ILLINOIS INDEPENDENT

TAX TRIBUNAL

MIDWEST MEDICAL EQUIPMENT SOLUTIONS, INC., Petitioner,	)	
v.	)	17 TT 120, 19 TT 93, and 21 TT 77
ILLINOIS DEPARTMENT OF REVENUE, Respondent.	)	Chief Judge James M. Conway

DECISION ON SUMMARY JUDGMENT MOTIONS

The Medicaid program provides medical assistance to low-income individuals and to people with disabilities. The federal and state governments jointly fund and administer the Medicaid program. Each state administers its own Medicaid program.

Midwest Medical Equipment Solutions, Inc. ("Midwest") is a licensed provider of medical items to individuals enrolled in Medicaid.

Prior to the audit periods at issue, the State of Illinois directly reimbursed Midwest when Midwest provided certain items to Medicaid enrollees and billed the State directly. Accordingly, Midwest categorized those transactions as direct sales to the government and Midwest properly treated those sales as tax exempt from State of Illinois sales tax as sales made to a government body.

Beginning in approximately 2011, the State of Illinois began contracting with Managed Care Organizations ("MCOs") to handle claims and, among other things, to provide care coordination for Medicaid enrollees.[1] During the audit periods at

[1] The Federal Medicaid website currently describes Managed Care as follows, in part: "Managed Care is a health care delivery system organized to manage cost, utilization, and

issue, Midwest supplied items to Medicaid enrollees covered under MCO plans and obtained direct reimbursements from MCOs pursuant to contracts between Midwest and the MCOs. Rather than treat those direct reimbursements as coming from the MCOs and as sales transaction subject to sales tax, Midwest treated those reimbursements as coming from the State of Illinois and did not pay sales tax on those transactions.

The Illinois Department of Revenue audited Midwest for three tax periods comprising June 2012 through April 2020. At the conclusion of those audits, the Department issued Notices of Tax Liability totaling approximately $313,000 in tax plus interest and penalties based on its inclusion of Midwest's sales with MCOs being subject to sales tax and not exempt sales to the State of Illinois.

Midwest argues that the State inserted MCOs as intermediaries between the State and Medicaid beneficiaries and that its sales are tax exempt regardless of whether the reimbursement payments come directly from the State or from the State via MCOs.

The Department argues that Midwest is not paid directly by the State of Illinois on its MCO sales, and it further argues that Midwest failed to provide exemption certificates required under its regulations as proof of sales to government bodies.

As explained below, Midwest's summary judgment motion is denied, and the Department's summary judgment motion is granted.

I.
Background

The Illinois Retailers' Occupation Tax Act ("ROTA") imposes a tax upon persons engaged in this State in the business of selling tangible personal property to purchasers for use or consumption. 86 Ill. Adm. Code 130.101. The Use Tax Act imposes a tax upon the privilege of using in this State tangible personal property purchased at retail from a retailer. 86 Ill. Adm. Code 150.101. Taken together, those taxes comprise "sales tax" in Illinois.

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quality. Medicaid managed care provides for the delivery of Medicaid health benefits and additional services through contracted arrangements between state Medicaid agencies and managed care organizations (MCOs) that accept a set per member per month (capitation) payment for these services." Stipulations ("Stip.") ¶ 100.

ROTA provides that certain sales transactions are exempt from tax imposed under that act. Section 2-5, titled Exemptions, states "Gross receipts from proceeds from the sale of the following tangible personal property are exempt from the tax imposed by this Act" and includes, in part:

> (11) Personal property sold to a government body, to a corporation, society, association, foundation, or institution organized and operated exclusively for charitable, religious, or educational purposes, or to a not-for-profit corporation, society, association, foundation, institution, or organization that has no compensated officers or employees and that is organized and operated primarily for the recreation of persons 55 years of age or older. … On and after July 1, 1987, however, no entity otherwise eligible for this exemption shall make tax-free purchases unless it has an active identification number issued by the Department.

35 ILCS 120/2-5 (11).

The Department's regulation, 86 Ill. Adm. Code 130.2080- Sales to Governmental Bodies, Foreign Diplomats and Consular Personnel, prior to 2015, provided, in part, that "Sales made to a governmental body (Federal, State, local or foreign) are exempt from the Retailers' Occupation Tax. Such sales are not exempt unless a governmental body has an active exemption number issued by the Department." That regulation was amended in 2015 to add, in part, that "[o]nly sales of tangible personal property invoiced directly to and paid by government bodies that possess active E-numbers are exempt." Stip. ¶¶ 97-98.[2]

A.
Midwest Transactions

Midwest is a licensed provider of medical products, otherwise known as durable medical equipment ("DME"). Midwest's DME includes nebulizers and breast pumps. Stip ¶ 1.[3] Midwest provides those items pursuant to medical prescriptions to Medicaid enrollees. Pet'r Mem. in Supp. of Mot. for Summ. J. at 2.

Prior to the audit periods at issue, when Midwest provided DME to a Medicaid enrollee before the State began contracting with MCOs, the State of Illinois would reimburse Midwest by issuing payment directly to Midwest. *Id*. at 3.

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[2] Administrative regulations have the force and effect of law and are interpreted with the same canons as statutes. See *Hartney Fuel Oil Co. v Hamer*, 2013 IL 115130, ¶37 (citing *People ex rel. Madigan v. Ill. Commerce Comm'n*, 231 Ill. 2d 370, 380 (2008)).

[3] Nebulizers are used to inhale medication into the lungs *Id*.

Midwest, in turn, would treat those sales as tax exempt from ROT pursuant to the government body exemption found in ROTA. *Id*.

Since approximately 2011, the State of Illinois, through its Department of Healthcare and Family Services ("IDHFS"), began utilizing mandatory MCOs in the Medicaid healthcare services process.[4] *Id.* MCOs contract with the State and are paid from IDHFS for services they provide to Medicaid patients. *Id*.; Stip. ¶ 48. In 2018, Illinois expanded its managed care program to cover all counties in Illinois under a program called HealthChoice Illinois. Stip. ¶ 57.

New Medicaid patients are required to choose an MCO of their choice, and if they don't select an MCO, one is selected for them by IDHFS. *Id*. at 4. Currently, over 80% of Illinois Medicaid enrollees use an MCO and that number continues to grow. *Id*; Stip. ¶ 50.

Licensed providers of DME, like Midwest, are required to enter into contracts with MCOs in order to provide their items to Medicaid enrollees covered through MCOs. Pet'r Mem. in Supp. of Mot. for Summ. J. at 3.

While not germane to the audit periods at issue, Illinois Public Act 102-700, effective July 1, 2022, exempts sales and purchases of breast pumps from ROTA, the Service Occupation Tax Act, the Use Tax Act, and the Service Use Tax Act. Accordingly, going forward, sales of breast pumps from Midwest to MCOs will be exempt from ROTA regardless of whether or not the government body exemption applies to those sales.

B.
State of Illinois and MCO Contracts and Payments

The State of Illinois, through IDHFS, enters into contracts with MCOs. Stip. ¶ 27. IDHFS-MCO contracts are substantially similar and a model contract form that can be adjusted as appropriate is available from IDHFS. Stip. ¶ 39.

Those contracts explicitly state that an MCO acts "as an independent contractor and not as an agent or employee of, or joint venture with, the State." Stip. ¶ 45. Those contracts further contain provisions that MCOs will indemnify and hold IDHFS harmless for certain claims, complaints, and causes of action related to an MCO's failure to pay providers as well as to hold IDHFS, its officers,

[4] MCOs are also referred to as Medicaid Health Maintenance Organizations or HMOs. Stip. ¶ 23.

agents, and employees harmless from disputes between MCOs and third parties. Stip. ¶¶ 43 and 46.

The general duties of a MCO pursuant to a contract with IDHFS include, but are not limited to:

> a. providing covered services to Medicaid enrollees;
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> b. establishing, maintaining, and providing a provider network for enrollees;
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> c. providing care coordination services, care management services, health assessments, and care planning;
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> d. informing enrollees of provided services;
>
> e. meeting quality assurance and health and safety guidelines;
>
> f. remitting payments to providers; and
>
> g. entering into agreements with providers.

Stip. ¶ 41.

The general duties of the IDHFS pursuant to a contract with an MCO, include, but are not limited to, tasks relating to enrollment, paying the MCO, reviewing marketing materials, and providing MCOs with historical claim data. Stip. ¶ 42.

MCOs are reimbursed through IDHFS through what are known as capitated payments. Stip. ¶ 37. The capitated payments are based on certain "rate cells" such as age, sex, location, and other information. *Id*. Those cells are multiplied by the number of patients in a particular month which results in a "fixed-fee" per patient multiplied by the number of patients. *Id*. MCOs' acceptance of capitated payments is considered payment in full. Stip. ¶ 44. In other words, an MCO is paid a lump sum from IDHFS to pay for all services for all patients provided by the MCO regardless of what specific services, if any, are provided to any particular patient in a particular month. Additionally, a monthly lump sum payment from IDHFS to an MCO is made without regard to what transactions, if any, are conducted between an MCO and all outside third parties, like Midwest.

C.
Midwest Medical and MCO Contracts

After the State began contracting with MCOs, Midwest entered into contracts with MCOs in order to continue to service and be reimbursed for DME it provided to Medicaid patients covered under MCOs. Ex. H. Pursuant to those contracts, the amount of reimbursements MCOs pay Midwest are related to a fee schedule posted by IDFHS and which is updated periodically. *Id.*

The reimbursements are known as "Fee for Service" as a specific fee is paid from the MCO to Midwest for each item of DME provided to each of the patient based on the applicable fee schedule.

In order to send DME to a patient, Midwest would request proof of the patient's eligibility for Medicaid from the patient and confirm the Medicaid status of the patient through a State of Illinois website database. For those patients who were covered by an MCO, Midwest would prepare an invoice for the DME provided to the patient and submit the invoice to the MCO for payment. Stip. ¶¶ 62-66.

The charge for the DME was based on the fee schedule posted by IDHFS. Ex. E. The fee schedule is the same fee schedule used by Midwest when it would bill the State directly. Stip. ¶ 67. In other words, Midwest utilized the same fee schedule in seeking reimbursement directly from the State and also when it sought reimbursement from MCOs.

II.
Analysis

The Department conducted three separate audits of Midwest. The audits covered periods June 2012 through December 2015; January 2016 through December 2017; and January 2018 through 2020. At the conclusion of each audit, the Department assessed Midwest additional sales tax along with interest and penalties by treating Midwest's sales to MCOs as taxable transactions and by disregarding Midwest's characterization of those sales as direct and, therefore, exempt sales tax transactions made to the State of Illinois. The aggregate amount of sales tax assessed by the Department is approximately $314,915, and the aggregate amount of late payment penalties is approximately $70,729. Stip. ¶¶ 77,82,88.

The Department's findings were included in notices of deficiencies issued to Midwest for those sales tax periods. The findings contained in those notices are deemed to be *prima facie* correct and are *prima facie* evidence that the amount of tax and penalties calculated on those findings due are correct. 35 ILCS 5/904(a). At this juncture in the proceedings, it is Midwest's burden to come forward with clear and convincing evidence as to why its transactions with MCOs should be treated as direct sales to the State of Illinois. *See Copilevitz v. Department of Revenue*, 41 Ill. 2d 154, 156-157 (1968).

Summary judgment is proper when "the pleadings, depositions and admissions on file, together with affidavits, if any, show there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." *Performance Marketing Association, Inc. v. Hamer*, 2013 IL 11496, ¶12 (2013) (quoting 735 ILCS 5/2-1005(c)(2010)). In this matter, the parties have agreed to a stipulation of facts and submitted certain exhibits. Midwest filed a Motion for Summary Judgment, a Brief in support of its Motion for Summary Judgment and a Combined Reply and Response. The Department has filed a Cross-Motion for Summary Judgment and a Response and a Memorandum in Support of its Cross-Motion and its Response.

Midwest is claiming an exemption from tax. As a general proposition, a taxpayer claiming an exemption from tax bears the burden of proving it is entitled to the exemption. "Under Illinois law, taxation is the rule. Tax exemption is the exception." *Provena Covenant Medical Center v. Department of Revenue*, 236 Ill. 2d 368, 388 (2010). "A person claiming an exemption from taxation has the burden of proving clearly that he comes within the statutory exemption. Such exemptions are to be strictly construed, and doubts concerning the applicability of the exemptions will be resolved in favor of taxation." *Zenith Electronics Corp. v. Department of Revenue*, 293 Ill. App. 3d 651, 655 (1st Dist. 1997) (citing *Van's Material Co. v. Department of Revenue*, 131 Ill. 2d 196, 216 (1989)).

While Illinois case history on the burden of proof standard in claiming a tax exemption and the limited role of judicial interpretation of exemptions is not new, it was recently repeated and emphasized in *Safety-Kleen Sys. v. Department of Revenue*, 2020 Il App (1st)191078, *Pet. denied*, 2020 Ill. LEXIS 664. In *Safety-Kleen,* Justice Pucinski wrote:

> Tax exemptions are strictly construed, and we must resolve any doubts regarding an exemption's applicability in favor of taxation. *Horsehead Corp. v. Department of Revenue*, 2019 IL 124155, ¶ 42. "Under Illinois law, taxation is the rule. Tax

exemption is the exception." (Internal quotation marks omitted.) *Oswald v. Hamer*, 2018 IL 122203, ¶ 12, 425 Ill. Dec. 626, 115 N.E.3d 181. "Provisions granting tax exemptions *** must come not only within the terms of the statute but also the authority given by the constitution." [***11] (Internal quotation marks omitted.) *City of Chicago v. Illinois Department of Revenue*, 147 Ill. 2d 484, 491, [****102] [**954] 590 N.E.2d 478, 168 Ill. Dec. 841 (1992). "Courts have no power to create exemption from taxation by judicial construction ***." *Id.* The party seeking tax exemption bears "[t]he burden of proving the right to exemption," and in determining whether the property is subject to the exemption, we must construe all facts and debatable questions in favor of taxation. (Internal quotation marks omitted.) *Eden Retirement Center, Inc. v. Department of Revenue*, 213 Ill. 2d 273, 289, 821 N.E.2d 240, 290 Ill. Dec. 189 (2004).

2020 IL App 191078 at ¶ 18.

A.
The Government Body Sales Tax Exemption

Midwest begins its arguments by discussing statutory interpretation and referencing the Department's regulation, 86 Ill. Adm. Code 130.101, that describes certain sales that are exempt from ROT, including those "(i) are made to any governmental body…"[5]

"The fundamental rule of statutory interpretation is to determine and give effect to the intent of the legislature, and the statutory language is the best indicator of the legislature's intent." *Quality Saw & Seal, Inc. v. Illinois Commerce Com'n*, 374 Ill. App. 3d 776, 781 (2nd Dist. 2007). "The best indication of legislative intent is the statutory language, given its plain and ordinary meaning." *Andrews v. Kowa Printing Corp*., 217 Ill. 2d 101,106 (2005). "Where the language is clear and unambiguous, we must apply the statute without resort to further aids of statutory construction." *Id*. The familiar rules of statutory construction apply with equal force to administrative regulations. *Kean v. Wal-Mart Stores, Inc*., 235 Ill. 2d 351, 367 (2009).

The language of the statute and regulation when they employ the term "government body" is clear and unambiguous. Midwest doesn't quarrel with that specific term, but it improperly states that "The Code sets forth a number of categories that are exempt from the ROT, including sales that are ultimately paid

[5] The identical term "governmental body" is used in ROTA's exemption Section 2-A which exempts "(11) Personal property sold to a government body…"

for by government bodies." Pet'r Mem. in Supp. of Mot. for Summ. J. at 8. Neither the statute or regulation use the term "ultimately paid for," but state the exemption applies to "property sold to a government body" (the statute) and sales "made to any government body"(the regulation). In other words, the exemption applies when the sales transaction is conducted directly with a government body.

B.
Economic Substance Over Form Doctrine and the Application to Midwest

Midwest argues that transactions between the State and MCOs and those between MCOs and Midwest should, in effect, be collapsed and viewed to reflect that MCOs are really just conduits or agents of the State, and that when Midwest provides a medical device to an MCO member, it is the State and not the MCO, who is really paying for the medical device. Pet'r Mem. in Supp. of Mot. for Summ. J. at 10-14. To support its position, Midwest argues that the "substance over form" doctrine should be applied in its case to determine the true economic realities of its medical device sales.

The long-standing substance over form doctrine stands for the principle that substance over form determines the taxability of transactions and that legal transactions and entities that have no real economic substance or business purposes are disregarded for tax purposes. That doctrine was first advanced in *Gregory v. Helvering*, 293 U.S. 465 (1935). [6]

The substance over form doctrine pronounced in *Gregory* has been applied, or at least uniformly recognized even where it was found not to be applicable, over the better part of the last century since *Gregory* was decided, including in both federal and state courts' income and sales tax cases. Illinois is no exception. *See JI Aviation, Inc. v. Department of Revenue*, 335 Ill. App. 3d 905 (1st Dist. 2002) (substance over form doctrine required a purchase from a non-retailer, which used a retailer conduit to convey title involving a like-kind exchange of aircraft, to be treated as a non-taxable sale); *Zebra Technologies Corp. v. Topinka*, 344 Ill. App. 3d (1st Dist. 2003) (transactions involving intellectual property between U.S. company and Bermuda subsidiary required "a look at substance over form."). *See also, Exelon Corporation v. Commissioner of Internal Revenue*, 906 F.3d 513 (7th Cir. 2018) (Exelon's structuring of SILO tax shelter transactions did not reflect the

[6] A longer history and review of the substance over form doctrine can be found in this court's ruling on summary judgment motions in *PepsiCo Inc. & Affiliates v. Illinois Department of Revenue*, (16TT82 and 17TT16-Docket No. 49 May 5, 2021).

economic realities of the transactions); *In re Stoecker*, 179 F.3d 546, 550 (7th Cir. 1999) (substance over form doctrine applied to disregard title transfer from aircraft retailer to its financing affiliate in a bankruptcy matter).

The substance over form doctrine is used by federal and state taxing authorities to prevent manipulation by taxpayers to avoid taxation by arranging transactions that have no economic reality. Its application results in transactions being collapsed or ignored. It is a sword to be wielded by tax authorities.

It is exceedingly rare for a taxpayer to claim, and to ultimately succeed, that the doctrine should apply to transactions cast and set in motion by the taxpayer. To allow a taxpayer to avail itself of the substance over form doctrine as a shield against taxability, except in unique and rare circumstances, would have unintended consequences as taxpayers would ignore their own actions and provide an overly simplistic view of events to skirt tax laws in a chaotic and uneven manner.

Midwest cites to the *JI Aviation* case as supporting its position that the true economic reality of its DME sales to MCO members are really sales made directly to the State. Pet'r Mem. in Supp. of Mot. for Summ. J. at 11-14. In that case, JI Aviation purchased an airplane from the Richland Development company, but the parties explicitly inserted Nationsbanc Leasing Corp. in their sales contract to act as a conduit in effectuating a like-kind exchange of aircraft and the transfer of title between them.

The Illinois Department of Revenue assessed use tax on the transactions as it deemed Nationsbanc as a retailer of airplanes and as the seller in the transaction.

JI Aviation argued that Nationsbanc's role in the overall transaction should be ignored and that Richland should be considered the true seller. With Richland considered a non-retailer and the sale of the plane to be an isolated or occasional sale, the sale would not be subject to use tax.

The Department's administrative law judge affirmed the notice assessing use tax, but, upon appeal, the Circuit Court of Cook County agreed with JI Aviation and reversed the Department's decision.

Upon further appeal, the Illinois Appellate Court also agreed with JI Aviation and held that Nationsbanc's role as a conduit could be ignored to reflect that the true purchaser and seller of the airplane was JI Aviation and Richland. The court expressly noted the limited role of Nationsbanc in the written agreements between the 3 entities, that Nationsbanc was obligated to transfer legal title to JI

Aviation, and that it was impossible to view Nationsbanc as anything but an intermediary. 335 Ill. App. 3d at 919-921.

In addition to citing to *JI Aviation,* Midwest argues that the MCOs act as agents for the State and that the State exerts a significant degree of control over the MCOs as support for its contention that the substance over form doctrine is applicable in this case. But the factual record and legal analysis in this case support the opposite conclusion.

In *JI Aviation*, the contractual language spelled out Nationsbanc's limited role which was to be a conduit between the true buyer and seller. In the present case, there is no contractual relationship between the State and Midwest for Midwest's sales to the MCOs. The State-MCO contracts explicitly state that the MCOs are independent contractors and are not agents of the State. MCOs and Midwest have separate contracts for transactions between them, and Midwest does not have contracts with the State relating to the sale of DME to the MCOs. While the State- MCO contracts understandably have many terms and provisions due to the highly regulated field of providing health care, the State does not "control" MCOs, explicitly or implicitly. MCOs simply are not utilized for the limited purpose of being a mere conduit for DME sales between the State and Midwest.

The role of MCOs in their contracts with the State is to provide comprehensive health care, and not just DME, to its members. The MCO payments received from the State in providing the Medicaid health care plans and benefits are not tied to any DME provided to its members, but to the capitated rates set by the State. The MCOs receive those payments regardless of whether they provide no DME, some DME, or an inordinate amount of DME to its members in any billing period. Midwest was not a party to those contracts and Midwest's Chief Operating Officer stated in his deposition that State-MCO contracts were never reviewed, nor were the specific terms of those contracts even known before he executed contracts on behalf of Midwest and with the MCOs. Ex.D. p. 70.

The State is not a party to the MCO-Midwest contracts. While Midwest agreed for payments received from MCOs for DME to be set to publicly available State fee schedules for DME sales made directly to the State, the MCOs and Midwest were free to choose any agreed upon payments without regard to any fee schedule in their roles as the exclusive parties to their DME arrangements. [7]

[7] Midwest does not argue that any term or provision in State-MCO contracts or MCO-Midwest contracts are ambiguous.

In arguing that the substance over form doctrine is inapplicable in this case, the Department points to *JB4 Air LLC v. Department of Revenue*, 388 Ill. App. 3d 970 (2nd Dist. 2009). In that case, the taxpayer, a single member LLC which purchased an airplane, claimed that the LLC should be considered an "individual" under the Use Tax Act and, as a result, the airplane purchase should be exempted from use tax. The Appellate Court disagreed and found the term "individual" to be unambiguous and referred to natural humans and not to business entities. *Id*. at 973-75.

The court went on to address, and reject, *JI Aviation* as lending support for the LLC's additional argument that the "substance over form" doctrine should be applied in the case. *Id*. at 976.[8] The court held that:

> We find both *JI Aviation* and *Weber-Stephens* inapplicable here. In those cases, the courts faced situations where an intermediary was used in the sales transaction and where sales documents limited the role of the intermediary and identified the role of the intermediary as an agent of the true seller or purchaser. …In the present case, we need not evaluate the substance of the transaction, as the identity of the purchaser was undisputed and there was no intermediary…

388 Ill. App. 3d at 977 (citations omitted).

Similarly, in the present case, the identities of the purchasers (the MCOs) are undisputed pursuant to the MCO-Midwest contracts and the MCOs are not simply intermediaries. Midwest cannot undo or recast its contracts with MCOs in light of the express contractual terms it had with the MCOs and the lack of the State's involvement in setting the terms of those contracts or playing any role in those contracts. Midwest cannot disavow the MCO transactions of its own choosing and suggest its DME transactions are really with the State. Midwest's "substance over form" argument is rejected.

[8] The court also rejected *Weber-Stephens Products, Inc. v. Department of Revenue*, 324 Ill. App. 3d 893 (1st Dist. 2001) ("substance over form" used to determine seller and purchaser where an intermediary was used for an aircraft sale).

C.
Entities with Agency Relationships with a Government Body Are Not Entitled to the Government Body Exemption

Midwest argues that all MCOs are agents of the State of Illinois and Midwest is therefore entitled to claim a government body exemption. Pet'r Mem. in Supp. of Mot. for Summ. J. at 13-14.

The MCOs are not agents of the State of Illinois. As noted above, the State-MCO contracts contain provisions that explicitly state that the MCOs are not agents of the State. A factual review of the language in both groups of contracts in this case do not support a finding that the MCOs are agents of the State, but quite the contrary. The State does not own or control MCOs. MCOs do not stand in the shoes of the State. MCOs cannot subject the State to liability. Moreover, and more importantly, even if the MCOs were considered agents for the State, the exemption still would not apply as a matter of law.

The Department addresses Midwest's agency argument by citing to *Lombard Public Facilities Corp. v. Department. of Revenue*, 378 Ill. App. 3d 921 (2d Dist. 2008) ("*Lombard*").[9] In that case, the Village of Lombard utilized the plaintiff, Lombard Public Facilities Corp. ("LPFC"), to help in securing financing for a construction project. The village gave LPFC certain powers with regard to securing the financing.

LPFC was denied a government body exemption by the Department and appealed claiming it was an agent of the Village and entitled to the exemption.

In *Lombard*, the court held that the government body exemption statute's language was unambiguous and only applied to government bodies, and not agents or instrumentalities thereof. *Id*. at 930.[10] Accordingly, the exemption was denied.

Midwest's rejoinder to the Department's citations to *Lombard* is to claim "That while the court in *Lombard* held that LPFC could not avail itself of the government body exemption because the exemption did not extend to the agents of

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[9] The Department also cites to, *inter alia*, *Berwyn Lumber Co. v. Korshak*, 34 Ill. 2d 320 (1966) (exemption denied to downstream vendor which was an independent contractor as not being a governmental body). "If the intention of the General Assembly was to make the exclusion depend on more remote economic effects it has not said so, …" *Id*. at 323.

[10] The court further noted that LPF did not meet the definition of an agent of the Village in any event. *Id*. at 933.

the government body, that court did not address agency from a substance over form standpoint as Midwest Medical argues this Court should do so here." Pet'r Response at 12. Midwest cannot get in the back door what is barred from the front door. Midwest's particular arguments as to both agency and the application of the substance over form doctrine are both found to be without merit.

D.
Exemption Certificates

86 Ill. Adm. Code 130.2080-Sales to Governmental Bodies, Foreign Diplomats and Consular Personnel provides that, in order to claim that a transaction to a government body is exempt from ROT, the governmental body has to have an active "E-number" and it has to provide that number to the retailer. Without proof of that number, an exemption cannot be claimed.

Of course, because the MCOs are not "government bodies," they cannot obtain an E-number so Midwest cannot provide the proof required to claim an exemption on all its MCO sales.

Midwest first argues that it would be impractical for MCOs to provide exemption certificates on every transaction they complete with service providers and, secondly, that it doesn't matter whether an MCO has an E-number as payment is ultimately issued from the State to the provider. Pet'r Mem. in Supp. of Mot. for Summ. J. at 13. Its first premise about impracticality is not correct, but it also presupposes that MCOs have E-numbers, which they do not as they are not government bodies. If they were government bodies, they could simply provide the required E-Number to a service provider just like actual government bodies do on a routine basis to retailers who sell tangible personal property directly to them. The second statement is also incorrect as a requisite payment necessary to claim the exemption is not whether the payment is ultimately issued, but rather directly issued, from the State to the provider, in this case, Midwest. The State is not party to any direct payments from the MCOs to Midwest.

In order to claim an exemption for its direct sales with MCOs, Midwest has the burden to provide proof of the MCOs E-numbers. It is axiomatic that providing such proof is an impossibility in this case as MCOs are not government bodies. Midwest's failure to provide exemption certificates provides an additional ground to require Midwest to pay sales tax on its sales to MCOs.

E.
Penalty Abatement

The Department assessed approximately $70,000 in late payment penalties in the aggregate on the three Notices in this matter that cover the sales tax periods from June 2012 through April of 2020, a period of almost 9 years in which Midwest did not pay sales tax on its MCO DME transactions.

Certain penalties, including late payment penalties, can be abated where reasonable cause to excuse the non-payment of taxes exists. *See* 35 ILCS 735/3-8. In determining whether reasonable cause exists, "[t]he most important factor is the extent to which the taxpayer made a good faith effort to determine the proper tax liability and to file returns and pay the proper liability in a timely fashion." 86 Ill. Adm. Code 700.400(b). "A taxpayer will be considered to have made a good faith to determine and file and pay the proper tax liability if the taxpayer exercised ordinary business care and prudence in doing so. A determination of whether a taxpayer exercised ordinary business care and prudence is dependent on the clarity of the law or its interpretation and the taxpayer's experience, knowledge, and education. " 86 Ill. Adm. Code 700.400 (c).

The determination of whether a taxpayer acted with reasonable cause is made on a case-by-case basis, taking into account all pertinent facts and circumstances. In the *Horsehead* case, the Illinois Supreme Court reviewed the appropriateness of a late penalty assessment in a case involving the application of a chemical exemption under the use tax statute and whether a certain manufacturing process involving coke caused "a direct and immediate change" on the product manufactured. *Horsehead Corp. v. Department of Revenue*, 2019 IL 124155, ¶¶ 49-52. The court found that the term "direct and immediate change" in the use tax chemical exemption had no specific statutory definition and that the case law provided no guidance as to how the chemical exemption should be interpreted and applied to the use of coke in its manufacturing process. *Id*. at 51.[11]

[11] The Court also noted the severity of the late payment penalty for the Horsehead company which was pegged at almost a quarter of the assessed tax liability. The Illinois legislature sets the calculations for late penalty payments by statute. A failure to pay penalty based on an assessed tax deficiency calculated when a tax audit is conducted is calculated at "20% of any amount that is paid after the date the Department has initiated an audit or investigation of the taxpayer." 35 ILCS 735/3-3(b-20)(2). That statutory calculation, applied to the tax periods at issue that span approximately 8 years of unpaid sales tax on DME by Midwest, validates the penalty assessments calculations, which appear to be facially severe, but upon scrutiny, are more a matter of the lengthy 94 months' worth of unpaid sales taxes on DME provided to MCOs by Midwest.

In arguing that the late payment penalties should be abated in this case, Midwest claims that there is no case law directly on point on whether DME sales to MCOs are exempt from ROT, so the assessment of late payment penalties is inappropriate. Midwest Reply at 15. But that is defining, and misconstruing, the issue in this case way too narrowly. That would allow many taxpayers to claim a specific transaction or set of transactions they are engaged in to be unique and not covered by case law. MCOs are just like any other company that contracts with the State and then separately contracts with unrelated third party vendors to provide certain tangible personal property for which the government body, upstream from the vendors, can be said to be the indirectly source of payment that the vendors receive. The issue in this case is whether a business which is not paid directly, but indirectly, and is downstream from government body can claim an exemption from sales tax.

As noted previously, there was case law directly on point and available to Midwest that indirect payments to a downstream vendor company from a government body were not exempt from sales tax prior to the audit years at issue, including *Berwyn Lumber Co. v. Korshak*, 34 Ill. 2d 320 (1966) and *Lombard Public Facilities Corp. v. Department. of Revenue*, 378 Ill. App. 3d 921 (2d Dist. 2008) (both cases cited *infra*.)[12]

Simply saying that the State/MCO transactions and the MCO/Midwest transactions should be collapsed to achieve the result Midwest would like is not reasonable in light of the unambiguous government body exemption statute, the terms of the contracts including the State/MCO contracts that Midwest did not know the terms of before entering the contracts with MCOs, and the case law on the exemption not being available to downstream business who, arguably at best, can claim they receive State funds indirectly through a completely separate entity than the State.

On balance, the late payment penalties assessed for the three audit periods at issue are reasonable. Midwest's request for penalty abatement is denied.

[12] The Department also cites to several Department general information letters ("GILs") that pre-date the audit periods at issue that state only direct payments from the State are exempt. GILs are not precedential, however, they do alert the public to the Department's position on a matter.

III.
Conclusion

The court is mindful that the government body exemption, once available to Midwest when it dealt directly with the State, became unavailable to Midwest when the State switched to a MCO Medicaid model. Whether or not the State wishes to exempt DME products sold to MCOs is an issue for the State Legislature which can give and take away tax exemptions. It is not a matter for judicial intervention.

Midwest has failed in its burden to prove it is entitled to the government body exemption under ROTA. Its sales of DME to MCOs are not sales made directly to the State of Illinois. The Department's Notices of Deficiency, for the three audit periods at issue, are upheld.

For the reasons stated above, Midwest's Motion for Summary Judgment is DENIED and the Department's Motion for Summary Judgment is GRANTED.

This is a final order subject to appeal under section 3-113 of the Administrative Review Law, and service by email is service under section 3-113(a). See 35 ILCS 1010/1-90; 86 Ill. Adm. Code 5000.330. The Tax Tribunal is a necessary party to any appeal.

_/s/ *James Conway*_____
JAMES M. CONWAY
Chief Administrative
Law Judge

Date: September 6, 2022