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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 January 2025 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 judicial decisions and legislative developments 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:

- State Tax Policy—The Fine Line Between Delegation and Abdication
- Illinois Loses First Shot at Interchange Fees on State and Local Taxes
- Supreme Court of Arkansas Allows Corporation to Allocate Interest Expense Incurred to Fund Corporate Spin-off
- Longtime Iowa Taxpayers Lose Out on Capital Gains Deduction
- Supreme Court of Ohio Affirms Denial of Healthcare Service Provider's Commercial Activity Tax Refund Claim

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.

Updates from previous editions. In the December 2023 edition of *The BR State+ Local Tax Spotlight,* Eugene J. Gibilaro authored an article titled "State Tax v. Local Tax—Is There a Difference?" in which he discussed the Pennsylvania Supreme Court's decision in *Zilka v. Tax Review Board.* After that article was published, we provided updates that the Appellant in that case (Diane Zilka) had petitioned the U.S. Supreme Court for a writ of certiorari, and in a June 2024 order, the U.S. Supreme Court had invited the solicitor general to file a brief in the case. As a further update, on January 13, 2025, the U.S. Supreme Court denied Diane Zilka's petition for certiorari.

In the March 2024 edition of *The BR State+ Local Tax Spotlight,* Nicole L. Johnson authored an article titled "Ruling Outside the Lines," in which she discussed a series of rulings from the Michigan Supreme Court and Court of Appeals that centered on determining whether a company had the necessary nexus for the City of Detroit to impose income tax. Despite the Court of Appeals leaving certain issues unanswered—as discussed in Nicole's article—on January 7, 2025, the parties involved in the ongoing litigation notified the Michigan Tax Tribunal via letter that they have reached a pending settlement resolving all claims between them. The letter does not describe the terms of the settlement. Despite the Court of Appeals leaving certain issues unanswered—as discussed in Nicole's article—on January 7, 2025, the parties involved in the ongoing litigation notified the Michigan Tax Tribunal via letter that they have reached a pending settlement resolving all claims between them. On January 21, 2025, the Detroit City Council approved a $45,000 settlement via a voice vote.

In the December 2024 edition of *The BR State+ Local Tax Spotlight,* Josh Sivin authored an article titled "Asphalt Company Not Liable for $2.6 Million in Sales Tax Where Judge Found No Sale," in which he discussed an administrative law judge's ("ALJ's") decision in *Asphalt Emulsion Industries LLC v. North Carolina Department of Revenue.* In a petition filed with the North Carolina General Court of Justice, Superior Court Division, the North Carolina Department of Revenue has appealed the ALJ's decision.

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

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EUGENE J. GIBILARO
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State Tax Policy—The Fine Line Between Delegation and Abdication

By Eugene J. Gibilaro

As is true of the U.S. government, within the executive branch of state governments live administrative agencies, which state legislatures have vested with powers to implement and enforce the laws enacted by state legislatures. Pennsylvania courts have established what is known as the nondelegation doctrine which allows the Pennsylvania General Assembly to delegate authority and discretion to administrative agencies, such as the Department of Revenue. However, the Pennsylvania Constitution requires the General Assembly make the basic policy choices and set sufficient standards to guide and restrain the administrative agencies. A recent decision by the Pennsylvania Commonwealth Court is an example of a taxpayer successfully pushing back against the Department of Revenue (the "Department") when it acts without proper legislative restraints. *East Coast Vapor LLC v. Dep't of Revenue*, No. 153 C.D. 2023 (Pa. Commw. Ct. Jan. 3, 2025).

> **State legislatures may delegate, but they may not abdicate, and taxpayers should not be afraid to fight back against improperly unrestrained state taxing authorities.**

At issue in the case was Pennsylvania's Tobacco Products Tax Act (the "Act"), which imposes taxes on certain types of tobacco products, such as e-cigarettes and e-liquids, and creates a licensing regime for manufacturers, wholesalers, and retailers of those products. The Act creates three categories of licenses for manufacturers, wholesalers, and retailers and prohibits anyone from selling, transferring, or delivering tobacco products in Pennsylvania without first obtaining the proper license. For manufacturers, the Act provides that an applicant can obtain a license by "submitting an application to the [D]epartment containing the information requested by the [D]epartment and designating a process agent." Unlike for manufacturers, the Act further includes other specific requirements for wholesalers and retailers that the Department could seek to confirm through the information requested in the license application (*e.g.,* that the "premises on which the applicant proposes to conduct business are adequate to protect the revenue").

East Coast Vapor LLC (the "Company"), sells e-cigarettes and e-liquids at retail in Pennsylvania, including e-liquids that it makes itself. The Company applied for a manufacturer's license under the Act and submitted a Manufacturing License Application Form to the Department along with other requested information. However, the Company did not submit a License Application Consent Form ("Consent Form"). The Consent Form would authorize the Department's Bureau of Criminal Investigations "to conduct consensual investigations/searches of East Coast's financial accounts and other financial records and credit records." The Company asked the Department to provide legal authority justifying the Consent Form requirement for manufacturers but not for wholesalers or retailers. The Department never responded to the Company's request and denied the Company's application on the grounds that the Company had not provided all requested information.

On appeal, the Commonwealth Court found that the Act violated Pennsylvania's nondelegation doctrine, noting that while the provisions for wholesalers and retailers "at least contain some enumerated criteria or requirements of applications, there is nothing in the manufacturer's provision that suggests what information would be appropriately required." The lack of express criteria of what information the Department could request from manufacturers "allows the Department to make unconstrained, arbitrary, capricious requests for any information whatsoever." Finding that the Act was an unconstitutional delegation of legislative authority to the Department with respect to the licensing of manufacturers, the Court struck the provisions of the Act relating to the licensing of the manufacturers but left undisturbed the provisions relating to the licensing of wholesalers and retailers. As a result of its decision, the Court found that the Department could no longer license manufacturers under the Act and, accordingly, reversed the Department's decision to deny the Company's application and directed the Department not to further consider the Company's application.

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MITCHELL A. NEWMARK
PARTNER

Illinois Loses First Shot at Interchange Fees on State and Local Taxes

By Mitchell A. Newmark

Illinois enacted a law that prohibits a credit card holder's bank from charging or receiving interchange fees on the portions of transactions that include Illinois state or local taxes and gratuities, in effect starting July 1, 2025. IL Interchange Fee Prohibition Act ("IFPA") 815 ILCS 151/150-1 *et seq.* The Illinois Bankers Association and others collectively sought relief in the federal courts to prevent the IFPA from taking effect and asserted that the IFPA is preempted by federal laws, is unconstitutional under the Supremacy Clause of the United States Constitution, and is discriminatory under the dormant Commerce Clause of the United States Constitution because it imposes a regulatory measure that "benefit[s] in-state economic interests by burdening out-of-state competitors." Compl. ¶ 202 to 224. They won a preliminary injunction that temporarily blocks the law while the challenge proceeds. *Illinois Bankers Association's et al. v. Kwame Raoul, in his official capacity as Illinois Attorney General*, No. 24 C 7307 (N. D. Ill. Dec. 20, 2024).

A preliminary injunction in any court requires, at a minimum, the court to believe that the party seeking the injunction has a reasonable likelihood of success on the merits of the actual case and will suffer irreparable harm if application of the law is not stayed while the case proceeds. This means at least two things. First, you have to be prepared for a mini-proceeding on the case before you get to the trial stage at which you would put on your full case. That is, if you cannot demonstrate that you are likely to ultimately win and you would be harmed by not halting the law early, why would the court want to stay the application of a law at an early stage of your case? Second, if you win a preliminary injunction, you are more likely to ultimately prevail.

The court found that:

1. the IFPA prohibits charging or receiving interchange fees on the portion of a credit card transaction that includes Illinois state or local taxes or gratuities;

2. the IFPA defines an interchange fee as "a fee established, charged, or received by a payment card network for the purpose of compensating the issuer for its involvement in an electronic payment transaction[;]"

3. under the federal National Bank Act powers, banks are authorized to engage in any activity that is "incidental to the business of banking [;]"

4. Office of the Comptroller of the Currency guidance makes clear that processing credit and debit card transactions is part of the business of banking;

5. the IFPA directly regulates credit and debit card transactions by dictating the amount that banks can charge for a transaction; and

6. by barring a credit card issuer from charging interchange fees on state and local taxes and gratuities, the IFPA alters a bank's right to determine how best to structure their non-interest fee arrangements with merchants.

The banks demonstrated irreparable harm by proving that costs to make changes to their payment processing systems (the current systems do not distinguish between whether the transaction is for state and local tax or gratuities) would not be recouped if the law was later struck down.

> **The takeaway here is that a preliminary injunction and a challenge in federal court are powerful tools that can add leverage if the case is right for using them.**

Often state tax challenges are prohibited in federal courts under the Tax Injunction Act, which provides that federal courts "shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law where a plain, speedy and efficient remedy may be had in the courts of such State." 28 USC § 1341. However, if you can get there, make a federal case out of it!

IRWIN M. SLOMKA
SENIOR COUNSEL

Supreme Court of Arkansas Allows Corporation to Allocate Interest Expense Incurred to Fund Corporate Spin-off

By: Irwin M. Slomka

A recent Supreme Court of Arkansas decision has upheld a multistate corporation's allocation to Arkansas of 100% of its interest expenses from borrowings to fund a spin-off. It also rejected as irrelevant the state's attempt to condition entitlement to such allocation on the taxpayer showing that it did not apportion any of the interest expense in its tax returns filed in other states. *Hudson v. Murphy Oil USA, Inc.*, 2024 Ark. 179 (Ark. Sup. Ct., Dec. 12, 2024).

The Facts: Murphy Oil USA, Inc. ("Murphy Oil") is an Arkansas-based operator of retail-fueling stations in 24 states. Murphy Oil was spun off from its prior parent company. In order to fund the spin-off, Murphy Oil borrowed $650 million through notes and credit agreements, which amount was then distributed to its new parent company. None of the funds were used to finance Murphy Oil's retail-fueling operations. Murphy Oil incurred interest expenses on its borrowings, and it was the deductibility of those interest expenses in Arkansas that was the subject of the dispute.

In its originally filed Arkansas corporate tax returns, Murphy Oil apportioned the interest expense among all the states in which it conducted business, so that it was only partly deducted in Arkansas. Murphy Oil later amended its Arkansas returns, allocating 100% of the interest expenses to Arkansas—its commercial domicile—on the grounds that it related to nonbusiness activities (the corporate spin-off), which resulted in Arkansas refund claims.

The Arkansas Department of Finance and Administration (the "Department") denied the refunds, but a state circuit court judge granted summary judgment in favor of Murphy Oil. This appeal followed.

The Department took the position that the interest was either (i) not deductible at all because Arkansas law prohibited deductions for expenses "allocable to nonbusiness income," or (ii) related to apportionable business income (as Murphy Oil had originally filed its returns). It also argued that the refund should be denied on "uniform fairness grounds."

The Decision: The Supreme Court of Arkansas ruled in favor of the taxpayer, holding that under the Uniform Division of Income for Tax Purposes Act ("UDITPA," which Arkansas has adopted), the separation from one parent company to another in a spinoff was an "extraordinary, non-recurring event" (*i.e.,* not business income under the so-called "transactional test"). The court also rejected the Department's "functional test" argument for business income treatment, noting that Murphy Oil did not use the borrowed funds to acquire, manage or dispose of its business property.

In addition, the court rejected the Department's alternative argument that Arkansas law prohibited any deduction for the interest expenses if such expenses are found to relate to nonbusiness income under UDITPA. In interpreting Arkansas law—which the court found to be open to more than one interpretation—the court found that the Arkansas legislature's purpose for the provision was to limit deductions related to "tax-exempt income," noting that "it was not materially disputed that these interest expenses were unattributable to [any] income."

Relevance of Tax Filings in Other States: Finally, the court also addressed an important (and commonplace) issue concerning the relevance of a taxpayer's returns filed in other states. The Department argued, on "fairness" grounds, that allowing a 100% deduction for Arkansas purposes, without Murphy Oil also having to amend its tax returns in other states where the interest expense was apportioned (and therefore partly deducted), was "unjust" and would allow Murphy Oil a potential tax "windfall" and the refund claims should therefore also be denied on that basis.

The court emphatically and unambiguously rejected the Department's argument: "It is not the role of this court to adjust Arkansas tax returns based on unfairness to Tennessee, Mississippi, or other states" or to somehow have "a role in requiring taxpayers to file returns in multiple states uniformly under the UDITPA." Rather, the court viewed its sole role in the case as interpreting and applying Arkansas law.

State tax auditors often request that taxpayers provide information regarding tax returns filed under the laws of other states.

> **The Supreme Court of Arkansas correctly rejected the relevance of such information in interpreting the deductibility and allocation of expenses under Arkansas law.**

MELANIE L. LEE
ASSOCIATE

Longtime Iowa Taxpayers Lose Out on Capital Gains Deduction

By: Melanie L. Lee

The tax consequences of the sale of a business are complex, and strategizing to avoid one tax type may lead to unanticipated tax in another form. A recent decision of the Court of Appeals of Iowa illustrates this point. *Clark v. Dep't of Revenue*, No. 23-1529 (Iowa Ct. App. Dec. 4, 2024).

The Facts: Two business partners, William Clark and Barry Bengston (the "Taxpayers"), started an insurance business in the 1970s. Each owned 50% of the business and worked as employees—engaging in administration, management, and sales-related activities. These activities resulted in the cultivation of goodwill, held by the Taxpayers as individuals.

In 2016, the Taxpayers sold their insurance business to an unrelated limited company (the "L.C.") via an asset sale. Simultaneously, each individual Taxpayer sold their goodwill to the L.C. While neither Taxpayer had a non-compete agreement with their business prior to the sale, each signed a non-compete agreement with the L.C. and sold their goodwill to it in exchange for $525,000 each.

On their Iowa personal income tax returns for 2016, both Taxpayers sought to deduct the capital gain earned on the sale of their goodwill. The Iowa Department of Revenue (the "Department") disallowed the deduction, finding that the sale of the goodwill was not deductible because it did not amount to the sale of a business. After losses before the Department and the district court, both Taxpayers appealed to the Court of Appeals of Iowa.

The Decision: In determining whether the Taxpayers' sale of goodwill qualified for Iowa's capital-gains deduction, the Court of Appeals found that the following four requirements must be met:

1. The capital gain must be "from the sale of a business" as defined under Iowa law;
2. The taxpayer must have sold "all or substantially all of the... service of the business"—with "service of the business" defined to include goodwill;
3. The taxpayer must have held the business for at least 10 years at the time of the sale; and
4. The taxpayer must have materially participated in the business for at least 10 years at the time of the sale.

Because the Taxpayers owned the goodwill personally, they contended that they met the aforementioned requirements because they engaged in "the separate 'business' of being" employees and "cultivated personal goodwill." The court was unpersuaded—finding the Taxpayers failed to provide any rationale "as to how providing services as an employee qualifies as a business."

Even applying Iowa's broad definition of a business, which includes any activity engaged in by any person "with the object of gain, benefit, or advantage[,]" the court found nothing in the record to support the Taxpayers' argument that the actions that created the goodwill were done as part of a business separate from the Taxpayers' insurance business. As the Taxpayers were unable to provide any evidence to support that they engaged in separate businesses as employees, the court determined that the sale at issue did not amount to the sale of the "service of the business," making the capital gain deduction unavailable to the Taxpayers.[1]

(continued on page 6)

1. Perhaps the evidence the Taxpayers needed was in the transcript of the hearing before the administrative law judge—which the court noted was not provided to it nor to the district court.

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Despite its holding, the court and the Department both acknowledged that the outcome of the case would likely have been different if the Taxpayers had first sold their goodwill to their insurance business in exchange for a non-compete agreement. If such a sale had taken place, the personal goodwill would have been transformed “into an asset of the business of being an employee.” Capital gain from the subsequent sale of the goodwill would then be deductible assuming the other enumerated requirements were met.

The Takeaway: The structure of the Taxpayers’ sale of their insurance business as the separate sale of the assets and their personal goodwill is a common one—desirable from a federal tax perspective because the sale of the personal goodwill should qualify for long-term capital gain treatment. However, the Department’s deduction denial certainly resulted in unanticipated state tax from the sale. While both the court and the Department acknowledged that the sale could have been structured differently to avoid the Iowa tax, such a structure may have cost the Taxpayer’s their federal capital gains treatment.

Though sometimes taxation is inevitable, and a goal may be tax minimization, it is imperative that taxpayers plan for the federal *and* state tax consequences of the sale of their business prior to the sale taking place.

STEPHANIE N. TERINONI
ASSOCIATE

Supreme Court of Ohio Affirms Denial of Healthcare Service Provider's Commercial Activity Tax Refund Claim

By Stephanie N. Terinoni

The Supreme Court of Ohio upheld the denial of Total Renal Care, Inc.'s ("TRC") refund claim of Ohio Commercial Activity Tax ("CAT") that it paid on services that it performed outside of Ohio. *Total Renal Care Inc. v. Harris*, Slip Op. No. 2024-Ohio-5685 (Ohio Dec. 9, 2024).

The Facts: TRC, a subsidiary of DaVita, Inc., provides dialysis to patients with kidney disease and end-stage renal disease. Dialysis treatments are administered at locations throughout the United States, including in Ohio. In addition to dialysis services, TRC provides laboratory testing services and administrative services, such as back-office support, data processing, and procuring medical equipment and supplies. TRC conducts these services in a number of states outside of Ohio.

For the years at issue, TRC originally paid CAT on all gross receipts it received from locations in Ohio where dialysis was provided. TRC subsequently filed refund claims and asserted that a portion of those gross receipts were related to its laboratory and administrative services, which were performed outside of Ohio.

The Ohio Tax Commissioner denied TRC's refund claims, and the Ohio Board of Tax Appeals (the "Board") affirmed. TRC appealed the Board's decision to the Supreme Court of Ohio.

The Law: The CAT is imposed on "each person with taxable gross receipts for the privilege of doing business in [Ohio]." The statute defines "taxable gross receipts" as receipts with an Ohio situs and provides that receipts from services are sitused to Ohio in the proportion that the purchaser received the benefit of the service in Ohio.

Ohio's Administrative Code governing situsing receipts provides "the physical location where the purchaser ultimately uses or receives the benefit of what was purchased is paramount in determining the proportion of the benefit received in Ohio." The Administrative Code lays out a standard specific to healthcare services, which indicates that gross receipts from healthcare services are sitused to Ohio if the healthcare services are performed there.

The Decision: The Supreme Court of Ohio ultimately affirmed the Board's decision, concluding that patients who received TRC's dialysis treatment in Ohio received the benefits of such treatment there. The court focused its analysis on TRC's provision of dialysis because TRC conceded that "the only service it provides to *its* patients is dialysis[.]" (Emphasis added.) And it admitted that laboratory and administrative functions "exist solely for its provision of dialysis services to patients in Ohio." Thus, the court concluded that the gross receipts at issue were from the provision of dialysis services, not the provision of dialysis, laboratory, and administrative services.

> **The court analyzed the facts under both the statutory language and the administrative rules and concluded, under either application, the result was the same.**

In applying the statute, the court stated "[w]hen determining the location to which gross receipts should be sitused, the taxing authority must look at the location where the purchaser benefited from the purchased service," and indicated that the purchaser's physical location is "paramount" to this inquiry. Applying this interpretation to TRC's facts, the court held that patients who received dialysis in Ohio benefited from such treatment there. In applying the administrative rules, the court stated "if a healthcare service is provided entirely in Ohio, then the entirety of the receipts for that service are sitused to Ohio." Applying this interpretation to TRC's facts, the court held that the healthcare service TRC provided was dialysis and such service was provided entirely in Ohio.

Accordingly, the court held that TRC's gross receipts it received from locations in Ohio where it provided dialysis should be sitused entirely to Ohio.

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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.

The National Multistate Tax Symposium

- Blank Rome State + Local Tax partner Craig B. Fields will be speaking at the National Multistate Tax Symposium in Orlando, Florida on February 6, 2025. Craig’s speech is titled “M&A twists and turns: Transaction tips for multistate direct and indirect taxes.”

ABA-IPT Advanced State Income Tax Seminar

- Blank Rome State + Local Tax partner Nicole L. Johnson will be speaking at the ABA-IPT Advanced State Income Tax Seminar in New Orleans, Louisiana on March 11, 2025. Nicole’s speech is titled “Rocking Reserves! How to Manage Compliance Issues for Fun and Profit.”

COST Spring Conference

- Blank Rome State + Local Tax partners Nicole L. Johnson, Craig B. Fields, and Eugene J. Gibilaro will be speaking at the COST Spring Conference in New Orleans, Louisiana on April 29 and 30, 2025. Nicole’s speech (April 29th) is titled “Business Purpose and Economic Substance Principles are In Focus Once Again,” Craig’s speech (April 30th) is titled “Key Apportionment Issues,” and Eugene’s speech (April 30th) is titled “Apportionment of Foreign Source Income.”

Start-Up Conference

- Blank Rome State + Local Tax partners Craig B. Fields and Nicole L. Johnson will be speaking at the Start-Up conference in Charlotte, North Carolina on May 7, 2025. Their speech is titled “State of the States.”

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