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Chicago Personal Property Lease Transaction Tax

Although businesses entering a new jurisdiction are often primed to handle local sales and use taxes, even sophisticated taxpayers can be unprepared for the myriad of unfamiliar local taxes waiting to greet them when beginning to transact business in Chicago. Whether leasing equipment in the City of Chicago or transferring software to a licensee, the Chicago Personal Property Lease Transaction Tax ("Transaction Tax") tax may apply and present certain challenges for a taxpayer not familiar with the tax. This post provides an overview of the Transaction Tax, including who is subject to tax under the Chicago Personal Property Lease Transaction Tax Ordinance ("Ordinance") and significant issues of ambiguity that taxpayers may face in applying the Transaction Tax. Additional posts in the Practitioner Series will further explore the application of the Transaction Tax to software and delve into contested issues such as the taxability of service or convenience fees.

APPLYING THE TRANSACTION TAX

The Transaction Tax is imposed upon: (1) the lease or rental in the city of personal property, or (2) the privilege of using in the city personal property that is leased or rented outside the city. M.C.C. § 3-32-030. Additionally, the rate varies based upon the type of transaction. The Tax is generally imposed on receipts or charges for leases at a rate of 9 percent. However, charges for the "non-possessory lease" of a computer to input, modify or retrieve data or information that is supplied by the customer are subject to a lower 5.25 percent rate.*Id.*

Although the term a "nonpossessory computer lease" is not necessarily within the vocabulary of many taxpayers, the language has been a part of the Ordinance since 1994 and generally applies to the usage of remote or computing software, including, but not limited to, SaaS, IaaS, and PaaS. *See* Chicago Transaction Tax Ruling 5; Chicago Transaction Tax Ruling 12. The term is defined by the Ordinance as a nonpossessory lease in which the customer obtains access to the provider's computer and uses the computer and its software to input, modify, or retrieve data or information. M.C.C. § 3-32-010(I). Additionally, taxpayers should be aware that the Transaction Tax does not apply to services, such as custom software made for hire.*Id.*

DETERMINING LOCATION OF THE LEASE

In assessing whether the Transaction Tax applies, taxpayers are faced with the issue of where the lease occurs. The Ordinance provides that a lease of personal property is deemed to take place at the location where the lessee takes possession or delivery of the property. M.C.C. § 3-32-030(C). Accordingly, when leasing tangible personal property, such as equipment, where the lease occurs may appear obvious. However, the Ordinance is beset by ambiguities created by Personal Property Lease Transaction Tax Ruling No. 1("Ruling 1"), which is discussed further below, and Personal Property Lease Transaction Tax Second Amended Ruling No. 11 ("Ruling 11"). The Illinois Supreme Court in *Hertz Corp. v. City of Chicago*, 2017 IL 119945 (Ill. Jan. 20, 2017) recently reviewed Ruling No. 11, which requires lessors located outside

Chicago to collect Chicago Transaction Tax on leased vehicles when the lessee was a Chicago resident. Concerned with Ruling 11's application of the Transaction Tax based on a lessee's presumed or intended use, rather than actual use, the court held that Ruling 11 violated principles of extraterritorial taxation by improperly extending its home rule authority to tax beyond its borders. As a result, the court has effectively invalidated Ruling No. 11.

Further, in determining whether a lease of software occurs in Chicago, the answer is even more opaque. In the case of a nonpossessory computer lease, the location of the customer's use is key. *See* Info. Bulletin (November 2015). Specifically, the place of the lease or rental is treated as the location of the terminal or other device by which a user accesses the computer. M.C.C. § 3-32-010(I). As a result, liability for the tax is triggered when a customer in Chicago makes remote use of a provider's customer or software, even if the provider's software is located outside Chicago. If the customer's location is not otherwise clear or where the user accesses the provider's computer from a mobile device, the Chicago Department of Finance ("Department") will apply the rules set forth in the Illinois Mobile Telecommunications Sourcing Conformity Act, 35 ILCS 638. *Id*. As a result, the Transaction Tax will generally apply to customers whose residential street address or primary business street address is in Chicago, as reflected by their credit card billing address, zip code or other reliable information. Additionally, where a charge for software covers both Chicago and non-Chicago use, meaning that the taxpayer's employees or other individuals use the provider's computer from terminals or devices both within and outside Chicago, the Department allows a taxpayer to apportion the charge based on the location of the use. *See*, Ruling No. 12. Although the opportunity to apportion a charge provide flexibility to taxpayers, it muddies an already difficult issue.

EXEMPTIONS FROM TRANSACTION TAX AND CREDIT FOR TAXES PAID

The Ordinance exempts the use of personal property leased or rented outside Chicago if the property is primarily used (more than 50 percent) outside the City. M.C.C. § 3-32-050(A)(1). As a result, the 50 percent test only applies where the agreement is outside Chicago. However, as explored previously, the Ordinance does not provide guidance as to where the lease occurs, and there are uncertainties created by the Department's rulings. Ruling No. 1 provides that if the agreement is signed in Chicago, then any use or delivery in the city will subject the entire license to Transaction Tax. If the agreement is not signed in Chicago, then the 50 percent test will apply. Leases for property used more than 50 percent in Chicago will be entirely subject to the tax, whereas leases for property used less than 50 percent in Chicago will be subject to no tax. An issue taxpayers may face in applying Ruling No. 1 is the potential internal inconsistency it may create between local jurisdictions. Additionally, although rulings are often treated by the Department as authoritative regulations, they arguably do not have the force and effect of law. Nevertheless, it is advisable for taxpayers to comply with Ruling No. 1 to the extent practicable.

Similar to the Chicago Retailers' Occupation Tax, the Ordinance includes a lease for re-lease exception. M.C.C. § 3-32-060. Consequently, a lessee is not subject to the Transaction Tax if it in turn acts as a lessor of the same property, provided the lessee supplies written verification to the lessor that the property is being re-leased, in addition to either a re-lease certificate or documentary evidence. *Id*. However, for the exemption to apply, the property re-leased must be the same property, meaning that if

the taxpayer modifies or transforms the usage of the property, the exemption is not available.

Further, the Ordinance contains a *de minimis* exemption, commonly referred to as "Exemption 11", which provides that if the customer's use or control of the provider's computer is *de minimis* and the related charge is predominantly for information transferred to the customer rather than for the actual use or control of the computer, the lease is exempt from Transaction Tax. M.C.C. § 3-32-050(A)(11). For example, the lease of a computer to receive price quotations or other information with a transitory character is exempt. *Id.* However, to be exempt, the information must be delivered passively, with a minimum search functionality. *See*, Ruling No. 12. Additionally, there is an exemption allowed if the personal property is used primarily (more than 50 percent) outside the City. M.C.C. § 3-32-050(1).

The Ordinance also allows for a credit for municipal tax properly due and actually paid to another municipality with respect to the lease or rental of the property. M.C.C. § 3-32-030(E). However, because few municipalities have a comparable tax on the lease of property, the credit permitted for taxes paid is largely unavailing.

ITEMS EXCLUDED FROM THE TAX

Commonly, tangible personal property or software is not leased by itself, but rather is provided in conjunction with other items. Notably, the "lease price" or "rental price" excludes separately stated optional charges not for the use of personal property. M.C.C. § 3-32-010(K). As a result, if charges for nontaxable items, such as services, are separately *state and optional*, only the amount charged for the lease is subject to Transaction Tax. However, the difficulty in applying the Ordinance is that there is no clarification regarding whether items must be separately stated in the contract, the invoice provided to the customer, both, or elsewhere. Additionally, the Ordinance fails to define the term "optional" or provide guidance on when the Department will deem a charge to be optional. Consequently, taxpayers opting to apply the exclusion should be prepared to defend the position if audited by the Department.

COLLECTION ISSUES

As written, the Ordinance places the incidence of the tax and obligation to pay the tax upon the lessee of the personal property. M.C.C. § 3-32-030(A). However, the lessor is required to collect the tax from the lessee at the time of each lease or rental as a separately stated item, and to remit the tax to the Department. M.C.C. § 3-32-070. As a result, if the lessor fails to collect or remit the tax, it is liable for the amount of the outstanding tax. This creates a hotly contested issue within the Ordinance: if the lessor is unable to collect the tax from the lessee, does the incidence then fall upon the lessor? Frequently presented in litigation with the Department, many lessors have argued that as applied, the Ordinance commonly functions as an impermissible tax upon a certain occupation, rather than a tax upon the lessee. *See* Ill. Const. Art. VII, Sec. 6.

FILING RETURNS

Transaction Tax should be remitted to the Department on the last day of each calendar month, along with a remittance report. M.C.C. § 3-32-080. The remittance report should include the tax attributable to lease or rental payments received during the immediately preceding calendar month. *Id*. If taxpayers prefer to use the accrual rather than the cash basis, they can receive prior authorization from the Department. *Id*.

In addition, an annual tax return ("Form 7550") must be filed with the Department on or before August 15

of each year. *Id*. Although the Department previously accepted paper filing of the Form 7550, all returns must now be filed and paid online at WebTax, the Department's Electronic Tax Filing and Payment site.

CONCLUSION

Compliance in a new jurisdiction is never simple, and Chicago does not take it easy on taxpayers by imposing a number of unique local taxes, including the Transaction Tax. In short, any taxpayer that leases tangible personal property to customers who take possession or Chicago or that leases software to licensees who will use the software in Chicago should closely evaluate its filing position and consider the applicability of the Transaction Tax.

Click here to contact Samantha with questions about the Chicago Transaction Tax.