

WHO ARE TAXABLE?—BASIC PROBLEMS IN DEFINITION UNDER THE ILLINOIS RETAILERS' OCCUPATION TAX ACT

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In the same sense, and perhaps to the degree, that all men are political animals, all men are consumers of the goods they produce. The tax directly premised upon the economic act of consumption of goods is, in the light of modern distribution of wealth, the tax most universally applicable and most burdensome. Although the consumers' tax is, in general, meant to apply to each individual as he engages in the act of consumption, administration of a consumers' tax is wholly unpalatable, and, hence, not feasible or practical when the tax gatherers are required to hold each consumer immediately responsible as the tax remitter. Minimum necessities of decent public administration in consumer taxation require that the number of all persons directly and immediately responsible to the tax agency be smaller than the number of all the consumers who actually pay the tax or directly bear its burden. To assure practical administration, the modern tax administrator must adjust tax gathering to modern distribution methods in consumers' goods.

So it is found that, wherever possible in the realm of consumers' taxation, "retailers" are made tax collectors on behalf of the tax agency. The retailer is a hybrid quasi-public official, bound under penalties of law to serve a public function in the collection of tax, simultaneously serving two masters, his government and his profit. A simple principle justifies this dual status to the tax administrator. In a typical state there is one retailer to every 50 to 100 consumers; it is, therefore, cheaper and easier to deal with the retailer. Even in such states as Illinois, where the consumers' tax is technically a "retailers' occupation tax," and the retailer is technically the "taxpayer," the retailer is actually a collector.¹ Whatever the legal theory, the retailer is, from

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¹ Ill. Ret. Occ. Tax Rules and Reg. (rev. Oct. 1, 1939), issued by the Department of Finance of the State of Illinois, distinguishes in Article 20 between the actual and the seeming as follows: (1) "The Retailers' Occupation Tax Act imposes upon retailers [that is, persons engaged in the business of selling tangible personal property to users or consumers] the duty of paying the State a tax at the rate of three per cent of the gross receipts from their business." (2) "[The Retailers' Occupation Tax Act] does not impose a tax upon the consumer." (3) ". . . but nothing contained in the [Retailers' Occupation Tax] Act prohibits a retailer, in fixing the price of his merchandise, from setting up as a separate item the amount of tax to be paid by him, provided that such separate item is identified as a part of the selling price." (4) "The retailer shall not, in any event represent to his customers that he is acting as an agent for the State in collecting a tax from them."

the point of view of the tax administrator, in essence a collector because he so considers himself.²

The anomalous quasi-public capacity of the retailer as either public or private tax collector stimulates conflicts between his public duties, enforced by statutory penalties, and his own self-interests as a competitor attempting to achieve competitive advantages over other retailers. Administrative definitions of what or who are taxable must consider at all times the role of the retailer in the tax-gathering process and, whatever the legal framework, specific definitions must be adjusted to the feasibility of actual collection by a retailer in specific circumstances. Statutory definitions of the "taxable transaction" or "taxable event" in consumers' taxes are characterized by limited enumeration and broad scope, affording to the tax administrator ample scope for interstitial policy-making. Administrative ruling attempting specific definition to achieve the Nirvana of tax administration—complete certainty and acceptance of tax liability by tax collectors and the taxpaying public—shifts, as a process, from legal semantics to economic policy-making. The technique of definition in these circumstances is neither wholly law nor entirely economics; it is a delicate and sometimes explosive mixture of both. These are the broadest of principles underlying the administrative process in consumers' tax definition.

In a tax as immediate and as pervasive as a general consumer's tax, definition of what is taxable must coincide, so far as rational, with the predisposition to functional classification prevalent among business men prior to enactment of the tax. Administrative definition cannot in too many instances risk running counter to industrial, retailing, or consuming views as to who is a consumer. Merely legalistic construction of statutory language without weighty regard to public functional experience or psychology adds cumulative irritant to the basic irritant of the consumers' tax itself and by a Gresham's law of litigation results in almost proportional resort to the courts by outraged taxpayers. The disposition of lower courts to invoke lay attitudes in deciding definitional issues in consumers' taxation is notorious and has plagued tax administrators everywhere.³ In part this is due to a lack of judicial expertness in this field, in part to a judicial sensitivity to public attitudes toward administration of the unpopular and regressive general consumers' tax. It is axiomatic, therefore, that the excellent tax administrator will excel in the making of tax policy through definitions, laying stress on legalisms only as administrative strategy necessitates a practical prejudgment of what the courts in his state may be expected to do. His excellence, however, will not be tested by the astuteness of his legal formulation as much as by his ability to overcome, within the technical range of the statute, the stresses and strains in public psychology and confidence created by the general consumers' tax.

² Problems of state consumption tax collection and enforcement, including the basic matter here referred to, are canvassed in Huston and Berryman, *Collection and Enforcement of State Consumption Excise Taxes*, *supra* this issue.

³ A general analysis of judicial interpretation of the taxable transaction for consumption taxation is to be found in Cohen, *The Taxable Transaction in Consumers' Taxes*, *infra* this issue.

That there is a technical ambit within which specific definition must stay is, of course, elementary. Apart from the social implications of consumer taxation, and the sensitivity of the public to administrative extension or retrenchment by definition, it is a statute that must be construed. In Illinois, under the Retailers' Occupation Tax Act, the economic activities by which men live and accumulate wealth must be tested and taxed by the words: "Any transfer of the ownership of, or title to, tangible personal property to the purchaser, for use or consumption and not for resale in any form as tangible personal property, for a valuable consideration. . . ." ⁴ The tax (3%, 2% after June 30, 1941) is imposed on persons "engaged in the business of selling tangible personal property *at retail* . . ." measured by gross receipts from such sales. ⁵ ". . . for use or consumption and not for resale in any form as tangible personal property" are the basic words around which Illinois consumers' tax policy must be fashioned.

The quest for certainty is nowhere more exacting than where a taxpayer doubts that his own business activities come within the ambit of a sales, occupation, or other consumers' tax. Tax liability, in the context of retailing, has an important impact on normal competition. Most retailers suffer an occupational urgency to prevail upon the tax administrator that he treat all unusual facts as borderline, and, hence, doubtful, applying all doubts in favor of the retailer and his non-responsibility or non-liability. Characteristically, this urgency is implemented by another occupational urgency; no administrative tax definition is a sound definition which does not include or exclude within the range of tax liability the entire competitive context: that no competitive advantage be afforded, directly or indirectly, by administrative ruling. This concept of competitive advantage or disadvantage is not the same as, nor can it always be tested by, the ordinary legal principles guiding a determination of what constitutes "discrimination." The *motif* of individual or trade association argument when administrative tax definition is in course of formulation may be paraphrased as follows: "We deny that your classification is correct, but if you call a trade classification of retailers '*A*,' it is far worse that some members of *A* are ruled to incur tax liability and others not, than that all members of *A* are *improperly* ruled to incur tax liability." Given the practice by all members of *A* of tax shifting to their customers, the attack upon the tax administrator for improperly defining the whole category as taxable is of relatively minor consequence. In such circumstances the challenge of definition is legalistic, technical, carried on professionally, and often with due regard to whether tax monies are paid in escrow and whether successful litigation will result in the retention of such monies by the retailers themselves or in its return to those from whom the retailers have already collected a tax. But where definition purports to, but does not realistically define all members of *A* in terms of their mutual competitive interrelationship, tax admin-

⁴ 24 ILL. STAT. ANN. (Jones, 1940) §119.450 (definition of "sale at retail").

⁵ *Id.* §119.451.

istration commences to disintegrate in the face of a multiform attack which transcends the merely legal. The technique of administrative definition, to be successful, must be premised upon the most careful fact-finding as to the functional characteristics of those who exercise the taxable function or discharge the taxable event. It is basically a problem for those tax-policy-makers who can expertise in the peripheral aspects of the legal definition itself, in the economics of competition and consumption, in the permutations of public and group psychology generated by a regressive tax upon day-to-day living.

A basic problem in administrative tax definition happens to be the first problem in point of time. Should an agency administering a consumers' tax state, in detail and in advance, its views as to who are and who are not taxable, what is and what is not taxable? Or should the tax agency require the taxpayer to determine his own tax liability by consulting the statute and/or legal counsel, the agency reserving the right to agree or disagree with him after examining his tax return? To what extent and to what degree should the tax agency publicly define tax liability in advance of court adjudication? These questions necessitate some consideration of the rule-making function, normally given to the tax agency by the statute, which constitutes its legal justification to promulgate definitions.

Under the Illinois Retailers' Occupation Tax Act "the Department [of Finance] is authorized to make, promulgate, and enforce such reasonable rules and regulations relating to the administration and enforcement of the provisions of this Act as may be deemed expedient."⁶ The Department of Finance deemed it expedient to promulgate nearly 100 "rules" relating to particular trades, professions, businesses and conditions affected by the act. Extensive circulation of these rules affords to Illinois taxpayers formal definitions as to specific tax liability. Selection of the subject to be specifically defined was, in general, determined by two distinct methods: (1) within a relatively short time after the enactment of the tax, those taxpayers who urgently pressed upon the tax administrators the contention that they were not subject to the tax obtained, owing to the sheer pressure of the economic burden exerted by customers who resisted the tax collection, a formal ruling containing a definition either including or excluding all similar retailers from the scope of the tax; (2) taxpayers who sought resort to the courts and obtained judicial rulings settling definitional issues in their favor, as opposed to the views of the tax administrator, obtained, as a matter of course, formal rulings promulgated by the tax administrator embodying the contrary position of the courts.

The impact of judicial action upon the administrative process of definition periodically results in revision of promulgated rulings to adjust other definitions to the rationale of the determinations reached in the courts. Hence in an examination of the publicly promulgated definitions of an agency administering a consumers' tax it surprises no sophisticated student of consumption taxation to note the prominence given to apparently trivial definitional formulations of tax liability, such as those

⁶ *Id.* §119.464.

concerning picture framers,⁷ monument vendors,⁸ pest exterminators,⁹ blacksmiths,¹⁰ and the like. There is no necessary relationship between the amount of tax forthcoming from any taxpayer group and the need for publicly formulating a definition of liability. Where adequately conceived and formulated, such single definitions serve as constituent elements in a pattern of definition whereby administrative and taxpayer determination of who or what are taxable can be made by analogy and with due regard to rational consistency. It is conceivable, for example, that a definition formulated as to shoe or harness repairmen,¹¹ whose total tax liability, in the fiscal picture of the state, may be relatively insignificant, may in so far as the definition can be defended from attack, control, or have an important bearing upon, the theory of tax liability of building contractors¹² from whom the total tax due may be of major fiscal importance.

But the administrative technique of definition is not confined merely to formal promulgation of definitions under the rule-making power. In a state as important commercially as Illinois, the process of administrative definition is continuous and never-ending. Although formal definition may be shaped in terms of occupational grouping, individual taxpayers continuously solicit rulings as to their liability. Consistency is here the watchword. In the interests of tax policy, and without necessary regard to the opinions of the lower courts, individual rulings, upon the solicitation of individual taxpayers, must be consistent with the definitional formulations which have been publicly promulgated.

The alternative administrative procedure thus suggested raises the question whether it is more desirable to minimize the number of publicly promulgated definitions, and thereby maximize the number of individual solicitations of rulings by taxpayers, or better to elaborate the pattern of publicly promulgated general definitions. The philosophy of tax administration under the Illinois Retailers' Occupation Tax Act has been to choose the latter policy, since definition has been considered to be not only a method for resolving the initial doubts of the taxpayer as to his tax liability, but one also for stabilizing and controlling the tax assessment procedure within the Department of Finance. The most important function of administrative tax definition is its controlling force upon the internal structure of the tax agency—investigation, auditing, tax assessments, penalties, hearings. Administrative tax definition may be merely educational as it applies to the taxpayer, but, in Illinois, it is mandatory and furnishes a generative force within the tax agency for the making and enforcement of tax assessments.

Here it is necessary to contrast the judicial and administrative views as to the significance of administrative tax definition and its binding effect. Despite the fact that the Illinois Retailers' Occupation Tax Act confers upon the Department of Finance, as has been seen, the power to "make reasonable rules and regulations," an

⁷ Ill. Ret. Occ. Tax Rules and Reg. (1939) Rule 47.

⁸ *Id.* Rule No. 42.

⁹ *Id.* Rule No. 80.

¹¹ *Id.* Rule No. 13.

¹⁰ *Id.* Rule No. 48.

¹² *Id.* Rule No. 6.

administrative definition affirmatively providing for tax liability is not considered binding by most Illinois courts. The lower courts are prone to insist upon an untrammelled judicial prerogative of applying the facts of a case *de novo* to the language of the statute and arriving at independent formulations of tax liability where definitional issues are raised. The extent to which they will give binding effect to the definition of tax liability varies with the degree to which the court can exercise an expert judgment and to the extent that the court will respect the ability of the administrative officials. But definitions formulated administratively do not always affirmatively pronounce the defined occupation or event to be taxable. Several of these definitions hold that the administrative agency does not consider the defined event or occupation taxable. Whatever the views of the courts as to the affirmative formulation of taxability, there can be no question as to the binding effect of negative formulations of non-taxability. It is clear, as practical tax administration goes, that if the administrative agency formulates, by definition, a rule of non-taxability, those affected will not seek recourse to the courts to have their immunity overthrown. Since, as has been seen, administrative tax definition is mandatory internally within the tax agency, the negative definition is the outstanding responsibility of the tax administrator in consumers' taxation. The basic, ultimate and controlling function of administrative definition in Illinois is to state who are *not*, not who *are*, taxable.

In Illinois, as in most consumers' tax jurisdictions, the general consumers' tax was enacted in the midst of the last great depression as an emergency measure. For eight years, the Illinois Retailers' Occupation Tax, now seemingly a permanent and integral part of the state fiscal structure, has been administered with continuous regard to taxpayer acceptance of the tax. Definitions of taxability and non-taxability have been meticulously drafted to assure that major end. Rules embodying definitions, negative and affirmative, have accreted over eight years, as policy has unfolded and supreme court opinions have come down, into an elaborate pattern. And while, in legal effect, the consistency of two rules is not controlling as to the validity of either, consistency of all rules which, by definition, arrive at non-taxability, is a basic necessity in assuring taxpayer acceptance of continuation of this form of tax. Pertinent, therefore, is the inquiry as to whether this consistency has been achieved, and if so, how the Department of Finance has effected the feat in applying definitions to over 157,000 retailers in Illinois.

In general, the Department has premised taxability and non-taxability alike on the distinction between (1) the occupation of engaging in the business of selling tangible personal property to users or consumers in Illinois and (2) the occupation of engaging in the business of rendering services in Illinois, recognizing that where services are rendered *qua* services or in conjunction with sales of tangible personal property, there are five logical possibilities. Either a person (a) renders service and nothing else (non-taxable), or (b) sells tangible personal property and nothing else (taxable), or (c) renders services and in rendering them incidentally transfers tangible personal property, or (d) sells tangible personal property and incidentally renders

services, or (e) sells tangible personal property and renders services, both items constituting a substantial portion of the transaction. Illustratively, in reconciling to Illinois taxpayers its rulings on definitional issues under (c), (d) and (e), the Department has taken the following positions:

All persons or institutions engaged in the business of rendering services, who in the rendition of such services transfer no tangible personal property, or who transfer quantities of personal property which are entirely incidental to the *nature* of the services rendered, or inconsequential in relation to the *value* of the services rendered, do not incur tax liability under the act because not engaged in selling.¹³

When a person is engaged in the business of selling tangible personal property at retail and incidentally renders services in connection therewith, the total receipts are within the measure of the Retailers' Occupation Tax Act. Whether the service is incidental or not depends upon the nature of the business involved and the character of the commodity sold.¹⁴

All persons engaged in the business of rendering services who, in the rendition of such services, transfer a substantial or considerable quantity of tangible personal property are required to keep books, segregating receipts realized from services performed and those derived from the sale of such tangible personal property. Such persons incur tax liability measured by the gross receipts realized from the sale at retail of tangible personal property.¹⁵

Under these major conceptual formulations, there are, of course, subsumed the various propositions, which, in Illinois, are of necessity stated in terms of the "occupation" of the seller and which, in other consumers' tax jurisdictions, take the direct form of formal, definitional distinction between "sale" on the one hand and "fabrication," "lease," "rental," "license for use or consumption," *etc.*

Since the nature of the activity of the seller of tangible personal property is the touchstone of taxability in Illinois, questions as to the nature of a "sale," the nature

¹³ Rendition of services: electrotypers, stereotypers and matrix makers (Rule No. 20); paper cutters (Rule No. 27); furniture and storage warehousemen (Rule No. 29); public amusement places (Rule No. 56); operators of hotels, boarding and rooming houses (Rule No. 84). Rendering of services and transference of personal property incidental to the *nature* of the services performed: correspondence schools (Rule No. 17); optometrists, oculists, opticians (Rule No. 32); hospitals, infirmaries, sanitaría (Rule No. 34); physicians and surgeons (Rule No. 52); dentists and dental laboratories (Rule No. 57); veterinarians (Rule No. 79); schools, fraternities, and sororities which operate cafeterias or restaurants for their membership (Rules No. 74, 68 and 7). Rendering services but also transferring a quantity of tangible personal property inconsequential in relation to the value of the services rendered: operators of barber and beauty shops (Rule No. 11); book binders (Rule No. 27); watch and jewelry repairmen (Rule No. 22); automobile chassis lubricators (Rule No. 31); tire and tube repairmen (Rule No. 43); automobile refinishers and painters (Rules No. 69 and 92); title abstractors (Rule No. 72); hatcheries (Rule No. 73); pest exterminators (Rule No. 80); public stenographers (Rule No. 83); advertising agencies (Rule No. 86); photostaters, blue printers, photo-finishers (Rule No. 87); pattern makers (Rule No. 93).

¹⁴ Incidental services: newspaper, magazine and periodical publishers (Rule No. 2); contractors who sell and install fixtures (Rule No. 6); restaurants and other eating places (Rule No. 7); pharmacists and druggists (Rule No. 12); tangible personal property made to order (Rule No. 30); memorial stone and monument makers (Rule No. 42); florists and nurserymen (Rule No. 77).

¹⁵ Funeral directors and undertakers (Rule No. 8); automobile repair shops and garages (Rule No. 10); shoe or harness repairmen (Rule No. 13); tire retreaders (Rule No. 43); picture framers, except where the picture is installed in the customer's frame (Rule No. 47); blacksmiths (Rule No. 48); fur and garment repairers (Rule No. 53); furniture repairmen and upholsterers (Rule No. 54).

of "fabrication," the nature of a "lease," *etc.*, must be recast into functional evaluation of the recipient of "receipts," *i.e.*, is such recipient a "seller" of tangible personal property at retail?¹⁶ And since there would be no need for administrative evaluation, were there *no* tangible personal property transferred by the recipient of receipts, inclusion and exclusion is here, as almost everywhere, a question of degree. Were the administrative purpose given full effect in Illinois, it could be stated as follows:

"Use or consumption," in addition to its usual and popular meaning, includes the employment by a person engaged in a service occupation, trade or profession, of tangible personal property in the rendering of his services where, as a necessary incident to the rendering of the service, transfer of all or of part of such tangible personal property is made from the person engaged in the service occupation, trade or profession to his customer and client. Any transfer for a consideration of property not necessary to the rendering of a service is not a "use" by the person engaged in a service occupation, but constitutes a sale at retail. "Use or consumption" also includes any disposition not for a valuable consideration of tangible personal property from one person to another.

But to offset the breadth of the formulation, there is the following *caveat*:

"Use or consumption" shall not include any transformation, conversion, or alteration of tangible personal property in the course of a process of production whereby the tangible personal property becomes in any form part of an article which will be the subject of a "sale at retail" either by the manufacturer or by a subsequent transferee of such manufacturer.

These propositions, and others, are appeals to reason, amelioratives of rational consistency. Fundamentally, no tax is as bad as an unmitigated general consumers' tax; fundamentally, no other tax requires so greatly the tempering of the administrative process.

¹⁶ This, of course, is not true of necessary distinctions to be drawn between "personalty" and "realty." In determining what is "tangible personal property" no specialized orientation of definition is requisite in Illinois. Thus Article 15 (the administrative definition of "tangible personal property") epitomizes the conventional. *Inter alia*, "the term 'tangible personal property' embraces all goods, wares, merchandise and commodities . . . real property consists of land and improvements to land, such as permanent buildings and all appurtenances thereto and parts thereof." The problem here is in a strict legal context.