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Illinois Appellate Court Holds Online Cosmetics Retailer Lacked Use Tax Nexus

In a case filed under the Illinois False Claims Act, the Illinois Appellate Court recently held that an online cosmetics retailer did not have a duty to collect and remit use tax because it did not have substantial nexus with the state under the Commerce Clause of the U.S. Constitution.¹ The Court held that the online retailer lacked the required nexus with Illinois because it did not have a physical presence in the state. Also, a retailer with stores located in Illinois that sold similar products under the same brand name did not act as the online retailer's agent. Further, the Court ruled the online retailer did not act with reckless disregard when considering potential use tax liability in the state.

Background

Lush Internet, Inc. ("Lush Internet") is an online retailer that sells Lush Fresh Handmade cosmetic products to customers via its Web site. Lush Cosmetics NY ("Lush Cosmetics"), a distinct and separate legal entity, also sells Lush Fresh Handmade cosmetic products through brick-and-mortar retail stores located throughout the United States, including Illinois. Lush Internet and Lush Cosmetics both licensed their merchandise from Lush Licensing Inc. However, unlike Lush Cosmetics, Lush Internet did not have employees within Illinois. The products that were purchased through the Lush Internet Web site could not be returned to the physical Lush Cosmetics brick-and-mortar stores.

During the tax periods at issue, both Lush Internet and Lush Cosmetics considered each other as competition. Lush Internet limited its advertising expenditures to Internet search engine optimization that ensured it appeared first in an online search, and Lush Cosmetics never received payment from Lush Internet for advertising. Lush Cosmetics employees received commissions for in-store sales and did not refer customers to Lush Internet's Web site. Both companies prepared their own financial statements and filed separate income tax returns. Due to a consolidation of the business operations of the two entities, however, Lush Internet began to collect and remit Illinois use tax on February 1, 2015. Among other changes, customers could pick up items purchased online directly from the Lush Cosmetics stores.

¹ *Illinois ex rel. Stephen Diamond, P.C. v. Lush Internet, Inc.*, Illinois Appellate Court, First District, No. 1-16-1601, Sep. 25, 2017. Note that this decision was filed under Illinois Supreme Court Rule 23 and may not be cited as precedent by any party except in limited circumstances.

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An attorney (“Relator”) filed an action under the Illinois False Claims Act,² formerly known as the Whistleblower Reward and Protection Act, which allows private citizens to bring a civil action on behalf of the state for false claims, including tax matters. The claim alleged that Lush Internet violated the Illinois use tax statute by failing to collect tax on Internet and telephone sales to Illinois customers from August 14, 2007 through January 31, 2015. Also, Relator argued that Lush Internet acted with reckless disregard of its alleged obligation to collect and remit use tax. The trial court held in favor of Lush Internet, and Relator subsequently appealed.

No Nexus with Illinois

In affirming the trial court, the Appellate Court agreed that Lush Internet did not have substantial nexus with Illinois. The Appellate Court noted that the U.S. Supreme Court held in *Quill Corp. v. North Dakota*³ that the Commerce Clause of the U.S. Constitution requires a taxpayer to have a physical presence in the state and its activities to have substantial nexus with the state before the state may impose sales or use tax. Relator argued before the trial court that Lush Internet was a “retailer maintaining a place of business” in the state under two provisions of the Illinois use tax statute: (i) a retailer has an agent or representative operating in the state (the “agent and representative provision”); and (ii) “[a] retailer soliciting orders for tangible personal property by mail if the solicitations are substantial and recurring and if the retailer benefits from any . . . marketing activities occurring in this State or benefits from the location in this State of authorized installation, servicing, or repair facilities” (the “mail-marketing provision”).⁴ On appeal, Relator contended that the trial court erroneously focused on the agent and representative provision. According to Relator, Lush had a duty to pay use tax under the mail-marketing provision because it solicited orders from Illinois customers by mailing catalogs and benefited from the marketing activities of the Lush Cosmetics stores.

On appeal, Relator argued that the trial court erred by failing to consider the mail-marketing provision and solely focusing on the agent and representative provision. The Appellate Court determined that the trial court had adequately considered whether Lush Internet was a “retailer maintaining a place of business” under Illinois law. Also, the Appellate Court agreed with the trial court that the key determination was that Lush Internet did not have a physical presence in Illinois. Even if Relator had satisfied the “retailer maintaining a place of business” threshold under Illinois law, this would be insufficient because Relator failed to meet the substantial nexus requirement under *Quill* due to a lack of physical presence.

The Appellate Court affirmed the trial court’s determination that Lush Internet did not have nexus because it lacked a physical presence in Illinois. For the relevant tax years, the evidence indicated that Lush Internet and Lush Cosmetics were distinct entities that had separate merchandise and marketing strategies. Rather than acting on behalf of Lush Internet, Lush Cosmetics competed against Lush Internet for business. For example, Lush Cosmetics employees received bonuses based on items they sold in the store, but they did not receive a bonus for items sold through Lush Internet. Also, Lush Cosmetics

² 740 ILL. COMP. STAT. 175/1 *et seq.*

³ 504 U.S. 298 (1992).

⁴ 35 ILL. COMP. STAT. 105/2.

employees were discouraged from referring customers to Lush Internet. Items purchased from Lush Internet could not be returned to Lush Cosmetics stores. Accordingly, Lush Internet was not required to collect use tax for the relevant tax years.

No Reckless Disregard

Relator unsuccessfully argued that Lush Internet acted with reckless disregard by not considering Illinois law, making tax decisions that ignored tax advice, and failing to investigate applicable tax law. Under Section 3 of the Illinois False Claims Act, reckless disregard has been described as “the ostrich type situation where an individual has buried his head in the sand and failed to make simple inquiries which would alert him that false claims are being submitted.”⁵

Lush Internet refuted these points by providing evidence that it sought, received and evaluated tax advice from legal and tax professionals regarding a potential Illinois use tax obligation. The evidence indicated that Lush Internet consulted an outside tax advisor and reviewed the issue on a yearly basis during its financial audit. As such, the Court held that Lush Internet did not act with reckless disregard when considering use tax in Illinois.

Commentary

Although this case may not be cited as precedent, this ruling provides valuable insight into the Appellate Court’s analysis when considering whistleblower litigation and making nexus determinations in Illinois. Over the past several years, whistleblower litigation in Illinois has been a polarizing issue. There have been several unsuccessful attempts at reforming the Illinois False Claims Act and legislation continues to be proposed. A prior version of S.B. 9 would have provided that the Illinois False Claims Act does not apply to any taxes administered by the state, but this provision was not included in the final version of S.B. 9 that was enacted in July 2017.⁶ The legislature also has proposed H.B. 1814⁷ and S.B. 1250,⁸ which would provide that no court has jurisdiction over false claims regarding a tax administered by the Department of Revenue unless the action is brought by the Attorney General. Also, this proposed legislation would add a new statute providing that the Department would have the sole authority to bring an administrative action resulting from information provided by any person alleging a false claim, statement or record pertaining to a tax administered by the Department.

In addition to the issues surrounding whistleblower litigation, this ruling provides insight into the Court’s analysis of physical presence considerations. In its opinion, the Court acknowledged that the law regarding what constitutes sufficient physical nexus to satisfy *Quill* is unclear, and that reasonable minds can differ on whether sufficient physical presence has been established in certain situations, leaving room for interpretation. In many cases, the close relationships between a business housing brick-and-mortar stores and an Internet affiliate of the business may result in a finding of sales tax nexus for the

⁵ *People ex rel. Beeler, Schad & Diamond, P.C. v. Relax the Back Corp.*, 65 N.E.3d 503 (Ill. App. Ct. 2016), quoting *Illinois ex rel. Schad, Diamond & Shedden, P.C. v. National Business Furniture, LLC*, 62 N.E.3d 1061 (Ill. App. Ct. 2016).

⁶ P.A. 100-0022 (S.B. 9), Laws 2017. Under existing law, income taxes are the only taxes barred under the Illinois False Claims Act. 740 ILL. COMP. STAT. 175/3(c).

⁷ Introduced in Illinois House on Feb. 2, 2017.

⁸ Introduced in Illinois Senate on Feb. 7, 2017.

Internet affiliate in the jurisdictions in which the brick-and-mortar stores are located through affiliate or agency nexus concepts. The fact pattern described in this case (that was applicable to Lush Internet and Lush Cosmetics prior to February 1, 2015) was somewhat different, as the affiliated companies were not aligned to work as a unit. Without an affiliated relationship, the sending of marketing materials, catalogs and emails would not by itself meet the requirements for physical presence in the state. Illinois has an affiliate nexus statute, but it is part of the click-through nexus statute.⁹ If Illinois had a separate affiliate nexus statute for the years at issue providing that an out-of-state retailer is subject to tax in Illinois if it sells the same or a substantially similar line products as a person located in Illinois, Relator's claim may have succeeded.

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⁹ 35 ILL. COMP. STAT. 105/2.