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THE BR STATE + LOCAL TAX SPOTLIGHT

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CONTENTS

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Note from the Editors

By Joshua M. Sivin and Melanie L. Lee

Welcome to the SEPTEMBER 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:

- New York State Formally Proposes Regulations Implementing 2014 Corporate Tax Reform
- New Jersey Still Wrestles with Unity, but Don't Forget the Rules
- California Administrative Tribunal Upholds Special Industry Apportionment Formula for Mutual Fund Service Provider

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 State Formally Proposes Regulations Implementing 2014 Corporate Tax Reform

By Kara M. Kraman

On August 9, 2023, the New York State Department of Taxation and Finance (the "Department") formally proposed Business Corporation Franchise Tax Regulations under the State Administrative Procedure Act ("SAPA"). The proposed regulations implement the wholesale reform of New York State's corporate tax framework enacted by Part A of Chapter 59 of the Laws of 2014.

> **The formal proposal of these regulations marks the culmination of an eight-year process involving multiple versions of draft regulations and over 80 detailed comments from industry members and individuals.**

Now that the regulations have been formally proposed, SAPA requires that the State provide an additional comment period of at least 60 days before it can adopt the proposed regulations, giving interested parties an additional (and possibly final) opportunity to comment on the proposed regulations. The Department has asked that all comments be submitted by October 10, 2023.

While the regulations have undergone numerous changes during the multi-year drafting process, in its Regulatory Impact Statement, the Department expressly notes some areas in which the final proposed regulations make changes to former draft versions of the regulations. Some of the more noteworthy changes include:

- The proposed regulations no longer treat all members of an LLC as subject to tax in New York, and instead treat corporate members of LLCs (that are treated as partnerships for tax purposes) in a comparable manner to limited partners of partnerships for purposes of determining whether the corporate members are subject to tax.
- The proposed regulations eliminate the "unusual events" rule and related examples under which receipts not earned in the regular course of business were generally excluded from the receipts factor.
- The proposed regulations expand the safe harbor that allows taxpayers sourcing receipts from digital products to source those receipts based on customer billing addresses for taxpayers with more than 250 customers (as opposed to 10,000) and eliminates the requirement that taxpayers must first make a reasonable inquiry to attempt to source those receipts under the digital products hierarchy.
- The proposed regulations provide additional guidance on the general attributes of a unitary business and set forth presumptions that, when met, will be indicative of a unitary business.
- The proposed regulations remove a provision allowing the Department to undo the election of a corporation meeting the capital stock requirement to be included in a combined report regardless of whether the corporation is conducting a unitary business.

Once formally adopted, the proposed regulations will repeal existing Business Corporation Franchise Tax regulations (20 NYCRR Subchapter A, Parts 1 through 9) and existing Franchise Tax on Banking Corporations Regulations (20 NYCRR Subchapter B) and will make the necessary changes to the Franchise Taxes on Insurance Corporations (20 NYCRR Subchapter C).

MITCHELL A. NEWMARK
PARTNER

New Jersey Still Wrestles with Unity, but Don't Forget the Rules

By Mitchell A. Newmark

As the New Jersey Division of Taxation changes leadership and issues guidance regarding legislative changes, including for unity, it is time to recall some fundamentals of unity and put the unity statute change in context. First, we wish outgoing Acting Director of the Division of Taxation John Ficara well and congratulate Marita Sciarrotta as the new Acting Director.

New Jersey modified its statutory definition of unity by changing an "and" to an "or" (enacted along with many other Corporation Business Tax changes). Summarizing the new unity statute language, commonly owned businesses have statutory unity when they are sufficiently "inter-dependent, integrated, **or** interrelated" so as to provide a synergy and mutual benefit, a sharing or exchange of value among them, and a significant flow of value among the separate parts. P.L. 2023, c. 96 (NJSA 54:10A-4(gg)) (emphasis added to show the change). The guidance explains that while the language changed, the tests remain the same. TB-93(R) (Revised August 14, 2023).

> **The statute's instruction that "unity" shall be construed to the broadest extent permitted under the Constitution of the United States is a peculiar statement because the statutory definition of "unity" contains 300 words.**

Yet, inasmuch as "unity" is also a constitutional concept, if the statutory word "unity" is to be construed as broadly as constitutionally permitted, then why not state that statutory unity "will be synonymous with constitutional unity" (six words), for which there is much case law in existence. Because those 300 words must mean something, and words matter, there are opportunities in the language.

The statute, however worded, cannot reach beyond constitutional unity. The U.S. Supreme Court stated:

> As we indicated in [*Mobil Oil*]: "Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business." The constitutional question becomes whether the income "derive[s] from 'unrelated business activity' which constitutes a 'discrete business enterprise.'"

Allied-Signal v. NJ Division of Taxation, 504 US 768, 780 (1992) (referring to *Mobil Oil v. Vermont*, 445 U.S. 425, 442 (1980)). In *Allied-Signal*, the U.S. Supreme Court recognized that in one of its prior decisions it "reaffirmed that the constitutional test focuses on functional integration, centralization of management, and economies of scale." *Id*. at 783 (referring to *Container Corp. of Am v. CA FTB*, 463 U.S. 159, 179 (1983)). The question in *Allied-Signal* was unity within the legal entity confines. The U.S. Supreme Court's *Container* decision held that the unity concept can cross legal lines, thus allowing for California's then-new unitary combined reporting methodology and finding unity under the facts in that case.

In *Container*, the U.S. Supreme Court gave us important conditions for unity, two of which I highlight here. First, to have a unitary business, you must have "a flow of *value*, not a flow of goods." *Container Corp*., 463 U.S. at 178 (1983) (emphasis in original). Second, arm's length transactions do not constitute flows of value. *Id*. at 180 n.19 (1983). That is, the mere existence of related-party transactions between two entities does not make two entities unitary.

These important concepts are overlooked in New Jersey's guidance. New Jersey states its view that: "Existence of arm's length pricing between entities, however, does not indicate a lack of unity." TB-93(R). Many auditors believe that they do not have to consider, and can ignore, transfer pricing reports, which is wrong and is subject to challenge. When auditors assert unity by related-party transactions and the transactions are at arm's length, stand up and fight!

IRWIN M. SLOMKA
SENIOR COUNSEL

California Administrative Tribunal Upholds Special Industry Apportionment Formula for Mutual Fund Service Provider

By Irwin M. Slomka

An investment management company subject to California corporate franchise tax was required to source its receipts from the provision of management, administrative, and distribution services furnished to mutual funds based on the locations of the mutual fund shareholders and could not source the receipts using the California market-based sourcing statute. *Appeal of Janus Capital Group, Inc. and Subsidiaries*, Case No. 20096605 (Calif. Office of Tax Appeals, July 27, 2023, released Sept. 2023).

The Facts: Janus Capital Group, Inc. ("Janus"), an investment management company headquartered in Colorado, provides management, administrative, and distribution services to mutual funds. In its original California corporate tax returns filed for the years 2013 through 2016, Janus sourced its gross receipts from those services based on the locations of the mutual funds' shareholders, as required under the California Franchise Tax Board ("FTB") mutual fund service provider regulation (Cal. Code Regs. Tit. 18, § 25137-14, the "Regulation"). Janus subsequently filed refund claims seeking to source the receipts to the locations of the mutual funds themselves, none of which were located in California. The FTB denied the refund claim, rejecting Janus' position, and this appeal followed.

The Dispute: At the Office of Tax Appeals ("OTA"), Janus first argued that the Regulation was not properly promulgated under the State Administrative Procedure Act ("APA").

Janus also claimed that the FTB was required to make a showing of distortion before applying the Regulation, which employs a "look-through" approach. Janus asserted that it was entitled to source its receipts based on the California market-based sourcing statute, which looks to where the "purchaser of the service" receives the "benefit of the services." According to Janus, since the Regulation conflicted with the market-based sourcing statute, the Regulation could be applied only if application of the statute was shown to result in distortion.

The Decision: On Janus' first argument, the OTA found that as a state administrative agency, it had no authority to rule on whether a regulation was adopted in compliance with the California APA. On Janus' second argument, the OTA held in favor of the FTB, finding that the Regulation constituted a proper invocation of the FTB's authority to cure distortion relating to the mutual fund service provider industry under the standard California apportionment method. Therefore, having properly promulgated the Regulation, it became the standard apportionment methodology for mutual fund service providers such as Janus, unless Janus, as the party seeking to deviate from that methodology, showed distortion, which it did not do.

> **The OTA concluded that the FTB had no obligation to show that application of the market-based sourcing statute resulted in distortion.**

It noted that numerous special industry apportionment regulations under FTB Regulation 25137 significantly deviate from the standard apportionment methodology in order to cure distortion.

It is not clear from the decision, however, what "distortion" the Regulation was seeking to cure. The OTA reasoned that "declining to apply the relief [under the Regulation] to the industry would allow significant tax loopholes that would be susceptible to manipulation." This suggests that the OTA may consider the "distortion" to be the hypothetical possibility of "locating" mutual funds in other states in order to reduce the service provider's California tax liability.

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.

Mitchell A. Newmark Named to Law360's 2023 Tax Authority State & Local Editorial Advisory Board

- Blank Rome LLP is pleased to announce that partner Mitchell A. Newmark has been named to Law360's 2023 Tax Authority State & Local Editorial Advisory Board. 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 be speaking at the 2023 78th Annual Tax Executives Institute Conference, which will be held October 23 through 25, 2023, in New York City. Mitchell will be a panelist for a session titled "Recent Developments in State Income Tax "on October 23rd. To learn more, please click here.

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