential sales tax revenue do not properly account for the above-mentioned factors. For example, The University of Tennessee study starts with overestimates of electronic commerce activity. It includes too much business-to-business sales activity that would either not be subject to taxation or is the subject of voluntary compliance; and it includes business-to-consumer sales activity that would already be subject to taxation since the retailer likely has a physical presence in the State of Illinois.

Most evidence points to a figure of roughly $100 million that Illinois could have reasonably expected from the taxation of remote retailers in 2001 and 2002 had the Agreement been in effect. The Illinois Economic & Fiscal Commission, the Direct Marketing Association, and the projections made in this report support this conclusion. There is also a strong likelihood based on new estimates presented here that the amount of state tax revenue for e-commerce alone would be less than $50 million. While other studies have not accounted for either the distinction between electronic commerce and total remote retail sales or the presence of a business model that integrates remote sales with traditional brick-and-mortar stores, the new estimates developed in this section of the report account for both factors. Table 7 summarizes the findings of all the studies reviewed here.

Table 7
Estimates of State & Local Sales Tax Revenue
in Illinois from Remote Retailers & E-Commerce
($ Millions)

	2001		2002	
	All Remote Retail Sales	**E-Commerce Only**	**All Remote Retail Sales**	**E-Commerce Only**
Civic Federation				
State	**$86**	**$20**	**$81**	**$23**
Local	**$21**	**$5**	**$20**	**$6**
<u>Other Studies</u> **IL Ec. & Fisc.** (High Est.)				
State				**$46**
Local				**$11**
IL Ec. & Fisc. (Low Est.)				
State				**$23**
Local				**$6**
Univ. Tenn.				
State		**$426**		
Local		**$107**		
DMA				
State		**$45**		
Local		**$11**		

COMPLIANCE COSTS

This section is divided into four sections. The first three sections each examine areas in which fundamental changes to Illinois' sales tax system would be required. A fourth section briefly looks at several secondary changes that also merit consideration. The first section looks at how Illinois must change the way the location of sales are determined for tax purposes in order to conform with the requirements of the Agreement. The second area examines changes to the taxation of leased goods that may be required for Illinois to be in compliance with the terms of the Agreement. The third section is concerned with the required changes to the Service Occupation Tax and Service Use Tax, which extend the sales tax to tangible personal property transferred as part of an otherwise untaxed service transaction. The final area briefly addresses the Agreement's requirements that participating states have a single state and a single local sales tax rate, that states adopt a uniform set of definitions for administering the sales tax, and that they forego the ability to directly audit any retailer utilizing a third-party sales tax collection service provider.

Issues for Consideration

While additional sales tax revenue will be generated through taxing remote retail transactions, any balanced analysis of the Agreement must include the cost of the changes necessary to bring Illinois into compliance with the requirements of the Agreement. These changes will have ancillary impacts on state and local government revenue streams that could significantly offset potential revenue gains. Various costs of the changes will be borne either by state government, local government, or both. In other instances, consumers will be confronted with increases in the sales taxes paid on certain items. All of these impacts must be part of the public dialogue on the desirability of Illinois becoming a member of the Agreement.

Unfortunately, there is no authoritative guidance for Illinois to consult in making the required changes. Compliance with the Agreement is to be determined by the other states participating in the Agreement. Prior to the creation of a governing authority, a three-fourths vote of the other states seeking to be part of the Agreement determines whether or not a state is in compliance.[44] After the creation of a Governing Board, a similar three-fourths vote by the participating states is required.[45] However, as Illinois tries to determine if some components of its existing system are in compliance and if certain kinds of changes to other components would be in compliance, there is no way of determining with certainty if the other participating states or the eventual Governing Board will view the changes as acceptable. Only the terms of the Agreement, which in some instances can be interpreted differently by different individuals, can guide Illinois policymakers. If Illinois changes its laws prior to being granted the authority to compel the collection of sales taxes by out-of-state retailers, the only additional sales tax revenue to offset the cost of the changes would result from voluntary compliance by some retailers. Only the costs would exist unless or until remote retailers began voluntarily

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[44] SSTP Agreement Section 702, page 39.
[45] SSTP Agreement Section 804, page 41.

collecting sales taxes or the U.S. Congress granted states the authority to require the retailers to collect the taxes.

Sourcing Rules

Sourcing rules are how a state determines where a retail sale occurs for the purpose of imposing local taxes. When a consumer purchases and takes possession of an item at a store, the store's location determines which local tax applies. Sourcing rules become complicated when they apply to instances in which the goods are delivered, and the purchaser takes possession at a location other than the retailer's place of business. Under current Illinois law, retailers collect and remit the tax in effect at the business' location when a purchase order is accepted and the goods must be delivered. Compliance with the Agreement would require the State of Illinois to change its sourcing rules so that when goods are delivered, the place where purchaser takes possession of the goods determines the local tax to be applied.[46] At the state level, this would require changes to the current construction of Illinois' sales tax laws. At the local level, this would cause a redistribution of sales tax revenues between communities. Illinois must carefully evaluate both the legal and the financial implications of changing the construction of its sales tax laws to accommodate the requirements of the Agreement. At the minimum, a study should be conducted before changing existing laws that looks at the impact of shifting revenues and the fairness of diverting revenues from the municipality that provides infrastructure to support the retailer.

Destination Sourcing Requires Fundamental Changes

The complexity of this issue for Illinois is compounded by the way in which its "sales tax" is constructed. Technically, Illinois does not have a true "sales tax;" it has two distinct taxes that interact so that for all practical purposes a tax is collected from the purchaser by the retailer and remitted to the state. However, it is not a tax on the transaction. It is a tax on the occupation of being a retailer and a tax on the privilege of using goods purchased at retail. Therefore, retailers can claim that they are not conducting their occupation in a jurisdiction to which goods are only delivered and as a result are not liable to collect taxes in that jurisdiction. Compounding the problem, the General Assembly has only granted the authority to impose one half of the "sales tax" to local taxing jurisdictions. Currently, municipalities and other local taxing jurisdictions only have the authority to impose local retail occupation taxes, not local use taxes.

The development of the "sales tax" in Illinois began under the 1870 Illinois State Constitution, which was interpreted by the courts to limit the state's taxing authority to property taxes, occupation taxes, and franchise taxes.[47] As a result, the power to tax sales was deemed beyond the scope of state power since it was not explicitly authorized. To impose a "sales tax" the state was therefore forced to tax the occupation of selling goods at retail. The Retailer's Occupation Tax (ROT), adopted in 1933, is imposed on the gross

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[46] Section 310 of the SSTP Agreement provides the General Sourcing Rules. Section 805 requires that states seeking membership be in substantial compliance with each of the Agreement's provisions.
[47] *Bachrach v. Nelson*, 349 Ill. 579, 183 N.E. 909 (1932)

receipts of retailers conducting business within the State of Illinois at a rate of 6.25%.[48] Although the Illinois Supreme Court eventually changed its interpretation of the 1870 Constitution, and the 1970 Illinois State Constitution contained no comparable limitation on taxing authority, the ROT remains the fundamental method of taxing sales.[49]

Because the tax was imposed on the retailer and not the purchaser of the goods, an economic incentive was created for purchasers to buy from out-of-state retailers and have the goods delivered to Illinois. In 1955, the loss of business for Illinois retailers to out-of-state competitors led to the enactment of the Use Tax. The Use Tax is imposed on the "privilege of using in this State tangible personal property purchased at retail" at a rate of "6.25% of either the selling price or the fair market value."[50]

The retailer and the purchaser have independent tax liabilities that interact when the purchase is made from a retailer within the State of Illinois and effectively place the tax burden on the purchaser. When the purchase is made from a business located in Illinois, the retailer incurs a tax liability equal to 6.25% of the gross receipts from the sale. The retailer is also required to collect the Use Tax from the purchaser; and as long as the retailer remits its tax liability to the state, it is allowed to retain the Use Tax collected from the customer.[51] The practical effect of the interaction between these two laws is that the purchaser of retail goods pays a "sales tax."

When the purchase is made from a retailer outside the state, and the goods are delivered to Illinois, the Use Tax operates independently. No Retailer's Occupation Tax is due at the point of sale because the retailer is not considered to be conducting retail business in Illinois.[52] The purchaser is liable directly to the state of Illinois for 6.25% of the selling price of the goods purchased. Compliance is a legal requirement, and one that is observed by large corporate purchasers. Otherwise, except when the out-of-state retailer has a physical presence in Illinois and therefore has a statutory duty (that Illinois may constitutionally enforce) to collect the Use Tax from the customer and remit it to the state, the vast majority of individual purchasers ignore the requirement to pay the Use Tax and the state has historically made no effort to collect it.

While state statute authorizes certain local taxing jurisdictions to impose local Retailer's Occupation Taxes, it does not authorize non-home rule jurisdictions to impose a corresponding local Use Tax.[53] In the case of municipalities, the state authorizes the imposition of a local ROT in 0.25% increments through the passage of an ordinance.[54] The statute that allows the imposition of this local ROT also allows the retailer to pass the

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[48] 35 ILCS 120/2-10

[49] *Bachrach v. Nelson* was overruled in *Thorpe v. Mahin*, 43 Ill.2d 36, 250 N.E.2d 633 (1969). For interpretation of the 1970 Constitution, see *Hagerty v. General Motors*, 59 Ill.2d 52, 319 N.E. 2d 5 (1974).

[50] 35 ILCS 105/3 and 35 ILCS 105/3-10

[51] 35 ILCS 105/3-45

[52] See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)

[53] The exception is the City of Chicago, which under its home rule authority has adopted a Use Tax. The other exception to this statement is that the state permits the imposition local Use Taxes on the sale of motor vehicles.

[54] 65 ILCS 5/8-11

cost of the local tax on to the purchaser by including it in the charge for the state Use Tax.[55] Most purchasers perceive that they are liable for both the state "sales tax" of 6.25% and the local "sales tax." However, because there is only a local ROT that is imposed upon the gross receipts of the retailer, purchasers may not be legally obliged to pay the amount charged to them to reimburse the retailer for a local occupation tax liability.[56]

The current Illinois' "sales tax" laws therefore results in a clear Use Tax liability for purchasers of retail goods at the state level, but not at the local level. If the purchase of goods from a remote retailer were to be subjected to current Illinois law, it is possible that only the state's 6.25% Use Tax would be applicable. Simply changing the sourcing rules to make retail sales in which the goods are delivered to the purchaser taxable at the point of delivery would not necessarily allow local taxing agencies – other than the City of Chicago – to collect local sales taxes. Because it is not clear that a remote retailer is engaged in the occupation of selling at retail in a local jurisdiction just because the purchased goods are delivered there, the local ROT may not be sufficient to require the collection of local taxes on retail purchases made from remote retailers.

The simple solution is for the State of Illinois to allow local taxing jurisdictions the authority to impose local Use Taxes. Rather than merely permitting retailers to reimburse themselves for their tax obligation, this would explicitly place the tax liability on the purchaser of the retail goods. Unfortunately, the imposition of a local Use Tax does not end the problems associated with collecting sales taxes at the point of delivery rather than the point of order acceptance.

The problem can best be seen when a purchaser has goods delivered to one jurisdiction, but uses them in another jurisdiction with a different tax rate. For example, assume that a purchaser buys goods from a remote retailer and has those goods delivered to a city with a local Use Tax of 1%, but subsequently uses those goods in a city with a local Use Tax of 2%. The purchaser would be liable for the additional 1% Use Tax liability, but there would be no mechanism other than voluntary compliance or an audit of the customer for the state to collect the additional 1% Use Tax liability. Because of the economic incentive to have goods delivered to a low tax jurisdiction, purchasers of large amounts of retail goods may be encouraged to have goods delivered to a different location than the one in which the goods will be used. One suggested remedy is to legislatively declare that satisfaction of a Use Tax liability at the point of delivery satisfies all Use Tax liabilities regardless of where the goods are used. Although this simplifies compliance, it does not address tax avoidance strategies that may develop as a result.

While such tax avoidance strategies are in all probability not a severe problem at the state level, the state must adequately address the issue on behalf of the local jurisdictions that could be affected. It is not a problem at the state level because the size of the taxing jurisdiction effectively deters tax avoidance strategies. That is, it is only economically

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[55] 65 ILCS 5/8-11
[56] *Johnson v. Marshall Field*, 57 Ill. 2d 272 (1974)

advantageous to have goods delivered to a lower sales tax state and subsequently transported to Illinois in the case of very large-scale purchasers of retail goods. Such large-scale purchasers are highly likely to be subject to audits by the Illinois Department of Revenue and therefore are highly likely to voluntarily comply with the state's Use Tax liabilities. However, the state must be concerned with the fact that at the local level the scale of retail purchases for such a tax avoidance strategy to be economically advantageous diminishes. As the scale of the retail purchases involved in such a tax avoidance measure diminishes, the likelihood of voluntary compliance from the threat of audit also diminishes. Because the State of Illinois regulates the imposition of local "sales taxes" for both home rule and non-home units of local government, this is a difficulty with the sourcing requirements of the Agreement that must be addressed by the State of Illinois.[57]

Sourcing Changes Can Disrupt Local Economies

An immediate concern to Illinois' local and state governments is the fact that changing the sourcing rules for the imposition of the sales tax will redistribute existing sales tax revenues. The State of Kansas experienced tremendous difficulties in implementing changes in sourcing similar to those that Illinois would have to implement. The State of Washington recently completed a study that has serious implications for the amount of revenue that may be shifted as a result of changing the sourcing rules for sales taxes.[58] The Washington study also found that overall local tax revenue could decline as a result of transactions being taxed in lower tax rate jurisdictions. Finally, there are certain justifications for the current structure of sales tax distribution that must be addressed before changes to the system can be justified.

Currently, the State of Illinois observes "origination sourcing," meaning that the location of the retail store or the business location where the order is accepted determines the sales tax liability. In Illinois those engaged in the occupation of selling tangible personal property at retail are required to collect the appropriate tax in effect at their business location (regardless of whether or not the customer takes possession of the goods there) and remit those collections to the state. The state then distributes 20% of the state's sales tax collections back to local governments according to a formula that is partially dependent upon where the order is accepted.[59] Some local governments impose their own sales tax and this is also distributed to them based upon order acceptance. Therefore, sourcing rules impact all local jurisdictions, even those without a locally imposed sales tax.

The Agreement requires that participating states observe "destination sourcing," meaning that the point at which the purchaser takes possession of the goods determines the tax. For most transactions, the purchaser takes possession of the goods in the retail store or business location. These transactions will not be affected. For those transactions where the purchaser places an order in one taxing jurisdiction and has the goods delivered to

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[57] See Illinois State Constitution, Article VII.
[58] Washington Department of Revenue, "Streamlined Sales and Use Tax Agreement Sourcing Study," December 2003. Available at www.dor.wa.gov/docs/reports/FinalSourcingStudy03.pdf
[59] 30 ILCS 105/6z-18

another taxing jurisdiction, the tax revenue from the sale will move from the taxing jurisdiction in which the order was taken to the jurisdiction in which the goods were delivered.

The experience of the State of Kansas provides a cautionary example for Illinois of the impact from changing from origination to destination sourcing. The Kansas sales tax system was structured similarly to Illinois' system. It was a system of origination sourcing without a local use tax. In May 2003, the Kansas State Legislature passed House Bill 2005 and the Governor signed the legislation. The legislation instituted a local use tax and changed the sourcing rules from origination-based to destination-based. The effective date of the legislation was July 1, 2003. On July 2, 2003, Governor Kathleen Sebelius announced that implementation of the legislation would be delayed indefinitely. Enforcement of the new rules was then relaxed until January 1, 2004. As of March 2004, efforts were underway to postpone implementation of the legislation until Congress authorizes the collection of taxes on remote retailers.[60]

Implementation of HB 2005 became controversial among both small businesses and some local governments. Small businesses in the state stridently opposed the change to destination-based sourcing. Requiring these businesses to calculate tax liabilities based on the location to which products are delivered, rather than on the single tax rate in place at the store's location, places an additional burden on those businesses. Local governments are wary of the changes and are waiting for more evidence to determine if the legislation significantly disrupts their revenue streams. According to one report, "Thirty-four of 80 Kansas counties with a sales tax saw increases or decreases of more than 10% of revenue from the year before. Ninety-nine cities across the state saw changes of greater than 10%."[61]

A study conducted by the State of Washington is also informative for Illinois since Washington is also considering changing from origination to destination sourcing to comply with the requirements of the Agreement. In 2003 the Washington Legislature adopted Senate Bill 5783, which included several provisions of the Agreement and mandated that the Department of Revenue conduct a study of the fiscal impact of changing from origination to destination based sourcing. The "Streamlined Sales and Use Tax Agreement Sourcing Study," was released in December 2003.[62] The study finds that changing the sourcing rules would affect 15% of taxable sales in the state. The total value of those sales, or the sales tax base, amounts to $12.9 billion. An estimated 97 municipalities and 5 counties would lose revenue, while 184 cities and 34 counties would gain revenue. In the majority of cases the change in revenue was less than 10%, but a large enough amount of local government revenues was affected to initiate a call for legislation to protect those jurisdictions that would lose money. The study determined that business hubs, jurisdictions with large numbers of warehouses, and jurisdictions with high population bases tended to lose revenue. To the extent that there was a shift from a

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[60] Jim Sullinger, "Kansas House Tentatively OKs Suspension of Sales Tax System," The Kansas City Star, March 9, 2004.
[61] Joel Mathis, "Sales Tax Fortunes Reversed," Lawrence Journal-World. December 18, 2003.
[62] Available at dor.wa.gov/docs/reports/FinalSourcingStudy03.pdf

higher tax rate jurisdiction to a lower tax rate jurisdiction, there was also an overall loss in revenue.

Finally, the existing system of origination sourcing is founded upon a rationale that would be completely overturned by changing to a system of destination sourcing. To provide an environment attractive to retailers and other businesses, cities and counties across Illinois have for many years invested public funds into making improvements in their fire and police protection, water and sewer systems, and in modernizing transportation systems and infrastructure. These communities anticipated that building and maintaining high quality public infrastructure would generate tax revenues from the businesses attracted by their investments. This justification for the distribution of sales tax revenues to the localities supporting the order distribution centers must be addressed in any effort to change the current souring rules.

Conclusions Regarding Changes to Illinois' Sourcing Rules

The changes to the state's sourcing rules necessary for Illinois to come into compliance with the requirements of the Agreement present a number of difficulties for both the state and local governments. Fundamental changes are required to the technical components of Illinois' "sales tax" that will raise questions about decades of established legal practices and decisions. In addition to legal difficulties, these changes are likely to confront the state with both political and economic burdens. Local governments are likely to experience dislocations in existing revenue streams, but cannot be guaranteed additional revenues from the taxation of electronic commerce and remote sales.

Changing from origination sourcing to destination sourcing would necessitate a fundamental alteration of the nature of Illinois' sales tax. Since its inception, Illinois' "sales tax" has actually been a tax on the occupation of selling tangible personal property at retail. The Use Tax, which is legally distinct and operates in a fundamentally different manner, is imposed on the privilege of using goods purchased at retail and is due whether or not it is collected by the retailer. If the retailer collects it, the Use Tax serves as a reimbursement for a tax liability stemming from the occupation of retailing. With the exception of Chicago, there is currently no authorization for local jurisdictions to impose a corresponding Use Tax. Furthermore, a change to "destination" sourcing cannot guarantee that the appropriate Use Tax liability is satisfied.

More fundamentally, such sourcing changes would arguably transform a tax on an occupation into a tax on a transaction, which would constitute a fundamental change in both law and practice. Retailers may be able to claim in court that they cannot be forced to collect taxes in a jurisdiction where they are not engaged in the occupation of retailing. Illinois case law is premised on the ROT being imposed on an occupation, with tax liability measured by gross receipts.[63] For example, a recent decision from the Illinois Appellate Court stated, "Although the amount of the tax is based on the value of the products sold, the tax is on the seller and the seller's business, not on the product or the

[63] See Soho Club, Inc. v. Department of Revenue, 269 Ill. App. 3d 220, 228-29, 645 N.E. 2d 1060, 1066 (1995).

consumer."[64] The courts have also made clear that the tax is on the occupation, not on the transaction.[65] Determining a retailer's tax liability based upon where a consumer takes possession of the goods shifts the determination of tax liability from the retailer's gross receipts to individual transactions. The retailer's gross receipts would be subdivided into individual transactions, and the tax liability associated with each transaction would be individually determined. Such a scenario is especially relevant should local taxes be applied based on destination sourcing. Each delivery to a different jurisdiction could potentially result in a unique tax liability for that portion of the retailer's gross receipts. Decades of legal decisions could potentially be brought into question with Courts forced to reinterpret the appropriateness of well-settled practices.

Changing to destination sourcing would impact local government revenues in a number of ways. Cities and counties with warehouse facilities stand to lose virtually all the tax generated by those facilities. Those facilities are, under the sales tax rules in place today, considered "places of business" of the retailer and those communities receive the sales tax imposed on sales shipped from those warehouses where an order is accepted to customers throughout Illinois. Other communities that could suffer revenue loss from the Agreement's sourcing rules would be those having regional shopping centers within their borders. To the extent that customers have products delivered to their homes or places of business, the sales tax generated at the shopping center will follow the goods to surrounding communities. Particularly at risk are communities with regional shopping facilities that are surrounded by communities having lower overall sales tax rates. To the extent that the goods are delivered to lower tax rate jurisdictions, overall sales tax revenue could decline.

The dislocations caused by changing to destination sourcing may not be worth the price, if those changes are made prior to seeing any benefits from compliance with the requirements of the Agreement. Kansas discovered that changing to destination based sourcing before any of the proposed benefits of the Agreement are realized increases tax compliance costs for businesses. Until the Agreement is operational, there are no intermediaries to perform the seller's sales and use tax functions. Local businesses, never faced with calculating multiple sales tax liabilities before, are confronted with the responsibility of determining which of the hundreds of different local sales tax rates must be applied when goods are delivered. Likewise, in the absence of any ability to encourage or require the collection of sales taxes on remote sales transactions, local governments could see sales tax revenues decline as a result of changes to sourcing rules without any offsetting increases from taxing remote retail sales.

The political and economic costs Illinois can expect are similar to those experienced in Kansas and projected for Washington. In Kansas, local businesses oppose the increased burden of determining the appropriate tax rate in each jurisdiction to which they deliver goods; and local governments, which lose a portion of their current local sales tax revenues, oppose the changes to existing law. The political costs experienced in Kansas

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[64] *Subway Restaurants of Bloomington-Normal, Inc. v. Topinka*, 322 Ill. App. 3d 376, 381, 751 N.E. 2d 203, 208 (2001) citing Soho Club, Inc. v. Department of Revenue (1995).
[65] *Central Television Service, Inc. v. Isaacs*, 27 Ill. 2d 420, 426 (1963).

result from decision-makers failing to anticipate the negative consequences of changing sourcing rules on these constituencies. Illinois should seriously consider the approach of making implementation of the changes contingent upon Congressional authorization to collect sales taxes on remote transactions. In Washington, there is another method of addressing these issues, which would also have economic implications. There is discussion in Washington of creating a "hold-harmless" fund that would reimburse local governments for revenue lost as a result of sourcing rule changes until those governments could impose taxes on remote sales. Such an idea might also be necessary in Illinois to prevent certain local governments from losing an unacceptable amount of sales tax revenue.

While modeling the impact of the Agreement's sourcing rule on Illinois communities is beyond the scope of this report, applying some of the results of the Washington Department of Revenue study to Illinois' sales tax collections can shed light on the degree to which local government sales tax revenue could be impacted. The Washington study determined that changing from "origination" to "destination" sourcing would impact 15% of the total value of all retail sales transactions subject to local sales taxes. The approximate amount of local sales tax revenue that would shift between jurisdictions amounted to 1.9% of all local sales taxes collected in 2002. Applying those percentages to the State of Illinois' local sales tax collections 2001 shows the total value of all retail sales transactions impacted would be approximately $18.75 billion.[66] The amount of local sales tax collections shifted between jurisdictions would amount to $41.9 million. The State of Illinois should conduct a study similar in methodology to the one conducted in Washington so that policymakers can make a more informed judgment about the costs associated with changing to destination based sourcing.

Table 8
Estimated Impact of Sourcing Rule Changes on Local Sales Tax Revenues

	$ millions	Factor
Washington State 2002		
Estimated Value of All Sales Transactions	$86,000	
Estimated Value of Sales Transactions Impacted	$12,900	15.0%
Total Local Sales Tax Revenues	$1,793	
Approximate Sales Tax Revenue Shifted	$34.0	1.9%
Illinois 2001		
Estimated Value of All Sales Transactions	$125,000	
Estimated Value of Sales Transactions Impacted	$18,750	15.0%
Total Local Sales Tax Revenues	$2,210	
Approximate Sales Tax Revenue Shifted	$41.9	1.9%

[66] Calculations based on Washington Department of Revenue, "Streamlined Sales and Use Tax Agreement Sourcing Study," December 2003, available at www.dor.wa.gov/docs/reports/FinalSourcingStudy03.pdf, and Illinois Department of Revenue, Annual Report of Collections and Distributions, Fiscal Year 2002.

Leased Property

In the first several years following implementation of the changes required by the Agreement, the single largest revenue impact from coming into compliance with the requirements of the Agreement could be a sharp loss of revenue resulting from a shift in the taxation of leased personal property. Under current Illinois law, the person or business leasing the property to others (lessor) is generally considered the end-consumer of the property and all sales taxes are imposed at the time the lessor purchases the goods. The state does not tax the gross receipts received from the subsequent leasing of tangible personal property. While there is considerable debate on the issue, the Agreement may require that the lessor not be taxed at the time the goods are purchased, but be required to collect tax on the subsequent stream of lease payments during the time that the property is used in Illinois. If Illinois must make such a change in order to comply with the Agreement, the current stream of revenue from the sales and use taxes on leased goods would be disrupted. If Illinois is accepted into the Agreement without making a change, legal challenges to Illinois' compliance with the Agreement may arise.

Current Taxation of Leased Property in Illinois
In general, the State of Illinois does not tax the leasing of personal property, but local jurisdictions can, and the City of Chicago does.[67] Both the Retailer's Occupation Tax (ROT) and the Use Tax only tax the transfer of title or ownership.[68] The statute is silent on leases except with regard to property otherwise exempt from taxation, in which case the exemption is specifically extended to goods purchased for leasing.[69]

The Illinois Administrative Code specifies how tangible personal property purchased by a lessor is subject to the ROT and the Use Tax.[70] The Code states that the gross receipts from bona fide rent or lease agreements are not subject to the ROT because such lessors are not "engaged in the business of *selling* tangible personal property to others" (emphasis added).[71] However, leases structured to result in a sale, such as leases that give the lessee the right to buy the property by paying a nominal price, are considered conditional sales and are therefore subject to the ROT. Aside from a few, minor exceptions, the person or entity that purchases tangible personal property for bona fide rental or leasing to another is considered the end user of the goods. Therefore, the lessor is subject to the Use Tax on the purchase price of the goods at the time of purchase.

City of Chicago Lease Tax
The City of Chicago currently imposes its own tax on the use of leased personal property within the City.[72] The tax is imposed on leases of tangible or intangible property other than real property at a rate of 6% of the rental or lease price. The lessee pays the tax at

[67] Exceptions include the Automobile Renting Occupation Tax (35 ILCS 155), which covers automobile renting or leasing for periods of 1 year or less. See also IL Adm. Code Sec. 130.2010 (a) and (c).
[68] See 35 ILCS 120/1, definition of "sale at retail."
[69] For examples see 35 ILCS 105/3-5 and 35 ILCS 120/2-5. Examples include product based exemptions and sales to charitable or governmental institutions.
[70] 86 IL Adm. Code Sec. 130.2010
[71] 86 IL Adm. Code Sec. 130.2010 (b)
[72] Chicago Municipal Code, Chapter 3-32 Chicago Personal Property Lease Transaction Tax

the time of each lease payment, and it is the responsibility of the lessor to remit the payments to the City.

SSTP Agreement Requirements for Leased Property

Although the terms of the Agreement do not specifically address the manner in which Illinois taxes leases, the way in which leases are handled in the Agreement indicates that the taxation of leased property is to be based on each of the individual lease payments. Two specific components of the Agreement indicate that Illinois may not be in substantial compliance with the Agreement's requirements for the taxation of leases. The first is the definition of retail sales or sales at retail. The second is the manner in which the taxation of leases is handled under the sourcing requirements of the Agreement.

The agreement defines retail sales or sales at retail as meaning "any sale, *lease, or rental* for any purpose other than for resale, sublease, or subrent" (emphasis added).[73] Thus, the Agreement's definition of a retail sale considers leases to be retail sales. This definition directly contradicts the Illinois Administrative Code, which states that leases are not the selling of tangible personal property.[74] Under Section 327, the Agreement outlines the policies to which each state must adhere in regard to definitions.[75] It requires each member state to use the common definitions provided in the Agreement in its "statutes or administrative rules or regulations." Member states are prohibited from using a definition that is contrary to the meaning contained in the Agreement.

While there is no explicit requirement that leases must be subject to the sales tax, the provisions covering exemptions and sourcing indicate that leases are considered to be subject to the sales tax. The exemption provisions provide for product-based, use-based, and entity-based exemptions.[76] However, they do not provide for a transaction-based exemption, i.e. exempting a sale in which title or ownership is not transferred. The taxation of leases is also covered extensively in the General Sourcing Rules of the Agreement.[77] The rules for sourcing contained in Section 310 of the Agreement treat each individual lease payment as being subject to sales tax. The Agreement states that a tax on leases requiring recurring periodic payments is determined by the location at which the goods are received for the first payment, and subsequent payments are taxed at the address indicated by the lessee as primary location of the lessee. When there are no recurring payments, the point at which the lessee receives the goods is the source for taxation. The taxation of transportation equipment occurs either at the primary address of the lessee or the point at which the lessee receives the goods. Because the Agreement specifically defines the manner in which leases are subject to taxation, it may be necessary for the State of Illinois either to specifically exempt lease payments from its sales and use taxes or to tax lease payments rather than the purchase of goods to be leased.

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[73] SSTP Agreement Appendix C Part I pg. 58
[74] 86 IL Adm. Code Sec. 130.2010 (b)
[75] SSTP Agreement Section 327: Library of Definitions pgs. 31-32
[76] Section 315 and Section 316, pgs 21 – 22
[77] Section 310 - B, Streamlined Sales and Use Tax Agreement, Adopted November 12, 2002

The City of Chicago's locally imposed tax on leases of personal property also appears to be in conflict with the requirements of the Agreement. The Agreement requires that state and local jurisdictions have identical tax bases by December 31, 2005.[78] Prior to December 31, 2005, states seeking to comply with the requirements of the Agreement must have common sales tax bases throughout all local taxing jurisdictions. Because the Agreement requires a common state and local sales tax base, whatever the State of Illinois must do to comply with the terms of the Agreement affects the City of Chicago's Lease Transaction tax. If the state specifically exempts lease payments from its sales tax, it would be difficult to distinguish the City of Chicago's taxation of those payments as something other than a sales tax, which would mean the state and local sales tax bases would be inconsistent. If Illinois must make individual lease payments subject to sales and use taxes, the uniform tax base requirement of the Agreement would force Chicago to tax leases under the sales tax rather than the lease tax and would provide a temporary disruption in the state's current collection of sales taxes from leased property.

Reasons Why the Need for Change is Unclear

The construction of the Agreement does not provide clarity on whether or not Illinois would be able to continue taxing leases in the current manner. At present, the Agreement has not obtained enough states seeking membership to create a Governing Board with the authority to definitively answer questions such as this. Without such an entity to provide guidance, no one can say with certainty whether or not Illinois would be able to join the Agreement with its current treatment of leases in place.

States currently seeking membership in the SSTP are required to submit a petition certifying their compliance with the terms of the Agreement to each of the other states seeking to participate in the project. Once a minimum threshold of petitions is received, a meeting will be called where the petitioning states vote on whether or not each of the other petitioning states is in compliance with the Agreement. A three-fourths vote is required for a state to be found in compliance. The Agreement indicates that "substantial compliance" with each provision of the Agreement is a requirement for admission into the organization formed by participating states.[79] The unanswered question is whether or not the other states participating in the project interpret "substantial compliance" to include taxing individual lease payments rather than the purchase of goods by the lessor. If Illinois must change the way it taxes leases, the state and the City of Chicago could see significant disruption to revenue streams from taxes on the leasing of tangible personal property. Even if the Governing Board determined that Illinois does not need to change the way it taxes leases, a successful court challenge to the issue of compliance would jeopardize Illinois' ability to collect the tax or its continued participation in the Agreement.

Revenue Impact of Change Would Be Substantial

If "substantial compliance" with the terms of the Agreement is interpreted to mean that Illinois must change from taxing the full purchase price of the goods at the point at which they are purchased by the lessor to taxing the revenue stream of the lease, such a shift in

[78] SSTP Agreement, Section 302: State and Local Tax Bases, pg. 10
[79] Section 805: Compliance, pg. 41

policy would serve to defer most of the state revenue generated by taxing the purchases of property for lease and Chicago's Lease Transaction Tax would have to be repealed. A significant shortfall in state and local tax revenues would be inevitable in the short-term. While it is beyond the scope of this report either to predict how substantial compliance will be interpreted by the Governing Board or to attempt to quantify the full impact of this change, the magnitude of the issue becomes clear from examining the City of Chicago's Lease Transaction Tax and information on state sales tax collections from just of two types of property commonly leased: automobiles and computers.

Repeal of the 6% City of Chicago Lease Transaction Tax would have eliminated a $100 million revenue source for the City in 2002. According to the FY2002 City of Chicago Comprehensive Annual Financial Report, the Lease Transaction Tax generated $100 million. As discussed above, compliance with the Agreement may require the City to repeal this tax. In such an event the current revenue stream would be entirely lost, but other changes would also occur. First, the taxation of lease payments under the sales tax would generate some revenue for the City. Lease payments would be subject to the state ROT rate of 6.25% (of which a rate of 1.25% is dedicated to the City) as well as the City's Home Rule Retailers Occupation Tax rate of 1%. These two tax rates could have generated approximately $33 million for the City of Chicago in 2002. On the other hand, the City will lose sales tax revenue currently collected from the purchase of goods for the purpose of leasing. Purchases made by lessors in the City of Chicago currently contribute to the City's sales tax collections. Although it is beyond the scope of this report to determine the amount of revenue currently generated by sales to lessors, it is assumed here that it would offset the amount of revenue gained by taxing individual lease payments.

Table 9
Estimated Impact of Taxing Leases Under the Sales Tax Rather Than The Personal Property Lease Transaction Tax

	$ millions		$ millions
	Revenue	**Tax Rate**	**Est. Tax Base**
Current City Revenue			
FY2002 Lease Transaction Tax	$100	6%	$1,667

At the state level, a disruption in sales tax revenue could occur in the first few years as a result of a change in the timing of sales tax collections. Instead of being collected on the selling price at the time the goods are purchased, collections will occur on the smaller, monthly lease payments. The revenue loss to the state would be the greatest in the first year after such a change, and it would diminish over time as tax collections on lease payments approached the amount of revenue lost on the purchase of the goods.

The first example of the first-year revenue impact involves automobile leases. Lessors of automobiles for lease terms in excess of one year are required to pay sales tax on the cost price of the vehicle, but are not required to collect sales tax on the lease payments. The Illinois Department of Revenue reported that for Fiscal Year 2002 the total sales tax paid by businesses classified under SIC codes 5511 and 5521 (new and used car dealers) was approximately \$1.5 billion.[80] Assuming that 20% of the new and used car sales were leases rather than sales, approximately \$300 million in tax revenue would go uncollected in the first year following implementation of SSTP changes.[81] Rather than being collected at the time the vehicle is placed into service, the sales tax collection would be deferred over the life of the lease, and ultimately collected on the eventual sales price when the vehicle is sold. Assuming that the sales price of those automobiles was \$4.8 billion, and those vehicles are placed in three-year lease agreements at 6% interest and 50% depreciation, only \$64 million would be collected in the first year from taxing the lease payments. The first few years after such a change would create a significant disruption to state and local finances. However, the only permanent tax loss would result from any residual value of the leased property that is not taxed. This would occur if the lessee terminated the lease early in order to buy the vehicle.

Table 10
Estimated First Year Impact of Taxing Automobile Lease Under the Sales Tax Rather Than at the Time of Purchase

	\$ millions		\$ millions
	Revenue	**Tax Rate**	**Est. Tax Base**
Current State Revenue			
Assuming 20% Revenue from Leased Vehicles	\$300	6.25%	\$4,800
New State Revenue			
Assuming 20% Revenue from Leased Vehicles			\$4,800
3 year leases - 50% residual value - 6% interest	\$64	6.25%	\$1,016
Difference in Tax Revenue	\$236		

The second example involves changes in the taxation of leased computer equipment, which were the subject of earlier legislative initiatives.[82] An exhaustive study of the legislation's potential impact performed by KPMG, LLP regarding the legislation provides an estimate of the revenue impact related to shifting from the current "up-front" tax on leases of computers to a tax on the rental stream. The authors of the study estimated that the first year impact would be a decrease in state sales tax of \$14.5 million and a decrease in local government sales tax of \$3.7 million excluding the loss of Home Rule Retailer's Occupation Taxes. This loss to local government revenue related to Home Rule Retailer's Occupation Taxes was not estimated in the study. The combined first year loss of more than \$18 million on the lease of computers alone portrays the

[80] Illinois Department of Revenue SIC Reporting System Sales Tax for FY 2002 published 09-05-02. Revenue from SIC 5511\$1,360,000,553.72. Revenue from SIC 5521 \$137,367,537.10.
[81] The national average lease versus purchase rate is approximately 30% according to figures provided by a "big-three" domestic automobile manufacturer's finance division.
[82] The state legislature did **not** pass Senate Bill 0666 (The Qualified Technological Equipment Leasing Occupation and Use Tax Act) in the 91st Illinois General Assembly, which was known as House Bill 0533 in the 90th Illinois General Assembly.

magnitude of shifting the collection of taxes on leases away from the full taxation at the time the leased property is purchased by the lessor.

These are just two examples of the wide range of leased, personal property. The tax treatment of other leased goods such as construction equipment, industrial machinery, photocopiers, and other office equipment would likely be affected if Illinois joined the Agreement. The immediate revenue impact would therefore be much greater.

Conclusions Regarding Leased Property

The apparent incompatibility of Illinois' treatment of leased property with certain sections of the Agreement raises serious questions for policymakers. Based on the observations made in this section, there is reason to believe that the current construction of the Agreement does require Illinois to change the way it taxes leased goods. If Illinois' current method of taxing leases is incompatible with the requirements of the Agreement, the City of Chicago's Lease Transaction Tax would likely have to be repealed and the state would experience dramatic initial declines sales tax revenue.

Furthermore, opinions on the compatibility of Illinois' treatment of leased goods made prior to a definitive answer from either the Agreement's Governing Board or a three-fifths majority of the participating states are unsubstantiated. While some supporters who have examined the issue predict that Illinois' taxation of leased goods will not have to be changed in order to comply with the Agreement, they cannot guarantee that outcome. Prior to the creation of a Governing Board to rule on such issues, the Agreement requires states seeking to become members to submit a petition.[83] A three-fifths vote of all petitioning states is required for a state to be found in compliance with the terms of the Agreement. Once states are found to be incompliance with the terms of the Agreement, decisions are to be made by a Governing Board consisting of 4 representatives from each member state. A majority vote on the Board is required for any action.[84] Prior to other participating states' representatives voting on the issue in either of these two methods, there is no certainty of Illinois' system of taxing leased goods being in compliance with the requirements of the Agreement.

Finally, even if the participating states view Illinois' current system as being in compliance with the Agreement, the reasoning behind such a decision may be challenged in court. The Agreement states that compliance cannot be the grounds for any legal action based on the contention that a state or a political subdivision of a state is not in compliance with the requirements of the Agreement.[85] However, those seeking to invalidate certain actions of a state, which they deem to be inconsistent with the terms of the Agreement, are likely to bring action nonetheless.

These serious questions must be addressed before the Illinois General Assembly takes any final, binding actions to come into compliance with the Agreement. The revenue loss

[83] SSTP Agreement, Section 702, page 39.
[84] SSTP Agreement Section 806, page 41.
[85] SSTP Agreement, Section 1103, page 49.

to the City of Chicago, the dislocation of state revenue streams, and the potential for litigation must all be carefully weighed.

Service Occupation Tax

In Illinois, services – except telecommunications, natural gas, automobile rentals and hotel occupancy services – are not subject to sales taxes. The Service Occupation Tax (SOT) and the Service Use Tax (SUT), however, apply to every transfer of tangible personal property made incident to a seller's provision of a service.[86] The SOT and SUT provide the conditions specifically tailored to transfers of tangible personal property in conjunction with the provision of services.

Current Construction of Service Occupation & Use Taxes

The SOT is imposed on the service provider. The SUT is imposed directly on the service provider's customer and is intended to complement or "backstop" the SOT, just as the Use Tax complements the Retailer's Occupation Tax ("ROT"). The sales tax on service providers and service purchasers is calculated in one of four different ways, depending on the extent to which the service provider transfers goods as part of his service business, the service provider's decision to itemize or not itemize the portion of the selling price on his invoice, and the serviceman's registration status with the Department of Revenue.

Which of the four methods applies depends first on whether the service provider is a regular or a "*de minimis*" service provider.[87] This distinction in turn depends on the price paid by the service provider for the tangible personal property transferred in relation to the service provider's service sales. If the total cost to the service provider of the tangible personal property transferred during a year is more than 35% of the service provider's gross receipts from service transactions, the first two methods of calculating SOT and SUT apply (the ratio is 75% for a service provider transferring prescription drugs or engaged in graphic arts production). If the service provider's ratio is less than 35% for the year, the serviceman would be a "*de minimis*" serviceman and the two other methods for calculating sales tax would become applicable. For example, an auto mechanic who installs parts for which he paid $5,000 has gross receipts of $50,000 from his service business for the year (5000/50000=10%). This mechanic would be a "*de minimis*" serviceman.

If the cost ratio is greater than 35%, the service provider must register with the Department of Revenue and remit the SOT. If the service provider itemizes the selling price of the tangible personal property on the invoice, he is liable for the 6.25% SOT on the itemized selling price (Method 1). If the service provider does not itemize the price of the tangible personal property, he must pay the 6.25% SOT on 50% of the entire invoice for both goods and services (Method 2). In no event, however, can the SOT be based on an amount less than the service provider's cost price of the property transferred.

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[86] See 35 ILCS 115 and 35 ILCS 110 respectively.

[87] "De miminis" is an abbreviation of a longer Latin phrase "de minimis non curat lex," meaning "the law is not concerned with trivial matters."

If the serviceman's cost ratio is less than 35% of gross receipts from his service business for the year, the service provider is considered "*de minimis*" and has two methods for calculating sales tax, which depend on whether or not the service provider is already registered with the Department of Revenue under the Retailers Occupation Tax (because the service provider also acts a retailer with respect to other tangible personal property sales). If the service provider is already registered as a retailer, he or she must collect the 6.25% SOT on the cost price of the goods, rather than the selling price (Method 3). In this case, the tax is limited to the cost price of the goods whether or not the provider itemizes the portion of the price attributable to the goods on his invoice to the purchaser. If the *de minimis* service provider is not required to register with the Department of Revenue as a retailer, he is considered the end user of the goods and is liable for the Use Tax on any purchases he makes (Method 4). Such a service provider may separately bill an amount equal to his Use Tax liability to the customer, but any itemized charge on the invoice must be clearly identified as a reimbursement and may not be characterized as a tax.

The resulting four-part test for determining the tax liability on a service provider's transferring of tangible personal property can be summarized in the following manner:

1. Over the 35% threshold the SOT may be imposed on the **separately stated selling price** of the property transferred to the service customer.
2. Over the 35% threshold the SOT may be imposed on **50% of the entire bill** if the tangible personal property portion is not itemized.
3. Under the 35% threshold the SOT is imposed on a "registered *de minimis*" service provider on the provider's **cost price** of the property transferred to the customer.
4. Under the 35% threshold the Use Tax is imposed on an "unregistered *de minimis*" service provider's **cost price** of the property transferred.

To illustrate the above requirements, a hypothetical example of two repairmen is useful. Over the course of one year, Repairman #1 pays $35 for parts that are installed as part of the repairs and charges a total $100 for both parts and labor. Repairman #2 also pays $35 for the exactly the same parts, and he does exactly the same work. However, Repairman #2 charges a total $102 for both parts and labor. Repairman #1 is liable for SOT on the price he charged the customer for parts if the bill is itemized, or if the bill is not itemized he is liable for SOT on $50 in gross receipts. If Repairman #2 is already registered with the Department of Revenue, he is liable for SOT on the $35 he paid for the parts. If he is not registered, he pays Use Tax to his parts supplier.

How the Service Occupation & Use Taxes Contradict SSTP Requirements

While the Agreement does not specifically address the taxation of services, changes to the Illinois Service Occupation Tax and Service Use Tax would be required to conform to the Agreement. For both legal and administrative reasons, the second and third methods of imposing the tax would have to be eliminated. Service providers registered with the Department of Revenue would be subject to the SOT, and service providers not registered with the Department would be subject to the Use Tax on their purchases.

The most relevant requirement for a uniform tax base is contained in Section 323 of the Agreement. This section requires that member states not have any caps or thresholds on the application of state sales or use taxes or exemptions after December 31, 2005.[88] The 35% cost ratio is essentially a threshold test that provides for different methods of imposing the same tax. The SOT Act imposes a differential tax burden based on a threshold test applied to the service provider's receipts. It states that for "sales of service in which the aggregate annual cost price of tangible personal property transferred as an incident to the sales of service is less than 35%…the tax imposed by this Act shall be based on the serviceman's cost price."[89] In order to comply with the prohibition on thresholds or caps, the determination of tax liability through the threshold tests contained in the Illinois SOT would have to be eliminated. Second, the Retailers Occupation Tax is imposed on the "total selling price" of retail goods.[90] Therefore, to maintain a consistent tax base the application of the SOT would have to also be on the sales price, not the cost price, of the goods.

Also potentially relevant is Section 316 of the Agreement, which prohibits member states from having partial exemptions of certain products. Subsection (A) states, "if the Agreement has a definition for the product or for a term that includes the product, a member state may exempt all items included within the definition but shall not exempt only part of the items included within the definition unless the Agreement sets out the exemption for part of the items as an acceptable variation."[91] The definitions of both purchaser and seller, which are core definitions in Article II of the Agreement, include both tangible personal property and services as goods potentially subject to taxation. Goods or services are clearly indicated to be potential subjects of taxation. As such, they must either be completely exempted or completely subject to the tax. Under the second method--in which the service provider elects not to itemize the selling price of the tangible personal property on the bill—the provider is liable for tax on 50% of the entire bill. This amounts to either a partial exemption from taxation for the tangible personal property being transferred or a partial exemption for the services being provided.

Furthermore, simplified administration of the SOT is necessary to facilitate the collection of taxes from out-of-state vendors. Section 303 of the Agreement requires each member state to participate in an online registration system that will facilitate the collection of sales taxes from out-of-state vendors.[92] Registration constitutes an agreement by the seller to collect and remit sales and use taxes into any member state.[93] The registration process includes selecting a method of remitting sales and use taxes.[94] The seller may choose to use an agent (known as a Certified Service Provider or CSP) to perform all the seller's sales and use tax functions (except remittance of sales tax on the seller's own purchases), or it may choose to utilize a software system approved for this purpose.

[88] SSTP Section 323: Caps and Thresholds, pgs. 29-30.
[89] 35 ILCS 115/3 – 10
[90] 35 ILCS 120/1 "gross receipts" and "selling price"
[91] SSTP Agreement Section 316: Enactment of Exemptions, (A) pg. 22
[92] SSTP Section 303, pgs. 10-11
[93] SSTP Section 401, pg. 33
[94] SSTP Section 403, pg. 34

In the case of an out-of-state service provider registering to use a CSP, the CSP would not be able to determine an appropriate tax liability in Illinois under the current SOT regime. Both the second and third methods require knowledge of the cost price of the tangible personal property to determine tax liability. The second method is not permitted if the tax liability on 50% of the total bill is less than the tax liability on the cost price of the goods; and the third method calculates tax liability based on the cost price of the goods. Since the CSP would have no knowledge of the seller's cost price of the goods, it would be administratively impossible for the CSP to calculate the appropriate tax liability. The only viable method is for a registered service provider to be liable for SOT on the itemized selling price of the tangible personal property and for an unregistered service provider to be considered the end user of the goods, subject to the appropriate use tax.

Conclusions Regarding the Service Occupation & Use Taxes

In order for a third party CSP to administer Illinois' SOT and SUT, and perhaps for the state to be in substantial compliance with the terms of the STTP Agreement, the second and third methods of imposing the tax would have to be eliminated.[95] The new construction of the taxes would still impose a tax on the transfer of tangible personal property incident to the provision of services, but a simplified structure would have to be adopted. The information necessary to analyze the revenue impacts of such a change is not available. However, it is not unreasonable to predict that because the sales price of goods is higher than the cost price, the amount of sales tax revenue generated is likely to increase. The challenge for the State of Illinois is likely to be from those service providers currently paying the SOT and SUT, who may oppose any changes to the current system.

In order for a third party to administer the taxes, and to comply with the requirements of the Agreement, Illinois could amend the SOT and SUT so that the tax is always imposed on the itemized sales price of the goods. All service providers registered with the Department of Revenue would be subject to the tax. Any service provider not registered with the Department of Revenue would be considered the end-user of the goods, and be liable for the Use Tax at the time he purchases the goods. This solution would not only establish a feasible method of administering the SOT, it would replace a threshold test on the application of the tax to a description of those service providers required to register with the Department of Revenue. Instead of imposing different tax liabilities based on the value of transactions over the course of one year, the "*de minimis*" criterion would determine whether or not a service provider is required to register. Anyone required to register would be subject to the SOT. Any service provider not required to register with the Department would have to pay the Use Tax on his purchases.

[95] While the SSTP Agreement does not specifically address the taxation of goods transferred incident to the provision of services, there is a very high likelihood that changes to the administration of these two laws would be necessary to conform to the requirements of the Agreement. Both the SOT and SUT are part of the 4 separate laws constituting the state's sales tax structure. As such they are, in all likelihood, subject to the requirements of the Agreement. If nothing else, the multiple tax bases currently in place for the SOT and SUT violate the spirit of the Agreement, which is to create a uniform tax base.

Returning to the hypothetical situation described above illustrates how compliance with the requirements of the Agreement changes the methods of imposing tax liabilities on service providers. Repairman #1 pays $35 for parts and charges $100 for parts and labor. Repairman #2 also pays $35 for the same parts does exactly the same work, but charges $102 for parts and labor. Repairman #1 must register with the Department of Revenue and remit SOT on the sales price of the parts. Repairman #2 must pay Use Tax on the $35 dollars of parts purchased.

It is not possible with the information currently available to determine the revenue impact of such changes. However, some changes in amounts and locations of tax revenues would be unavoidable. Eliminating the second method for payment of the SOT could either increase or decrease tax revenue depending upon how many service providers' tax liabilities through itemization would be greater that the tax liability on 50% of the entire bill. Eliminating the third method for paying the SOT would increase SOT collections in proportion to the difference between the cost and sales price of the goods currently taxed under this option. In combination with the changes of sourcing rules, a shift in the localities receiving the tax revenue would occur. The location where the customer receives the tangible personal property would determine the taxes. Thus, a service provider will be required to apply the tax rate in effect at the customer's location. While the additional burden of calculating tax liability based on the point of delivery may be especially hard on small businesses, a larger impact will be noticed by those jurisdictions with either a high concentration of service business office locations or a high concentration of service customers.

Finally, the greatest cost associated with this change in Illinois' sales taxes may well be political rather than fiscal. Those service providers, and perhaps even the local jurisdictions, negatively impacted by the changes would undoubtedly seek to maintain the current system. Certain municipalities may receive less revenue as a result of the changes to the SOT and SUT necessary for Illinois to comply with the Agreement. The change in sourcing rules in combination with these changes in the SOT may lead some local jurisdictions to call for a "hold-harmless" fund like the one proposed in the State of Washington. In addition, the current construction of the SOT, particularly the four-part test for determining tax liability, benefits certain service providers. For example, pharmacists and graphic artists have a 75% threshold rather than a 35% threshold for determining whether or not they are a *de minimis* service provider. This higher threshold for these two types of service providers increases the amount of tangible personal property that can be sold while limiting the service provider's tax liability by using the cost price rather than the sales price. In other instances, the impossibility of clearly distinguishing the value of the service from the value of the tangible personal property most likely contributed to the creation of that particular test. Eliminating that test will reopen the difficult questions of tax liability avoided by the current construction of the SOT.

Other Issues for Consideration

There are several additional changes to Illinois' sales tax system that may have to be made in order for Illinois to conform to the uniform tax base and uniform tax rate requirements of the Agreement. This section of the report provides an overview of those requirements and highlights the potential impact of the statutory changes necessary to comply with the Agreement. Where possible, we have also estimated the fiscal impact of these ancillary changes.

Single State Tax Rate

States participating in the Agreement may not have multiple state tax rates other than a second rate for food and drugs.[96] The Illinois delegation succeeded in preserving the state's ability to tax food and drugs at a rate lower than other goods. However, stiff opposition to the dual rate concept prevented the agreement from extending the second rate to medical appliances.

Currently, medical appliances, as well as food and drugs, are taxed at 1% instead of the general tax rate of 6.25%.[97] Therefore, the Illinois legislature must either increase the tax on medical appliances by 625% or stop collecting the tax on these devices altogether.[98] Medical appliances include a range of goods from artificial limbs and dialysis machines to eyeglasses and insulin.[99] The social policy behind the application of a reduced tax on these devices is the same as that behind the reduced tax rate for food and drugs. The cost of these items consumes a disproportionate share of low-income individual's resources. However, the legislature will be forced to choose between imposing a higher tax burden on individuals using these products or suffering a revenue loss.

No data is available to calculate the impact of either alternative. The Illinois Department of Revenue does not separate by type the various kinds of goods subject to the 1% sales tax rate. Therefore, the amount of sales tax revenue currently collected from the sale of medical appliances cannot be determined.

Single Local Tax Rate

The Agreement prohibits the imposition of more than one tax rate per jurisdiction.[100] An important question facing Illinois is how the participating states will interpret the term "jurisdiction." If the term is interpreted to refer to an entire local taxing agency, compliance requires one sales tax rate per municipality. Difficulties would arise in municipalities with multiple tax rates, particularly in the City of Chicago. If "jurisdiction" is interpreted more loosely, for example as localized as a zip code for example, local taxing agencies would not be affected.

[96] SSTP Agreement Section 308

[97] See 35 ILCS 120/2-10

[98] The tax is currently imposed at a rate of 1% and the minimum rate under SSTP would be 6.25%.

[99] 86 IL Adm. Code Sec. 130.310 (c) and (d)

[100] SSTP Agreement Section 308B. The exception is a lower rate for food and drugs.

Currently, over 100 municipalities are located within two or more counties with the potential to have different rates within the municipality. Drastic increases or decreases in tax rates across the state may be necessary to comply with this requirement.

For example, the City of Chicago is located within both DuPage and Cook Counties. In the areas located in DuPage County, the combined tax rate is currently 7.5% whereas the areas located in Cook County have a combined tax rate of 8.75%. Compliance with this part of the Agreement may require an increase in the DuPage County tax rate, a decrease in the Cook County tax rate, or both. Alternatively, the sales and use taxes collected on behalf of the counties in Illinois could be limited to apply only in those unincorporated areas of the county. This, naturally, would result in a sharp decline in county tax collections statewide. Also, the Home Rule Municipal Use Tax Act would require amendment to provide that the tax be imposed at the same rate as any sales tax imposed by that municipality.

Uniform Definitions
The Agreement contains a vast array of definitions that must be incorporated into the state's sales tax statutes.[101] For example, the application of the new definition of "soft drinks" would effectively remove certain beverages from the lower tax applied to food. Current law provides that the low rate of tax applies to certain beverages containing coffee, tea and 50% fruit or vegetable juice.[102] The Agreement would require the imposition of the higher rate of tax on these items. No estimate of the revenue impact of this change is available.

Even those definitional changes that appear to have little real impact on the imposition and collection of the tax may invite litigation surrounding the application of the tax in areas that have been considered well settled for years. Changes to the definition of "food," "prepared food," "drugs," and "grooming and hygiene products" could result in the application of the full 6.25% tax on items currently taxed at the 1% rate. In each instance, one can anticipate litigation by parties opposed to the increase in the tax. Moreover, the social policy considerations that underpin the reasoning for the current application of a lower tax would be violated by an increase in the tax. For example, the new definition of "prosthetic device" would require a tax increase on wheelchairs and dialysis machines.[103]

State Audit Function
Under the Agreement Section 203, sellers using a Certified Service Provider (CSP) to collect the tax and file returns are exempt from audit liability. The state would be allowed only to audit the systems of the service provider. Questions regarding the financial ability of a particular CSP to pay the potentially significant liabilities of a major retailer, the qualifications to serve as a CSP, and the impact of the auditor's inability to directly audit the books and records of the retail business have yet to be addressed. The

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[101] SSTP Agreement Section 104
[102] 35 ILCS 120/2-10
[103] Under current law (86 IL Adm. Code Sec. 130.31(c)(2) a tax is applied to these items at a rate of 1%. Under SSTP the minimum rate would be 6.25%.

Department of Revenue, in a Practitioners Questions and Answers release, noted that abuse and loss of revenue might result:

> "Illinois law provides that the sellers are responsible for the sales tax incurred on their sales. The Streamlined Project allows certified third parties to collect the tax and remit the tax to the state on behalf of the sellers. The sellers under such a method would no longer be liable for the tax and, unless the state can show the seller has committed fraud or made a material representation, the seller is no longer subject to audit for those sales. This method could lead to abuses and loss of state revenue." [104]

State Level Administration
The Agreement requires state level administration of sales and use taxes.[105] The Illinois Department of Revenue would be the only entity with which sellers are required to register; it would be responsible for the collection and distribution of local sales and use taxes; and it would have sole responsibility for conducting all audits on behalf of local jurisdictions. The City of Chicago's Department of Revenue currently administers several taxes, which may be considered sales and use taxes under the Agreement. Examples include the Chicago Soft Drink tax Ordinance,[106] the Chicago Personal Property Lease Transaction Tax,[107] and the Chicago Use Tax Ordinance for Nontitled Personal Property.[108]

The Chicago Use Tax, a 1% tax on goods purchased outside – but used within – the City, is paid directly to the City, primarily by large companies, which are subject to audits by the City's Department of Revenue. The City's auditors currently maintain high levels of tax compliance through aggressive auditing. Transferring the job of auditing for this tax to the Illinois Department of Revenue could result in the auditors merely relocating. The more likely result is additional responsibilities being placed on existing state auditors. The additional responsibility, if combined with inadequate resources, could result in less thorough audits and diminished compliance with the local use tax. Another concern results from the State's past practice of delaying the disbursements of local government tax collections. The City could experience cash flow difficulties resulting from delays in the State's disbursement of the funds collected from this tax.

Conclusions – Potential Costs

The costs associated with changing the Illinois sales tax system are both widespread and difficult to quantify. Changing the sourcing rules for the sales tax will not lead to significant changes in overall sales tax revenue, but the distribution of that revenue will shift among local governments. If the State of Illinois can expect the same kind of impact that the State of Washington projects, the impact would be that approximately

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[104] Available at http://www.revenue.state.il.us/LegalInformation/practqna/2001/salesqna.html
[105] SSTP Agreement Section 301
[106] Chicago Municipal Code, Chapter 3-45
[107] Chicago Municipal Code, Chapter 3-32
[108] Chicago Municipal Code, Chapter 3-27

15% of the state's sales tax base would move between jurisdictions. If the resulting redistribution of sales tax revenue among local jurisdictions is proportionate, then local governments in Illinois could expect to see a redistribution of $42 million.

Changing the taxation of leased property will result in a reconfiguration of the revenue streams. Under current practice, the State of Illinois receives sales tax revenue on the full value of the tangible personal property to be leased at the point in time when the lessor purchases the goods. Under the Agreement, there is every indication that the practice would have to be changed so that the purchase of the tangible personal property is exempt from taxation and the lessee is taxed on each lease payment. Initially there would be a decline in revenue due to lessor's purchases being free from sales taxes. Over time, the taxation of lease payments would replace that revenue. Estimates of the initial impact of such changes range from a decline in sales tax revenue $18.2 million from the taxation of computers purchased to be leased to $236 million from the leasing of automobiles. Because the state and local tax bases must be the same by 2005, the City of Chicago will also have to conform to the state's practice of taxing leases. The City currently taxes leases under a separate Home Rule tax at a rate of 6%. The repeal of this tax could cost the City $100 million per year.

Changes to the Service Occupation Tax would also be required. The impact of these changes on the revenues of state and local governments is more difficult to quantify. The nature of the changes makes it reasonable to assume that the changes would increase revenue for the state. However, there would be an increase in compliance cost for service people who would be required to calculate tax liability based on the point at which the customer took possession of the goods. Such a change in the sourcing rules would also redistribute the local government revenues derived from the Service Occupation Tax in the same manner that changes to sourcing rules generally would.

Other issues to keep in mind include the manner in which medical appliances will be treated, how "substantial compliance" will be interpreted by member states with regard to the requirement that there be a single local tax rate, the impact of Illinois conforming to uniform definitions of products, and the liability issues surrounding state audits of third party collectors.

Table 11 Estimates of Potential State & Local Revenue Losses from the Changes Required for Compliance with the SSTP Agreement	$ millions
Change to Destination Based Sourcing *	$42
Change in Taxing Lease Payments **	
City of Chicago - LeaseTax	$100
State - Computer Leases	$18
State - Automobile Leases	$236
Change in Taxing Service Occupations	Insufficient Information
Other Areas for Consideration	Insufficient Information
Total	$396

* Represents revenue shift. Loss only occurs in certain jurisdictions

** City loss permanent. State loss first year only.

CONCLUSION

The Streamlined Sales and Use Tax Project is an effort by many of the smaller states to simplify and standardize the various methods used by the states to collect sales taxes. Each participating state is expected to voluntarily bring its sales tax laws into compliance with a uniform set of requirements described in the Streamlined Sales and Use Tax Agreement. Proponents of the Agreement argue that two fundamental benefits would result from such actions: an easing of the burden on taxpayers of complying with the various sales tax systems across the jurisdictions, and an increase in sales tax revenue for state and local governments from taxing remote retail transactions. Easing compliance burdens may benefit not only taxpayers, but also improve compliance with and respect for sales tax laws. The increase in sales tax revenue for Illinois compared to the potential costs associated with the changes is less certain, and is the main subject of this report.

After reviewing the available information, this report estimates that the State of Illinois could have realized $86 million in additional sales tax revenue during FY2001 and $81 million in FY2002 from taxing all remote retail sales. Local governments could have realized $21 million in FY2001and $20 million in FY 2002. The total for Illinois' state and local governments therefore would have been $107 million and $101million, respectively. This estimate is less than other published estimates, and dramatically less than the largest estimates. However, this estimate is based upon the most current and specific category of information from the U.S. Census Bureau's survey of economic activity. It is further justified by a number of factors, all of which indicate that the amount of revenue to be gained from taxing remote retail transactions is considerably less than popularly reported in the media and by proponents of the Agreement.

The Civic Federation estimate takes into account Illinois' share of sales tax collections, the state's share of total economic activity, transactions exempt from sales taxes, and most importantly transactions upon which sales taxes are already collected. Recent estimates from Forrester Research indicate that in 2002, almost three-quarters of all Internet sales were conducted by retailers who also have traditional, brick-and-mortar store locations.[109] This new business model, in which Internet portals and physical stores are part of the same integrated business, is becoming predominant. Such a trend serves to offset growth in Internet retail transactions, and further justify a very conservative approach to estimates of the revenue potential from taxing sales by out-of-state retailers.

These conservative revenue projections must be viewed in light of the potential costs associated with modifying the current construction of Illinois' sales tax. Those costs could potentially reach $396 million.

First, a change in sourcing rules would fundamentally alter Illinois' unique legal approach to the sales tax and shift substantial amounts of revenue between local taxing agencies. The costs associated with the litigation that is likely to arise as a result are not

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[109] Carrie Johnson, "The Growth of Multichannel Retailing," A Forrester Research, Inc., document prepared for the National Governor's Association and the National Conference of State Legislatures, July 2004.

possible to estimate. However, if Illinois could expect results similar to a study conducted by the State of Washington, approximately $42 million in sales tax revenue would be shifted among local taxing agencies in Illinois. This will either result in a net loss of revenue for some of those taxing agencies, or increased costs to the State of Illinois in order to hold those municipalities harmless from the change.

Table 12
Potential Costs & Benefits
of Joining the SSTP Agreement

	$ millions
Potential Revenues	
State & Local Sales Tax Revenue 2002	
State Sales Tax Revenue	$81
Local Sales Tax Revenue	$20
Subtotal: Revenues	**$101**
Potential Costs	
Change to Destination Based Sourcing*	$42
Change in Taxing Lease Payments**	
Chicago LeaseTax	$100
Computer Leases	$18
Automobile Leases	$236
Simplifying the Service Occupation Tax	Insufficient Information
Other Areas for Consideration	Insufficient Information
Subtotal: Costs	**$396**
Total Potential Fiscal Impact in the First Year	**-$295**

Note: Figures may not sum due to rounding

* Represents revenue shift. Loss occurs only in certain jurisdictions

** City loss permanent. State loss in first year only.

The majority of the potential costs presented here come from changes to the way in which Illinois taxes the leasing of tangible personal property. Although there are various opinions on the necessity of changing the way Illinois taxes leases of tangible personal property, a reasonable reading of the Agreement indicates that the state would have to start taxing lease payments, and the City of Chicago would have to tax leases under the sales tax rather than under its lease transaction tax. The City would stand to lose $100 million, while the state could lose $254 million from sales taxes just on computers and automobiles.

The results of this analysis indicate a potential for the State of Illinois to lose $295 million more than it gains from making the changes necessary to join the Streamlined Sales and Use Tax Agreement. Although there remains considerable opportunity for the proponents of the Agreement to develop strategies for addressing the many administrative issues and potential revenue losses raised in this report, this analysis strongly indicates that caution and foresight are necessary on the part of the General Assembly before embracing and enacting the requisite sales and use tax restructuring that will be needed to join the Agreement. Clearly a good deal more planning is needed to ensure that the State of Illinois and its units of local government do not suffer severe economic dislocations as a result of the proposed changes.

GLOSSARY

Brick-and-Mortar Establishments- Places of business that have physical buildings where their goods or services are provided.

Business-to-Business sales- Transactions between two companies to provide goods and services. Contrasted with Business-to-consumer sales, defined below.

Business-to-Consumer sales- Transactions between a business and the general public that purchases their goods or services.

E-Commerce- The buying and selling of goods and services over the Internet, particularly the World Wide Web.

Internet Transactions- Sales over the Internet, more commonly called E-Commerce.

Nexus- The physical presence of a store or employees within a state that is required for that business to collect state sales taxes.

On-line sales- Sales over the Internet. This type of sale is currently exempt from collection of sales taxes.

Retailer's Occupation Tax- Sales tax collected on all applicable tangible personal property and services. Can be imposed by counties with home rule jurisdiction. This tax is applied in Cook County.

Sales Tax- A tax levied on the sale of goods and services. It is usually calculated as a percentage of the purchase price, and collected by the seller.

Streamlined Sales Tax Project- An initiative begun to simplify the sales and use tax system nationwide. Begun in February 2002.

Streamlined Sales Tax Agreement- The detailed proposal for reform of the sales and use tax system. First presented on November 12, 2002. As of October 20, 2003, 20 states have enacted implementing legislation.

Use tax- A tax paid for tangible goods purchased outside of one's home state. Use tax can only be collected if the goods will be brought back to the home state for use or consumption.

APPENDIX A

Total E-Commerce as a Percentage of Total Retail Sales				
	$ millions			
	1999 revised	2000 revised	2001 revised	2002
Total Retail Trade	$ 2,866,898	$ 3,059,173	$ 3,141,400	$ 3,230,122
Total E-Commerce	$ 15,004	$ 28,152	$ 34,382	$ 44,287
E-Commerce % Total	0.5%	0.9%	1.1%	1.4%

Electronic Shopping as a Percentage of Electronic Shopping and Mail Order Houses				
	$ millions			
	1999 revised	2000 revised	2001 revised	2002
Total E-Commerce and Mail Order Houses	$ 92,923	$ 110,211	$ 109,158	$ 114,480
E-Commerce Only	$ 11,720	$ 21,209	$ 25,145	$ 32,191
E-Commerce % Total	12.6%	19.2%	23.0%	28.1%

U.S. Census Bureau, 2002 E-commerce Multi-sector Report. Table 5. April 15, 2004.
U.S. Census Bureau, 2001 E-commerce Multi-sector Report. Table 5. March 19, 2003.
U.S. Census Bureau, 2000 E-commerce Multi-sector Report. Table 5. March 18, 2002.
Source: U.S. Census Bureau, Annual Retail Trade Survey.
Available at http://www.census.gov/eos/www/ebusiness614.htm

APPENDIX B

Illinois Sales Tax Collections as a Percentage of GSP			
	Illinois Gross State Product	Illinois Sales Tax Collections	
Year	$ Millions	$ Millions	%
1995	$359,451	$6,331	1.76%
1996	$375,949	$6,565	1.75%
1997	$400,327	$6,825	1.70%
1998	$423,175	$7,159	1.69%
1999	$440,899	$7,570	1.72%
2000	$466,312	$8,165	1.75%
2001	$475,541	$8,014	1.69%

Illinois Sales Tax Collections
Illinois Department of Revenue. Annual Report of Collections and Distributions. Fiscal Year 2001. page 23. Includes Motor Vehicle Use Tax and 20% share disbursed to units of local government.

Illinois Gross State Product
U.S. Department of Commerce, Bureau of Economic Analysis. Released May 2003. Available at http://www.unm.edu/`bber/econ/st-gsp4.htm

US Sales Tax Collections as a Percentage of GDP			
	U.S. Gross Domestic Product	State & Local General Sales Tax Revenue	
Year	$ Billions	$ Billions	%
1995	$7,398	$160	2.17%
1996	$7,817	$169	2.16%
1997	$8,304	$179	2.15%
1998	$8,747	$189	2.16%
1999	$9,268	$201	2.16%
2000	$9,817	$215	2.19%
2001	$10,101	$223	2.21%
2002	$10,481	$223	2.13%

State & Local General Sales Tax Revenue
U.S. Census Bureau, Governments Division. Government Finances 1994-95, 1995-96, 1996-97, 1997-98, 1998-99, 1999-2000, 2000-01, Table 1.

U.S. Gross Domestic Product
U.S. Department of Commerce, Bureau of Economic Analysis. Released March 2004. Available at http://www.bea.gov/bea/dn/nipaweb/SelectTable.asp?Popular=Y

APPENDIX C

According to the Census Bureau, Illinois' population in 2001 represented 4.38% of the country's total population. The Bureau of Economic Analysis reports that in 2001, Illinois' Gross State Product was 4.72% of the country's Gross Domestic Product.

Calculating a Factor for Determining Illinois' Share of National E-Commerce Transactions			
	Population	**Gross Product** $ Millions	**Average**
U.S.	285,093,813	$10,082,000	
Illinois	12,517,168	$475,541	
IL % of Total	4.39%	4.72%	4.55%

U.S. and Illinois Population
U.S. Census Bureau, Illinois Quick Facts
http://eire.census.gov/popest/data/states/tables/NST-EST2003-01.php

U.S. Gross Domestic Product
Bureau of Economic Analysis, Industry Accounts Data
http://www.bea.gov/bea/dn2/gpoc.htm#1994-2001

Illinois Gross State Product
Bureau of Economic Analysis
http://www.bea.doc.gov/bea/regional/gsp/

APPENDIX D

Food, Drugs & Medical Appliances as a Percentage of the Total Estimated Sales Tax Base	$ millions
FY01 Receipts of Taxable Food, Drugs, Med. Appliances	**$ 22,070**
Total Sales Tax Collections	$ 8,014
Sales Tax at 6.25%	$ 7,793
Sales Tax at 1%	$ 221
Estimated Tax Base: 6.25%	$ 124,695
Estimated Tax Base: 1%	$ 22,070
Total Estimated Tax Base	**$ 146,765**
Estimated Tax Base: Food, Drugs & Medical Appliances as a Percentage of Total Estimated Tax Base	**15%**

FY01 Receipts of Taxable Food, Drugs & Medical Appliances
Illinois State Comptroller. Tax Expenditure Report (detailed), Fiscal Year 2001.
http://www.apps.ioc.state.il.us/Office/ResearchFiscal/PublicTaxExp/Report/PublicReportMenu.cfm

Difference in Tax Rates
5% state tax rate minus 1% tax rate applied to food, drugs and medical appliances.

Estimated Tax Base: Food, Drugs & Medical Appliances
Tax Expenditure: Food, Drugs & Medical Appliances divided by Difference in Tax Rates

Total Sales Tax Collections
Illinois Department of Revenue. Annual Report of Collections and Distributions. Fiscal Year 2001. page 23.

Sales Tax at 6.25%
Total Sales Tax Collections minus 1% of Estimated Tax Base: Food, Drugs & Medical Appliances

Sales Tax at 1%
1% of Estimated Tax Base: Food, Drugs & Medical Appliances

Estimated Tax Base: 6.25%
Sales Tax at 6.25% divided by 6.25%

Estimated Tax Base: 1%
Sales Tax at 1% divided by 1%

Total Estimated Tax Base
Estimated Tax Base: 6.25% plus Estimated Tax Base: 1%

APPENDIX D (continued)

Percentage of Sales Transactions Subject to Exemption or Reduced Rate			
	Total	E-Commmerce	
Books & Magazines	$ 3,825	$ 1,691	
Clothing & Clothing Accessories	$ 15,021	$ 3,165	
Computer Hardware	$ 22,653	$ 5,506	
Computer Software	$ 4,110	$ 1,110	
Drugs, Health Aids, & Beauty Aids	**$ 16,130**	**$ 951**	
Electronics & Appliances	$ 3,877	$ 1,508	
Food, Beer & Wine	**$ 1,901**	**$ 487**	
Furniture & Home Furnishings	$ 6,442	$ 1,633	
Music & Videos	$ 3,960	$ 1,256	
Office Equipment & Supplies	$ 6,416	$ 1,872	
Sporting Goods	$ 1,718	$ 502	
Toys, Hobby Goods & Games	$ 2,954	$ 895	
Other Merchandise	$ 16,137	$ 2,914	
Nonmerchandise Receipts	**$ 4,014**	**$ 1,655**	
Total	$ 109,158	$ 25,145	
Total Exempt / Reduced Rate Goods	$ 22,045	$ 3,093	
			Average
Percentage of Total	20%	12%	16%

U.S. Census Bureau, 2002 E-commerce Multi-sector Report. Table 5. April 15, 2004.