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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 March 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:

- City's Electric Slide Stumbles as Invalid Tax
- Tax Assessments: Minimum Evidentiary Foundation Required
- California Snags Former Resident for Tax Due on Stock Options

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 edition. In the December 2024 edition of *The BR State + Local Spotlight,* Craig B. Fields authored an article titled "Virginia Court Rules That Corporation Is Not Unitary with 17% Owned Limited Liability Company" in which he discussed the recent decision of the Virginia Court of Appeals in *Dep't of Tax'n v. FJ Management, Inc., d/b/a FJI, Inc*. On December 23, 2024, the Department of Taxation petitioned for further review to the Supreme Court of Virginia. The appeal is ongoing.

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

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MITCHELL A. NEWMARK
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City's Electric Slide Stumbles as Invalid Tax

By Mitchell A. Newmark

We often focus on whether a levy is a tax masquerading as a fee because a state tax must be fairly apportioned under United States Constitutional precedent, while a fee is not so limited. Some "fees" can be quite material in amount, so it is important to have a second route of attack: challenge the levy as an improperly enacted tax. After improper enactment, the City of East Lansing (the "City") lost badly to such a challenge. *Heos v. City of East Lansing*, Docket No. 165763 (Mich. Feb. 3, 2025).

The City of East Lansing realized that its budgeting was resulting in the City's underfunding of its pension and other post-employment benefits obligations. To fill the gap, the City determined to charge a franchise "fee" for providers of electricity services and passed an ordinance to enact the levy—the levy was never voted on by City voters.

The franchise "fee" levy was negotiated into the franchise agreement for one of the City's two electricity providers (the second provider refused to participate). The franchise agreement included a levy of 5 percent of revenue and was to be collected and remitted by the electricity system provider and placed on the bills of customers who receive and pay the energy bills. The provider was not liable for the levy itself, only for collecting and remitting it to the City.

Prior to the above-mentioned creative budgeting ordinance by the City, the "Headlee Amendment" to the Michigan Constitution was enacted. The Amendment prohibits units of local government:

> from levying any tax not authorized by law or charter when [the Headlee Amendment was] ratified or from increasing the rate of an existing tax above that rate authorized by law or charter when [the Headlee Amendment was] ratified, *without the approval of a majority of the qualified electors of that unit of Local Government voting* thereon. Const 1963, art , § 31 (emphasis added).

As the Michigan Supreme Court aptly framed the issue: "Although the levying of a new tax without voter approval violates the Headlee Amendment, a charge that constitutes a user fee does not." The Court observed with broadbrush that: "Generally a 'fee' is 'exchanged for a service rendered or a benefit conferred, and some reasonable relationship exists between the amount of the fee and the value of the service or benefit.'…A 'tax,' on the other hand, is designed to raise revenue." This is as useful a distillation as the author has seen by a high court over the past nearly thirty years.

The Court explained with particularity that for a levy to be considered a fee, the levy must: (1) "have a regulatory purpose and not a general-revenue-raising purpose[;]" (2) "be proportionate to the required costs of the service[;]" and (3) "be voluntary."

A majority of justices found that (1) the City stated publicly that the fee had a revenue raising purpose to fill a budget gap and funds collected and remitted by the electricity service provider went into the general revenue fund to be used for any City purpose, (2) the fee was not "proportional to the costs the City incurred for granting [the electricity service provider] the right to provide electrical services to plaintiff[,]" and (3) the fee was not voluntary because, if the plaintiff did not pay the electric bill that contained the fee, the electric service was subject to being turned off. Applying those findings, the Court concluded that the levy was indeed a tax. Further, inasmuch as the City's voters had never had the opportunity to vote on the levy, the levy failed as a tax on which a proper vote had not been conducted.

On a secondary issue, whether plaintiff electricity user was a taxpayer eligible to bring suit, a majority of justices answered in the affirmative. However, one justice wrote in dissent to conclude that the plaintiff was not a taxpayer (two justices did not participate in the decision).

> **The takeaway here is that if you are faced with a levy, ask what the levy is accomplishing and determine whether the levy is susceptible to challenge either as an unapportioned tax or, as in *Heos*, an improperly enacted tax.**

EUGENE J. GIBILARO
PARTNER

Tax Assessments: Minimum Evidentiary Foundation Required

By Eugene J. Gibilaro

When a taxpayer challenges an assessment issued by a state or local taxing authority, the taxing authority will typically assert that its assessment should be afforded a presumption of correctness, and the burden of proof is on the taxpayer to prove that the assessment is incorrect. While this is typically true, a presumption of correctness can only attach to an assessment if there is a rational basis and minimum evidentiary foundation for the assessment. While this should not be a high bar to cross for state or local taxing authorities, there are nonetheless times when they do not meet even these minimal requirements, and assessments are issued with no rational basis and no minimum evidentiary foundation.

A recent decision by the Alabama Tax Tribunal ("Tribunal") highlights such an instance where local Alabama taxing authorities issued sales tax assessments that could not even satisfy these minimal requirements, and the assessments were voided without the company or a representative of the company even appearing at the trial. *VV & Co., LLC v. City of Boaz;* Docket No. City 23-1081-LP; *VV & Co., LLC v. City of Albertville;* Docket No. City 23-1082-LP (Ala. Tax Trib. Feb. 3, 2025). While it is never recommended that an appealing company not show up for its trial, the decision is a reminder that state and local taxing authorities are not unrestrained in their authority to issue assessments, and minimum requirements must be satisfied before the burden of proof shifts to a taxpayer to prove that an assessment is erroneous.

The two Alabama localities here engaged a third-party auditor that conducted a "desk audit" of the company that resulted in the sales tax assessments. In its appeal to the Tribunal, the company asserted that it did not do any business in the localities and that it only made wholesale sales of cars, and had no sales tax liability because it made no retail sales. At trial, the auditor from the third-party firm testified and the company did not appear. The auditor testified that the reason for the assessments was that the company had historically filed sales tax returns in the localities (several reporting zero sales), but beginning with the audit period, the company stopped filing returns. The assessments were calculated using estimation techniques based on the amounts reported on the company's historic sales tax returns. The auditor further testified that neither locality had received any documents from the taxpayer indicating that the company made any sales in the localities during the audit period.

> **The Tribunal explained that while assessments in Alabama are "*prima facie* correct," it is also "well established that the final assessments must be 'based on a minimum evidentiary foundation.'"**

The Tribunal also noted that sales tax liabilities may only be estimated if "there is evidence reasonably establishing that the retailer conducted business and made sales during the period." Finding that the "sole foundation" for the assessments issued by the localities was that the company "had filed tax returns at some point prior to the audit periods in issue but then stopped filing returns," the Tribunal concluded that such reasoning was "insufficient to justify the final assessments," and voided the assessments.

MELANIE L. LEE
ASSOCIATE

California Snags Former Resident for Tax Due on Stock Options

By Melanie L. Lee

Many employees receive stock options as compensation from their employers. When receiving this type of compensation, the state tax implications may not be at the forefront of the employees' minds, especially where it may be years between when the options are granted and when the options actually result in recognized income. However, failure to consider the state tax implications when stock options are granted may lead to unanticipated and sometimes costly consequences in this unsettled area of law. A recent opinion from the California Office of Tax Appeals ("OTA") illustrates this point. *Matter of Hall,* 2025-OTA-113 (Cal. OTA Issued Dec. 13, 2024).

The Facts: Appellant served as president of Monster Beverage Company ("MBC") from 2007 to 2013 and as chief brand officer of MBC in 2014. From 2009 to 2013, while Appellant was a resident of California, MBC granted Appellant non-qualified stock options ("NSOs") and restricted stock units ("RSUs"). In December 2013, Appellant moved to Hawaii. Thereafter, in September 2014, the RSUs that Appellant received vested, and Appellant exercised his NSOs.

On Appellant's 2014 California nonresident return, he reported none of the income that he recognized from the exercised NSOs and vested RSUs as California source income. Three years later, California commenced an examination of Appellant's returns, during which it determined that the exercised NSOs and vested RSUs resulted in California source income because they were attributable to personal services performed by Appellant in the State. To determine the amount of income sourced to the State, California applied a ratio of California working days to total working days—resulting in a total tax assessment of $674,452 plus interest. Appellant appealed the assessment.

The Decision: In a nonprecedential opinion, the OTA first reviewed the taxability of NSOs and RSUs, identifying three critical points under California law: (i) income earned from the exercise of NSOs and the vesting of RSUs is treated as compensation for services; (ii) if an NSO does not have an ascertainable fair market value at grant, the grantee recognizes income in the taxable year the option is exercised; and (iii) taxable income from RSUs is generally taxable in the year the RSUs vest. Applying these points of law to Appellant, the OTA found "no dispute" that Appellant recognized income from the exercised NSOs and vested RSUs. Thus, the only issues remaining were: (1) whether the income Appellant recognized was subject to California income tax if Appellant was a nonresident at the time of exercise/vesting; and (2) if so, whether the State's working day sourcing methodology was reasonable.

The OTA determined that it was "immaterial" that Appellant ceased being a California resident in 2014 because "the income from the NSOs and RSUs is treated as compensation for personal services…performed in California" between 2009 and 2013. Further, the OTA determined that the income at issue was reasonably sourced using the standard methodology of California working days to total working days—a methodology which the Appellant failed to argue, or show was incorrect.

Last, the OTA addressed Appellant's claim that he was denied procedural and substantive due process because his ability to claim a credit for taxes paid in Hawaii was foreclosed because the statute of limitations to file such a claim in Hawaii had expired. The OTA determined it lacked jurisdiction over this claim, finding as a general rule that its jurisdiction is "limited to determining the correct amount of a taxpayer's California [tax liability]."

The Takeaway: The Appellant would have benefited from considering the state tax implications and broader multistate issues of receiving stock options at the time of grant. If such consideration had been given, the Appellant could have at least tracked working days closely to avoid over-allocation to California and potentially timely sought a credit from Hawaii.

> **The importance of considering the state tax implications of stock options as compensation cannot be overstated, especially when considering that tax treatment varies by state.**

For example, when determining the portion of income from NSOs earned by nonresidents that is subject to tax, California looks to the taxpayer's activities during the period from the grant of the NSOs to when they are exercised, while New York looks to the period from the grant to when the NSOs vest.

Taxpayers filing in various jurisdictions should take care to track their stock options, their working days, and consider credits for taxes paid in the various jurisdictions in a timely manner. Consult your friendly Blank Rome tax advisor for help today!

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.

TEI Orange County SALT Day

- Blank Rome State + Local Tax partners Nicole L. Johnson, Craig B. Fields, and associate Melanie L. Lee will be speaking at the TEI SALT Day event in Fountain Valley, California on April 24, 2025. To learn more, please click here.

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 "The Apportionment of Foreign Source Income." To learn more, please click here.

Start-Up

- 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."

Energy Tax Association Conference

- Blank Rome State + Local Tax partners Craig B. Fields and Nicole L. Johnson will be speaking at the Energy Tax Association conference in San Antonio, Texas on May 15, 2025. Their speech is also titled "State of the States."

COST 2025 Intermediate/Advanced Sales & Use Tax School Conference

- Blank Rome State + Local Tax partner Eugene J. Gibilaro will be speaking at the COST 2025 Intermediate/Advanced Sales & Use Tax School Conference in Dallas, Texas on May 20, 2025. Eugene's speech is titled "Taxation of Foreign Income." To learn more, please click here.

COST 2025 SALT Basics School Conference

- Blank Rome State + Local Tax partner Mitchell A. Newmark will be speaking at the COST 2025 SALT Basics School Conference in Dallas, Texas on May 22, 2025. Mitchell's speech is titled "Restrictions on a State's Ability to Tax." To learn more, please click here.

TEI Region 10 Conference

- Blank Rome State + Local Tax partners Craig B. Fields and Nicole L. Johnson will be speaking at the TEI Region 10 conference in Dana Point, California on May 22 and May 23, 2025. Their speeches are titled "Tax Policy in 2025 —SALT Perspective" and "SALT Legislative Update." To learn more, please click here.

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