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THE BR STATE + LOCAL TAX SPOTLIGHT

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Note from the Editors

By Joshua M. Sivin and Melanie L. Lee

Welcome to the AUGUST 2023 edition of *The BR State + Local Tax Spotlight.* We know 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 as well as 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:

- Ohio Supreme Court Holds Equipment Used in Fracking Exempt from Use Tax
- New York State Division of Tax Appeals Finds Hotel Business Liable for Over $15 Million in Franchise Tax
- Payback, New Jersey Style

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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CRAIG B. FIELDS
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Ohio Supreme Court Holds Equipment Used in Fracking Exempt from Use Tax

By Craig B. Fields

The Ohio Supreme Court, reversing the Board of Tax Appeals, held that various items of equipment used in providing fracking services were directly used in the production of oil and gas and, consequently, were exempt from Ohio use tax. The decision shows the importance of testimony in tax cases. *Stingray Pressure Pumping, L.L.C. v. Harris*, Slip Opinion No. 2023-Ohio-2598 (Aug. 2, 2023).

The Facts: Fracking entails pumping a pressurized mixture of water, chemicals, and sand into the earth to fracture and open rock formations and extract oil and gas. Stingray Pressure Pumping ("Stingray") purchased numerous pieces of equipment which it used in its fracking business.

> **While the Tax Commissioner acknowledged that some of the equipment was exempt from tax, he asserted that several pieces of equipment used in the process were taxable because they also served a storage function.**

The statute at issue (which was amended during the litigation and which both sides agreed applied) provided an exemption where the purpose of the purchaser was to "use or consume **the thing transferred** directly in production of crude oil and natural gas for sale." R.C. 5739.02(B)(42)(q) (emphasis added). The statute also included a list of items that qualified as a "thing transferred" and another list of items that did not constitute a "thing transferred." *Id*.

The Decision: The Court acknowledged that each piece of equipment at issue served multiple purposes as each was used both in hydraulic fracturing and also had a storage or delivery function. It noted, however, that numerous everyday items have storage, holding or delivery functions in addition to other functions. "A flashlight produces light, but it also holds and stores batteries. And a squirt gun wouldn't be much use in soaking a victim if it didn't also hold and deliver water."

The Court, therefore, looked to the primary use of each item and found that all but one item (a motor vehicle described as a "data van") qualified for the exemption. The Court relied heavily on the testimony of a single witness, Stingray's vice president of operations, who described in detail how each of the various pieces of equipment were used in the fracking process in a rapid, synergetic process which he analogized to a recipe in which all the ingredients must be added together.

For example, the testimony demonstrated that the use of a "blender" (which mixes the chemicals, water, gel, and sand together) "for blending outranks, in terms of essentiality or utility, the use of a blender for holding. A washing machine holds clothes during a wash cycle, but no one would say the primary use is to hold clothes. Similar logic applies here."

After determining that all but one of the pieces of equipment qualified as a "thing transferred," the Court had little difficulty in concluding that that equipment was used directly in the production of oil and gas for sale, again relying on the testimony of Stingray's witness.

JOSHUA M. SIVIN
OF COUNSEL

New York State Division of Tax Appeals Finds Hotel Business Liable for Over $15 Million in Franchise Tax

By Joshua M. Sivin

An Administrative Law Judge ("ALJ") at the State Division of Tax Appeals sustained two deficiency notices assessing over $15 million in tax against Cushlin Limited ("Cushlin"), a business that acquires and refurbishes hotels. The ALJ determined that the Division of Taxation ("Division") had a rational basis for assessing the tax and that Cushlin failed to substantiate its claimed losses and deducted expenses. *Matter of the Petition of Cushlin Limited*, DTA NO. 829939 (State of NY Division of Tax Appeals, July 13, 2023).

The Facts: Cushlin was a corporation formed under the laws of the Isle of Man, and its business model was to acquire and refurbish three- and four-star hotels in New York. Cushlin failed to file tax returns for tax years 2002 to 2008 and was audited by the Division. When Cushlin did file its tax returns, seven years after the audit began, it claimed losses and expense deductions for each year. The Division determined that Cushlin failed to substantiate its claimed losses and deductions and issued two deficiency notices assessing Cushlin over $15 million in tax. Cushlin challenged the assessments arguing that they lacked a rational basis because the Division did not explain the audit adjustments and failed to utilize information contained in Cushlin's late-filed returns.

The Decision: The ALJ began by stating that the deficiency notices were presumptively correct and that Cushlin bore the burden of proving by clear and convincing evidence that the assessments were erroneous. The ALJ found that because the Division utilized figures provided by Cushlin in calculating the amounts owed, there was a rational basis for the assessments: "Where the division utilized the numbers provided by petitioner that were verified on its real estate transaction database, the division established a rational basis for the tax due in the notices of deficiency."

The ALJ further found that Cushlin failed to meet its burden of establishing entitlement to claimed deductible expenses and losses. The ALJ found that Cushlin did not provide sufficient documentation to substantiate its claimed deductions and losses, among other reasons, because it did not provide any third-party verifiable documentation or proof of payment for any of the invoices submitted. "Schedules without any source documents verifying the payment are not enough."

> **Indeed, Cushlin's witness at hearing, an accountant from the United Kingdom, could not testify that the claimed expenses were actually paid.**

The Takeaway: A taxpayer bears the burden to establish claimed expenses and deductions. Conclusory documentation, without supporting source material, will be insufficient to overcome the presumption of correctness that attaches to a notice of deficiency.

EUGENE J. GIBILARO
PARTNER

Payback, New Jersey Style

By Eugene J. Gibilaro

On July 21, 2023, New Jersey Governor Phil Murphy signed into law retaliatory tax legislation aimed directly at its neighbor, New York. Assembly Bill No. 4694. The rule in the majority of states, including the rule in New Jersey prior to enactment of the new law, is that nonresident individuals are only taxed on their income earned from services actually performed in the state. To the great consternation of New Jerseyans, New York has long been an exception imposing what is known as the convenience of the employer rule. This rule requires nonresidents of New York to source their income to New York if their employer's office is in New York, even if the nonresident performs the work for their employer outside of New York in their state of residency. The only exception to this rule is if the nonresident works for their New York employer outside of New York for the benefit of the employer and not for the convenience of the nonresident employee.

New York's convenience of the employer rule has long disadvantaged both: (a) New Jersey residents who still are required to pay New York income tax if their office is located in New York even if they work from their homes in New Jersey; as well as (b) New Jersey itself, which provides its residents with a credit for the income tax that they pay to New York, effectively subsidizing New York's taxation of New Jersey residents working in New Jersey.

Under the new legislation, nonresidents of New Jersey who work for a New Jersey employer and reside in a state that has a convenience of the employer rule (looking at you, New York), must source their income from services performed outside of New Jersey to New Jersey, unless the work is performed outside of New Jersey for the benefit of their employer.

Further, the legislation provides a tax credit to any New Jersey resident who successfully challenges another state's convenience of the employer rule (looking at you again, New York), as well as a one-time credit to any New Jersey resident currently assigned to an office in another state (ahem, New York) who "seeks from the employer and accepts a permanent reassignment of work location to a New Jersey location during the taxable year."

Finally, the legislation provides grants to businesses of 25 or more full-time employees that are principally located in another state (perhaps New York?) that, on or before July 1, 2028, "assign their employees, who are New Jersey residents assigned to locations outside of the State, to New Jersey locations."

> **It is often said that two wrongs do not make a right**

New Jersey and other states would better serve their residents who are caught up in the crosshairs of another state's convenience of the employer rule by helping them to invalidate those rules rather than enacting their own such rules. The validity of New York's convenience of the employer rule is currently being challenged at the New York Tax Appeals Tribunal (by a Connecticut resident, not a New Jersey resident). In the *Matter of the Petitions of Edward A. and Doris Zelinsky*, New York Division of Tax Appeals, DTA Nos. 830517; 830681 (Hearing April 24, 2023). Should that challenge progress into the New York courts, it is not known whether New Jersey would seek to intervene or file an amicus brief in support of the nonresident taxpayer.

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.

AI in Tax

- Blank Rome State + Local Tax partner Nicole L. Johnson and associate Melanie L. Lee will present the myCPE live webinar "AI in Tax" on Thursday, September 21, 2023. To learn more, please click here.

COST's 54th Annual Meeting

- Blank Rome State + Local Tax partners Craig B. Fields, Mitchell A. Newmark, Eugene J. Gibilaro, and Nicole L. Johnson will serve as panelists at the Council on State Taxation's ("COST") 54th Annual Meeting, which will be held October 17 through 20, 2023, in Las Vegas, Nevada. Blank Rome LLP is pleased to be a Platinum Sponsor of the program. To learn more, please click here.

The 30th Annual Paul J. Hartman State and Local Tax Forum

- Blank Rome State + Local Tax partners Nicole L. Johnson and Mitchell A. Newmark will be speaking at the 30th Annual Paul J. Hartman State and Local Tax Forum which will be held from October 23rd through the 25th in Nashville, Tennessee. Nicole will be a panelist for a session titled "Here a Local Tax – There a Local Tax – Everywhere a Local Tax!" on October 24th. Mitchell will be a panelist for a session titled "Market-Based Sourcing – Looking Through the Looking Glass" on October 25th. To learn more, please click here.

2023 78th Annual Tax Executives Institute Conference

- Blank Rome State + Local Tax partner Mitchell A. Newmark will serve as a panelist at the Tax Executives Institute ("TEI") 2023 Annual Conference, being held October 22 through 25, 2023, at the New York Marriott Marquis in New York, New York. Blank Rome is pleased to be a Bronze Sponsor of the Conference. To learn more, please click here.

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