



**ILLINOIS STATE
BAR ASSOCIATION***

Tax Trends

The newsletter of the ISBA's Section on State & Local Taxation

February 2024 • Volume 67 • Number 7 •

Illinois Appellate Court Holds Governmental Sale Tax Exemption Does Not Apply to Taxpayer's Sales to Managed Care Organizations

By David J. Kupiec JD, CPA & Natalie Martin J.D.

On December 26, 2023, the Illinois Appellate Court issued an order in *Midwest Medical Equipment Solutions, Inc. v. Illinois Department Of Revenue and Illinois Independent Tax Tribunal*, 2023 IL App (1st) 221518-L, first division, affirming the Illinois Independent Tax Tribunal (hereafter "Tax Tribunal") judgment in favor of the Illinois Department of Revenue (hereafter "Department") holding that Medical Equipment Solution's (hereafter "Midwest") sales to a managed care organization (hereafter "MCO") were subject to the Illinois Retailers' Occupation Tax (hereafter "ROT"). The appellate court also affirmed the Tax Tribunal's denial of Midwest's request for penalty abatement.

By way of background, Midwest is a licensed provider of durable medical equipment (hereafter "DME") and provides breast pumps and nebulizers to individuals enrolled in Medicaid. As part of its business, Midwest, as well as other suppliers of DME, received payments for their sales of such items from the Illinois Department of Healthcare and Family Services (hereafter "DHFS"). In 2011, the State of Illinois expanded its use of MCOs resulting in the majority of Medicaid recipients being enrolled in MCOs. As a result of this expanded use of MCOs, Midwest was reimbursed by MCOs for certain transactions rather than the DHFS.

The Department audited Midwest for three separate audit periods between June 2012 through April 2020. During the audits the Department allowed Midwest the government body exemption for payments received directly from DHFS while assessing the lower 1 percent medical ROT on those transactions from which Midwest received reimbursement from an MCO. The Department contended that the governmental body exemption was not available to Midwest for payments received from MCOs as such transactions were not sales to DHFS or any other governmental body. Midwest filed protests with the Tax Tribunal contesting the assessed 1 percent ROT, as well as related penalties, and claiming that such sales continued to fall within exemption for sales to governmental bodies as DHFS was the ultimate purchaser.

The Tax Tribunal granted the Department's motion for summary judgment and denied Midwest's summary judgment motion finding that MCOs are not governmental bodies but merely private companies that contracted with DHFS and other governmental bodies. The Tax Tribunal added that MCOs were not DHFS's agent or conduits and that MCOs had separate contractual relationships with both DHFS and the providers like Midwest. The Tax Tribunal also denied Midwest's request to abate the tax penalties.

Midwest appealed the Tax Tribunal order to the appellate court arguing: 1) that Midwest was entitled to the Governmental Body ROT Exemption; 2) that limiting the exemption to actual governmental bodies would lead to a financial hardship to Midwest as they were contractually bound to charge the MCO a set charge according to DHFS's fee schedule which did not include the ROT; and 3) that the substance over-form-doctrine dictates that the governmental body DHFS was the purchaser of Midwest's products.

The appellate court explained that under the Illinois ROT Act a "tax is imposed upon the person engaged in the business of selling at retail tangible personal property" (35 ILCS 120/2(a)(West 2012). It added that medical appliances, such as those sold by Midwest, are taxed at the reduced 1 percent rate (86 Ill. Adm. Code 130.311(2022)) unless exempt from ROT if the sale was made to a governmental body. 35 ILCS 120/2-5(11)(West 2012). Moreover, only sales of tangible personal property invoiced directly to and paid by the governmental bodies that possess active E-numbers are exempt. 86 Ill. Adm. Code 130.2080(2015).

In addressing Midwest's first argument, the appellate court stated that the plain language of the statute unambiguously states that the sales proceeds are not exempt from the ROT unless the sale was made to a governmental body. The appellate court further explained that it has previously held that the term "governmental body," as used in the statute, does not include "agents or instrumentalities thereof" *Lombard Public Facilities Corp. v Department of Revenue*, 378 Ill App 3d 921, 929-30 (2008). Moreover, the appellate court noted that even if the sales to MCOs could conceivably constitute a sale to a government body, the exemption would not apply unless the MCOs provided an exemption identification number, which the MCOs do not possess. Accordingly, the appellate court held that that the governmental body exemption does not apply to Midwest's sales to MCOs.

The appellate court also dismissed Midwest's financial hardship argument noting that Midwest failed to develop a cohesive argument supporting its conclusion that it cannot as a practical matter negotiate to recover fees from the MCOs that are greater than those fees Midwest received from DHFS. The Court next dismissed Midwest's substance-over-form argument explaining that DHFS contracted with MCOs to provide Medicaid recipients with managed care plans in contrast to Midwest selling DHFS the tangible items at issue. The appellate court, in construing the record in the light most favorable to Midwest, found that there was no genuine issue of material fact, that Midwest was not entitled to the Governmental Body Exemption, and that the Department was entitled to summary judgment.

Finally, the appellate court denied Midwest's request for penalty abatement under the reasonable cause provisions citing the plain unambiguous language of the Governmental Body Exemption as confirmed by prior case law. The appellate court also noted that Illinois' exemption identification number requirement by itself should have put Midwest on notice of the taxability of the transactions at issue and is further support for denying Midwest's penalty abatement request.

As more governmental bodies look to contractually outsource certain operations and activities to be more efficient, decrease expenses, or simply to address staffing needs, uncertainties applying state and local tax exemptions like the governmental body exemption will become more common.

Please note that this order was filed under Supreme Court Rule 23 and may not be cited as precedent by any party except in their limited circumstances allowed under Rule 23 (e)(1). As of the date of this article, Plaintiff has not sought to appeal this matter to the Illinois Supreme Court.

© Illinois State Bar Association