JUNE 2021

# THE BR STATE + LOCAL TAX SPOTLIGHT

BLANKROME
CELEBRATING 75 YEARS

CONTENTS




STATE + LOCAL TAX TEAM:

Craig B. Fields | cfields@blankrome.com
Hollis L. Hyans | hhyans@blankrome.com
Nicole L. Johnson | njohnson@blankrome.com
Mitchell A. Newmark | mnewmark@blankrome.com
Irwin M. Slomka | islomka@blankrome.com
Matthew F. Cammarata | mcammarata@blankrome.com
Eugene J. Gibilaro | egibilaro@blankrome.com
Kara M. Kraman | kkraman@blankrome.com
Philip M. Tatarowicz | ptatarowicz@blankrome.com
Michael A. Pearl | mpearl@blankrome.com
Peter H. Hull | peter.hull@blankrome.com

# Note from the Editors

By Matthew F. Cammarata and Eugene J. Gibilaro

**Welcome to the June 2021 edition of *The BR State + Local Tax Spotlight.*** We understand the unique demands of staying on top of important State + Local Tax developments, which happen frequently and across numerous jurisdictions. Staying updated on significant legislative developments and judicial decisions helps tax departments function more efficiently and improves strategy and planning. That is where *The BR State + Local Tax Spotlight* can help. In each edition, we will highlight for you important State + Local Tax developments that could impact your business. In this issue, we will be covering:

- A recent Massachusetts Supreme Judicial Court decision that addresses apportionment of sales tax for software used in multiple states;
- An opinion from the Supreme Court of Ohio concerning the City of Cleveland's taxation of a nonresident's income from stock options;
- A recent New Jersey Tax Court decision that bars the assessment of tax in years open under the statute of limitations if the assessment is based on audit adjustments to net operating losses in closed years; and
- The U.S. Solicitor General's arguments in an amicus brief filed in a dispute between Massachusetts and New Hampshire over the taxation of telecommuting employees' income.

**We invite you to share *The BR State + Local Tax Spotlight* with your colleagues and visit Blank Rome's State + Local Tax webpage for more information about our team. Click here to add State + Local Tax to your subscription preferences.**

## Co-Editors, *The BR State + Local Tax Spotlight*


**MATTHEW F. CAMMARATA**
Of Counsel
212.885.5142
mcammarata@blankrome.com



**EUGENE J. GIBILARO**
Of Counsel
212.885.5118
egibilaro@blankrome.com

CRAIG B. FIELDS
PARTNER

# Massachusetts High Court Finds Statutory Right to Apportionment of Sales Tax for Software Used in Multiple States

By Craig B. Fields

The Massachusetts Supreme Judicial Court denied the Commissioner of Revenue's attempted money grab and held that there is a statutory right to apportion sales tax on receipts from the sale or license of software that was purchased and used in Massachusetts, but also used in multiple other states. It also held that this statutory right could be exercised by vendors through the timely filing of refund claims (called applications for abatement in Massachusetts). *Oracle USA, Inc. v. Comm'r of Revenue,* 487 Mass. 518 (Mass. 2021). This case highlights the extent that some taxing agencies will go through to keep taxes to which they are not entitled. It is particularly noteworthy to see the court soundly reject the commissioner's attempts here, ensuring that sales tax was only due on software actually used in the commonwealth.

**This case highlights the extent that some taxing agencies will go through to keep taxes to which they are not entitled.**

**Facts:** A company purchased or licensed software from vendors, which it then installed on its servers in the commonwealth. The vendors collected and remitted Massachusetts sales tax on the total price they charged the purchaser. *Id.* at 519-520.

The purchaser subsequently informed the vendors that the software was also being used by its employees outside of the commonwealth (for one vendor, only 17 percent of the employees using the software were in Massachusetts). The vendors then timely filed for refunds. *Id.* at 520.

The commissioner did not dispute that the refund claims reflected the correct Massachusetts tax due had the vendors been allowed to apportion the sales tax. Nonetheless, the commissioner denied the claims on the basis that a regulation required the vendors to have obtained the apportionment information from the purchaser at the time of the sale. *Id.* at 520-521.

**The Decision:** The court rejected the commissioner's assertions, first holding that the Massachusetts statutes contain a statutory right to apportion sales tax for software that is transferred for use in more than one state. It reviewed the 2005 amendments to the statute, which made software, regardless of whether transferred in physical or electronic form, subject to sales tax, and concluded that the legislature intended to allow taxpayers to apportion sales tax on software that was to be used in multiple states and that the method of apportionment would be based on the location of the software's use. The court noted that the commissioner's assertions that the statute afforded him not only the discretion to decide how, but also whether, to apportion sales tax on software raised separation of powers concerns since the legislature may not delegate its constitutionally vested authority to tax to the commissioner. *Id.* at 521-525.

The court then had little difficulty in finding that the vendors could exercise their statutory rights of apportionment by seeking refund through the general abatement process for the sales taxes paid to the commonwealth. *Id.* at 528. It held that the commissioner's regulation regarding obtaining apportionment information from the purchaser at the time of the sale was only necessary if the vendors were not collecting and remitting tax on the entire sales price. The regulations did not, however, preclude vendors that subsequently learn that apportionment is necessary from later seeking timely abatement. *Id.* at 528-530. □

EUGENE J. GIBILARO
OF COUNSEL

# Ohio High Court Upholds Taxation of a Nonresident's Income from Stock Options

By Eugene J. Gibilaro

The Supreme Court of Ohio upheld the City of Cleveland's taxation of a nonresident's income from stock options even though the income was recognized by the nonresident seven years after the nonresident had ceased working or residing in the city. *Willacy v. Cleveland Bd. of Income Tax Revenue,* No. 2020-0795, 2021 Ohio LEXIS 988 (Ohio May 25, 2021). This is the second time in as many years that the court has upheld the city's taxation of nonresidents on their income from stock options. *See Willacy v. Cleveland Bd. of Income Tax Review,* 151 N.E.3d 561 (Ohio 2020) *("Willacy I")*. The case is noteworthy for both individuals receiving compensation in the form of stock options as well as employers required to withhold state and local income tax that have issued stock options to employees. The Ohio Supreme Court's decision here follows decisions from other states in the last several years that have upheld similar attempts by state taxing agencies to tax nonresidents on their income from stock options despite the nonresident having no connection to the state in the year that the income is recognized.[1]

**The case is noteworthy for both individuals receiving compensation in the form of stock options as well as employers required to withhold state and local income tax that have issued stock options to employees.**

**Facts:** Willacy earned stock options in 2007 from her former employer while she was working in Cleveland for the employer. She retired and moved to Florida in 2009, without having exercised the options. Willacy exercised a portion of the options in 2016, resulting in taxable income, and her former employer withheld Cleveland income tax on that income. Her refund claim for the withheld tax was denied and this appeal followed. *Willacy,* 2021 Ohio LEXIS 988, at **1-**2.

**The Decision:** The court rejected Willacy's argument that the city's assessment was time-barred because the statute of limitations period began to run when she filed her 2016 income tax return in 2017, not when she received the stock options in 2007. The court also declined to overrule its prior decision in *Willacy I,* which held that there was a sufficient minimum connection between Willacy and the city for constitutional due process purposes because the income from Willacy's stock options was derived from work performed by Willacy in the city (albeit several years earlier). *Willacy,* 2021 Ohio LEXIS 988.

A spirited dissent in the case argued that Willacy's due process rights had been violated inasmuch as "by the time the city imposed its tax in 2016, Willacy had not been a resident or worker there for over seven years." *Willacy,* 2021 Ohio LEXIS 988, at **12 (Fischer, J., dissenting). As the U.S. Supreme Court has not yet weighed in on the constitutional issue, this due process argument remains viable for both employers and employees seeking to challenge similar taxation schemes in other states. □

1. *See, e.g., Allen v. Comm'r of Revenue Servs.,* 152 A.3d 488 (Conn. 2016); *Matter of Gleason,* DTA No. 823829 (N.Y.S. Tax App. Trib. Mar. 18, 2014).

MATTHEW F. CAMMARATA
OF COUNSEL

# You Had Your Chance: New Jersey Tax Court Prohibits Audit Adjustments to Closed Years

By Matthew F. Cammarata

The New Jersey Tax Court held that the Division of Taxation ("Taxation") cannot assess tax in years open under the statute of limitations if the tax is attributable to the elimination of net operating loss ("NOL") carryforwards from years that are closed under the statute of limitations. *R.O.P. Aviation, Inc. v. Dir., Div. of Tax'n,* No. 001323 2018, 2021 N.J. Tax LEXIS 8 (N.J. Tax Ct. May 27, 2021). The decision is significant because it prohibits an audit strategy many states use that effectively operates as an end-run around statutes of limitation.

**Facts:** R.O.P. Aviation, Inc. ("Aviation") is engaged in the business of leasing aircraft to unrelated parties and affiliates. For tax years 2007 through 2011 (the "Closed Years"), Aviation's corporation business tax ("CBT") returns were accepted as filed and not audited. The returns for the Closed Years reported approximately $18.5 million in NOLs available for carryforward. *Id.* at *1-*4.

Taxation conducted an audit of Aviation's CBT returns for the tax years 2012 through 2015 (the "Open Years"). During the audit, Taxation eliminated Aviation's NOL carryforwards from the Closed Years, claiming that certain intercompany leases were not arm's-length, and that Aviation should have reported a larger profit in the Closed Years. By increasing income in the Closed Years and eliminating NOL carryforwards, income in the Open Years also increased, resulting in the assessment for the Open Years. Aviation argued that Taxation's adjustments to the Closed Years were barred under the statute of limitations. *Id.*

**The Decision:** The tax court first held that the statute of limitations to conduct an audit is subject to the same statute of limitations applicable to tax assessments, which is four years from the date the return is filed (absent any allowable extensions). *Id.* at *13. Even though the statute does not expressly impose a time limit for Taxation to conduct an audit, the tax court reasoned that because an assessment flows from an audit, the audit must be conducted in the same period within which an assessment must be made. The court noted that permitting an adjustment of the NOL in the Closed Years would be an indirect assessment of tax, and would result in Taxation "doing indirectly what the statute does not permit directly: bypassing the four-year statute of limitations." *Id.* at *16. Because the parties agreed that the Closed Years were not open to assessment under the four-year statute of limitations, the tax court held that the elimination of the NOLs in the Closed Years was untimely.

The tax court also held that Taxation could not use its powers to adjust intercompany transactions to audit the Closed Years and eliminate the NOLs. *Id.* at *20.

> **The decision is significant because it prohibits an audit strategy many states use that effectively operates as an end-run around statutes of limitation.**

Although the tax court recognized Taxation's broad powers to audit and adjust intercompany transactions, it nonetheless held that this authority cannot be construed to defeat the four-year statute of limitations for assessment. *Id.* at *18.

Finally, the tax court refused to follow IRS audit procedures, which both parties agreed would allow the IRS to adjust NOLs in closed years and assess tax in an open year. The court reasoned that it was not bound by IRS audit procedures or the IRS's interpretation of its own authority, and was firm in its construction of New Jersey law: "[i]f [the] audit is untimely, the NOL cannot be revised." *Id.* at *23. □

NICOLE L. JOHNSON
PARTNER

# Grasping at Straws: The Amicus Brief of the United States in *New Hampshire v. Massachusetts*

By Nicole L. Johnson

Last October, New Hampshire filed a challenge with the U.S. Supreme Court condemning Massachusetts's temporary rule requiring nonresident employees of Massachusetts's employers to continue sourcing income to Massachusetts, even if the employees were no longer working in the state. *New Hampshire v. Massachusetts,* No. 22O154 (filed Oct. 19, 2020). In January, the Supreme Court invited the Acting Solicitor General ("Solicitor General") to file an amicus brief on behalf of the United States.

On May 25, 2021, the Solicitor General filed its amicus brief. Brief for the United States as Amicus Curiae, New Hampshire v. Massachusetts, No. 22O154 (filed May 25, 2021). While there are valid arguments for the Supreme Court to grant original jurisdiction[1] as well as valid arguments against, the Solicitor General's brief ventures into the absurd.

> **While some states may like the ability to tax one and all, that is not the standard.**

The Solicitor General posits that the Supreme Court should deny New Hampshire's motion. *Id.* at p. 1. The brief lays out numerous logical arguments in support of denial. And then things turn a bit ridiculous. For example, the Solicitor General suggests that Massachusetts may be able to constitutionally tax "a New Hampshire resident who exclusively works [remotely from New Hampshire] on computers and servers located in Massachusetts, collaborates with a team of colleagues based in Massachusetts, and conducts transactions that occur in and are regulated by Massachusetts." *Id.* at p. 18. Having colleagues and using computer equipment located in Massachusetts is a tenuous connection at best and certainly insufficient for the state to subject the employee to tax.

Similarly, the Solicitor General opines that "[a] telecommuting employee's physical location thus need not map precisely onto the location of the governmental services needed to support that employee's work." *Id.* at 21. However, this statement is fundamentally wrong.

The standard is whether the services provided by the state are fairly related to the tax imposed. *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977). Thus, the state must actually provide services to the nonresident employee—providing services to the employee's colleague is insufficient. Reducing the standard so drastically as to allow Massachusetts to tax 100 percent of an employee's income simply because that employee virtually works with colleagues located in Massachusetts or because there is a computer server in the state would render the "fairly related" requirement meaningless. *Id.*

While some states may like the ability to tax one and all, that is not the standard. The Solicitor General's tangential statements have no basis in the law and should be viewed as nothing more than grasping at straws. The Solicitor General's response highlights the need for mobile workforce legislation at the federal level. □

1. Original jurisdiction is the jurisdiction granted to the Supreme Court to try certain disputes, including disputes between two states, without any other court's prior review. U.S. Const. art. III, § 2.

BLANKROME
CELEBRATING 75 YEARS

## Save the Date: August 13, 2021


# State + Local Tax Summit

**Friday, August 13, 2021**

**Registration:** 8:30 a.m.–9:00 a.m. ET • **Program:** 9:00 a.m.–2:00 p.m. ET

**Location: Blank Rome LLP**
1271 Avenue of the Americas • New York, NY 10020

**REGISTER HERE**

Please join us as we return in person for our annual State + Local Tax Summit.

The Summit will include discussion of the state and local issues affecting your company, including:

- An overview of the top judicial and legislative updates across the country;
- An update on changes to the sales factor sourcing; and
- A discussion of the tax benefits and consequences of a work from home environment.

Breakfast and lunch will be served.

New York CPE and CLE certification will be requested. There is no fee to attend.

**Blank Rome is aware of the continued concerns regarding COVID-19.** The health and safety of our clients and employees are our highest priorities. We continue to monitor the situation closely and have implemented precautionary measures across our business.

As we move ahead, Blank Rome will continue to place high importance on facilitating measures that will ensure optimal health and sanitary conditions for everyone. If the prohibitions against large gatherings are reinstated, we will postpone the event.

Please contact Nicole Johnson at 212.885.5286 or **njohnson@blankrome.com** for more information about this event.





BLANKROME