Morrison & Foerster News
Mitchell A. Newmark and Scott M. Reiber, Co-Editors Fall 2010

State & Local Tax Insights

Look What the CAT Dragged in: Ohio Imposes the New Tax on Business Activities Outside Its Borders

By Thomas H. Steele and Kirsten Wolff

Introduction

As most national businesses are already aware (perhaps painfully so), Ohio is phasing out its Corporate Franchise Tax and introducing a Commercial Activity Tax ("CAT") on gross receipts from business activities in its place. The CAT is a gross receipts tax—not a sales tax—and therefore must be fairly apportioned to reflect the taxpayer's business activities in the state in order to meet the requirements of the Commerce and Due Process Clauses of the U.S. Constitution.

However, the CAT, at least where services are involved, does not fairly apportion receipts based on business activities. Rather, the CAT sourcing rules, promulgated by the Ohio Department of Taxation (the "Department"), source gross receipts from services to the state based on the benefit that the purchaser receives in Ohio. Because the location of the benefit to the purchaser often has no relationship to the location of the business activities that created that benefit, the sourcing rules result in the improper apportionment of income to Ohio. The CAT sourcing rules are distortive at best and entirely unconstitutional at worst. It is only a matter of time before taxpayers begin to take notice and challenge these rules.

(Continued on page 2)

Inside

State & Local Tax Group

San Francisco
Thomas H. Steele 415.268.7039 tsteele@mofo.com
Andres Vallejo 415.268.6793 avallejo@mofo.com
Peter B. Kanter 415.268.6005 pkanter@mofo.com
James P. Kratochvill 212.336.4007 jkratochvill@mofo.com
Scott M. Reiber 415.268.7630 sreiber@mofo.com
Kirsten Wolff 415.268.6638 kwolff@mofo.com

Denver
Thomas H. Steele 303.592.2243 tsteele@mofo.com

Los Angeles
Gary W. Maeder 213.892.5846 gmaeder@mofo.com

New York
Paul H. Frankel 212.468.8034 pfrankel@mofo.com
Hollis L. Hyans 212.468.8050 hhyans@mofo.com
Craig B. Fields 212.468.8193 cfields@mofo.com
R. Gregory Roberts 212.336.8486 rroberts@mofo.com
Irwin M. Slomka 212.468.8048 islomka@mofo.com
Michael A. Pearl 212.468.8135 mpearl@mofo.com
Amy F. Nogid 212.468.8226 anogid@mofo.com
Roberta Moseley Nero 212.506.7214 rnero@mofo.com
Mitchell A. Newmark 212.468.8103 mnewmark@mofo.com
Marjorie S. Elkin 212.468.8133 melkin@mofo.com
Richard C. Call 212.336.4364 rcall@mofo.com
Nicole L. Johnson 212.336.4305 njohnson@mofo.com
Rebecca M. Ulich 212.336.4308 rulich@mofo.com

Sacramento
Eric J. Coffill 916.325.1324 ecoffill@mofo.com
Carley A. Roberts 916.325.1316 croberts@mofo.com
Timothy A. Gustafson 916.325.1312 tgustafson@mofo.com
Jenny Kim 916.325.1336 jennykim@mofo.com

Washington, D.C.
Linda A. Arnsbarger 202.887.1598 arnsbarger@mofo.com

New Ohio CAT

(Continued from Page 1)

The CAT'S Sourcing Rules

The CAT is imposed on "each person with taxable gross receipts for the privilege of doing business in [Ohio]." Ohio Rev. Code Ann. § 5751.02. The statute sources gross receipts from services to Ohio "in the proportion that the purchaser's benefit in this state with respect to what was purchased bears to the purchaser's benefit everywhere with respect to what was purchased." *Id.* § 5751.033(I); Ohio Dep't Tax, Tax Rule 5703-29-17(A). The statute provides that "[t]he physical location where the purchaser ultimately uses or receives the benefit of what was purchased shall be paramount in determining the proportion of the benefit in this state to the benefit everywhere." Ohio Rev. Code Ann. § 5751.033(I); Ohio Dep't Tax, Tax Rule 5703-29-17(A). Thus, receipts from a service will likely have an Ohio situs if the service is used by the purchaser in Ohio.

The Department has provided specific sourcing rules for 54 different types of services, from accounting to waste management. Ohio Dep't Tax, Tax Rule 5703-29-17(C)(1)-(54). Many of these sourcing rules plainly apportion an unwarranted amount of income to Ohio. In certain factual instances, the rules effectively apportion 100% of a business's receipts to Ohio even though there can be little doubt the business has no activities there.

For example, legal services are sitused to Ohio if those services "relate to Ohio . . . regardless of where the services are performed." Ohio Dep't Tax, Tax Rule 5703-29-17(C)(32)(a). Thus, "if an attorney drafts a will in Kentucky for a client who resides in Ohio, the gross receipts from this service will be sitused to Ohio since the services relate to an Ohio estate." *Id.* Similarly, if an attorney prepares a client's case for the Ohio Board of Tax Appeals and travels to the client's business location in Tennessee, for example, in order to prepare the case, "[t]he gross receipts received by the attorney for *all services*, including those services related to interviewing the client's employees in Tennessee, are sitused to Ohio." *Id.* (emphasis added). In cases in which the legal matter does not "relate to Ohio," the rules provide for sourcing principles based on the location of the purchaser of the legal services. Ohio Dep't Tax, Tax Rule 5703-29-17(C)(32)(b)-(e). None of these rules relate to the location in which the legal services are performed, which, of course, would be the most relevant location for the purposes of determining where the activities producing the gross receipts are located.

The rules for other services are no better. For example, the rules for cable and satellite television provide that "[g]ross receipts from cable/satellite services are sitused to Ohio, in general, if the purchaser's (subscriber's) place of primary use is in Ohio, regardless of where the cable and satellite services originate." Ohio Dep't Tax, Tax Rule 5703-29-17(C)(9)(a). The rules note that "[i]n general, the purchaser's (subscriber's) billing address will be accepted as the primary use location unless the seller of the service knows the purchaser (subscriber) is using the service in multiple locations." *Id.* Thus, the Department's sourcing rule does not apportion gross receipts for cable and satellite services sold to customers in Ohio on the basis of the service provider's activities in the state, but rather looks only to the billing address of the customer.

Internet and web-hosting services and computer programming are also sourced without regard to the location of the business activities that produce the benefit of these services. Instead, "[i]f Internet or web hosting services are performed for a purchaser only located in Ohio, one hundred per cent of the gross receipts are sitused to Ohio regardless of where the web host is located." Ohio Dep't Tax, Tax Rule 5703-29-17(C)(30)(a); *see also* Ohio Dep't Tax, Tax Rule 5703-29-17(C)(13)(a) (parallel provision for computer programming).

Thus, the Department's sourcing rules for services taxed by the CAT are affixed to the location of the purchaser of the service, not to the location of the business activities of the taxpayer. If current Supreme Court Commerce Clause decisions are to be respected, this misattribution results in a tax that is probably unconstitutional on its face, and almost certainly unconstitutional as applied in cases in which the operations of the taxpayer are physically located outside of Ohio.

Constitutional Standards for Apportionment

The United States Supreme Court has repeatedly held that, under the Commerce Clause, a state may only tax a fairly apportioned share of the tax base (e.g., income or gross receipts) produced by an interstate activity. *See*, *e.g.*, *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) (taxes on interstate commerce must meet a four-part test, including the

(Continued on page 4)

Upcoming 2010 Speaking Engagements

September 22

Annual State and Local Tax Update: West Coast

San Francisco, California
Eric J. Coffill
Edward L. Froelich
Hollis L. Hyans
Peter B. Kanter
James P. Kratochvill
Scott M. Reiber
Thomas H. Steele
Andres Vallejo
Kirsten Wolff

September 23

CalCPA Society

Sacramento, California
Carley A. Roberts

September 24

ABA Section of Taxation 2010 Joint Fall CLE Meeting

Recent State Challenges to Related Party Transactions

Toronto, Canada
Craig B. Fields

September 25

National Conference of State Tax Court Judges

St. Paul, Minnesota
Paul H. Frankel

September 27

Institute for Professionals in Taxation (IPT) Sales Tax Symposium

Indian Wells, California
Paul H. Frankel

September 29

Strafford Webinars: Single-Sales Apportionment: Crafting a Comprehensive Multi-State Strategy

Craig B. Fields

October 20 – 22

Council on State Taxation (COST) Annual Meeting

Phoenix, Arizona
Paul H. Frankel
Carley A. Roberts
Andres Vallejo

October 20

The Knowledge Congress Live Webcast Series: Multi-State Taxation Critical Issues: Sales & Use Tax, Nexus, E-commerce, and Cloud Computing

Mitchell A. Newmark

October 25

NJ Institute for Continuing Legal Education and NJ Bar Association

New Jersey State and Local Tax Day

New Brunswick, New Jersey
Mitchell A. Newmark

October 28

Chicago Tax Club

Rosemont, Illinois
Paul H. Frankel

November 4 – 6

2010 California Tax Policy Conference

San Diego, California
Eric J. Coffill
Paul H. Frankel
Carley A. Roberts

November 9

Michigan Tax Conference

Detroit, Michigan
Paul H. Frankel

November 10

Institute for Professionals in Taxation (IPT) Income Tax Symposium

Miami, Florida,
Hollis L. Hyans

November 11

16th Annual Paul J. Hartman SALT Forum

Nashville, Tennessee
Paul H. Frankel
Hollis L. Hyans

November 22 – 23

2010 Tax Update and Planning Conference, CalCPA Society

San Francisco and Burbank, CA
Carley A. Roberts

December 8 morning

New Jersey CPA State Tax Day

Edison, New Jersey
Paul H. Frankel

December 8 afternoon

New York TEI Chapter Holiday Symposium

New York, New York
Paul H. Frankel

December 13 – 14

New York University's 29th Institute on State and Local Taxation

New York, New York
Craig B. Fields
Paul H. Frankel
Hollis L. Hyans
Thomas H. Steele

New Ohio CAT

(Continued from Page 2)

requirement that the tax be apportioned); *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 31 n.4 (2008); *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995).

As a refinement to this rule, the Supreme Court has drawn a clear line between income and gross receipts taxes, which must be apportioned in order to pass constitutional muster, and sales and use taxes, which need not be apportioned. *See Jefferson Lines, Inc.*, 514 U.S. 175; *Cent. Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653 (1948) ("*Central Greyhound*").

Sales and use taxes are not subject to the apportionment requirement because they are generally understood to be a tax on the consumer, as opposed to a tax on the seller, such as, for example, a gross receipts tax. *Jefferson Lines*, 514 U.S. at 178. Moreover, the Court has found that tradition, custom, and the practical problems of administering the apportionment of a tax imposed on individual transactions justify an exception for sales taxes from the general requirement of apportionment. *Id*.

In contrast to a sales tax, a tax on gross receipts is "simply a variety of tax on income, which [is] required to be apportioned to reflect the location of the various interstate activities by which it was earned." *Id.* at 190. Thus, "[t]he true distinction between those levies that ought to be apportioned and those that need not be is whether they are designed as taxes on business activity or as taxes on the consumer of goods or services." Walter Hellerstein, Michael J. McIntyre & Richard D. Pomp, *Commerce Clause Restraints on State Taxation After* Jefferson Lines, 51 Tax. L. Rev. 47, 87 (1995).

The Supreme Court has fashioned the so-called external consistency test as one means of ascertaining whether a tax on interstate commerce satisfies this apportionment requirement. That test looks to the "economic justification for the state's claim upon the value taxed, to discover whether [a state's] tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing state." *Jefferson Lines*, 514 U.S. at 185. While this test does not require a strict accounting, "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983). This scrutiny ensures that a state reaches only "that portion of the revenues from interstate activity which reasonably reflects the in-state component of the activity being taxed." *Goldberg v. Sweet*, 488 U.S. 252, 262 (1989); *see also Gen. Motors Corp. v. City & Cnty. of Denver*, 990 P.2d 59, 71 (Colo. 1999) ("In the context of . . . taxes on gross receipts, apportionment must take into account the location where the revenue is generated.").

The language of these opinions also makes clear that a state cannot simply attach the tax to some nominal local activity (e.g., the right to do business in the state) as a cover for disguising the actual sweep of the tax. Thus, the Court has stated that "labeling [a tax] . . . a tax on 'business activity' does not permit us to forgo examination of the actual tax base and apportionment provisions. 'A tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes.'" *See Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358, 374 (1991) (citing Jenkins, *State Taxation of Interstate Commerce*, 27 Tenn. L. Rev. 239, 242 (1960)); *see also MeadWestvaco Corp.*, 553 U.S. at 31 n.4 (confirming the need for a connection between the apportionment formula used by the state and the income that the state seeks to tax); *Allied-Signal, Inc. v. Comm'r of Finance*, 588 N.E.2d 731 (N.Y. 1991) (the apportionment system used by the state must be matched to the tax base employed in determining the tax). The Court's rejection of form over substance, of course, is the lynchpin of the Court's modern Commerce Clause doctrine. *Complete Auto Transit, Inc.*, 430 U.S. 274 (sanctioning direct taxation of interstate commerce so long as the tax meets a four-pronged test intended, among other things, to ensure that the state does not tax values fairly attributed to other states).

MoFo Attorney News

Morrison & Foerster's State and Local Tax Group would like to welcome the following new attorneys to the firm.

- **Richard C. Call**
- **Rebecca M. Ulich**

They both join us as associates in the New York office.

Ohio's CAT Does Not Pass Constitutional Muster

The Ohio Supreme Court has recently dispelled any doubt about the character of the CAT: the CAT is a gross receipts tax, not a sales tax. Therefore, to satisfy the Commerce Clause, the tax must be apportioned, and the state's failure to adopt a reasonable apportionment formula for services means the CAT is unconstitutional. As such, Ohio's CAT as applied to services is unconstitutional.

As a starting point, the CAT does not contain any explicit apportionment mechanism for services whatsoever. Accordingly, the CAT is facially unconstitutional. Further, under the CAT's situsing rules discussed above, the

(Continued on page 6)

Telecommuting: Don't Allow State Tax Issues to Disrupt the Connection

By Hollis L. Hyans and Amy F. Nogid[1]

Telecommuting has grown exponentially in the last few years. The number of employees working remotely at least one day per week rose 74% from 2005 to 2008,[2] with 20 to 30 million doing so in 2008. Recently the U.S. Senate unanimously passed the 2010 Telework Enhancement Act to expand telecommuting opportunities for federal employees.[3] A white paper issued collaboratively by the U.S. General Services Administration and Telework Exchange, a public-private partnership, set out some of the benefits of telecommuting, including: reduction of carbon emissions due to decreased vehicle use; increase of employee morale and decrease of stress; accommodation of employees with disabilities and those with family care issues; reduction of office space needs and operating costs; and continuity of operations during emergency situations (e.g., terrorist attack, pandemic influenza, natural disaster).[4] State and local governmental agencies are also recognizing the need for and implementing telecommuting programs.[5] By one estimate, if 33 million Americans were to telecommute, oil imports would decrease by between 24% and 48%, greenhouse gases would be reduced by up to 67 million metric tons per year, and as much as 7.5 trillion fewer gallons of oil would be consumed per year.[6]

Despite the burgeoning telecommuting workforce in government and private industry, and the clear imperative supporting the institution of broad-based telework programs, state and local income tax laws and withholding tax provisions remain muddled and inconsistent and, when employers and employees are not careful, risk placing telecommuters and their employers at a considerable disadvantage from a state and local tax perspective.

Nexus

No good deed goes unpunished. An employer that allows its employees to telecommute and perform work in a state in which it does not already have nexus, i.e., does not have a sufficient connection with that state to allow the state to assert tax jurisdiction under the U.S. Constitution, could find itself subject to income tax and responsible for the collection of sales tax (to name just a couple of the potential tax obligations a state could assert) in the state from which the employee telecommutes.

Recently, the New Jersey Tax Court ruled that a software developer that "regularly and consistently permits" an employee to work from her home in New Jersey is doing business in the state and is subject to New Jersey's corporation business tax.[7] The court concluded that a corporation is "'doing business' at the place where its employees are expected to report for work, where they are regularly receiving and carrying out their assignments, where those employees are supervised, where they begin and end their work day, and where they deliver to their employer and customers a finished work product."[8] The court also noted that because the employee used a laptop provided by the employer, the company also employed property in the state, which "bolster[ed]" the conclusion that the company was doing business in, and was therefore taxable in, New Jersey. The court rejected the company's challenge under the Due Process Clause of the U.S. Constitution, holding that the company had "fair warning" that it could be subject to New Jersey law because of its employment relationship with an individual working for it in New Jersey. Also rejected by the court was the company's claim that the daily presence of the employee in the State failed to satisfy the "substantial nexus" requirement of the Commerce Clause.

As the New Jersey Tax Court cautioned: "[I]t is for the taxpayer to make its business decisions in light of tax statutes, rather than the other way around. . . . That [the company] may not have realized the State tax consequences of its business decisions regarding the employment of [the telecommuting employee] does not insulate the company from corporate tax liability."[9]

Unfortunately, once a corporate toe has been dipped in state waters, it's not just the toe that gets taxed. States have aggressively pursued tax policies intended to grab the maximum amount of tax revenues from those with the least connection to the state, thereby exporting tax burdens. Employers should therefore evaluate the implications of telecommuting *before* approving telecommuting requests of their employees.

(Continued on page 8)

New Ohio CAT

(Continued from Page 4)

tax will be imposed on 100% of gross receipts in Ohio from many types of services, including, e.g., legal services and Internet and web hosting services, that are not performed in Ohio. Thus, the rules can—and do—severely distort individual taxpayers' tax burdens in Ohio in many cases and lead to instances of unconstitutional application of the CAT.

A. The CAT Is a Gross Receipts Tax and Not a Sales Tax

Under the Supreme Court precedents described above, a gross receipts tax must be apportioned, but a sales tax need not be. Accordingly, the first step in testing the constitutionality of the CAT is to establish that the CAT is a gross receipts tax, as opposed to a sales tax.

The Ohio Supreme Court has recently held just that, concluding explicitly that the CAT is not a sales tax, but rather is a gross receipts tax. *Ohio Grocers Ass'n v. Levin*, 916 N.E.2d 446 (Ohio 2009) ("*Ohio Grocers*"). In *Ohio Grocers*, the grocers' association contended that the CAT was a sales tax and challenged its constitutionality under the Ohio Constitution, which prohibits the imposition of taxes on the sale of food. Ohio Const. art. XII § 3(C).

The court held that the CAT was not an unconstitutional "tax upon the sale or purchase of food," for several reasons. First, the legislature described the CAT as a franchise tax, i.e., a tax "for the privilege of doing business in this state." *Ohio Grocers*, 916 N.E.2d at 455 (quoting section 5751.02(A)). In addition, the CAT is imposed on the seller, who is prohibited from adding the tax to the price of the goods sold, in contrast to a sales tax, where the tax is often added to the sales price. *Id.* Further, the CAT is imposed on the value of the privilege of doing business in Ohio, as determined using a "broad measure of market access," and is computed based on results over whole business periods (as opposed to on a transaction-by-transaction basis). *Id.* at 312. Accordingly, the court concluded that the CAT is a gross receipts tax and not a sales tax.

B. As a Gross Receipts Tax, the CAT Must Be Apportioned

Given that the final arbiter of these matters, the Ohio Supreme Court, has concluded that the CAT is a gross receipts tax and not a sales tax, it must be fairly apportioned to reflect the business activities generating the receipts in order to comply with the Commerce Clause. The U.S. Supreme Court has struck down an unapportioned gross receipts tax on strikingly analogous facts. In *Central Greyhound*, the Court examined a gross receipts tax imposed by New York on 100% of the receipts from the sale of bus tickets in the state. The question was whether New York could constitutionally impose a tax on all of the bus company's gross receipts from New York ticket sales, even though the transportation services were provided to the ticket holder in multiple states, simply because the ticket was purchased (and therefore the income was realized) within the state. *Central Greyhound*, 334 U.S. at 662. The Court held that because a substantial portion of the activities conducted by the transportation service provider were performed outside the state and those services were clearly associated with gross receipts to be taxed, New York was not permitted to tax 100% of the gross receipts derived from the sale of those services.

Simply, the CAT suffers from the same infirmity as the New York tax at issue in *Central Greyhound*. Here, just as in *Central Greyhound*, Ohio imposes a gross receipts tax upon 100% of the revenues derived from a variety of interstate services purchased within the state, even under circumstances in which the vast majority of the activities (or even all of the activities) conducted by the taxpayers that provide those services were performed outside the state. Just as New York's unapportioned tax was impermissible in *Central Greyhound*, the application of the unapportioned CAT is impermissible here.

Moreover, we believe the two arguably "modern" Supreme Court decisions rejecting challenges to unapportioned gross receipts taxes do not change that conclusion. *See Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232 (1987) ("*Tyler Pipe*"); *Standard Pressed Steel Co. v. Dep't of Revenue*, 419 U.S. 560 (1975) ("*Standard Pressed Steel*"). First, and most importantly, to the extent these cases held that a gross receipts tax need not be apportioned if it is imposed on a "local" subject, they have been effectively overruled by the more recent decision in *Jefferson Lines*, in which the Supreme Court explicitly reaffirmed that gross receipts taxes must be apportioned. *See* Walter Hellerstein, Michael J. McIntyre & Richard D. Pomp, *Commerce Clause Restraints on State Taxation After* Jefferson Lines, 51 Tax. L. Rev. 47, 98 (1995). Accordingly, after *Jefferson Lines*, "once a levy is properly classified as a gross receipts tax, the arguments in favor of apportionment must be addressed." *Id.*

Second, those cases are plainly at odds with the Supreme Court's modern view approving the direct taxation of interstate activities so long as the tax is apportioned and abandoning artificial

(Continued on page 7)

New Ohio CAT

(Continued from Page 6)

attempts to segregate some local tax event from the interstate business. This view finds support in a number of state court cases striking down unapportioned gross receipts taxes imposed on services by local municipalities following *Jefferson Lines* and *Central Greyhound*. For example, the Supreme Court of Pennsylvania has invalidated local unapportioned gross receipts taxes twice, noting that "gross receipts taxes imposed upon receipts from interstate commerce are prohibited unless the tax is apportioned to the taxpayer's activities in the state" and relying heavily on the reasoning and holding in *Jefferson Lines*. *Phila. Eagles Football Club, Inc. v. City of Philadelphia*, 823 A.2d 108, 129 (Pa. 2003); *see also Northwood Const. Co. v. Twp. of Upper Moreland*, 856 A.2d 789 (Pa. 2004). The Arizona, California, and Virginia courts have reached similar conclusions. *See S. Pac. Transp. Co. v. Dep't of Revenue*, 44 P.3d 1006 (Ariz. 2002); *Nw. Energetic Servs. v. Cal. Franchise Tax Bd.*, 159 Cal. App. 4th 841 (2008); *City of Modesto v. Nat'l Med., Inc.*, 128 Cal. App. 4th 518 (2005); *City of Winchester v. Am. Woodmark Corp.*, 471 S.E.2d 495 (Va. 1996).[1]

C. The CAT Cannot Be Deemed to Be Apportioned Based on an Imputed Single-Sales-Factor Formula

One might surmise that the CAT's sourcing rules for services could be viewed as providing for apportionment based on a single-sales factor, and that such a single-sales-factor formula is permissible under *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978) ("*Moorman*").

Not so. First, *Moorman* does not alter the requirement that a gross receipts tax on an interstate service be apportioned to fairly reflect the activities within the taxing state, nor does it hold that single-sales-factor apportionment is permissible in every instance. *Moorman* involved an Iowa income tax that was imposed on a taxpayer's net income apportioned by applying a single-sales-factor formula. The Supreme Court upheld the tax because there was no evidence that the single-sales-factor formula did not fairly reflect the taxpayer's activities in the state in that case. Thus, the taxpayer failed to show that "Iowa in fact taxed profits not attributable to activities within the State during" the applicable period. *Moorman*, 437 U.S. at 272. Nevertheless, the Court noted that, in other cases, it has "found that the application of a single-factor formula to a particular taxpayer violated due process" and the Commerce Clause. *Id*. at 274.[2]

Ohio's CAT involves a gross receipts tax, which is unlike the net income tax at issue in *Moorman*. In contrast to net income—which, one may rationally speculate, may have arisen entirely in the taxing state—gross receipts are closely linked to costs and are necessarily closely linked to the location of the taxpayer's business activities. Thus, even if the CAT's sourcing rules are viewed as a single-sales-factor apportionment formula, the application of that formula to many taxpayers that provide interstate services will clearly tax receipts far in excess of those earned from activities in Ohio. This is precisely the evidence the Court indicated was lacking in Moorman's unsuccessful constitutional challenge.

In this case, by taxing 100% of a taxpayer's gross receipts in Ohio—whether those receipts are from legal services, Internet hosting, or the provision of cable television—without providing any apportionment mechanism at all, Ohio's CAT clearly "reaches beyond" the portion of value created by the service that is fairly attributable to the taxpayer's economic activity within Ohio.

Conclusion

In sum, the CAT is a gross receipts tax that must be apportioned in order to comply with the requirements of the U.S. Constitution. Because the CAT contains no apportionment mechanism whatsoever, it is facially unconstitutional. Moreover, the CAT's sourcing rules for many types of services impose the tax based on the location of the purchaser and not, as is constitutionally required, on the location of the business activities that generate the receipts. Thus, for many taxpayers, the application of the CAT's sourcing rules will be severely distortive.

Ohio can presumably head off a broad challenge to the CAT by adopting legislation apportioning the tax base by a formula that is meaningfully related to the location of the business activities that produce the receipts being taxed. In the interim, the Department should work with individual taxpayers or industries to employ specifically tailored solutions to eliminate distortion.[3] ■

---

1 Two state supreme courts, one in the state of Washington and the other in Delaware, suggest that, at least where the gross receipts tax is imposed upon the sale of tangible personal property, the requirement of apportionment may not be as categorical as that imposed upon taxes on services. In *Ford Motor Co. v. City of Seattle*, 156 P.3d 185 (Wash. 2007), *cert. denied*, 552 U.S. 1180 (2008), the Supreme Court of Washington upheld the City of Seattle's and City of Tacoma's assessments upon Ford Motor Company for business and occupation (B&O) tax, which is measured by the receipts from wholesaling vehicles in the state. Similarly, in *Ford Motor Co. v. Director of Revenue*, 963

(Continued on page 8)

New Ohio CAT

(Continued from Page 7)

A.2d 115 (Del. 2008), *cert. denied*, 130 S. Ct. 86 (2009), the Delaware Supreme Court upheld the imposition on Ford of wholesalers' gross receipts tax derived from vehicles physically delivered in Delaware. While conceptually there would appear to be no sound logic for limiting the requirement of apportionment to services only (and therefore the Washington and Delaware cases may simply be wrong in ignoring the *Jefferson Lines* distinction between sales taxes and gross receipts taxes), there is at least a basis for concluding that sales of automobiles by local wholesalers may be treated as a wholly local event for purposes of taxing the receipts from those sales. However, that logic makes no sense in the context of a tax on the value of services performed wholly or partly outside the state. Particularly where electronic services are involved, there may not even be a local activity to be isolated because the sale of the service will often occur in cyberspace and the service will involve simultaneous and necessary actions in a variety of states.

2 In addition, it cannot be that the Court's careful distinction between sales taxes, which need not be apportioned, and gross receipts taxes, which must be, can be circumvented simply by adopting a single-sales-factor apportionment formula. Such a formula would, *in every case*, produce the same tax base as the unapportioned gross receipts tax. Surely the Court did not intend that result when, in *Jefferson Lines*, it reaffirmed that gross receipts taxes must be fairly apportioned.

3 Our observations regarding the CAT are now equally applicable to Washington's B&O Tax on services. Effective June 1, 2010, apparently bowing to pressure from in-state businesses, the state abandoned its prior system, which looked to the location of costs, in favor of an Ohio-like system of looking solely to the location of the benefit of the services. Second Engrossed Substitute Senate Bill 6143, L. 2010, Chapter 23 § 105; Wash. Admin. Code 458-20-19402.

Telecommuting

(Continued from Page 5)

Personal Tax Liability and Tax Withholding

An employee's decision to telecommute can also have significant, unintended state income tax implications for the employee. Individuals are generally subject to tax on all of their income by their state of residence, regardless of where that income is earned. In addition, most states that impose a personal income tax also provide that even a single visit to the state by a nonresident is sufficient to subject that employee to tax by the nonresident state.[10] Although most states provide a credit for personal income taxes paid to another state, such credit mechanism has been found not to be required under the U.S. Constitution,[11] leaving the potential for double taxation a real and serious problem.

A byzantine labyrinth of state rules—that may or may not be tied to the employee's personal income taxability threshold—exists with respect to employers' withholding obligations. For example, in at least a couple of states, even though nonresidents are subject to income tax based on a single day's presence, employers are not required to withhold unless an employee is present for at least fourteen days.[12] In many states, the withholding obligation starts the first day the employee travels to the state,[13] while in other states the employee's earnings attributable to the state must exceed a certain wage threshold, and yet other states use an alternative of number of days or dollar threshold.[14] Even where a day threshold is adopted, the determination of what constitutes a day is not always clear: Does traveling through a state count? Does a portion of the day count? Implementing a tracking system for employees is essential, but even with such a system in place difficulties in administration exist. Certain states have reciprocal agreements with other states that allow an employer to withhold income taxes in the employee's state of residence irrespective of where the employee performs those services, which can help reduce an employer's burden.

For employees who are telecommuting and performing services in multiple states, ensuring that the employer withholds and remits taxes to the appropriate jurisdictions can also be a challenge. Generally, an employer is only required to withhold and remit taxes in the jurisdictions in which it does business, but its employees may be telecommuting from and providing services in jurisdictions in which the employer maintains that it is not doing business (notwithstanding the potential nexus issues discussed above). Some states authorize an employer to deduct and remit withholding taxes to the state of a nonresident employee if the employee provides written authorization.[15] However, if a telecommuting employee has income tax obligations to multiple jurisdictions, not all states provide an easy mechanism for a nonresident to direct the employer to limit withholding based on the portion of services rendered in-state.[16]

Further complicating personal income tax and withholding are issues such as New York's "convenience of the employer" rule.[17] New York's rule provides that days spent by a New York State's nonresident employed to provide services in New York, but who works at home outside the state, are to be sourced to the New York office, unless such work was performed outside the New York office

(Continued on page 9)

Telecommuting

(Continued from Page 8)

for the necessity of the employer rather than the employee's convenience.[18] New York courts have consistently rejected challenges to the "convenience of the employer" rule.[19] The States' basis for the convenience of the employer rule is that in the absence of such a rule, in-state and out-of-state employees would not be on a level playing field; residents would not be able to exclude income attributable to the work they perform in their homes while nonresidents would be able to do so.

Recently, an administrative law judge rejected New York State's assertion of tax against a software consultant and programmer, and recognized that even the "convenience of the employer" rule has its limits.[20] The individual was a New Jersey resident who worked exclusively in and reported all of his wages to New Jersey. His employer was an Illinois-based company with a one-room office in New York City. The individual did not, however, ever work from the New York City office, and on those facts the administrative law judge held no New York tax was due. While the proper result was reached here, the assertion of a liability under this factual scenario is a potent reminder that state tax issues can arise even when an employee has only the most tenuous connections to a state.

The welter of rules, exceptions to rules, and nuances to rules can place a significant withholding compliance burden on companies. Telecommuting employees are at risk for tax assertions by the jurisdictions to which they have traveled or from which they have performed services. In the current economic environment, the quest for tax dollars (particularly from non-voters) has increased and states' enforcement of nexus and withholding rules has likewise increased.

Employers will also need to determine the jurisdiction of employment for telecommuting employees for unemployment insurance purposes. Under the definition of "employment" adopted by most states, employment by a single employer of an employee performing services in multiple states

AN EMPLOYEE'S DECISION TO TELECOMMUTE CAN ALSO HAVE SIGNIFICANT, UNINTENDED STATE INCOME TAX IMPLICATIONS FOR THE EMPLOYEE.

is not to be fragmented, but should be allocated to the state where the employee is most likely to become unemployed and seek work. States apply the following successive tests to determine the state of coverage: (1) localization of employee's services; (2) employee's base of operations; (3) place of employer's direction and control of employee; and (4) residence. Under such a statute, only if none of these tests results in the services being attributed to a single state will split coverage be allowed.[21]

New York's highest court applied that definition to an employee telecommuting from Florida who performed services for a New York State-based corporation.[22] The court held that the telecommuter was localized in Florida where she was physically present and therefore Florida, not New York State, was responsible for the payment of unemployment insurance benefits. However, when a telecommuter performs services in multiple jurisdictions and is not localized to a single jurisdiction, it is unclear how the uniform rule will be applied by state labor departments and courts.

Federal Intervention

In response to increased audit activity over the last few years, business groups have advanced federal legislation to prohibit states' use of the "convenience of the employer rule" and to provide a uniform threshold before employers that would be required to withhold taxes.

In August 2004, the Telecommuter Tax Fairness Act[23] was first proposed. It would bar the "convenience of the employer rule" and require that an employee be physically present in the state as a precondition to imposition of tax on that worker. The legislation was most recently reintroduced in May 2009.[24]

First introduced in 2006,[25] and reintroduced most recently in 2009, is the Mobile Workforce State Income Tax Fairness and Simplification Act. This legislation would address the taxation of nonresident employees (with the exclusion of professional athletes, professional entertainers, and certain public figures) and would set a threshold of days below which a state could not subject the nonresident to state income tax. Although the initial bills had proposed a sixty-day threshold, due to state clamor a compromise was reached between employers and states and, in the most recent iteration of the bill, a thirty-day

(Continued on page 10)

Telecommuting

(Continued from Page 9)

threshold was proposed.[26]

The Multistate Tax Commission ("MTC"), an organization that represents states' tax interests, has proposed a Mobile Workforce Withholding and Individual Income Tax model statute that would decrease the threshold to twenty days. The MTC's model statute provides that a nonresident's income from work performed in the state of nonresidence would be exempt from withholding if the nonresident: (a) has no income derived from the nonresident state; (b) worked fewer than twenty days in that state (days in transit would be exempt from the day count); and (c) resides in a state that has a reciprocal exemption or does not impose a personal income tax. The MTC's model statute takes a broader view than most states do of the types of individuals excluded from the withholding protection: professional athletes, persons of prominence who perform services on a per-event basis, professional entertainers, construction laborers, and key employees. Qualifying employees would not have a filing requirement in the state of nonresidence and employers would not have a withholding requirement with respect to qualifying employees. However, the model act does not explicitly address nexus issues. At least one state, Montana, has criticized the MTC's model statute and the "working presence test" as creating complexity in states that have an income threshold for taxability, even claiming that nonresidents working fewer than twenty days could receive "special, favorable tax treatment" since a nonresident high-earner would be "excused" from filing returns while a resident with lower income would need to file.[27]

Although states take umbrage at the potential incursion on their sovereign immunity by Congress, the patchwork of disparate rules and the considerable compliance burdens decrease the competitiveness of companies in the worldwide marketplace and warrant federal intervention under the Commerce and Foreign Commerce Clauses to ensure that interstate and foreign commerce is not unduly impeded by a myriad of state and local rules. With the explosive expansion of technology facilitating telecommuting, and the environmental, societal, and security concerns addressed by telecommuting, Congressional action is sorely needed. In the meantime, employers and employees alike need to consider the state tax implications of telecommuting arrangements, and plan ahead to avoid unexpected assertions of nexus and withholding duties for the employer and personal income tax issues for the employee. ■

---

1. The authors would like to thank Mollie B. Gabrys for her valuable assistance with this article. Portions of this article were included in How to Save Gas . . . and Prevent Heartburn: The Legal Issues Surrounding Telecommuting, published in Morrison & Foerster LLP's Employment Law Commentary (June 2010), which Ms. Hyans and Ms. Nogid coauthored with Edward Froelich, Kalinda Howard, and Janie Schulman.
2. Undress for Success and the Telework Research Network, *Telecommuting Statistics*, http://undress4success.com/research/telecommuting-statistics/ (last visited June 9, 2010).
3. S. 707, 111th Cong. (2010).
4. U.S. General Services Administration and Telework Exchange, *The Benefits of Telework* (Sept. 2008), http://www.teleworkexchange.com/pdfs/The-Benefits-of-Telework.pdf (last visited June 9, 2010).
5. E.g., Virginia (established an Office of Telework Promotion and Broadband Assistance in 2006); Georgia (established "Work Away" program in 2003 and enacted a Telework Tax Credit, Georgia Code Annotated section 48-7-29.11, which became effective on July 1, 2007).
6. *Id.* at 3-4.
7. *Telebright Corp. v. Director, Div. of Taxation*, No. 011066-2008, 2010 N.J. Tax LEXIS 4 (N.J.T.C. Mar. 24, 2010).
8. *Id.* at 14.
9. *Id.* at 21-22 (citations and quotations omitted).
10. Some states exempt certain activities, such as attendance at trade shows or seminars, as activities that create nexus (and potential income tax liability) for an employee.
11. *Tamagni v. Tax App. Trib.*, 695 N.E.2d 1125 (N.Y.), *cert. denied*, 525 U.S. 931 (1998).
12. *See, e.g.*, Connecticut and New York.
13. A map provided by the Council on State Taxation ("COST") to the Multistate Tax Commission ("MTC") with its *Mobile Workforce Briefing Book* (Sept. 9, 2009) reflects the following states as requiring withholding from the first day that an employee travels to the state (Alabama, Arkansas, Colorado, Connecticut, Delaware, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, North Carolina, North Dakota, Ohio, Pennsylvania, Rhode Island, and Vermont). These states fail to pay heed to the notion that a single-day visit to a state is *de minimis* and should be an insufficient basis to support a nexus determination. *See, e.g.*, *Arizona Dep't of Revenue v. Care Computer Sys., Inc.*, 4 P.3d 469 (Ariz. Ct. App. 2000) (seven visits of out-of-state personnel within a seven year period to solicit business and follow up on business opportunities was deemed sufficient to establish nexus); *Orvis Co. v. Tax App. Trib.*, 654 N.E.2d 954 (N.Y.), *cert. denied sub. nom. Vermont Info. Processing, Inc. v. Comm'r*, 516 U.S. 989 (1995) (twelve visits over a three-year period were found to be sufficient to establish substantial nexus). As the United States Supreme Court stated in *Wisconsin Department of Revenue v. William Wrigley*, *Jr.*, *Co.,* 505 U.S. 214, 231 (1992) (citations omitted), "the venerable maxim *de minimis non curat lex* ('the law cares not for trifles'), is part of the established background of legal principles against which all enactments are adopted, and which all enactments (absent contrary indication) are deemed to accept."
14. The COST map lists sixteen states as having thresholds other than one day of travel into the state. Nine states are listed on the COST map as having no general personal income tax (Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming).
15. *See, e.g.*, Ariz. Rev. Stat. § 43-408; 18-125-803 Me. Code R. § 3; N.J. Admin. Code § 12:55-2.5. The voluntary collection and remittance of withholding to another jurisdiction may not "eliminate, reduce or replace" the employer's obligations to the state in which the employer is doing business. *See, e.g.*, N.J. Admin. Code § 12:55-2.5(g).
16. *Cf.* New York IT-2104.1, which allows nonresidents to allocate withholding tax based on the estimate of the percentage of services

(Continued on page 11)

Telecommuting

(Continued from Page 10)

that will be performed, to NJ-W4, which does not address decreased withholding for nonresidents who only perform a portion of their services in New Jersey. *See also* 20 N.Y. Comp. Code R. & Regs. § 132.18(a).

17. Other states that have analogous provisions include Nebraska (316 Neb. Admin. Code 22-003.01C) and Pennsylvania (61 Pa. Code §109.8).

18. *See New York Treatment of Nonresidents and Part-Year Residents Application of the Convenience of Employer Test to Telecommuters and Others*, TSB-M-06(5) I (N.Y.S. Dep't of Taxation & Fin. May 15, 2006) (Setting out the Department's policy on application of the "convenience of the employer" test, and specifying the factors to be considered in determining whether an employee's home office will be considered a "bona fide employer office." Factors include whether the home office contains or is near specialized facilities (primary factor); whether the home office is a condition of employment, the employer has a bona fide business purpose for the employee's home office location, the employee performs some of the core duties of his or her employment at the home office, the employee meets or deals with clients, patients, or customers on a regular and continuous basis at the home office, the employer does not provide the employee with designated office space or other regular work accommodations at one of its regular places of business, and the employer reimburses expenses for the home office (secondary factors); as well as other factors).

19. *See, e.g., Huckaby v. New York State Div. of Tax App.*, 829 N.E.2d 276 (N.Y.), *cert. denied*, 546 U.S. 976 (2005) (an individual working for a New York-based employer from his home in Tennessee had his entire income sourced to New York even though he spent only 25% of his time in New York); *Zelinsky v. Tax App. Trib*., 801 N.E.2d 840 (N.Y. 2003), *cert. denied,* 541 U.S. 1009 (2004) (an NYU law professor who worked from his home in Connecticut and taught in New York City a few days a week was held not to be working from home for the convenience of the employer, and taxing him on 100% of his NYU salary did not violate the Commerce Clause).

20. *In re Kumar*, DTA No. 822747 (N.Y.S. Div. of Tax App., Admin. Law Div. May 6, 2010).

21. New York State Department of Labor, *Determining Jurisdiction of Employment When Services are Performed in a Number of States* (undated); http://www.labor.state.ny.us/ui/pdfs/iall63.pdf; N.Y. Labor Law § 511.

22. *In re Allen*, 794 N.E.2d 18 (N.Y. 2003).

23. H.R. 1360; S. 785, 109th Cong. (2005).

24. H.R. 2600, 111th Cong. (2009).

25. H.R. 6167, 109th Cong. (2006); H.R. 3359, 110th Cong. (2007); H.R. 2110, 111th Cong. (2009).

26. H.R. 2110, 111th Cong. (2009).

27. Montana appears to minimize the fundamental difference between residents and nonresidents (who are taxable on all of their income regardless of where earned, subject to a credit if offered by the state). Clearly, greater governmental resources are expended to maintain the infrastructure and provide governmental services for individuals who are in the state 365 days a year than for those who are in the state for less than twenty days. In its comments to the MTC model act, Montana also criticized the MTC's adoption of a physical presence test, which it views as inconsistent with the economic nexus standard long urged by the MTC: "if the Commission were to endorse a physical presence test for individual income taxes, it has the potential for undermining the credibility of the Commission with regard to its historic opposition to federal legislation imposing a physical presence test on states for the imposition of their business activity tax. The Commission should be consistently supporting economic measures, instead of physical presence measures, with regard to the imposition of different forms of income taxation." E-mail from Dan Bucks, Director of Revenue, State of Montana, to Shirley Sicilian, MTC Hearing Officer (May 10, 2010) (available at http://services.taxanalysts.com/taxbase/eps_pdf2010.nsf/DocNoLookup/10431/$FILE/2010-10431-1.pdf). The economic nexus test fails to give appropriate consideration to the fourth prong of *Complete Auto Transit*, *Inc. v. Brady*, 430 U.S. 274 (1977), which requires that the tax imposed be fairly related to the benefits provided by the state to the person the state subjects to tax and be reasonably related to that person's presence or activities in the state.

Previously published in: *State Tax Notes*, July 19, 2010

About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, Fortune 100 companies, investment banks and technology and life science companies. Our clients count on us for innovative and business-minded solutions. Our commitment to serving client needs has resulted in enduring relationships and a record of high achievement. For the last seven years, we've been included on The American Lawyer's A-List. Fortune named us one of the "100 Best Companies to Work For." Our lawyers share a commitment to achieving results for our clients, while preserving the differences that make us stronger. This is MoFo.

This newsletter addresses recent state and local tax developments. Because of its generality, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. If you wish to change an address, add a subscriber, or comment on this newsletter, please write to Mitchell A. Newmark at Morrison & Foerster LLP, 1290 Avenue of the Americas, New York, New York 10104-0050, or email him at mnewmark@mofo.com, or write to Scott M. Reiber at Morrison & Foerster LLP, 425 Market Street, San Francisco, California 94105, or email him at sreiber@mofo.com.

www.mofo.com