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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 October 2024 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:

- Kentucky Court Issues Permanent Injunction of Law Discriminating Against Interstate Commerce
- New York ALJ Finds Convenience of Employer Rule Applicable to Nonresident but Provides a Roadmap for How a Taxpayer May Prove the Rule Is Inapplicable
- Departments Don't Always Know Best
- NYC Judge Applies Step Transaction Doctrine but Cancels Real Property Transfer Tax Assessment

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.

Update from previous editions. In the April 2024 edition of *The BR State + Local Tax Spotlight*, Nicole L. Johnson authored an article titled "**Misapplication of *Complete Auto***" in which she analyzes the Supreme Court of South Dakota's decision in *Ellingson Drainage, Inc. v. South Dakota Department of Revenue*. Since the publication of her article, Ellingson Drainage petitioned the U.S. Supreme Court to overturn the South Dakota Supreme Court's decision. On October 7, 2024, the U.S. Supreme Court denied Ellingson Drainage's petition for certiorari.

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

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CRAIG B. FIELDS
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Kentucky Court Issues Permanent Injunction of Law Discriminating Against Interstate Commerce

By Craig B. Fields

A U.S. District Court ruled that a Kentucky statute that requires the State's Public Service Commission ("PSC") to compute the reasonableness of the rates that utilities charge consumers by reducing fuel costs by any severance tax imposed by any jurisdiction unconstitutionally discriminates against interstate commerce and, therefore, granted an Illinois utility's request for a permanent injunction of the law. *Foresight Coal Sales LLC v. Chandler*, Civil No. 3:21-cv-00016-GFVT (ED KY, Central Div. Frankfort Sept. 24, 2024). This is another example of a company successfully challenging a discriminatory state statute.

Facts: Foresight Coal Sales LLC ("Foresight") sells coal produced in Illinois and competes with other producers for supply contracts with Kentucky utilities. The Kentucky utilities are regulated by the PSC, which periodically evaluates the reasonableness of the rates that the utilities charge consumers. As the cost paid for coal is a crucial factor considered by the PSC on its reasonableness review, the utilities are incentivized to purchase less expensive coal.

While Kentucky imposes a 4.5% severance tax on its coal producers, Illinois does not impose any severance tax. In 2021, S.B. 257 (codified as Ky. Rev. Stat. Ann. § 278.277) was enacted and directs the PSC to evaluate the reasonableness of fuel costs based on the cost of the fuel less any severance tax imposed by any jurisdiction.

Foresight challenged the statute on the basis that it discriminated against interstate commerce by giving an advantage to Kentucky coal producers over coal producers in Illinois in violation of the Commerce Clause. Foresight first successfully convinced the Sixth Circuit Court of Appeals that it was likely to succeed on the merits of its claim and that court issued a preliminary injunction. (See article discussing this case in the February 2023 issue of *Spotlight*.) The Sixth Circuit then remanded the case to the District Court.

The Decision: Relying heavily on the Sixth Circuit's decision, the District Court had little difficulty finding that the statute discriminated against interstate commerce in violation of the Commerce Clause (indeed, the court found that the Sixth Circuit had clearly so held). In doing so, the court rejected the PSC's assertions that the court should not follow the Sixth Circuit decision both on procedural grounds and as a more recent U.S. Supreme Court decision purportedly rendered the Sixth Circuit's decision inapposite as "a purposefully discriminatory law does not violate the Commerce Clause unless the law has 'substantial' negative effects on interstate commerce."

The court first held that the Sixth Circuit's decision is the law of the case and had to be followed here. It then determined that the more recent Supreme Court case did not change the Commerce Clause inquiry which begins with the question of whether the challenged law discriminates. It is only after that question is answered in the negative that the *Pike* balancing analysis asserted by the PSC applies. Here, the statute discriminated against interstate commerce and, so, the balancing analysis was unnecessary.

While the court acknowledged that although a discriminatory law is virtually per se invalid, it can be sustained upon a showing that it is narrowly tailored to advance a legitimate local purpose. Here, the PSC only asserted that the law was designed to nullify the competitive disadvantages created by Kentucky's severance tax. The court found that this was not a legitimate local purpose and that the statute unconstitutionally discriminates against interstate commerce.

The court then granted Foresight a permanent injunction enjoining the PSC from enforcing the law against Foresight.

> **When a statute, such as the one at issue here, clearly favors in-state businesses over out-of-state businesses, courts will find the statute unconstitutional.**

JOSHUA M. SIVIN
OF COUNSEL

New York ALJ Finds Convenience of Employer Rule Applicable to Nonresident but Provides a Roadmap for How a Taxpayer May Prove the Rule Is Inapplicable

By Joshua M. Sivin

In another challenge to New York's so-called convenience of the employer rule (the "convenience rule"), an Administrative Law Judge ("ALJ") recently issued a determination upholding application of the rule against a nonresident working for a New York company. *In the Matter of the Petition of Bryant*, DTA No. 830818 (Sept. 12, 2024). This is another decision in a line of cases where the New York Tax Appeals Tribunal upheld application of the convenience rule, which presumes that a nonresident employee's income from a New York employer is taxable by New York unless the employee works outside the state for the employer's necessity, not the employee's convenience, despite state-issued COVID-19 restrictions requiring businesses to employ telecommuting polices to the maximum extent possible.

Facts: The Bryants ("petitioners") filed a New York State nonresident income tax return for 2020, listing a New Jersey home address and claiming a refund of $54,044.00. The return further reported that Mr. Bryant's employer withheld $58,471 in New York State taxes. The Division of Taxation ("Division") audited the return and sent a request for information, requesting copies of W-2s and other documentation, and a questionnaire. In response, petitioners sent Mr. Bryant's W-2 and stated "OFFICE LOCATION IN NYC WAS CLOSED[,] I WAS ORDERED NOT TO COME IN TO NYC[.]" Mr. Bryant's W-2 indicated that he was employed by NN Investment Partners North America LLC and that $28,471.19 in New York State income tax was withheld. In response to the questionnaire, Mr. Bryant stated that he was employed by NN Investment Management located in Delaware. For his assigned primary work location, Mr. Bryant indicated "NONE." Petitioners also completed a day count table which did not reflect where Mr. Bryant worked for 42 workdays.

The Division subsequently issued an account adjustment notice recomputing petitioners' return by allocating all of Mr. Bryant's income to New York State and adjusting his claimed New York State withholdings from $58,471 to $28,471, the amount shown on his W-2. Petitioners responded by resubmitting documents, including a new response to the questionnaire. This time, Mr. Bryant indicated that: (i) he was employed by NN Investment Partners, an investing firm located in New York; (ii) his role was Vice President; and (iii) his assigned primary work location was his home address in New Jersey. Petitioners also included a new day count schedule which conflicted with the original schedule provided. The response showed that Mr. Bryant worked 40 days from his employer's office in New York City and stated: "My company closed their NY office during 2020, they provided a full home office equipment setup for full time remote work. I have not been into New York City since March 6th [2020], a formal communication was sent out the following week, attached[.]" The "formal communication" referenced was not included with the submission. Though New York's governor had issued an executive order requiring businesses to employ work-from-home policies to the maximum extent possible ("Executive Order"), the order did not apply to essential businesses, including banks and related financial institutions.

After receiving petitioners' revised submission, the Division issued a notice of disallowance ("Notice"), stating that the information petitioners provided was insufficient to establish that Mr. Bryant's assigned primary work location was outside New York or that his employer had established a bona fide employer office at his telecommuting location. As a result, the Notice concluded that Mr. Bryant owed New York State income tax on income earned while telecommuting and disallowed $51,610.12 of the claimed refund amount.

Decision: As an initial matter, the ALJ determined that Mr. Bryant's employer withheld $28,471.19, the amount indicated on Mr. Bryant's W-2, not the $58,471.00 listed on the return, and that the Division properly adjusted the withholdings to the correct amount. The ALJ further granted the Division's request that judicial notice be taken of New York guidance concluding that mandatory workforce reductions in the Executive Order did not apply to financial institutions, such as Mr. Bryant's employer. Petitioners did not avail themselves of the opportunity to be heard on the issue of whether the Executive Order applied to Mr. Bryant's employer.

As for the remaining issue of whether the Department properly allocated all of Mr. Bryant's income to New York, the ALJ applied the convenience rule. The ALJ found that petitioners did not meet their burden of establishing that Mr. Bryant worked from home due to his employer's necessity, rather than for his own convenience. The ALJ determined that in order to show the convenience rule is inapplicable, a nonresident employed by a New York employer must show that they work outside of New York, perform no work within New York, and have no office or place of business in New York. The ALJ concluded that petitioners did not make this showing because Mr. Bryant worked in New York City in the beginning of 2020. The ALJ noted that petitioners did not adduce evidence to support their position. While Mr. Bryant's employer was not under a legal mandate to close its New York office during the pandemic, it could have ordered its employees to report from specific locations outside of New York for its own necessity.

Though Mr. Bryant testified that his employer had issued such an order, there was no corroborating evidence, and the ALJ questioned Mr. Bryant's credibility given the inconsistent information contained in petitioners' two responses to the questionnaire. Furthermore, the ALJ noted that Mr. Bryant's testimony, alone, cannot carry the burden of proof.

Takeaway: The convenience rule has consistently been upheld by New York courts.

> **The ALJ seems to have provided a blueprint for what a petitioner must show in order to establish that the convenience rule is inapplicable.**

If petitioners had submitted evidence, other than Mr. Bryant's own testimony, that his employer required employees to work outside of New York for its own necessity, it appears that petitioners' claim would have at least been partially successful. Furthermore, though it seems unlikely based on other ALJ determinations (*see, e.g., In the Matter of Petition of Zelinsky*, DTA Nos. 830517 and 830681 (Nov. 30, 2023) and *In the Matter of the Petition of Struckle*, DTA No. 830731 (Aug. 8, 2024)), the Decision left open the question of whether the result would have been different had petitioners shown that the mandatory workforce reductions in the Executive Order applied to Mr. Bryant's employer. Unless and until the New York Court of Appeals hears a case involving application of the convenience rule while the Executive Order was in place, it appears that nonresidents will continue to be subject to the rule, despite their employers' New York offices being closed during the pandemic.

NICOLE L. JOHNSON
PARTNER

Departments Don't Always Know Best

By Nicole L. Johnson

Departments of Revenue are notorious for treating their guidance as the final and absolute word on an issue. However, that doesn't mean that they are always right. The recent decision of the Oregon Tax Court in *Microsoft Corporation v. Department of Revenue*, T.C. 5413 (Aug. 29, 2024), highlights just that.

As part of the federal Tax Cuts and Jobs Act, corporations were required to make a one-time repatriation of certain deferred earnings of controlled foreign corporations ("CFCs") for federal tax purposes. Oregon, like many states, treated the repatriated earnings as deemed dividends, which were included in the State's tax base at 20% (thereby excluding 80% of the income). In addition, the Oregon Department of Revenue issued Oregon Revenue Bulletin 2018-01 that explicitly stated that, although the repatriated earnings were included in the tax base, such earnings were excluded from the sales factor.

Microsoft filed its 2018 Oregon return including 20% of its repatriated earnings in the tax base and excluding such earnings from the sales factor, in line with the Department's guidance. Subsequently, Microsoft filed an amended return including the repatriated earnings in the sales factor, which the Department denied.

On appeal, the Tax Court examined two issues: first, whether the 20% of Microsoft's repatriated earnings included in the tax base should also be included in the sales factor; and second, whether other factor representation should be granted.

As to the first issue, the Tax Court succinctly determined that the portion of the repatriated earnings included in the tax base was required to be included in the sales factor. Under Oregon law, this inclusion was necessary as the earnings were derived from Microsoft's primary business activity because Microsoft operated as a unitary business with the CFCs—which was directly contrary to the Department's guidance. However, the court explicitly stated that it was expressing "no view as to whether it would reach the same conclusion if [Microsoft] and the CFCs were not engaged in a single unitary business."

On the second issue, Microsoft provided three alternative proposals to achieve factor representation. Unfortunately, the Tax Court was not persuaded by the Company's arguments. The court held that the 80% exclusion from the tax base of the repatriated earnings was a proxy for factor relief.

Ultimately, Microsoft achieved a substantial victory and established that what is included in the tax base must also be included in the sales factor.

> **In addition, this case serves as a reminder to taxpayers that guidance issued by Departments is merely the opinion of those Departments—not the law.**

IRWIN M. SLOMKA
SENIOR COUNSEL

NYC Judge Applies Step Transaction Doctrine but Cancels Real Property Transfer Tax Assessment

By Irwin M. Slomka

A recent New York City ("NYC") determination limited the impact of the step transaction doctrine under the New York City real property transfer tax ("RPTT"). An Administrative Law Judge ("ALJ") held that the collapsing of a deed to a newly formed entity, followed by a transfer of an economic interest in that entity, resulted in a nontaxable transfer of a less than 50% economic interest in the entity. *Matter of 105-02 Forest Hills LLC., et al., TAT (H) 20-18 (RP), et al.* (N.Y.C. Tax App. Trib., Adm. Law Judge Div., Sept. 17, 2024).

Facts: On May 2, 2017, Don Rick Associates LLC ("Grantor") deeded a commercial building located in Queens, New York, to 105-02 Forest Hills LLC ("Grantee") ("Deed Transfer"). At the time, Grantor's two members each held a 50% membership interest in Grantor, and also indirectly owned, through an intermediate entity, GG Forest Hills, LLC ("GG"), 50% membership interests in Grantee.

Since Grantor's two members owned 50% beneficial interests in the building both before and after the transactions, the RPTT filed for the Deed Transfer claimed a 100% exemption from the RPTT. Under the RPTT, a deed, instrument or transaction conveying real property or an economic interest in that property that effects a "mere change of identity or form of ownership" ("mere change in form") is exempt "to the extent the beneficial ownership" in the realty before and after the transaction remains unchanged. NYC Adm. Code § 11-2106.b(8).

On June 28, 2017—approximately two months after the Deed Transfer—another party, SPG Forest Hills LLC ("SPG"), was admitted as a member of Grantee in exchange for a one-dollar capital contribution ("Interest Transfer"). SPG's admission was anticipated at the time of the Deed Transfer. SPG received a 40% "percentage interest" in Grantee, entitling it to certain unspecified distribution rights relating to that percentage interest. The RPTT also applies to the transfer of a 50% or more ownership interest in "the capital, profits or beneficial interest in a partnership, association, trust or other entity." NYC Admin. Code § 11-2101.7 and .8. It does not appear that an RPTT return was filed for the Interest Transfer, presumably because it represented a less than 50% economic interest in Grantee.

NYC Position: The Department of Finance assessed RPTT, invoking the "step transaction" doctrine to collapse the Deed and Interest Transfers into a single deed to SPG of 40% of the realty. The Department relied on a 2016 decision of the NYC Tax Appeals Tribunal, *Matter of GKK 2 Herald LLC*, which applied the doctrine to treat the respective contributions of 45% and 55% ownership interests in a Manhattan building to a newly formed LLC in exchange for the same percentage interests in the LLC, immediately followed by the sale of the 45% membership interest to the 55% member, as the taxable sale of a 45% interest in the building.

Taxpayer's Position: The Grantor and Grantee asserted that the Deed Transfer was fully exempt from RPTT as a mere change in form, and that the City was without authority to reduce the exemption on account of the subsequent Interest Transfer. They claimed that the two-month period between the Deed and Interest Transfers distinguished it from GKK 2 Herald, demonstrating that the Deed Transfer had substance and independent significance apart from the Interest Transfer.

Decision: The ALJ ruled in favor of the taxpayers, holding that while the Department was authorized to apply the step transaction doctrine, the substance of the collapsed transaction was the transfer of a less than 50% membership interest in Grantee.

The ALJ noted that, "if viewed in a vacuum," the Deed Transfer and the Interest Transfer were both non-taxable. In his view, the step transaction doctrine could be applied because, under the "end result" test, both transfers were undertaken to admit a new member in the Grantee. It did not matter whether there was substance and independent significance.

However, the ALJ rejected the Department's recharacterization of the transaction as a *deed* made directly to SPG. In doing so, the ALJ found the case distinguishable from *GKK 2 Herald*, which he viewed as holding that the substance of the collapsed transactions was the sale of the 45% interest in the realty to the 55% LLC member, and not as a transfer of a minority economic interest. The ALJ concluded that no direct sale of realty was made to SPG in substance or in form, quoting federal case law that the step transaction doctrine "cannot generate events which never took place just so an additional tax liability might be asserted." Actually, in *GKK 2 Herald*, the NYC Tribunal concluded that there was in substance a taxable 45% deed to the LLC, not to the 55% member, which it held did not qualify as a mere change in form. Here, the ALJ found that the substance of the transactions was the transfer of a minority *economic interest* in an entity and that even if a 40% membership interest in Grantee was conveyed as the Department asserted, it was still a minority interest transfer and not subject to the RPTT.

> ***GKK 2 Herald* has led to considerable uncertainty, and this decision provides some needed clarity.**

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 Income and Franchise Tax

- Blank Rome State + Local Tax partner Nicole L. Johnson will serve as a panelist at the Chicago Tax Club's 70th Annual Fall Seminar being held October 24 and 25, 2024, in Lisle, Illinois. To learn more, please click here.

SALT in 2024: 10 Key Developments You Need to Know

- Blank Rome State + Local Tax partner Mitchell A. Newmark will serve as a panelist at the Tax Executives Institute ("TEI") 2024 Annual Conference, being held October 27 through 30, 2024, in San Antonio, Texas. Blank Rome is pleased to be a Bronze Sponsor of the Conference. To learn more, please click here.

31st Annual Paul J. Hartman State and Local Tax Forum

- Blank Rome State + Local Tax partners Nicole L. Johnson and Eugene J. Gibilaro will serve as panelists at the 31st Annual Paul J. Hartman State and Local Tax Forum, presented in conjunction with the Vanderbilt University Law School and being held October 28 to 30, 2024, in Nashville, Tennessee (with a virtual option available for all program sessions). To learn more, please click here.

Keynote Presentation: A State Affair

- Blank Rome State + Local Tax partner Mitchell A. Newmark will serve as a keynote presenter at the Michigan Association of Certified Public Accountants' ("MICPA") Michigan Tax Conference, being held on Thursday, November 7, 2024, from 8:30 a.m. to 5:20 p.m., in Livonia, Michigan. To learn more, please click here.

California Tax Policy Conference

- Blank Rome State + Local Tax partner Nicole L. Johnson and of counsel Joshua M. Sivin will be speaking at the California Tax Policy Conference in Anaheim, California on November 7th and 8th 2024, respectively. Nicole's speech is titled "California Litigation Update" and Josh's speech is titled "California Franchise Tax Board Residency Audits: Anticipation, Preparation, and Resolution." To learn more, please click here.

SALT Compliance: Tax Planning for Out-of-State Workforces

- Blank Rome State + Local Tax partner Nicole L. Johnson and associate Melanie L. Lee will present the Lorman live webinar "SALT Compliance: Tax Planning for Out-of-State Workforces" on Monday, November 18, 2024, from 1:00 to 2:40 p.m. EST. To learn more, please click here.

Institute on State and Local Taxation

- Blank Rome State + Local Tax partners Mitchell A. Newmark and Eugene J. Gibilaro will be speaking at the Institute on State and Local Taxation in New York, New York on December 16, 2024. Mitchell's speech is titled "Post Moor(tum) on Moore and Loper Bright" and Eugene's speech is titled "Top 10 SALT Cases – Away We Go." To learn more, please click here.