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THE BR STATE + LOCAL TAX SPOTLIGHT

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CONTENTS

STATE + LOCAL TAX TEAM:

Craig B. Fields | craig.fields@blankrome.com
Nicole L. Johnson | nicole.johnson@blankrome.com
Mitchell A. Newmark | mitchell.newmark@blankrome.com
Irwin M. Slomka | irwin.slomka@blankrome.com
Eugene J. Gibilaro | eugene.gibilaro@blankrome.com
Kara M. Kraman | kara.kraman@blankrome.com
Joshua M. Sivin | joshua.sivin@blankrome.com
Philip M. Tatarowicz | phil.tatarowicz@blankrome.com
Melanie L. Lee | melanie.lee@blankrome.com

Note from the Editors

By Joshua M. Sivin and Melanie L. Lee

Welcome to the April 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:

- South Carolina Legislature Severely Limits Department's Ability to Force Companies to File Combined Returns
- Arkansas Supreme Court Finds Auto Dealerships Liable for Sales Tax When They Provide Vehicles for Their Employees' Use
- Ohio Supreme Court Finds Federal Due Process Limitations Do Not Apply to Intrastate Taxation
- Misapplication of *Complete Auto*

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 March 2024 edition of *The BR State + Local Tax Spotlight,* Irwin M. Slomka authored an article titled "Microsoft Prevails in California Dispute on Inclusion of Gross Foreign Dividends in Apportionment Formula." Since the publication of his article, the California Office of Tax Appeals ("OTA") has designated its opinion in *Appeal of Microsoft Corporation and Subsidiaries,* Opinion on Petition for Rehearing, Case No.: 21037336 (Calif. Office of Tax Appeals, Feb. 14, 2024), as non-precedential. This designation means that the California Franchise Tax Board is not obligated to follow the OTA's opinion when similar cases arise in the future.

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

JOSHUA M. SIVIN
Of Counsel
212.885.5025
joshua.sivin@blankrome.com

MELANIE L. LEE
Associate
212.885.5371
melanie.lee@blankrome.com

CRAIG B. FIELDS
PARTNER

South Carolina Legislature Severely Limits Department's Ability to Force Companies to File Combined Returns

By Craig B. Fields

Since the South Carolina Supreme Court held in *Media General Communications, Inc. v. South Carolina Department of Revenue,* 694 S.E.2d 525 (S.C. 2010), that the Department of Revenue ("Department") had the authority to allow companies to file a combined unitary return (in that case the companies wanted to file on a combined basis), the Department has been attempting to forcibly combine taxpayers with their affiliates and usually with all of the companies included in the federal consolidated return. Fortunately, the Legislature has now severely limited the Department's ability to force combined returns.

The legislation (S298), which was modeled on similar legislation in North Carolina, was unanimously passed by both the Senate and House and signed into law by the Governor on March 11, 2024. It provides that the Department may only force a corporate taxpayer to file a combined unitary return if (1) the Department finds that the taxpayer's intercompany transactions either (a) lack economic substance or (b) are not at fair market value *and* (2) the Department is unable to properly determine the taxpayer's income attributable to the State through adding back, eliminating, or otherwise adjusting the intercompany transactions.

A transaction has economic substance if the transaction (1) has one or more reasonable business purposes other than the creation of state income tax benefits and (2) has economic effect beyond the creation of state income tax benefits. An affiliated group's having centralized cash management specifically does not constitute evidence of an absence of economic substance.

In determining whether transactions between affiliates are not at fair market value, the Department is required to apply the standards contained in the regulations adopted under Internal Revenue Code Section 482. This will likely increase the use of transfer pricing studies in South Carolina.

> **Significantly, the legislation applies to all open periods except for assessments under review by the Administrative Law Court, the Court of Appeals, or the Supreme Court as of the date of the Governor's approval. This should be helpful to many taxpayers.**

The cynical among us had often wondered whether the reason the Department stipulated in *Media General* that the standard method of apportionment did not fairly represent the taxpayer's income in South Carolina, and that a combined return did fairly represent the taxpayer's income in the State, was to obtain the right to force other taxpayers to file combined returns. The recent legislation will now prevent (or at least severely limit) such actions in the future.

JOSHUA M. SIVIN
OF COUNSEL

Arkansas Supreme Court Finds Auto Dealerships Liable for Sales Tax When They Provide Vehicles for Their Employees' Use

By Joshua M. Sivin

A recent decision from Arkansas' highest court reversed a circuit court decision and found that when auto dealerships allowed employees and their families to use vehicles, it subjected the dealerships to sales tax, despite the fact that the vehicles remained available for sale to the public and, in fact, were subsequently sold to unrelated third parties. *Arkansas Dep't of Finance and Admin. v. Trotter Ford, Inc. et. al.,* 35CV-22-238 and 35CV-22-240 (Ark. 2024).

The Facts: Auto dealerships allowed two employees and two employee family members to use vehicles with dealer license tags. The Arkansas Department of Finance and Administration ("ADFA") audited the dealerships, finding that the individuals to whom the cars were assigned did not qualify as authorized users for dealer tags under Arkansas law and that the assignment and use of the vehicles constituted "withdrawals from stock" requiring the payment of sales tax. The dealerships protested the assessments issued by the ADFA, and an administrative law judge sustained the assessments. The dealerships then appealed that ruling and filed motions for summary judgment. The circuit court granted the dealerships' summary judgment motions and reversed the assessments, reasoning that, because sales tax is triggered by a consumer on the purchase of a motor vehicle on or before the time for registration, and because the sales tax is collected from the buyer at the time the automobile license is issued, no tax is due because no title was transferred and no application for a license had been sought. ADFA appealed to the Supreme Court of Arkansas from the circuit court's orders.

The Decision: The Court focused on Arkansas Code Section 26-52-322 ("Withdrawal from stock—Definition") which subjects tangible personal property "withdraw[n] from stock" to the gross receipts (*i.e.,* sales) tax. "'[W]ithdrawal from stock' means the withdrawal or use of…tangible personal property from an established business…for consumption or use in the established business or by any other person." As a result, the "narrow issue" before the Court was "whether the use of the vehicles constitutes 'use' within the meaning of 'withdrawal from stock'" under the statute.

> **The Court found that the statutory language was unambiguous and under its plain meaning, the vehicles were used and therefore were subject to tax.**

The Court rejected the dealerships' argument that the statute requires a permanent withdrawal from stock or consumption of the property and found that because the vehicles were provided as part of the dealerships' compensation packages to their employees, and because the benefits of the vehicles were enjoyed without restriction, the vehicles were used and therefore withdrawn from stock under the plain language of the statute.

The Dissent: The dissent sought to look beyond the plain language of the statute and "give effect to the intent of the legislature." The dissent focused on a different statute, Arkansas Code Section 26-52-301, which applies the gross receipts tax to sales of tangible personal property. The dissent argued that under the plain language of that statute, the tax does not come due until there is a sale, and that there was no "sale" when the employees and their families were permitted use of the vehicles. The dissent further highlighted that the vehicles in question remained in the dealerships' active inventory and were, in fact, later sold and taxes were paid on the gross receipts that were generated. The dissent criticized the majority: "[i]t is absurd to call the use of these vehicles a withdrawal from stock. By the majority's reasoning, it is a withdrawal without actual withdrawal."

EUGENE J. GIBILARO
PARTNER

Ohio Supreme Court Finds Federal Due Process Limitations Do Not Apply to Intrastate Taxation

By Eugene J. Gibilaro

During the COVID-19 pandemic, many states enacted legislation trying to minimize the negative impact that the pandemic was having on state and local government budgets. It is in the context of the unprecedented circumstances of the pandemic that the Ohio Supreme Court recently considered legislation enacted by the Ohio legislature in March 2020 that provided that, for a limited time, Ohio workers would be taxed by the municipality that was their principal place of work, rather than by the municipality where they actually performed their work.

Over two dissenting opinions, the Court held that the temporary legislation at issue did not violate the Due Process Clause of the U.S. Constitution or Ohio law. *Schaad v. Alder,* Slip Opinion No. 2024-Ohio-525 (Ohio Feb. 14, 2024). In reaching its conclusion, the Court found that the federal due process requirement that there be a minimum connection between the taxing jurisdiction and the person or transaction it seeks to tax and the federal due process prohibition against taxation of extraterritorial values are "not implicated by the purely intrastate scheme of taxation at issue here."

The taxpayer lived in Blue Ash, Ohio, and, before the pandemic, worked primarily from his employer's office in Cincinnati, Ohio. In June 2020, he began working from his home in Blue Ash full time and did not return to the Cincinnati office until December 2020. The taxpayer's employer withheld Cincinnati income tax for the entire 2020 tax year and the taxpayer sought a refund from Cincinnati for the days that he worked outside of the City from his home in Blue Ash. Cincinnati, through its finance director, denied the refund claim and the taxpayer sued.

In analyzing the taxpayer's federal due process claims, the Ohio Supreme Court categorized the claims as substantive rather than procedural and, as the taxpayer was not alleging violation of a fundamental right, the Court concluded that the temporary legislation need only pass rational basis review. The Court found that "there was plainly a rational basis for the enactment—Ohio had a legitimate interest in ensuring that municipal revenues remained stable amidst the rapid switch to remote work that occurred during the pandemic."

Turning to the U.S. Supreme Court's due process precedents in tax cases, the Ohio Supreme Court concluded that "this strain of [the U.S. Supreme Court's] due-process jurisprudence does not apply to matters of intrastate taxation." In casting aside these cases as inapplicable to intrastate taxation, the Ohio Supreme Court declined to consider whether there was a minimum connection between the taxpayer and Cincinnati during the relevant period and whether Cincinnati had "jurisdiction or power to tax" the taxpayer. The Court also dismissed the taxpayer's claim that Cincinnati had collected an extraterritorial tax because "the federal due process clause is not implicated by the purely intrastate-taxation scheme at issue here."

The dissents questioned the majority's conclusion that "federal due process has no place in our deciding whether a municipal tax on nonresidents is lawful given the absence of a fiscal connection between the tax-funded benefits that a municipality provides (*e.g.,* roads, public safety) and a nonresident taxpayer who does not use any of those benefits."

> **One dissent stated that the Ohio Supreme Court has previously "recognized that there is a role for federal due process to play in matters of municipal taxation." Stay tuned regarding whether the taxpayer will ask the U.S. Supreme Court to hear the case.**

NICOLE L. JOHNSON
PARTNER

Misapplication of *Complete Auto*

By Nicole L. Johnson

The South Dakota Supreme Court recently analyzed the four-part *Complete Auto* test to determine if the State's use tax results in a burden on interstate taxation in *Ellingson Drainage, Inc. v. South Dakota Department of Revenue,* 2024 S.D. 8 (Feb. 7, 2024). Unfortunately, the decision missed the mark on its application of that test.

At issue in *Ellingson* was South Dakota's use tax assessed on equipment owned by a Minnesota company. The Company brought equipment into South Dakota for use on certain projects. The State's Department of Revenue assessed use tax on the value of the equipment—regardless of the length of time that the equipment was used in the State. Thus, if a piece of equipment was valued at $1 million and used in the State for one day or one year, the same amount of use tax (*e.g.,* $45,000) was assessed.

The Company appealed the use tax assessment as unconstitutional. On appeal, the Court reviewed the four prongs of the test established in *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274 (1977). The parties agreed that prongs one (whether there was sufficient connection to the State) and three (whether the tax was discriminatory) were not at issue.

Prong two of the test requires that the tax be fairly related to the benefits provided to the taxpayer. The South Dakota Supreme Court stated that the only benefit that a taxpayer is entitled to is an organized society. While the Company argued that the tax on one day of use of the equipment in the State did not relate to any benefit received, the Court found that the Company enjoyed the same benefits as any other person doing business in the State and the Company made the "unilateral decision" to only use the equipment for one day. However, such a finding renders the second *Complete Auto* prong meaningless.

Instead, the analysis should have assessed whether the benefits received by the Company for one day of equipment use was commensurate with the tax imposed. Using the South Dakota Supreme Court's analysis would make every tax fairly related to the benefits provided by a state.

Prong four of the *Complete Auto* test requires that the tax be fairly apportioned. The Company argued that the statute was not externally consistent because 90 percent of its activities occurred outside of the State, yet 100 percent of the equipment's value was taxed by South Dakota. The decision brushed aside the Company's arguments, in large part because the equipment was not subjected to tax in any other state. However, Minnesota's decision not to tax the equipment does not mean that South Dakota should be able to tax 100 percent.

> **The decision is an unfortunate outcome on an unjust assessment. Taxpayers should be mindful of South Dakota's aggressive use tax application.**

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 Council on State Taxation ("COST") 2024 Spring Meeting

- Blank Rome State + Local Tax partners Craig B. Fields, Nicole L. Johnson, and Mitchell A. Newmark will be speaking at the Council on State Taxation's 2024 Spring Meeting from May 1st through May 2nd in Boston, MA. To learn more, please click here.

State Tax Roundtable for Utilities & Power ("STARTUP") Spring Conference

- Blank Rome State + Local Tax partners Craig B. Fields, and Nicole L. Johnson, will be speaking at the State Tax Roundtable for Utilities & Power Spring Conference on May 7th in Columbus, OH. To learn more, please click here.

Tax Executives Institute ("TEI") 2024 Region 10 Conference

- Blank Rome State + Local Tax partners Craig B. Fields, and Nicole L. Johnson, will be speaking at the Tax Executives Institute's 2024 Region 10 Conference from May 22nd through May 24th in Dana Point, CA. To learn more, please click here.

The Council on State Taxation ("COST") SALT Basics School

- Blank Rome State + Local Tax partner Mitchell A. Newmark will be speaking at the Council on State Taxation's SALT Basics School event on May 23rd in Atlanta, GA. To learn more, please click here.