

## Illinois Department of Revenue Intends to Extend Its Multifactor Post-Hartney Sourcing Regulations to Interstate Transactions

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The saga over **local sourcing** of **Illinois retailers' occupation taxes** is well known. The [Illinois Department of Revenue has a dedicated webpage for the issue](#), and Inside SALT covered some of the litigation aspects last month (see [Illinois Regional Transportation Authority Suffers A Setback In Its Sales Tax Sourcing Litigation](#)). A new chapter is unfolding now, with [revised proposed local sourcing](#) rules that would apply a multifactor sourcing analysis to both intrastate and interstate sales. The regulations may be made final as soon as next month, and retailers with complex retailing processes should consider how the rules could apply to their operations.

### **Background: The Illinois Department of Revenue Issued Emergency and Proposed Local Tax Sourcing Regulations after the Supreme Court of Illinois Invalidated Its Old Rules in *Hartney***

Illinois has perhaps the most complex sales and use tax system in the country. One driver of this complexity is the fact that the Retailers' Occupation functions as a sales tax but is really an occupation tax measured by gross receipts – the tax imposed is on the privilege of engaging in the occupation of being a retailer. Illinois lets some local jurisdictions impose additional Retailers' Occupation Taxes, and so the effective local rate can climb higher than the 6.25 percent statewide base rate, e.g. the 9.25 percent rate applicable in Chicago. As the tax is imposed on the business occupation rather than the sale itself, origin-based sourcing principles apply. And for out-of-state sales shipped into Illinois and not subject to Retailers' Occupation Tax, retailers have only a use tax collection obligation at the 6.25 percent state rate.

For decades, the Department of Revenue's regulations applied a bright-line test based on order acceptance to determine where the taxable retailing activity had occurred for local Retailers' Occupation Tax sourcing purposes. Some taxpayers structured their operations in reliance on this approach. But the Supreme Court of Illinois struck down the bright-line order acceptance test in [Hartney Fuel Oil Co. v. Hamer, 2013 IL 115130 \(Nov. 21, 2013\)](#), holding that an evaluation of all the retailing activities was necessary to determine where the retailing occupation occurred and consequently to which local Retailers' Occupation Taxes a transaction was subject. The old local tax sourcing regulations were invalidated.

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After *Hartney*, the Department promulgated new emergency local tax sourcing rules, effective January 22, 2014 (see the Department of Revenue press release, [letter to Joint Committee on Administrative Rules](#), sample rule text). The emergency rules also served as a framework for the initial proposed final rules. These emergency and initial proposed final rules applied to intrastate tax sourcing and did not affect the Department's longstanding rule governing whether a transaction was subject to in-state Retailers' Occupation Tax or merely an out-of-state use tax collection obligation, 86 Ill. Admin. Code 130.610.

## **The Newly Revised Proposed Regulations Generally Consider Five Primary Factors in Determining the Location of the Taxable Retailing Activity**

After consulting stakeholders and receiving numerous comments, the Department substantially revised the proposed rules. This revised proposal was announced on May 29, and the Joint Committee on Administrative Rules approved this revised version at its June 17, 2014 meeting. These rules could be promulgated in final form as soon as mid-July. They are an evolution of the multifactor analysis in the original proposal and emergency rules.

The core of the revised proposed local tax sourcing regulations is a five-factor test considering:

1. The location of sales personnel who can both solicit and make sales;
2. The location where the seller takes action that binds it to the sale;
3. The location where payment is tendered and received, or from which invoices are issued;
4. The location of inventory if tangible personal property that is sold is in the retailer's inventory at the time of its sale or delivery; and
5. The location of the retailer's headquarters or principal place of its business of selling.

If one jurisdiction can claim at least three of the five factors, then the sale is considered to occur at that location. The relative certainty of this bright-line primary factor test is a significant addition that was not in the original proposed rules. If no jurisdiction can claim such a majority of primary factors, then additional secondary factors are considered:

1. The location where marketing and solicitation occur;
2. The location of the seller's own product procurement activities;
3. The location where the retailer sets its prices;
4. The location where purchase orders are received;
5. The location where title passes; and
6. The showroom or other display location.

There are also special rules for various industries and situations.

## **The New Proposed Regulations Would Apply to both Interstate and Intrastate Transactions**

A highly significant change from the emergency and original proposed regulations is that the rule would also apply to interstate transactions. *Hartney* involved intrastate fuel sales, and so the Supreme Court of Illinois did not consider the validity of 86 Ill. Admin. Code 130.610. Rule 130.610 tends to treat transactions as subject to Retailers' Occupation Tax if some aspect of the transaction beyond solicitation occurs in Illinois. For example, one or two of the new primary factors would often be enough to trigger Retailers' Occupation Tax under Rule 130.610.

The Department of Revenue has now announced the planned repeal of this regulation, which is consistent with language in the revised proposed local tax sourcing regulations that clearly states that the same rules apply to sourcing both interstate and intrastate transactions. This change would tend to shift transactions from the in-state Retailers' Occupation Tax to the out-of-state Use Tax collection obligation, because it effectively results in a higher in-state activity threshold for imposition of Retailers' Occupation Tax.

## **The Regional Transportation Authority (RTA) Has Promised to Challenge the New Sourcing Regulations**

The RTA has been a very active litigant in challenging local tax sourcing arrangements. It has announced an intent to file suit challenging these revised proposed regulations. Thus, while ordinarily one would expect the Department's revised proposed regulations to be made final as early as mid-July, a RTA challenge – if it is able to craft a viable claim – may complicate the implementation of the proposed revised local tax sourcing regulations.

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