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# THE BR STATE + LOCAL TAX SPOTLIGHT **BLANKROME**



## CONTENTS

1. Note from the Editors
2. Look at What the Tax Does and Raise Everything to Win!
3. New York State Updates Nonresident Audit Guidelines
4. Tax Appeals Tribunal Upholds Imposition of New York Sales Tax on IT Security Services
5. What's Shaking: Blank Rome State + Local Tax Roundup

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# Note from the Editors

By Eugene J. Gibilaro and Anna Uger

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**Welcome to the March 2022 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 Washington Superior Court decision invalidating the state's new Capital Gains Tax;
- The New York State Department of Taxation and Finance's recently revised Nonresident Audit Guidelines; and
- A recent New York tax appeals tribunal decision determining IT security services were subject to state sales tax because it enabled customers to prevent, detect, respond to, and predict cyberattacks.

**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.**

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MITCHELL A. NEWMARK

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# Look at What the Tax Does and Raise Everything to Win!

By Mitchell A. Newmark

The Washington State Superior Court, Douglas County, (“Superior Court”) recently relied on the Washington State Constitution to invalidate the new Washington Capital Gains Tax (“WACGT”). *Quinn/Clayton v. Washington*, Douglas Cnty Cons. Cause Nos. 21-2-0075-09 & 21-2-00087-09 (Wash. Super. Ct. March 1, 2022).

**What happened?** On May 4, 2021, Washington enacted a capital gains tax on individuals that came together in Engrossed Substitute Senate Bill 5096. S.B. 5096, 67th Leg., 2021 Reg. Sess. (Wash. 2021) (effective July 25, 2021). Several potential taxpayers filed suit very quickly. On March 1, 2022, less than one year after enactment, the Superior Court ruled that the WACGT violated the uniformity clause and the limitations clause of the Washington State Constitution.

The Department asserted that the WACGT is an excise tax to raise funds for education and, therefore, does not run afoul of the state’s longstanding hurdles preventing income taxes. Article VII, Section 1 of the Washington State Constitution provides:

“[a]ll taxes shall be uniform upon the same class of property within the territorial limits of the authority levying the tax and shall be levied and collected for public purposes only. The word ‘property’ as used herein shall mean and include everything, whether tangible or intangible, subject to ownership.”

*Quinn/Clayton* at 7.

The Washington Supreme Court long ago held that property includes income and that a graduated income tax is invalid as a non-uniform property tax even if one were to frame the tax as a tax on the privilege of receiving income. *Jensen v. Henneford*, 53 P.2d 607 (Wash. 1936); *Culliton v. Chase*, 25 P.2d 81 (Wash. 1933).

In 1951, Washington enacted an “excise” tax on corporations for the privilege of doing business in Washington, measured by net income. This tax was invalidated by the courts because courts should analyze how a tax operates (not its label) and Washington net income tracked federal corporate income tax. *Power, Inc. v. Huntley*, 235 P.2d 173 (Wash. 1951).

**The ruling.** The Superior Court latched onto the crux of *Power, Inc.* that labels don’t carry the day and the goal of raising funds for education is irrelevant:

“it is the State’s choices about ‘who is being taxed, what is being taxed, and how the tax is measured’ that determine its ‘incidents’ and whether it should be deemed a tax on income as opposed to an excise.”

*Quinn/Clayton* at 9.

It found that the WACGT relies on federal income tax returns, levies a tax on the same long-term capital gains that the federal income tax and the IRS characterize as income, is levied annually

**[W]hen commencing challenges, in addition to raising the statutes, regulations, administrative guidance, and U.S. Constitutional protections, raise the State constitutional protections.**

(like an income tax) and not by transaction (like an excise tax), is not levied on gross value but is levied on aggregate annual net gain, and permits a charitable deduction.

The Superior Court held that the tax violates the uniformity requirement of the Washington State Constitution because it imposes a seven percent tax on an individual’s long-term capital gains exceeding \$250,000 but imposes zero tax on long-term capital gains below that threshold because it is an income tax that fails the uniformity limits on income taxes. *Quinn/Clayton* at 12. The Superior Court also held that the tax rate exceeded the one percent maximum rate on property taxes.

**The takeaway?** Look at how the tax operates and raise everything. Challengers often jump to federal Constitutional limitations, such as the Due Process Clause or the Commerce Clause. States have their own constitutional limits that include protections similar to the federal Due Process Clause as well as uniformity, single object, and procedure clauses (such as requiring supermajority votes or three readings on the floor). We can help analyze potential arguments. However, when commencing challenges, in addition to raising the statutes, regulations, administrative guidance, and U.S. Constitutional protections, raise the State constitutional protections. There are winners there too! □



KARA M. KRAMAN

OF COUNSEL

## New York State Updates Nonresident Audit Guidelines

By Kara M. Kraman

The New York State Department of Taxation and Finance recently revised its Nonresident Audit Guidelines for the first time in seven years. This updated version, issued in December 2021, replaces the guidelines that were issued in June 2014.

**Overview.** The Nonresident Audit Guidelines were established by the New York State Department of Taxation and Finance to ensure uniformity and consistency in the examinations of nonresident returns and explain the tax law and regulations relating to residency, discuss audit policies and procedures, and address various technical issues and complex issues through examples and explanations. While the Nonresident Audit Guidelines are without legal force or

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effect, they are generally binding on New York State audit staff who are expected to follow the rules and procedures set forth in the guidelines when conducting an audit. As such, they provide a useful basis for challenging aspects of a personal residency audit, and a useful indicator of what facts and circumstances an auditor will consider determinative in a residency audit.

**Changes Made by 2021 Guidelines.** While most of the changes made by the December 2021 guidelines (“2021 Guidelines”) to the June 2014 guidelines (“2014 Guidelines”) were minor grammatical and typographical changes, the 2021 Guidelines do contain one significant change to the statutory residency rules. In general, a person is deemed to be a statutory resident of New York State if the person maintains a permanent place of abode in New York State and spends more than 183 days of the year in the state.

For statutory residency purposes, a person maintains a permanent place of abode in New York State if that person retains such abode for “substantially all of the taxable year.” State of N.Y. – Dep’t of Tax’n and Fin. Income Franchise Field Audit Bureau, Nonresident Audit Guidelines (2021).

The 2014 Guidelines provided that as a general rule “substantially all of the taxable year” meant a period exceeding 11 months. State of N.Y. – Dep’t of Tax’n and Fin. Income Franchise Field Audit Bureau, Nonresident Audit Guidelines (2014). The 2021 Guidelines provide that beginning in tax year 2022, “substantially all of the year” generally means a period exceeding 10 months. State of N.Y., Nonresident Audit Guidelines (2021). The 2021 Guidelines further provide that the 10-month rule “will” be

applied in tax years in which a taxpayer either acquires or disposes of a residence. *Id.* The 2021 Guidelines explain that this means that the 10-month rule would not apply, for instance, where a taxpayer rents out his upstate New York home for a few months each summer. In that case, the taxpayer would still be determined to be maintaining a permanent place of abode

since the rental did not occur during the year of acquisition or disposition, and it was available for use on a regular continuing basis except for occasional short-term absences such as short-term rentals. In contrast, the 2014 Guidelines provided that the 11 month rule will “generally” be applied to years where the taxpayer acquires or disposes of a residence. State of N.Y., Nonresident Audit Guidelines (2014).

**Takeaway.** New York State maintains an active residency audit program, and the changes to the Audit Guidelines lessen the threshold at which statutory residency status may be triggered. It is therefore important that persons who are planning to acquire or dispose of a residence in New York State, or who have recently done so, make sure that they are aware of all of the rules and tests applied by the Department in determining residency so that they can plan accordingly. □



IRWIN M. SLOMKA

SENIOR COUNSEL

# Tax Appeals Tribunal Upholds Imposition of New York Sales Tax on IT Security Services

By Irwin M. Slomka

The New York State sales tax on “protective and detective services” has been given an expansive reading by the New York State Tax Appeals Tribunal in a decision involving information technology (“IT”) security services. In *In re Secureworks, Inc.*, DTA Nos. 828328 and 828329 (N.Y. Tax App. Trib. Feb. 17, 2022), the Tribunal upheld the imposition of sales tax on the furnishing of IT security services that enabled customers to prevent, detect, respond to, and predict cyberattacks, holding that it constituted a taxable “protective service.”

**Facts.** Secureworks, Inc. (“Secureworks”) is an Atlanta-based IT security services provider. It furnishes customers with “monitoring” services, which involve reviewing thousands of “events” produced by a computer or related device, including software, and advising those customers when further investigation or customer attention is necessary. Secureworks sometimes provides customers with an additional “management” service, which involves making changes to the device or software to ensure that cyber threats are adequately prevented. Among the specific activities it performs are the monitoring and managing of computer firewalls, and network intrusion detection and prevention services that protect customer servers, laptops, and desktops.

At issue was whether these monitoring and managing security services constituted “protective and detective services” subject to sales tax under Tax Law § 1105(c)(8).

**Ruling.** The Tribunal upheld the imposition of sales tax on the IT security services, concluding that the statutory term “protective services”—*i.e.*, ‘alarm or protective systems of every nature, including ... protection against burglary, theft ... or any other malfunction of or damage to

property” — “plainly encompass[ed]” IT security services. *Id.* at 20. While Secureworks did not itself take overt action to block attempted cyberattacks, the Tribunal nonetheless concluded that by monitoring and configuring customer networks, devices, and software, it was protecting and guarding the customer against cyber threats, which it viewed as a taxable protective service similar to that provided by an “alarm company.”

**Observations.** The Tribunal decision is in line with Tax Department administrative pronouncements subjecting to sales tax the furnishing of anti-virus and anti-spyware protection (TSB-A-10(14)S, Apr. 8, 2010), or any service that prevents unauthorized access to a customer’s IT assets

(TSB-A-15(47)S, Nov. 18, 2015). However, it seems a stretch to view cybersecurity services as “plainly” constituting “protective services” under the statute, which historically applied to such services as alarm company burglary monitoring and security guard services. The New York courts have consistently held that tax imposition statutes,

such as Tax Law § 1105(c)(8), must be interpreted narrowly against the taxing authority, something that the Tribunal acknowledged but dismissed based on the reference in the statute to “all services provided by or through alarm ... systems of every nature” (emphasis added). *Id.* The question of statutory interpretation will undoubtedly be addressed if the decision is appealed to the New York courts.

The Tax Department also could attempt to use *Secureworks* as support for its controversial position that cloud-based credit card “fraud management services” offered to retail merchants also constitute a taxable protective service (TSB-A-15(16)S, May 7, 2015). □

**[I]t seems a stretch to view cybersecurity services as “plainly” constituting “protective services” under the statute, which historically applied to such services as alarm company burglary monitoring and security guard services.**

# What's Shaking: Blank Rome's State + Local Tax Roundup

Blank Rome's nationally prominent State + Local Tax attorneys are thought leaders in the community as frequent guest speakers at various local and national conferences throughout the year. Our State + Local Tax attorneys believe it is necessary to educate and inform their clients and contacts about topics that will impact their businesses. We invite you to attend, listen, and learn as our State + Local Tax attorneys interpret and discuss key legal issues companies are facing and how you can put together a plan of action to mitigate risk and advance your business in accordance with state and local tax laws.

## State + Local Tax Summit 2022

- ▶ Blank Rome LLP will be hosting our Annual State + Local Tax Summit on Thursday, May 26, 2022, at our New York office, 1271 Avenue of the Americas, New York, NY 10020. More information and details to follow in an upcoming issue of *The BR State + Local Tax Spotlight*. □

## COST 2022 Advanced State Income Tax School

- ▶ [Nicole L. Johnson](#) will serve as a panelist at the Council on State Taxation's ("COST") 2022 Advanced State Income Tax School, which will be held the week of May 15, 2022. Nicole's panel, "Advanced State Taxation Related to Foreign Income," will take place on Tuesday, May 17, 2022. To learn more, please click [here](#). □

## COST 2022 SALT Basics School

- ▶ [Mitchell A. Newmark](#) will serve as a panelist at the Council on State Taxation's ("COST") 2022 SALT Basics School, which will be held May 15 through 20, 2022, in Atlanta, Georgia. Mitchell's session, "Restrictions on a State's Ability to Tax," is scheduled for Tuesday, May 17, and the panel will review the various restrictions on a state's ability to impose taxes such as constitutional restrictions, federal legislation, and judicial pronouncements. To learn more, please click [here](#). □

## Lawline CLE

- ▶ [Craig B. Fields](#) and [Nicole L. Johnson](#) will serve as faculty for the Lawline CLE program, "State of the States: State & Local Tax Developments," taking place on Thursday, May 12, 2022, at 12:00 p.m. EDT, as a live webcast. Craig and Nicole will discuss the recent judicial developments in state and local taxation and provide a summary of the courts' decisions and the ramifications for taxpayers. The tax areas covered will include corporate income tax and sales & use tax. Topics include: identifying recent tax developments that may impact clients; ramifications of each decision; and potential issues and opportunities that have arisen as a result of the decisions. To learn more, please click [here](#). □

## TEI's 72nd Midyear Conference

- ▶ [Nicole L. Johnson](#) will be a speaker at TEI's 72nd Midyear Conference, which is being held March 20 through 23, 2022 as a fully hybrid event. The in-person portion of the conference will take place at the Grand Hyatt in Washington, D.C. Nicole's session, "Where are You Now? Addressing Tax Issues from a Permanent Mobile Workforce," will take place on Tuesday March 22, from 3:30 to 4:30 p.m. EDT. To learn more, please click [here](#). □