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SUTHERLAND

# SALT SHAKER

Shaking things up in state and local tax.

## The Lone Star State Swings the Lasso Around E-Commerce Services

In two recently issued letter rulings, the Texas Comptroller's office evaluated the sales and use taxability of certain unique web-based services. In Tex. Policy Letter Ruling 201207531L (July 31, 2012), the Comptroller's office ruled that Internet marketplace listing fees were not subject to Texas sales and use tax; however, the provision of webstore development services were taxable data processing services.

The taxpayer owned and operated an Internet marketplace website that provided third-party sellers the ability to list and sell their inventory on the taxpayer's website for a listing fee. The listing fee is paid for the taxpayer's service of "selling" the item—taxpayer collects the sales price, shipping costs, and sales tax from the buyer and remits the collected amount less the listing fee to the seller. The listing fee could be either charged on a per-item basis or on a percentage-based referral fee when the item is sold. The Comptroller's office explained that the listing fees received from third-party sellers were not subject to sales tax because the fees were analogous to a charge for placing a classified advertisement on a web page, which is not taxable.

However, the taxpayer also offered an "Internet Store Service" that allowed sellers to build and operate customer-facing websites with the seller's brand and their own Internet address that is maintained on the taxpayer's servers. As part of the service, the taxpayer provides the electronic infrastructure and tools that allow the seller to build and maintain an online business, including the design and look of the seller's website, as well as descriptions and pictures of the goods offered by the seller.

The Comptroller's office held that these services were taxable data processing services under Tex. Admin. Code § 3.330, which includes the creation and hosting of a website. However, the Comptroller's office further explained that pursuant to Tex. Admin. Code § 3.330(b), 20% of the total amount charged for data processing services is exempt from tax. Finally, the Comptroller's office noted that if the listing fee and Internet Store Services are bundled for a lump sum price that is not separately stated, tax will be presumed to be due on the total amount charged to the customer for the services, less the 20% exemption for data processing.

In the second ruling issued on the same day, the Comptroller's office concluded that an annual subscription fee to join a customer loyalty program was taxable because it contained taxable and non-taxable components for one bundled charge. In Tex. Policy Letter Ruling 201207532L (July 31, 2012), the taxpayer offered a subscription membership that entitled customers to view an unlimited number of instant videos, borrow designated electronic books from a library, and receive free or discounted shipping on eligible purchases.

In finding that the entire membership fee was subject to use tax, the Comptroller's office reasoned that the subscription membership was a bundled transaction consisting of two taxable items (the instant streamed videos and electronic books loaned to customers) and one non-taxable item (the prepaid charge for shipping). The Comptroller's office determined that providing instant videos fell under the definition of cable television service found in Tex. Tax Code § 151.0033 and is therefore taxable. Borrowing electronic books is a taxable information service under Tex. Tax Code § 151.0038(a)(2). While the prepaid shipping fee is not taxable if separately stated, when bundled with taxable items, it is also subject to Texas sales and use tax. Furthermore, the Comptroller's office concluded that the subscription membership should be sourced to Texas if the customer is located in Texas.

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## Don't Mess with Texas: No Three-Factor MTC Election for You!

In two recent decisions by the Texas Office of Administrative Hearings, the Comptroller affirmed its position that the evenly weighted three-factor apportionment formula contained in an election provided by the Multistate Tax Compact (MTC Election) does not apply to the Texas Margins Tax. *See* Tex. Compt. Dec. No. 106, 503 (Aug. 10, 2012); Tex. Compt. Dec. No. 106,508 (Jul. 13, 2012). Rather, taxpayers must apportion via the statutory single receipts factor.

Taxpayers have filed Texas returns claiming that the MTC Election allows taxpayers to apply an evenly weighted apportionment formula comprised of property, payroll and sales factors similar to successful attempts by California taxpayers to make the MTC election. *The Gillette Company et. al v. Franchise Tax Board,* 207 Cal. App.4th 1369 (Op. on Rehearing, Oct. 2, 2012). However, the Comptroller determined, without explanation, that the single-factor formula was required by Tex. Tax. Code Ann. § 171.106 and that the taxpayers were not allowed to elect the MTC three-factor formula.

A Texas taxpayer, Graphic Packing Corporation, recently filed a suit in Travis County District Court on September 27, 2012, challenging the Comptroller's position on the availability of the MTC Election. *See Graphic Pkg. Corp v. Combs,* No. D-1-GN-12-003038, Plaintiff's Original Petition (Trav. Cty. Dist. Ct. 2012). Texas will present an especially interesting environment for this challenge because the Comptroller is likely to contend that the Texas Margins Tax is not an income tax and thus the MTC Election is inapplicable.

## SALT PET OF THE MONTH

### Chloe

Meet Chloe, the yellow Labrador Retriever of Atlanta's newest Sutherland SALT associate, Suzanne Palms, and her boyfriend, Jeremiah. Suzanne, a self-proclaimed neat freak, was never a dog person, having grown up with outdoor cats. However, her desire for a furry companion outweighed her love of a spotless space after befriending her law school roommate's black Lab, Grace. It was not long after sharing her home with the adorable Grace that Suzanne was begging for a Lab of her own!

Jeremiah purchased Chloe as a Christmas present for Suzanne from a breeder on a farm in middle-of-nowhere Florida. Chloe was a patient study partner while Suzanne finished law school in Florida and was an excellent roommate even in the close quarters of Suzanne's 500-square-foot Washington, DC condo during Suzanne's LL.M. program at Georgetown. As a lover of space and sunshine, Chloe is thrilled that Suzanne decided relocate one more time to join Sutherland's Atlanta office. Chloe now lives in doggy luxury in a house with a yard, where she loves to play fetch and relax outside, and she always loves going on a run with Mom.

True to her breed, Chloe is a smart cookie. She understands the meaning of all kinds of words, including the name of each one of her toys and her dining options – "breakfast," "dinner," and "treat."

Suzanne and Jeremiah dote on Chloe so much that Chloe has started to think of herself as a human. In fact, whenever Chloe goes to doggie daycare, she prefers spending time with the staff rather than with the other dogs. She loves being the center of attention, and her tail is wagging extra fast at the thought of being selected as Pet of the Month.

**SALT Pet of the Month: It's Your Turn!!**

In response to many requests, the Sutherland SALT practice invites you to submit your pet (or pets) as candidates for SALT Pet of the Month. Please send us a short description of why your pet is worthy of such an honor, along with a picture or two. Submissions should be directed to Katie O'Brien at katie.obrien@sutherland.com.

## The Clicks Keep on Coming in Pennsylvania

While most states that have "click-through nexus" sales tax laws have issued little to no guidance addressing the scope of their provisions, the Pennsylvania Department of Revenue (Department) recently issued guidance explaining the types of payment mechanisms that will trigger nexus.

The Department's ruling supplements a December 1, 2011 Tax Bulletin (Tax Bull. 2011-01) issued by the Department. For purposes of Pennsylvania's "click-through nexus" provision, the Tax Bulletin interpreted "maintaining a place of business" to include a remote seller who contracts with an in-state entity or individual located in Pennsylvania whose website has a link that encourages purchasers to place orders with the remote sellers and where the in-state entity or individual receives consideration for the contractual arrangement.

In a letter ruling issued to the Performance Marketing Association on August 28, 2012, the Department stated that remote sellers do not have a "click-through" sales tax collection obligation if the remote seller pays an in-state entity or individual based on the effective placement of online advertising and not based on a percentage of sales. The Department's conclusion in its August 28 ruling reflects an important consideration in evaluating state "click-through" provisions—the method of consideration in a "click-through" arrangement may determine whether the out-of-state seller falls within the state's tax collection regime.

## Nebraska's Below-the-Belt Decision to Audit "Above the Line"

The Nebraska Department of Revenue (Department) recently declared, by way of an article in a third-party newsletter, that it has the authority to "examine all aspects of a return, including federal items." George Kilpatrick, *Nebraska Revenue Department's Audit and Examination Powers Discussed*, THE NEBRASKA CPA (Oct. 2012). While the article is aimed at personal income taxpayers, corporate taxpayers have good reason to be concerned because the statutory language relied on by the Department is applicable also to the corporate income tax.

The Department's authority to audit federal return information purports to derive from three sources: the Nebraska Constitution; the Nebraska Revised Statutes; and a Nebraska Supreme Court case. Each of these sources provides simply that Nebraska tax statutes can and do rely on the federal income tax laws. The Department also relies on determinations made in other states regarding the scope of a state tax authority's auditing power.

Importantly, the tax calculation has a definitional limit that the Department fails to note: both the individual and corporate income tax are imposed on "federal adjusted gross income" and "federal taxable income," respectively, subject to a finite list of statutory modifications under Neb. Rev. Stat. Ann. §§ 77-2716, 77-2716.01, and 77-2734.01. The specific references to federal adjusted gross income and federal taxable income arguably should prevent the Department from deviating from a federal tax calculation.

The Nebraska Department of Revenue interestingly frames the issue as one where it would be a dereliction of its duty if it were *not* to audit above the line. Unfortunately, the article is short on rationale for such a conclusion.

## Washington Court Prohibits Double Taxation of Natural Gas Sales

In a definitively pro-taxpayer decision, the Washington Court of Appeals limited the City of Lakewood's ability to impose its utility tax on agents operating outside the city limits. *CMS v. City of Lakewood,* Nos. 41509-7-II, 41744-8-II (Wash. Ct. App. 2012).

The City of Lakewood's utility tax is imposed on persons "engaged in or carrying on the business of selling, brokering, or furnishing" natural gas, and is based upon the taxpayer's total gross income "from such business in the City." The City attempted to extend this tax to CMS, a company that arranges for the purchase of natural gas by its customers from various third parties, monitors the natural gas market, and coordinates their natural gas supply.

The court rejected the City's attempt to impose the tax upon CMS, finding that CMS does not sell gas to its customers (and was prohibited from doing so by the Federal Energy Regulatory Commission) and that the actual seller (Puget Sound Energy) already had collected and paid the utility tax on such sales.

The court reasoned that CMS was not liable for Lakewood's utility tax because: (1) as a threshold matter, CMS did not perform any of the activities that would subject it to the tax; and (2) even if it did, all of CMS's revenue-raising activities, such as invoicing and remote gas meter monitoring, were performed outside of Lakewood at CMS's corporate headquarters on Mercer Island. The court thus found that there was no "reasonable relationship between CMS' activities and any taxable event occurring in Lakewood," and refused to allow the City to tax sales of the same units of natural gas twice.

## Ohio Supreme Court Sets the Record Straight

The Ohio Supreme Court held that a taxpayer can rely on evidence presented to the Ohio Board of Tax Appeals (BTA) that was not presented to the Tax Commissioner, provided the evidence was made part of the record before the BTA. *Bay Mech. & Elec. Corp. v. Testa,* Slip Opinion No. 2012-Ohio-4312 (Sept. 26, 2012).

In *Bay Mechanical,* the primary issue was whether the taxpayer's "purchases" of employment services from third parties were subject to Ohio sales tax. The case turned on whether employment services purchased from third parties were exempt "permanent-assignment" sales, i.e., personnel were provided under a contract of at least one year on a permanent basis.

The audit agent requested, in writing, additional information to determine whether the employees provided to the taxpayer were placed on a permanent basis. The taxpayer declined to submit additional evidence to the Tax Commissioner claiming that the information had been previously provided to the auditor during the course of the audit.

The Tax Commissioner denied the "permanent-assignment" exemption on the grounds that the taxpayer failed to supply evidence showing that it was entitled to the exemption. During discovery, the taxpayer produced the information previously requested by the Tax Commissioner. However, the taxpayer did not introduce the information provided in its discovery responses into evidence.

The Ohio Supreme Court held that the taxpayer did not meet its burden of proof because of the taxpayer's failure to produce the requested documentation. The court also found that the BTA acted reasonably in affirming the Tax Commissioner's determination because the taxpayer never introduced its records into evidence. *Ohio Bell Telephone Co. v. Levin,* 124 Ohio St. 3d 211 (2009) appeared to preclude a taxpayer from introducing new evidence to the BTA unless it had been presented to the Tax Commissioner.

*Bay Mechanical* makes it clear that the BTA may consider evidence presented by the taxpayer that was previously not provided during audit as long as that evidence is made part of the record.

## A Triangle is Not a Square in Indiana

An administrative hearing decision clarified that Indiana's related party add-back provisions do not apply to intangible payments paid to a related limited liability company (LLC). Ind. Ltr. of Finding No. 02-20110459 (Sept. 1, 2012).

The taxpayer, a multistate corporation, added back interest expense paid to affiliated corporations. However, the taxpayer did not add back interest expense paid to a related LLC. Indiana Code section 6-3-2-20(b) provides, in part, that a corporation is required to add back to taxable income intangible expenses, including related interest, paid, accrued, or incurred to one or more members of the same affiliated group. "Affiliated group" is defined by reference to I.R.C. § 1504(a)(1). The taxpayer asserted that since an "affiliated group" is defined pursuant to I.R.C. § 1504(a)(1) as includable corporations, and because a related LLC is not a corporation, intangible expenses paid to the LLC are not subject to Indiana's add-back requirement.

In finding for the taxpayer, the Department ultimately concluded that an LLC is treated as a partnership for federal income tax purposes and is neither an "includable corporation" nor a member of the "affiliated group" as defined by I.R.C. § 1504.

## South Carolina Cuts the Cord for Cellular Service Providers

The South Carolina Supreme Court held in favor of wireless communications providers, finding that the ambiguity created by the state's lack of a statutory definition of "telephone company" must be construed in favor of the taxpayers. *See Alltel Comm'ns, Inc., et al. v. South Carolina Dep't of Rev.*, Op. No. 27156 (S.C. 2012).

The South Carolina Department of Revenue (Department) determined that the Alltel wireless communications entities were classified as "telephone companies" subject to South Carolina's heightened license fee. The term "telephone company" is not statutorily defined but the parties stipulated to a definition.

On appeal to the South Carolina Supreme Court, the court held that the parties cannot stipulate to a question of law (i.e., the parties could not stipulate to their own definition of a "telephone company"). The court doubted that the taxpayers met the plain meaning definition of a "telephone company" since they used radio waves rather than landlines to transmit communications and had none of the other qualities of a public utility. Importantly, the court determined that the lack of a statutory definition of "telephone company" created an ambiguity that must be resolved in favor of the taxpayer. Therefore, the court held that none of the taxpayers met the definition of a "telephone company" for purposes of South Carolina's heightened license fee.

The South Carolina Supreme Court's decision in *Alltel* is promising. As taxpayers face increasing instances of ambiguous statutes related to incomplete or missing statutory definitions, *Alltel* is a welcome reminder that ambiguities should be resolved in favor of taxpayers.

## Alternative Apportionment is "Stacked" Against the Taxpayer

The Indiana Department of Revenue (Department) upheld its auditor's use of alternative apportionment to increase a consolidated group's Indiana taxable income without requiring proof of distortion. Letter of Finding No. 02-20120134 (Aug. 1, 2012).

The consolidated group included several entities with significant Indiana apportionment: one entity with significant losses and minimal Indiana apportionment, and a final entity with significant non-Indiana presence, all of which resulted in an overall Indiana taxable loss under Indiana's statutory apportionment and consolidation rules. The auditor found the standard apportionment methodology to be distortive, as the inclusion of the two entities with minimal Indiana ties placed the entire group in a "loss" position. However, the Letter did not provide a basis as to why the consolidated report was distortive, other than a passing reference to "minimal ties" and the fact that no tax was owed.

To relieve the perceived distortion, the auditor first considered excluding the two entities entirely from the consolidated return based on their *de minimis* presence, which would have resulted in an even higher liability. Instead, the auditor turned to what was described as a less "blunt" instrument by utilizing "stacked" or "separate accounting" under the state's alternative apportionment (UDITPA Section 18) provision. Under this methodology, the Indiana adjusted gross income of each corporation was computed separately, as if separate returns were filed for each corporation, and then consolidated (or stacked) into one amount of consolidated Indiana adjusted gross income.

Alarmingly, the Department appears to relieve the auditor from carrying the heavy burden of proving that distortion existed and that alternative apportionment was necessary. Under Indiana law, a proposed assessment is presumed correct, and the burden of proving that the proposed assessment is improper rests with the taxpayer. The Letter states that given the alternatives, the auditor's decision to choose an alternative apportionment method specifically permitted under statute was reasonable. Thus, the taxpayer bore the burden of proving that the proposed assessment, and therefore the auditor's use of alternative apportionment, was wrong. This contradicts the customary requirement that the burden of proving distortion is imposed on the party seeking relief from the statutory rules.

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## *Hartney:* Illinois Appellate Court Respects Tax Planning

In *Hartney Fuel Oil Co. v. Hamer,* 2012 Appeal Nos. 3-11-0144 & 3-11-0151 (Ill. Ct. App. 2012), an Illinois appellate court upheld the relocation of a taxpayer's operations for tax purposes.

Hartney, a fuel marketing company, moved its sales operations to Mark, Illinois. Hartney contracted with a third party to provide office space and personnel and to act as Hartney's managing sales agent in Mark. The sales agent was responsible for receiving, accepting, and processing fuel purchase orders from Hartney's customers. Hartney's headquarters, however, remained in the comparatively higher-tax Forest View, Illinois, during the tax years in question. The issue in *Hartney* was whether sales were attributable to the company's sales office in Mark or re-attributed to its headquarters in Forest View.

The Illinois Department of Revenue (Department) issued a substantial assessment for Retailers' Occupation Tax against Hartney on the ground that Hartney's daily purchase orders and sales made via long-term requirements contracts were attributable to Forest View. But the trial court held that Hartney's sales were attributable to Mark.

The appellate court affirmed the trial court's decision and noted that the ROT imposition statutes *expressly* provide that acceptance of an order or other contracting action in the making of a contract is the single most important factor for determining the situs of a sale. The appellate court rejected the Department's suggestion that the situs of sale must be determined by applying a "totality of the circumstances test," which, in the Department's view, would require consideration of all other sales-related activities, including where fuel prices were set and where credit decisions were made. The appellate court concluded that Hartney intentionally structured its business operations to minimize its ROT liability; however, the appellate court noted that Illinois law does not prohibit tax planning. In the absence of express legislative intent to the contrary, the appellate court felt compelled to respect Hartney's tax planning decisions.

*Hartney* is the latest iteration of the ongoing struggle between state tax authorities and taxpayers over a clear statutory outcome versus allegations of taxpayer planning.

## Not Such A Great "Deal-of-the-Day" in Kansas

The Kansas Department of Revenue (Department) recently republished administrative guidance that provides that "deal-of-the-day" transactions are treated in the same manner as gift certificates for sales tax purposes—sales tax must be charged on the full value of the taxable sale when the promotional deal is redeemed. Kan. Op. Ltr. No. O-2012-004 (Sep. 11, 2012).

"Deal-of-the-day" transactions are website promotions where customers purchase discount certificates that are redeemable at local retailers (e.g., a customer visits a deal-of-the-day website and purchases a $25 certificate redeemable at a local retailer for a $50 sweater). The Department provided that retailers must charge sales tax on the full selling price of the taxable sale (e.g., the $50 value of the sweater) and then apply the discounted promotional deal certificate to reduce the price that the customer owes on the transaction. This guidance is consistent with previous guidance issued by the Department on this same issue. See Kansas Q&A – Retail Promotional Deals (June 8, 2011).

The Department also provided guidance regarding buy-one, get-one free promotions. However, contrary to the Department's position on "deal-of-the-day" transactions, the Department provided that buy-one, get-one-free promotions are taxable only on the amount that the customer pays.

The inconsistent sales tax treatment between "deal-of-the-day" transactions and "buy-one, get-one-free" promotions results in inconsistent tax results between these two marketing approaches. And that is not the best "deal-of-the-day."

# CALIFORNIA SHAKING

## No Cheer(ios) for Taxpayer: California Appellate Court Finds 8.2 Percent Change in Apportionment is an FTB Lucky Charm(s)

The California Court of Appeal found the inclusion of gross receipts from a multistate food company's sales of grain futures to be both qualitatively and quantitatively distortive of its business activity in California. *General Mills, Inc. v. Franchise Tax Bd.*, 208 Cal.App.4th 1290 (Cal. Ct. App. 2012). The court upheld the Franchise Tax Board's (FTB) alternative apportionment formula to include only the net gain from the taxpayer's hedging transactions in the sales factor denominator.

While the court acknowledged the importance of the hedging activity in managing the risk of price fluctuations in the agricultural commodities used in General Mills' core business, it nevertheless concluded that General Mills' hedging activity was "qualitatively different" from its other sales activity. The court explained that the hedging transactions "rarely result in actual delivery of and payment for goods" and "play *only* a supportive function and would be economically meaningless if separated from ultimate sales of grain, flour and consumer food products for profit."

In ruling that the inclusion of gross receipts from the hedging transactions quantitatively distorted the apportionment formula, the court relied upon the following facts: for the relevant tax years, including hedging transaction gross receipts in the sales factor denominator resulted in allocating almost 9% of General Mills' multistate business activities to Minnesota; the profit margin from nonfutures business activity exceeded the profit margin of the company's futures trading activity by 81 times; and including the disputed receipts resulted in an average percentage reduction of 8.2% in the standard apportionment calculation.

The court found the FTB's proposed alternative apportionment formula, which included the net (not gross) gain from the futures trading activities in the apportionment formula, to be reasonable.

It is surprising to say the least, that General Mills' hedging transactions of commodities – which are critical to its business – are viewed as qualitatively different from its selling of consumer food products. Moreover, it is stunning that an 8.2% change to an apportionment factor justifies a finding of quantitative distortion.

This decision will no doubt lead to increased pursuit of equitable apportionment relief by taxpayers and the FTB. Note, California Revenue and Taxation Code section 25120(f)(2)(L) excludes hedging transactions from the definition of "gross receipts" as of January 1, 2011.

# CALIFORNIA SHAKING

## FTB Posits that the Potential to Integrate Leads to Actual Business Income

In Legal Ruling 2012-01, "Business/Nonbusiness Characterization on Sale of Stock" (Aug. 29, 2012), the California Franchise Tax Board (FTB) considered the distinction between the potential for integration and actual integration. The Ruling addressed whether the sale of stock in a target corporation creates business or nonbusiness income where operational ties existed between the acquiring corporation and the target corporation prior to acquisition, and the former intended at the time of purchase to integrate the latter into its unitary business operations but such integration never occurred.

The FTB framed its legal analysis using the "functional" test for determining whether income is characterized as business income under California Revenue and Taxation Code section 25120 and concluded that the paramount considerations for determining whether a disposition gives rise to business income are the "actual operational ties" between the taxpayer and the intended target and the "significance of such ties."

The FTB resolved any confusion surrounding the distinction between actual integration and potential integration by effectively jettisoning from the analysis the principle embodied in both *Appeal of Occidental Petroleum,* 83-SBE-119 (June 21, 1983) and *Appeal of Mark Controls,* 86-SBE-204 (Dec. 3, 1986): that the mere potential for integration into a taxpayer's unitary business is insufficient as a matter of law to support a finding that the gains on such sales are business income under the functional test.

By shifting the inquiry away from the issue of the potential integration and toward the degree to which a taxpayer and an investment company do business with one another, even if at arm's length, the FTB staked out a new litigating position: a corporate taxpayer's gain from the sale of a minority investment interest is *de facto* business income where any operating relationship with the investment company exists—no matter how minor.

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## Eighty Percent Apportionment Factor Leads to One Hundred Percent Discrimination

The California Court of Appeal recently held that California Revenue and Taxation Code section 18152.5 violates the dormant Commerce Clause by limiting the availability of capital gains deferral on the sale of stock in certain qualified small businesses that primarily operate within California. *Cutler v. Franchise Tax Bd*., 208 Cal.App.4th 1247 (Cal. Ct. App. 2012).

The statute authorizes gain deferral if the proceeds from the sale of qualified small business stock are used to purchase replacement stock in another qualified small business within 60 days of the original stock sale. However, the statutory benefit is limited to sales of stock issued by businesses that maintain at least 80% of their property and payroll in California. Cal. Rev. & Tax. Code §§ 18152.5(d)(1)(C),(e)(1)(A).

In *Cutler*, the Franchise Tax Board (FTB) denied a taxpayer's gain deferral from the sale of stock in an Internet start-up because, in part, it failed to meet the 80% requirement. The taxpayer paid the tax, filed a claim for refund, and brought an action in court, arguing that the 80% property and payroll requirement violated the dormant Commerce Clause because it facially discriminated against those that invest in companies conducting business outside California. The Court of Appeal concluded that "the statute 'favors domestic corporations over their foreign competitors in raising capital among [California] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.'"

The court remanded the case for a determination as to whether the taxpayer met the other statutory deferral requirements and whether, and to what extent, the taxpayer is entitled to a refund.

# NEW YORK, NEW YORK

## New York Court Derails the MTA Payroll Tax

The Supreme Court of New York Nassau County (a trial court) declared the New York Metropolitan Commuter Transportation Mobility Tax (MCTMT) unconstitutional. *Edware P. Mangano v. Sheldon Silver*, Docket No. 14444/10 (N.Y. Sup. Ct. Aug. 22, 2012).

In striking down the law, the court determined that the New York State Legislature was not on the right track when it unconstitutionally passed the MCTMT. The New York State Department of Taxation and Finance (Department), however, said that this decision was not the last stop. While the state appeals the decision to the Appellate Division, the Department is requiring taxpayers to continue to pay the tax and file returns.

By way of background, the MCTMT is a relatively new tax that applies to certain employers engaging in business in the metropolitan commuter transportation district (MCTD) beginning on or after March 1, 2009. The MCTD includes New York City and the counties of Rockland, Nassau, Suffolk, Orange, Putnam, Dutchess, and Westchester. Employers that have payroll expenses within the MCTD are subject to a 0.34% tax on payroll expenses of employees working within the MCTD.

The *Mangano* case is particularly interesting because it involves a constitutional challenge by a municipality. In general, municipalities lack capacity to mount constitutional challenges to New York statutes. However, New York provides several exceptions to this general rule, including when a statute impinges upon the "Home Rule" powers of a municipality that are constitutionally guaranteed under Article IX of the New York Constitution. These constitutional provisions provide that the legislature may enact a "general law" relating to the affairs of any local government or a "special law" relating to such affairs, but only with a two-thirds vote of the local legislature.

In this case, the state legislature did not obtain a two-thirds vote from the local legislature. The court found that the MCTMT related to the affairs of local government, but that it was a special law—thus violating Article IX without the proper vote—because it only applied to certain counties.

Although the court declared the law unconstitutional, taxpayers may want to consider whether they should file protective refund claims until the litigation is resolved.

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## Software in Conjunction with Information Services: What's Your Function?

The New York State Department of Taxation and Finance (Department) issued a pair of advisory opinions regarding the sales taxability of consulting services and software. New York's Tax Law generally imposes sales and use tax on receipts for furnishing information services. N.Y. Tax Law § 1105(c)(1). However, in both advisory opinions, the primary transactions were not subject to New York sales tax because they were within the exception for personalized information services and information services provided orally. *See* 20 NYCRR § 527.3(b)(2) & (3).

On August 29, 2012, the Department issued an advisory opinion, TSB-A-12(22)S, in which it concluded that access to software and a directory of consultants used to facilitate Petitioner's oral consultation service were not subject to sales tax. The Petitioner's primary business was offering oral consultation services through its group of independent contractor consultants. Petitioner offered its internally developed software and directory of consultants, without additional charge, to its customers in order to assist its customers in identifying particular consultants and scheduling a consultation. The Department also determined that written reports provided to Petitioner's customers as supplements to the consultation service were not taxable as an information service as long as the primary function of the service is obtaining advice from the consultants, the information provided is not derived from any common data source, and that information is not substantially incorporated into reports given to others.

One month later, on September 27, 2012, the Department released another advisory opinion, TSB-A-12(24)S, dealing with a similar transaction, and concluded that a customer's limited use of the Petitioner's specialized software did not cause its otherwise exempt information services to become taxable. The Petitioner gathered, mapped, and stored the customer's data, and created customized reports through its proprietary software based on that data. The customer was able to customize the report using the Petitioner's software; however, that use was limited to parameters set by the Petitioner. Under these facts, the Department determined the access to the software and directories was not subject to sales tax because the access was integrally related to the overall services provided by the Petitioners, which were not subject to sales tax.

These advisory opinions are important because they establish that the use of software bundled with other services will not automatically cause a transaction to become taxable. While this is generally a business-friendly position, taxpayers still must be careful when evaluating transactions involving the use of, or access to, software. They must engage in a fact-intensive inquiry into whether the object of the transaction is truly the sale of taxable software or whether the transaction remains nontaxable because the software is merely incidental to the transaction, or the transaction qualifies for another statutory exemption.

## Come See Us

**November 27, 2012**
**TEI Atlanta Chapter Meeting**
Maggiano's – Atlanta, GA
**Carley Roberts** and **Jack Trachtenberg** on Lessons Learned: State Tax Litigation Developments in California and New York

**November 29-30, 2012**
**New York University Institute on State and Local Taxation**
Grand Hyatt – New York, NY
**Jeff Friedman** on Review and Preview of Federal Constitutional Issues
**Prentiss Willson** on Combination – Constitutional Issues, Policy Issues, Accounting Issues
**Diann Smith** on Due Process – Significant Current Issues
**Jack Trachtenberg** on What's Happening Everywhere Today?

**December 4, 2012**
**COST Pacific Northwest Regional Meeting**
Nintendo – Redmond, WA
**Michele Borens** and **Jeff Friedman** on The Cats and Dogs of Sales Tax: Bundling, Absorption and Other Furry Creatures
**Marc Simonetti** and **Madison Barnett** on State Tax Cases and Issues to Watch
**Prentiss Willson** on Special Report – California Budget Woes and Tax Changes

**December 6, 2012**
**TEI State and Local Tax Controversy Seminar**
Hyatt Regency – Orlando FL
**Tim Gustafson** and **Pilar Mata** on Litigation Preparation
**Marc Simonetti** on After the Audit, During the Appeal

**December 6, 2012**
**Georgia Bar Association Economic Development Conference**
State Bar of Georgia – Atlanta, GA
**Eric Tresh** and **Charlie Kearns** on Across the Universe vs. Across the State and Threats to Tax-Exempt Financing

**December 12, 2012**
**Interstate Tax Conference**
Embassy Suites – Washington, DC
**Michele Borens** on How the Interstate Tax System Works/Jurisdiction and Nexus – Unitary Concept

**January 16, 2013**
**New York State Society of CPAs and Foundation for Accounting Education Tri-State Taxation Conference**
Citi Corp Executive Conference Center – New York, NY
**Jack Trachtenberg** on Candid Views on Tax Administration and Policy

**January 24-26, 2013**
**ABA Tax Section Midyear Meeting**
Hilton Bonnet Creek and Waldorf Astoria – Orlando, FL
**Jack Trachtenberg** on Transparency Issues in State Tax Administration

**January 29, 2013**
**MEC 22nd Annual Ohio Tax Conference**
Hyatt Regency – Columbus, OH
**Diann Smith** on Major Trends and Developments in State Business Taxation

**February 8, 2013**
**The National Multistate Tax Symposium**
Grand Floridian – Orlando, FL
**Jeff Friedman** on Legislative and Administrative Developments in State Taxation
**Marc Simonetti** on Apportionment

**February 22, 2013**
**UW/TEI Meeting**
Bellevue, WA
**Michele Borens** and **Jeff Friedman** on State and Local Nexus Expansion

## Recently Seen and Heard

**October 17, 2012**
**Entertainment Software Association GameLaw 2012**
Westin St. Francis Hotel – San Francisco, CA
**Steve Kranz** on Taxing the Virtual World

**October 21-24, 2012**
**Broadband Tax Institute Annual Conference**
The Breakers – Palm Beach, FL
**Jeff Friedman** on Significant Court Decisions Impacting Our Industry and on Seeking State Tax Fairness
**Steve Kranz** on State Tax Reform – UDITPA/Digital/Contingent Fee Audits: How the BTI Membership is Working Together to Impact the Policy World
**Eric Tresh** and **Jack Trachtenberg** on False Claims Act: What Can You Do to Protect Your Company?
**Doug Mo** on Significant Property Tax Developments and on Central Assessment and Intangibles
**Maria Todorova** on Emerging Transaction Tax Issues

**October 24-26, 2012**
**COST 43rd Annual Meeting**
Loews Portofino Hotel – Orlando, FL
**Steve Kranz** on Resolving State Tax Issues Through Congress – What's Cooking in Washington?
**Carley Roberts** on Monday Morning Quarterbacking: Strategic Lessons from the Top 10 Current State Tax Cases
**Eric Tresh** on Staying Out of Trouble – Due Diligence for Sales and Use and Employment Taxes Related to Mergers and Acquisitions

**October 26, 2012**
**Grant Thornton State Tax Seminar**
Meredith Corporation – Des Moines, IA
**Steve Kranz** on State Tax Issues Before Congress, Taxation of Cloud Computing and Digital Products

**October 28-31, 2012**
**TEI Annual Conference**
Westin Diplomat – Hollywood, FL
**Michele Borens** on Practical Guide to Handling State Tax Controversies

**October 30, 2012**
**IPT Northwest Arkansas Chapter Quarterly Luncheon**
Tyson Foods Discovery Center – Springdale, AR
**Steve Kranz** on Sales Tax Developments

**November 1-3, 2012**
**2012 California Tax Policy Conference**
Loews Coronado – San Diego, CA
**Prentiss Willson** delivering the keynote address, interviewing the Board of Equalization's new Executive Director, Cynthia Bridges
**Jeff Friedman** on A SALTy Countdown – the Top 10 Litigation Cases of 2012
**Jack Trachtenberg** on The Sales Factor – Finding a Method in the Madness
**Tim Gustafson** on Successfully Negotiating a State Tax Settlement – Even in This Economy

**November 4-7, 2012**
**IPT Income Tax Symposium**
Key Bridge Marriott – Arlington, VA
**Diann Smith** on Ask the Specialist!

**November 6, 2012**
**TEI/IPT Silicon Valley Joint Sate and Local Tax Day**
Oracle Corporation – Santa Clara, CA
**Steve Kranz** on Sales Tax Developments
**Doug Mo** on Elk Hills, Cardinal Health/AB 832, and Other Recent Developments

**November 8, 2012**
**MACPA/Maryland Bar Association Advanced Tax Institute**
Martins West – Baltimore, MD
**Jeff Friedman** on National Developments and Trends in State Taxes – Point/Counterpoint Discussion

**November 9, 2012**
**STARTUP State Tax Roundtable for Utilities and Power**
Louisville Gas & Electric – Louisville, KY
**Jeff Friedman** and **Pilar Marta** on State Tax Aspects of Attorney Client Privilege and Work Product Doctrine

**November 13-14, 2012**
**Bloomberg BNA Tax Policy and Practice Summit**
Ritz Carlton – Washington, DC
**Michele Borens** and **Eric Tresh** on State Taxation of Cloud Computing

**November 14, 2012**
**TEI Philadelphia Chapter Meeting**
Penn State Great Valley – Malvern, PA
**Eric Tresh** and **Pilar Mata** on Practical Guide to Handling State Corporate Income Tax Controversies

**November 14-15, 2012**
**Paul J. Hartman State and Local Tax Forum**
Loews Hotel – Nashville, TN
**Marc Simonetti** on Alternative Apportionment
**Prentiss Willson** on Combined Reporting Current Developments

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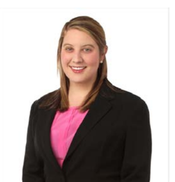
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