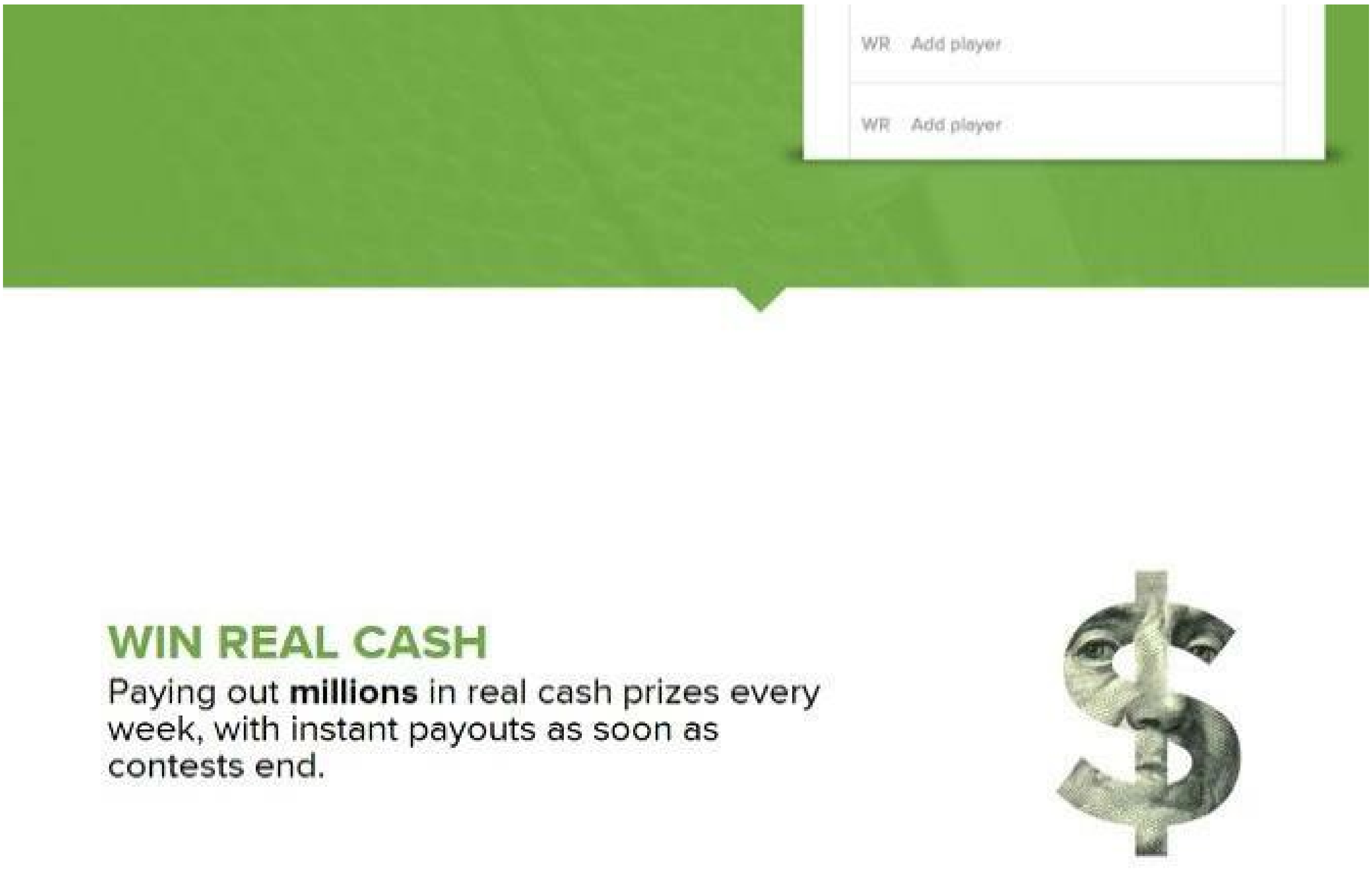
Multistate Tax Update: November 19, 2015



David M. Kall | Thursday, November 19, 2015

Florida: Gov. Scott continues push for $1 billion in tax cuts

The Sunshine State's fiscal year ended on June 30, and Gov. Rick Scott has kicked off a tour to reinvigorate his two-year, $1 billion tax cut plan. The Florida First For Jobs Proposal (Florida First) promises to "grow small businesses [and] diversify the economy."

Florida First focuses on expanding the manufacturing industry and small businesses, which Gov. Scott asserts will help protect the state against another economic downturn. The proposal contains broad outlines of his plan and highlights how businesses will benefit. Florida First proposes to:

- Permanently eliminate income tax on manufacturing and retail businesses, expected to reduce the cost for businesses in Florida by about $770 million annually, attract more firms to the state, and diversify Florida's economy by helping more businesses succeed.
- Permanently eliminate the tax on manufacturing machinery and equipment, which is estimated to reduce the tax liability of the state's manufacturing businesses by $76.9 million annually beginning in 2017. According to the governor, by permanently eliminating this tax, Florida will be more competitive for these kinds of firms to start or expand. If no action is taken during the upcoming legislative session, there will be a substantial tax increase on Florida manufacturers.
- Reduce the tax on commercial leases, which the governor believes unfairly targets small businesses. Florida is the only state that imposes a commercial lease tax, which is currently 6 percent. Gov. Scott wants to reduce the tax by 1 percent in 2017, which would save Florida businesses $339 million over the next two fiscal years.
- Extend the sales tax exemption on college textbooks for an additional year, which is expected to save students $46 million.
- Help families save by implementing two sales tax holidays, the first is a 10-day period for back-to-school purchases, and the other is a nine-day period for hurricane preparedness items. The projected taxpayer savings from these two sales tax holidays are $72.8 million.

Gov. Scott has not indicated where in the budget he plans to offset these cuts. The *Tampa Bay Times* quoted Senate Appropriations Committee Chairman Tom Lee who recognized that without this information, "it's hard to know how we would absorb" the cuts. Even so, he "certainly support[s] cutting taxes and [is] willing to support them to the maximum extent feasible."

Not all lawmakers feel this way. The *Times* also reported the opinion of House Democratic leader Mark Pafford who believes that "Rick Scott is at the helm of the Titanic…He sees the iceberg, and he's directing the vessel directly into this catastrophe." The congressman sees the plan as a "shocking neglect of Florida's needs and a loyalty to businesses at the expense of everyday people."

Indeed, Gov. Scott's plan is ambitious. In October 2014, Florida TaxWatch anticipated a budget surplus of $336.2 million for fiscal year 2015-16. Currently, this number is $635 million, but most of this is needed for Medicaid cost increases and the growing number of students in public schools, state colleges, and universities, according to the *Times*. In addition, Florida's services for the poor and disabled children, staff shortages in the prison system, crumbling equipment, rampant turnover, and antiquated technology in various state agencies, all need attention.

Budget negotiations will begin in the coming months.

Michigan: Court of Appeals resolves cloud computing taxation dispute

Last week, we described the Michigan Department of Treasury's stance on the taxation of cloud computing, as clarified in its current Treasury Update. We noted that whether a given transaction is subject to Michigan's 6 percent sales and use tax is a factual determination. However, as a general rule, software which is designed for the exclusive use and special needs of a single purchaser—custom software—is exempt from the sales and use tax, while prewritten computer software, pursuant to a transaction involving a license or subscription fee, delivered by any means, is subject to the 6 percent tax. While there has been litigation regarding what qualifies as a taxable cloud computing service, there have not been any decisions. Now, a recent decision in the case *Auto-Owners Insurance v. Department of Treasury* may begin to offer some guidance.

BACKGROUND

Headquartered in Lansing, Michigan, the plaintiff, Auto-Owners Insurance Company (Auto-Owners) provides insurance services through 35,000 independent agents in 26 states. The department conducted an audit involving the four years between Dec. 1, 2006, and Dec. 31, 2010, and determined that there was a basis for tax liability. The department assessed Auto Owners $871,625.24, for taxes due plus interest, as a result of the audit. Auto-Owners paid the assessment, under protest, and filed a complaint with the Court of Claims. That Court of Claims agreed with Auto-Owners that the transactions were not taxable and ordered a refund. The department appealed.

To render its decision, the appellate court considered contracts that Auto-Owners had with third-party companies for various services and organized them into six types:

1. Insurance industry specific contracts, including the provision of building valuation data, standardized formats for the flow of information, data confidentiality management systems, motor vehicle records, and electronic notification of coverage.
2. Technology and communications contracts, like videoconferencing, webinar, and online meeting services, along with other remote communications services for off-site employees.
3. Online research contracts providing for access to insurance-specific laws, filing guidelines, attorneys general opinions, and bulletins.
4. Payment remittance and processing support contracts, also including support, maintenance, and training.
5. Equipment maintenance and software customer support contracts.
6. Marketing and advertising contracts.

The operative issue in the case was whether the “complex and modern computing arrangements” at issue in the contracts were taxable.

THE DECISION

Ultimately, the court affirmed the lower court’s determination that the transactions inherent in the contracts were not subject to taxation, disagreeing with the conclusion reached by the department.

The determination was reached, in part, based upon the fact that in many transactions, “the mere transfer of information and data that was processed using the software of the third-party businesses does not constitute delivery by any means of prewritten computer software.”

Even in cases where Auto-Owners did receive “pre-written computer software that was delivered to it,” the court concluded that this was only incidental to the services that the third-party companies provided to Auto-Owners. In the end, the court did not see any indication that Auto-Owners “could purchase the software or other tangible personal property independent of the services, and the services gave value to the software and other tangible personal property.”

IMPLICATIONS

The department is not faring well in tax disputes concerning the taxation of cloud-based computing. In two other cases, *Rehmann Robson & Co., P.C. v. Dept of Treasury*, which was decided on Nov. 26, 2014, and *GXS, Inc. v. Dept of Treasury*, decided on March 25, 2015, the Court of Claims determined that the transactions at issue were not taxable.

The legislature does not appear inclined to help clarify the matter. Senate Bills 142 and 143, which would have amended the definition of "prewritten computer software" and excluded such transactions from taxation, have been idle since September 2013. Consequently, the department will likely be forced to continue fighting its tax assessments in the courts.

Some tax issues reach resolution while others are just beginning

UNCONSTITUTIONALITY OF CLEVELAND’S JOCK TAX STANDS

The well-publicized jock tax case, *Hunter T. Hillenmeyer v. City of Cleveland Board of Review*, that worked its way through Ohio’s courts and up to the United States Supreme Court, has finally been resolved. On Nov. 9, 2015, the high court decided that it would not consider the City of Cleveland’s appeal. This leaves intact the Ohio Supreme Court’s April 30, 2015, decision that Cleveland’s method of taxing nonresident professional athletes is unconstitutional.

As we discussed, the Ohio Supreme Court determined that Cleveland’s tax formula, which taxed professional athletes based upon the number of games the visiting team plays in the city divided by the total number of games in a season, was a due process violation. The prevailing argument asserted that Cleveland’s power to tax reaches only that portion of a nonresident’s compensation that is earned by performing work in Cleveland. The court agreed, finding that Cleveland’s games-played method was unconstitutional because it reached income for work that the athlete performed outside of Cleveland. As a consequence, the court required the city to issue a tax refund.

The Plain Dealer reported that in light of the holding, Cleveland might have to pay as much as $2.4 million in tax refunds to out-of-town NFL players, a figure which does not include claims by players in other sports. Quoting city spokesman Dan Williams, the paper noted what while the refund amount is still not clear, it "'will not be a significant impact' on Cleveland's $542 million budget…[Cleveland] will make up the difference from other revenue sources.”

FANTASY SPORTS AS GAMBLING?

When we addressed this topic recently, we noted that states like Massachusetts, Kansas, Florida, Washington, and Nevada have or are considering whether daily fantasy sports (DFS) are legal and thus taxable. Additionally, *The Washington Post* detailed New York’s attorney general’s position that the daily fantasy sites Draft Kings and Fan Duel violate that state’s gambling laws, prompting the attorney general to send them both sites cease-and-desist letters to stop accepting payments.

This month in Ohio, numerous outlets have reported that state Rep. John Eklund has promised to take up the question of whether DFS websites constitute legal gambling, which would subject it to taxation under the state’s gambling laws.

HOLOCAUST REPARATIONS NOT TAXABLE

In July, we explained that New Jersey lawmakers introduced legislation that exempts Holocaust reparations payments from legal process, and from estate recovery under Medicaid. In early November, Gov. Chris Christie signed the legislation into law, effective immediately.

More specifically, the law provides that, except for child support payment orders, monetary reparations payments designated for or received by a Holocaust survivor of Nazi persecution from any governmental source or victim assistance source shall be exempt from all claims of creditors and from levy, execution, attachment, or other legal process. The bill also exempts these monies from estate recoveries under the Medicaid program.

The bill text accomplishes this by exempting the following from what constitutes an estate:

- Amounts received as reparations or restitution for the loss of liberty or damage to health.
- Returns of tangible or intangible property seized, misappropriated, or lost as a result of Nazi actions or policies, and any cash values in replacement of such property.
- Payments of insurance policies purchased by Holocaust victims.
- Any accumulated or accrued interest on such amounts.

“AIRBNB TAXES” HERE TO STAY, BUT NOT WITHOUT A FIGHT

In October 2014, San Francisco passed an ordinance regulating the growing business of short-term home rentals like those that HomeAway and Airbnb offer. While allowing residents that live in their primary homes to rent them out on a short-term basis, the ordinance also imposes certain regulatory requirements, including transient occupancy tax assessments, permit, and reporting requirements on the homeowners.

HomeAway immediately filed sued, accusing the city of violating the commerce clause of the United States Constitution. The suit contended that the law discriminated against non-San Francisco-based operators of short-term accommodations by requiring that those who rent out their homes, collect fees, and pay the associated taxes be permanent residents of San Francisco, which is HomeAway’s business model. The court dismissed the case a few months later.

Airbnb did not object to the particular law because it does not collect fees directly from renters, and therefore is not subject to San Francisco’s tax. Even so, on Nov. 11, 2015, Airbnb published a Community Compact, in which it pledged to “work with cities to help ensure the efficient collection of tourist and hotel taxes.”

The actual language in the pledge states that “[i]n those places that respect the right of people to share their home, we will work to ensure that the Airbnb community pays its fair share of taxes while honoring our commitment to protect our hosts’ and guests’ privacy.” Airbnb guests pay more than $12 million in city taxes annually, according to an Airbnb billboard described by a TechCrunch blog post.

Despite this seemingly cooperative spirit, the blog post described the home sharing company’s $8 million expenditure to defeat Proposition F, San Francisco’s Nov. 3, 2015, ballot initiative to restrict short-term rentals. Proposition F, which was defeated 55.7 percent to 44.2 percent, would have limited private rentals to 75 nights per year, and imposed measures to ensure compliance with tax and regulatory laws.

Noting that Airbnb, valued at approximately $24 billion, has over two million listings in more than 34,000 cities, *The New York Times* pointed out the contradiction between the firm's Community Compact and its conduct relative to Proposition F. A company official justified Airbnb's position by stating that "our community will fight and win if the hotel interests are threatening the economic lifeline of home sharing, but on the natural we would prefer to be lovers of cities and not fighting with the hotel industry."

David M. Kall

Team member bio