taxnotes® state

Volume 98, Number 12 ■ December 21, 2020

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by Jennifer W. Karpchuk and Katherine Noll

Reprinted from *Tax Notes State*, December 21, 2020, p. 1333

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Jennifer W. Karpchuk

Katherine Noll

Jennifer W. Karpchuk and Katherine Noll are shareholders with Chamberlain, Hrdlicka, White, Williams & Aughtry in the firm's Philadelphia and San Antonio offices, respectively.

In this installment of Pennsylvania's SALT Shaker, Karpchuk and Noll discuss some of the good, the bad, and the ugly state and local tax cases of 2020.

Although in many ways 2020 has been quite a dismal year, it has actually brought some good news in the form of taxpayer wins that could have a lasting impact on state and local tax. Yet, not to be outdone, taxpayer losses were also prevalent during 2020. This article will discuss some of the good, the bad, and the ugly SALT cases of 2020.

The Good

No Look Through! Look Away!

In two 2020 sourcing wins, courts in Washington and Ohio held in taxpayers' favor and declined to accept the revenue departments' attempts to look through to the ultimate customer.

First, in Washington, lenders paid LendingTree for referrals to prospective borrowers.[1] LendingTree sourced its receipts to the location of its clients (the lenders), reasoning that the business activity related to LendingTree's service was the lender's receipt and evaluation of the lending referrals — which occurred at their respective business locations. The Department of Revenue, however, argued that the benefit was really received at the prospective borrowers' location. The Washington Court of Appeals disagreed, finding that the benefit of LendingTree's service was received at the lender's business locations, not the prospective borrowers'.

Next, in *Defender Security Co. v. McClain*, the taxpayer was an authorized ADT dealer that advertised for ADT in Ohio, installed security equipment at customer locations in the state, and entered into alarm services contracts with Ohio customers. Defender then sold the contracts to ADT, which performed the remote monitoring services from locations outside Ohio. The Department of Taxation asserted that the gross receipts should be sourced to Ohio because there would be no receipts from alarm services contracts absent the Ohio residents. The Ohio Supreme Court disagreed, finding that ADT purchased intangible contract rights and used and received the benefit of those contract rights at its locations outside Ohio.

Both *LendingTree* and *Defender Security* are huge taxpayer wins because they represent some of the first cases interpreting states' attempts to look through to the ultimate customer in

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[1] *LendingTree LLC v. State of Washington*, No. 80637-8-I (Wash. App. Ct. 2020).

interpreting market-based sourcing laws. If the trend in these decisions continues, taxpayers can expect more wins.

Sourcing of (Unique?) Intermediary Sales

Lockheed Martin was a huge victory for the taxpayer, but this Texas Supreme Court ruling may have limited applicability because of federal laws regarding foreign military sales.[2] Lockheed Martin manufactured F-16 fighter jets in Texas for foreign buyers. These specialized transactions are governed by federal arms-control laws. Applicable to this case was a law permitting the U.S. government to "enter into contracts for the procurement of defense articles" from private contractors that would be sold to foreign buyers.[3] Under this procurement pathway, the U.S. government enters into two contracts: one with the foreign buyer and the other with the private contractor. At issue in the case was whether the aircraft buyer was the U.S. government or the foreign purchaser.

The Texas Comptroller argued that the transaction was a sale for resale, with the initial sale of property in Texas to the U.S. government, which was then separately sold to the foreign buyer. However, in siding with the taxpayer, the supreme court held that the buyer was the foreign government, and that the United States' role was only that of a statutorily mandated intermediary required as a "condition of sale." The court further held that the products' ultimate foreign destination determined the sourcing, hence the aircraft sales were not properly sourced in Texas.

Notably, the supreme court differentiated this transaction from a standard sale-for-resale transaction. Although *Lockheed Martin* was a taxpayer win, it is yet to be determined if its application will be limited to federal defense law transactions, or if it will have broader application to specific intermediary transactions. Businesses operating as intermediaries should evaluate the specific conditions noted in the opinion as the basis of the holding that the intermediary was not a buyer to see if it could affect Texas franchise tax calculations.

[2] *Lockheed Martin Corp. v. Hegar*, No. 18-0566, 601 S.W. 3d 769 (Tex. 2020).

[3] Arms Export Control Act, 22 U.S.C. sections 2751-2799aa-2.

I'll Take 'Taxpayer Wins' for $3.6 Million

Answer: *This Louisiana game show jurisdiction case landed a big win for the taxpayer.*

SALT practitioners: *What is* Robinson v. Jeopardy Productions Inc.*?*

That's correct!

In another recent taxpayer win, the producers of *Jeopardy!* defeated Louisiana's attempt to collect taxes on over $3.6 million in royalties.[4] Jeopardy Productions Inc., a branch of Sony's television division, oversees the operations of the famous game show *Jeopardy!* Jeopardy Productions earned royalties in Louisiana through agreements with two third parties: CBS Television Distribution Group for its distribution of *Jeopardy!* to television stations, and International Gaming Technology PLC for its use of *Jeopardy!* trademarks on gaming machines. Louisiana sued to collect corporation and franchise taxes on the $3.6 million in royalty income.

Jeopardy Productions did not have any contacts with Louisiana, aside from the royalty income. Moreover, the agreements with CBS and International Gaming Tech gave those entities sole authority over where to distribute *Jeopardy!* or to license the trademarks. In dismissing the case and granting our third taxpayer win, the court held that Jeopardy Productions did not make any intentional or direct contact with Louisiana and therefore lacked a sufficient minimum connection with the state to establish jurisdiction over the company. *Jeopardy Productions* emphasizes the importance of not forgetting Civil Procedure 101: Always remember to consider due process jurisdictional claims.

Overcoming Distortive Assessments

In a blow to the Mississippi DOR and its $3 million-plus assessment, the Mississippi Supreme Court found in Comcast Cable Communications LLC's favor when it held that Comcast was entitled to make adjustments to its capital base and apportionment calculation for state franchise

[4] *Robinson v. Jeopardy Productions Inc.*, No. 2019 CA 1095 (La. App. 1st Cir. Oct. 21, 2020).

tax purposes.[5] Comcast is a provider of cable network and related services in various states. Comcast held investments in more than 50 unitary subsidiaries and held minority interests in approximately 10 non-unitary subsidiaries. The non-unitary subsidiaries were not engaged in the provision of cable services and had no connection with Mississippi.

The DOR claimed that (1) Comcast was not permitted to exclude the capital value and apportionment factors attributable to the non-unitary subsidiaries in calculating the tax base; and (2) Comcast was not permitted to use an alternative apportionment method. Regarding the first argument, Comcast claimed that it was entitled to present information showing the true value of its capital in the state when the franchise tax calculation does not result in an accurate measure of the amount of tax due. The supreme court agreed, holding that by including the value of Comcast's non-unitary subsidiaries in its capital, the DOR included billions of dollars in non-unitary assets in Comcast's tax base — which did not fairly represent the true value of Comcast's capital in the state. The case represents a promising taxpayer win for those trying to overcome distortive assessments.

The Bad

Where Is the Service Rendered?

In our first taxpayer loss, the Michigan Supreme Court tackled a timely topic in *Honigman Miller Schwartz v. Cohn LLP v. City of Detroit*, in which it ruled on the proper sourcing of income from a service.[6] Honigman, a law firm, apportioned its net profit using a three-factor formula consisting of property, payroll, and revenue — the numerator of which included revenue derived from services "rendered" in Detroit. The statute did not define the term "rendered." Honigman argued that rendered, as used in the statute, meant "delivered" — and therefore it sourced its service income to the location of its customers, resulting in 11 percent of revenue being sourced to Detroit. The city disagreed, countering that it should be sourced to the location where the services were performed. The city's position resulted in 51 percent of Honigman's revenue being sourced to Detroit, amounting to an assessment of approximately $1.1 million.

While acknowledging that both parties' arguments articulated plausible interpretations of the statute, the supreme court ultimately sided with the city. The court reasoned that rendered essentially meant "to do (a service) for another" — and therefore the focus is on where the service is performed. Thus, in the court's view, the Legislature had effectively adopted an origin-based test, not a market-based one. While many states and localities have moved to a market-based approach, some still take an origin-based approach to sourcing. More individuals are working from home during the pandemic, and if work from home becomes more permanent post-pandemic, companies in cities and states that use an origin-based test will need to evaluate and determine how to factor the work-from-home location where the employees are performing the service into their equation.

First Amendment Losses on Billboard Taxes

In two 2020 taxpayer losses, courts told taxpayers in Ohio and Maryland that the First Amendment did not bar the respective municipalities' imposition of billboard excise taxes. First, in *Clear Channel*, the taxpayer challenged Baltimore's imposition of a tax on outdoor advertising displays. In upholding the excise tax, the court found that the city's fee to use billboard space did not impermissibly burden the company's right to free speech in violation of the First Amendment.[7] *Clear Channel* was granted cert and is on appeal to the Maryland Court of Appeals.[8]

Second, in a case challenging Cincinnati's billboard excise tax, the trial court originally found in the taxpayer's favor — holding that the billboard tax unconstitutionally burdened the

[5] *Mississippi DOR v. Comcast of Georgia/Virginia Inc.*, No. 2019-CA-01134-SCT (Miss. 2020).

[6] *Honigman Miller Schwartz v. Cohn LLP v. City of Detroit*, No. 157522 (Mich. 2020).

[7] *Clear Channel Outdoor Inc. v. Director, Department of Finance*, No. 2910, September Term 2018 (Md. Ct. Spec. App. 2018).

[8] *Clear Channel Outdoor Inc. v. Director, Department of Finance*, No. 9, September Term 2020 (Md. 2020).

company's freedom of speech and targeted a small group of speakers. However, the appeals court, relying on *Clear Channel*, overturned the trial court's decision — holding instead that the excise tax did not violate the First Amendment.[9] As in *Clear Channel*, in *Lamar* the Ohio Supreme Court granted the taxpayers' request to review the case.[10]

There is certainly a trend of states and municipalities attempting to tax billboards and advertising. Several states considered implementing digital advertising taxes during 2020, none of which were enacted. But as states and localities look for ways to patch budget deficits brought about by COVID-19, more may look to tax these revenue streams. Practitioners should expect more SALT-related First Amendment cases soon and should look out for decisions from the supreme courts of Maryland and Ohio.

The Ugly

Confusion Regarding Software, Communications, And Technology

In *Citrix*, the Massachusetts Supreme Judicial Court was asked to address the question whether sales of subscriptions for three online software products (GoToMyPC, GoToAssist, and GoToMeeting) were subject to sales tax.[11] Each product enabled a screen-sharing connection between a host computer and a remote computer via the internet. Citrix's products operated through proprietary software that was neither downloaded nor otherwise transmitted to a customer.

The crux of the issue was whether the subscription fees were for a service or a sale of taxable software. The taxpayer argued that because there was never any download or transfer of software, the product was a nontaxable service. The court disagreed, reasoning that when a Citrix customer purchased a subscription for access to an online product, it gained access to a remote network of Citrix's servers running proprietary software, which was necessary for those products to function. As such, Citrix's subscription fees involved "transfers of rights to use software installed on a remote server." Finally, the court found that the true object of the transaction was not a service other than the software, but rather the use of the software itself.[12]

Companies and practitioners need to be increasingly careful in determining whether a product is a service or software. If the answer is gray, it is important to analyze how the software is provided and the reliance the customer puts on that software. This case underscores how ambiguity related to software products, combined with deference afforded departmental interpretations, can spell trouble for taxpayers.

In our next ugly case, the Texas Court of Appeals held in *Sirius XM* that out-of-state, subscription-based satellite radio service receipts should effectively be apportioned based on the location of the subscribers, applying a market-based sourcing approach.[13] At issue in *Sirius XM* was where the services were performed. During the tax years in question, Sirius XM's headquarters, transmission equipment, and 70 percent of the radio programming were located exclusively outside Texas. Sirius XM's primary revenue source was subscription fees for the programming using satellite-enabled radios owned by customers through equipment in their vehicles, which contained chip sets that decrypted the satellite radio to receive the programming.

Texas franchise tax sourcing rules apportion based on the fair value of the services performed in the state.[14] In evaluating what business was done in the state, the appellate court looked to the "receipt-producing, end product act" that allowed the customers to receive the programming and agreed with the Comptroller that it was Sirius XM's act of remotely decrypting the program and activating the customers' radios in their vehicles in Texas that was the receipt-producing activity. Thus, the court narrowly

[9] *Lamar Advantage GP Co. LLC and Norton Outdoor Advertising Inc. v. City of Cincinnati*, No. C-180675 (Ohio Ct. App., 1st App. Dist. 2020).

[10] *Lamar Advantage GP Co. LLC and Norton Outdoor Advertising Inc. v. City of Cincinnati*, No. 2020-0931 (Ohio 2020).

[11] *Citrix Systems Inc. v. Commissioner*, 484 Mass. 87 (Mass. 2020).

[12] 830 Mass. Code Regs. section 64H.1.3(14)(a).

[13] *Hegar v. Sirius XM Radio Inc.*, No 03-18-00573-CV (Tex. App. Ct. 3d Dist. 2020).

[14] Tex. Tax Code section 171.103(a); and Tex. Admin. Code section 3.591(e).

defined the scope of performance to the final act, excluding consideration of the fair value of programming and service-related activities — a standard previously articulated by the same appellate court in *Westcott Communications* for a satellite programming company.[15] Despite *Sirius XM*'s reliance on *Westcott*, the opinion distinguished the facts from *Westcott* because that case involved customized, subscription-based education and training services that "went well beyond simply providing a broadcast signal to customers."

Sirius XM creates uncertainty for taxpayers, particularly when comparing the ruling with the standards issued by the same court in *Westcott* regarding how to determine if a service is performed in the state. The only non-ugly aspect to *Sirius XM* is that the taxpayer is petitioning the Texas Supreme Court for review of the decision, which ideally will provide much-needed clarity.

Citrix and *Sirius XM* highlight the ugly SALT reality that many in the software, communications, and technology industries are constantly battling. Compliance can be difficult for any company, but it is becoming increasingly difficult for taxpayers in those industries as they combat the lack of clarity in tax laws and varying positions across the states. Compounding the issue is the fact that technology advances faster than the law; often there is not a clear answer regarding the proper tax treatment of these products and services. Further, many taxing authorities issue little or no guidance, but then use the benefit of hindsight to interpret statutes and generate revenue.

The good, bad, and ugly SALT decisions of 2020 have left taxpayers with important future considerations — from sourcing, to taxation of software and technology, to the First Amendment and due process clause of the U.S. Constitution. With many cases making the list currently on appeal, 2021 promises to be another interesting year in SALT. ■

[15] *Westcott Communications v. Strayhorn*, 104 S.W.3d 141 (Tex. App. 2003), *pet. denied*.