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THE BR STATE + LOCAL TAX SPOTLIGHT

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CONTENTS

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Note from the Co-Editors

By Eugene J. Gibilaro and Joshua M. Sivin

Welcome to the March 2023 edition of *The BR State + Local Tax Spotlight.* We understand the importance of remaining up-to-date on State + Local Tax developments, which appear often and across numerous jurisdictions. Staying informed on significant legislative developments and judicial decisions helps tax departments function more efficiently, along with improving strategy and planning. That is where *The BR State + Local Tax Spotlight* can help. In each edition, we will highlight important State + Local Tax developments that could impact your business. In this issue, we will be covering:

- New York City UBT Addback Upheld for Payment by Partnership to Related S-DISC under "Third-Party Payment Rule"
- Delaware Loses its Latest Grab for Purported Unclaimed Property
- New York State ALJ Determines Vendor Management Services Provided in Conjunction with Software are Subject to Sales Tax as the Sale of Prewritten Software

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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New York City UBT Addback Upheld for Payment by Partnership to Related S-DISC under "Third-Party Payment Rule"

By Irwin M. Slomka

Commission payments made by a New York City-based partnership to an S-DISC, whose shareholders were all partners in the partnership, were subject to the unincorporated business tax ("UBT") addback as nondeductible payments to partners, according to a recent decision of the New York City Tax Appeals Tribunal. *Matter of Skidmore, Owings & Merrill, LLP,* TAT (E) 17-21 (UB) (N.Y.C. Tax App. Trib. Jan. 26, 2023).

The UBT law disallows deductions for "amounts paid or incurred to a proprietor or partner for services or for use of capital." This provision is often invoked by New York City auditors as the basis for UBT audit adjustments, such as to disallow payments to bona fide employees who also hold non-executive officer titles with corporate partners of the unincorporated business. In *Skidmore,* the addback involved commissions paid to a non-partner flow-through entity owned by the same partners as the petitioner.

> **The NYC Tribunal upheld the ALJ determination, concluding that Skidmore's commission payments to S-DISC were properly disallowed as payments to partners.**

The Facts: Skidmore, Owings & Merrill LLP ("Skidmore") is an architectural, urban planning, and engineering firm subject to the UBT. During the years in issue (2011 and 2012), it had 14 active equity partners. Those partners were also the shareholders of a Domestic International Sales Corporation formed in 2004 that elected S-corporation tax treatment ("S-DISC"). S-DISC functioned as a commissioned sales agent, but also served two additional purposes. It enabled the shareholders—who, as noted, were also partners in Skidmore—to receive qualified dividends taxable at lower federal capital gains tax rates, and it increased the profit-sharing ratios of certain shareholders from their ratios in Skidmore.

Skidmore's commission payments to S-DISC, based on a percentage of designated services revenues, were fully deductible for federal purposes, and Skidmore also deducted them on its UBT returns. The Department of Finance disallowed the deductions for the payments to S-DISC as payments to Skidmore's partners for services. The dispute proceeded to litigation, and in a determination an Administrative Law Judge had sustained the addback, viewing the commissions as in substance payments to, or "for [the] benefit of," Skidmore's partners (discussed in the October 2021 issue of *Spotlight*). Skidmore appealed to the NYC Tax Appeals Tribunal ("NYC Tribunal").

The Decision: The NYC Tribunal upheld the ALJ determination, concluding that Skidmore's commission payments to S-DISC were properly disallowed as payments to partners. It viewed the S-DISC as a conduit to compensate Skidmore's partners for their services for Skidmore rather than for S-DISC, which was effectuated through the commissions which S-DISC then distributed to those partners.

The NYC Tribunal principally relied on the "Third-Party Payment Rule"—a term it previously coined for UBT regulation 19 RCNY 28-06(d)(1)(i)(B)—which provides that a payment "to any person" who is not a partner must nonetheless be added back so long as "the payment was consideration for services provided by a partner" of the taxpayer partnership. It found that the requirements for application of the rule were met and therefore the payments were nondeductible. Even though the regulation was promulgated in 2007 for the express purpose of adopting "the tax principles of [the federal] 'assignment of income'" doctrine, the NYC Tribunal rejected Skidmore's argument that it should only be applied to those situations, but without fully explaining why the stated purpose that led to adoption of the rule was irrelevant. The examples in the regulation for treating payments to non-partners as subject to the addback suggest a more limited application of the rule. □

MITCHELL A. NEWMARK
PARTNER

Delaware Loses its Latest Grab for Purported Unclaimed Property

By Mitchell A. Newmark

Delaware has maintained a nearly 60-year death-grip on its lucrative funding source of abandoned and unclaimed property. Another finger on that grip was loosened by Delaware's recent loss at the U.S. Supreme Court when Pennsylvania, Wisconsin, and Arkansas defeated Delaware's claim to certain prepaid money transmission instruments after they are deemed abandoned.

The Facts: The instruments at issue were Agent Checks and Teller Checks sold under a brand name as prepaid money transmission instruments that the payee can present for payment. The unclaimed property/instrument holder escheated under the model established in *Texas v. New Jersey,* 379 U.S. 674 (1965). That is, the two-tiered cascading rule of rights to escheatable property, *i.e.,* the holder is to escheat proceeds of abandoned financial products (1) "to the State of the creditor's last known address as shown by the debtor's books and records" when that State has an escheat custody law and, (2) if the first rule fails, "to the debtor's State of incorporation." *Pennsylvania v. Delaware,* 598 U.S. ___, slip op at 3 (2023), citing *Texas,* 379 U.S. at 680-682 (explaining the cascading rule and that the debtor entity holding the funds is the "holder").

Several states asserted that the instruments were protected by a federal safe-harbor fairness rule for certain financial instruments to escheat to the purchase address arising from Congress' recognition that often records of the address of the instrument-purchaser or the payee are not kept and that the purchase location address is kept (the Federal Disposition of Abandoned Money Order and Traveler's Checks Act (often referred to as the "FDA"), 12 USC § 2501). The instrument holder correctly asserted that it only had to escheat the funds once, paid the amounts into court, and left the states to fight out which had the better claim.

The Decision: The case turned on whether the instruments were of the kind expressly listed in the FDA or were sufficiently "similar" to the listed instruments to receive the fairness protection of the place of purchase. The U.S. Supreme Court found that the FDA specifically enumerated instruments and used the broad word "similar" to include other instrument types that were not specifically enumerated. It reasoned that Congress enacted the fairness rule to avoid record-keeping pitfalls inherent in the instruments themselves that would enable states of incorporation to receive a windfall. The Court ruled that the instruments are sufficiently similar to listed instruments to also receive protection, escheat under the FDA, and are paid to the state of the location of the place of purchase. The Court stated: "When a financial product operates like a money order—*i.e.,* [a prepaid instrument to transmit money to a payee] and…would escheat inequitably solely to the State of incorporation of the company holding the funds under our [*Texas* rule] due to recordkeeping gaps, then it is sufficiently 'similar' to a money order to fall presumptively within the FDA." *Pennsylvania v. Delaware,* slip op. at 22.

> **The instrument holder correctly asserted that it only had to escheat the funds once, paid the amounts into court, and left the states to fight out which had the better claim.**

The Takeaway: The U.S. Supreme Court many years prior explained that the Due Process Clause of the U.S. Constitution protects a holder from having to turn over funds more than one time. Intangible property is not easy to situate, became a source of friction over where to escheat, and forced the issue of needing a basic rule of escheatment that resulted in the two-tiered *Texas* rule defaulting to state of incorporation when owner addresses are unknown. Delaware's very high percentage of company formation made it the inadvertent beneficiary of the U.S. Supreme Court's two-tiered cascading *Texas* rule. Congress halted that unfairness as to certain financial instruments and "similar" instruments where owner address is not part of the normal record-keeping, but the company records the location of purchase. *Pennsylvania v. Delaware* reminds us that: (1) states hate Congressional action that limits their reach (*e.g.,* PL 86-272); and (2) the FDA's fairness safe harbor is interpreted broadly and may become very powerful as our modern world of payment options evolves. □

KARA M. KRAMAN
OF COUNSEL

New York State ALJ Determines Vendor Management Services Provided in Conjunction with Software are Subject to Sales Tax as the Sale of Prewritten Software

By Kara M. Kraman

An Administrative Law Judge ("ALJ") recently found that a taxpayer's vendor and labor management services, which were provided in conjunction with the grant of a software license, were subject to sales tax as the sale of prewritten software. *Matter of Beeline.com, Inc.,* DTA Nos. 829516 (N.Y.S. Div. of Tax App., Feb. 9, 2023).

The Facts: Beeline.com, Inc. ("Beeline") provided a "matching" service to match large national and global customers that desired to purchase the services of temporary workers with suppliers of temporary labor. Beeline provided its services by obtaining significant amounts of information from the customers about their needs and processes which it then matched with available suppliers. Hundreds of Beeline employees spent hundreds or thousands of hours gathering customer information in connection with these services. Beeline also provided legal compliance services to its customers and had employees dedicated to researching labor, tax, and other laws that affect contingent labor on a global basis. Each of Beeline's individual customers also had employees and teams that were dedicated to managing that customer's contingent labor program.

> **On audit, the auditor determined that Beeline sold licenses to use pre-written software and that such sales were subject to sales tax. The auditor issued a Notice of Determination on that basis.**

As part of the services it provided, Beeline granted customers a license to use its pre-written software program. Beeline's website described the software as "automat[ing] the hiring process of contract workers," and "help[ing] to manage and procure staffing services from requisition through billing." None of the services provided by Beeline were separately billed and invoices sent to customers did not contain a separate software license fee.

On audit, the auditor determined that Beeline sold licenses to use pre-written software and that such sales were subject to sales tax. The auditor issued a Notice of Determination on that basis.

The Decision: The ALJ noted that while sales of pre-written software are subject to sales tax, the services Beeline provided were generally not subject to sales tax. The ALJ further noted that in Beeline's case, the sale of taxable pre-written software was bundled together with nontaxable services and sold as one product. While the ALJ acknowledged the existence of the primary function test, under which sales of bundled taxable and nontaxable services are taxed based on their primary function, he noted that the Tax Appeals Tribunal "has reserved judgement" on whether the primary function test applies to mixed bundles of services and *tangible personal property.* Although the ALJ did not explicitly apply the primary function test, he found that the software was "anything but incidental" to what was sold and was "completely intertwined" with the services sold. The ALJ determined that what was being sold was taxable pre-written software and upheld the Notice of Determination.

This case is in sharp contrast to *Matter of Yesware, et al.,* DTA Nos. 829638, 829639 & 829640 (N.Y.S. Div. of Tax App., Sep. 29, 2022), in which the ALJ held that the sale of bundled nontaxable services and software was *not* taxable as the sale of pre-written software. In *Matter of Yesware,* the ALJ applied the "primary function test" to software bundled with a nontaxable information service and found that the primary function of what was being sold was a nontaxable information service. The Division did not appeal *Matter of Yesware* so that case remains nonprecedential. It remains to be seen if Beeline will appeal the ALJ's determination in this case. □

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.

45th Annual Advanced State & Local Tax Institute

- Blank Rome State + Local Tax partner Craig B. Fields will serve as a panelist at the 45th Annual Advanced State & Local Tax Institute, hosted by Georgetown Law on April 25th via Zoom. Craig will be a panelist for a session titled "Unwrapping the Oxymoron of Fair Apportionment and a Single Factor Apportionment Formula Based on Market Sales." □

North Atlantic Regional State Tax Seminar

- Blank Rome State + Local Tax partners Craig B. Fields, Eugene J. Gibilaro, Nicole L. Johnson, and Mitchell A. Newmark will serve as speakers at the Council on State Taxation's ("COST") North Atlantic Regional State Tax Seminar, being held March 29, 2023, from 8:30 a.m. to 3:15 p.m. Blank Rome is pleased to co-sponsor the event with Deloitte Tax LLP and host the Seminar at our office in New York, New York. A reception and networking will follow. To learn more, please click here. □

Remote/Mobile Workforce: Where Are We Now?

- Blank Rome State + Local Tax partner Mitchell A. Newmark will serve as a speaker at the Tax Executives Institute ("TEI") 73rd Midyear Conference, being held March 19 through March 22, 2023, in Washington, D.C. To learn more, please click here. □

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