Multistate Tax Update -- June 18, 2015

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Ohio: Supreme Court allows tax exemption for Ernest Angley's Grace Cathedral dormitory

Earlier this month, in ***Grace Cathedral, Inc. v. Testa***, the Ohio Supreme Court concluded that Grace Cathedral, Inc. was entitled to a tax exemption for 2010 for providing temporary housing free of charge to visitors participating in worship services, reversing the decision of the Board of Tax Appeals (BTA). The court relied, in part, on an Ohio **statute** that exempts "[h]ouses used exclusively for public worship, the books and furniture in them, and the ground attached to them" from taxation.

Background

Grace Ministries, Inc. is well known in and beyond Ohio. The congregation's leader, the Rev. Ernest Angley, travels and conducts a television ministry, and Grace Cathedral has members and supporters throughout the country and around the world. Worshippers often go to Akron to attend live services.

The dormitory building at issue is used approximately 40 to 50 percent of the weekends during a year to provide lodging. The rest of the time, religious services and related study classes are held there.

In order for the dorm, or any housing used exclusively for public worship, to qualify for the statutory exemption, the building must be used "in a principal, primary, and essential way to facilitate the public worship," a standard which the Ohio Supreme Court previously established.

The character of the dorm's use

When the BTA denied Grace Ministries the desired tax exemption, it determined that Grace Ministries failed to satisfy its burden of proof. In presenting its case, Grace Ministries argued, among other things, that the dorm "directly and primarily provides for the proper occupancy, use, and enjoyment of the church for public worship," comparing it to a church parking lot.

However, the BTA disagreed, largely because the testimony revealed that the dorm was vacant 50 to 60 percent of the time, and that very little public worship occurs on the property. By characterizing the use as "merely supportive of public worship," it could not trigger the used-exclusively-for-public-worship exemption required by the statute.

The Supreme Court's rationale

Instead of evaluating the percent of time the dorm was used for worship, as the BTA did, the Supreme Court considered the dorm's actual use, even if incidental. The Supreme Court ultimately concluded that the dorm facilitates public worship in a principal, primary, and essential way. The Supreme Court reasoned that Grace Ministries' dorm does so "by affording congregants proximity to attend church services and an opportunity for fellowship following services" in the same way that on-site church parking lots do. The court reasoned that parking lots also "facilitate public worship and are used only at times of worship and which routinely qualify for exemption."

California: Taxpayers who receive crowd-sourced funding should not guess whether the income is taxable

Crowdsourcing is the practice of engaging a crowd, often through the use of social media, for a common goal, like raising money.

Crowdsourcing was made possible, in part, by the 2012 **Jumpstart Our Business Startups Act** (JOBS Act), which eases regulations that would restrict crowd engagement activities meant to raise startup capital. For example, one section of the JOBS Act directs the Securities and Exchange Commission (SEC) to revise rules that prohibit certain general solicitation or advertising activities when the purchaser is an accredited investor. Another provision exempts certain people from having to register with the SEC as broker-dealers.

A March 2015 *Wall Street Journal* blog tells the story of former NBA star Yao Ming, who plans to raise $3 million via Crowdfunder. His Napa Valley company, Yao Family Wines, intends to use the money for a Napa Valley visitor center and a Shanghai tasting room. In return for an investment of as little as $5,000, the company promised that investors would receive “100% of all distributions out of free cash flow generated by the winery until they receive their investment back plus a 2% preferred return annualized. Thereafter they will receive 25% of all distributions out of free cash flow. Finally investors will receive 25% of any returns if the company gets acquired or has an IPO.”

With over $8 million in wine sales, Yao Family Wines describes itself as the biggest seller of high-end California wines in China by value.

One question that invariably arises with operations like this is whether the funds are taxable income. The California Franchise Tax Board (CFTB) recently issued practitioner guidance on that question, ultimately concluding that in most cases amounts raised are includable as taxable income unless specifically exempted by law. However, it should be noted that the answer depends on the facts and circumstances of each case, like how the funds will be used, and what the donor receives in return for his funding commitment.

The CFTB suggests that “when in doubt about whether or not some of your income is taxable, do not guess!”

According to *The New York Times*, many inexperienced entrepreneurs are “tripped up by the taxman.” This is so because in many states, sellers are subject to sales tax on anything they sell to an in-state buyer, but the type of goods triggering a filing obligation varies. And particularly relevant to crowdfunds is when an entrepreneur offers something intangible to attract funding, like an e-chat; some states tax these intangibles in the same way that they tax tangible goods.

States grapple with taxes on natural gas production

Ohio

When Gov. John Kasich introduced his **2016-17 budget proposal** in February, one key component was reducing income taxes. This would have been partially funded by the modernization of Ohio's oil and gas tax system, including the imposition of a 6.5 percent severance tax on oil and gas production levels at the wellhead for fracking wells, and a 4.5 percent tax for natural gas and natural gas liquids when sold downstream. Ohio's current oil and gas tax rate is 20 cents per barrel on oil and 3 cents per thousand cubic feet of natural gas. As we **noted** when the governor released his budget proposal, this provision is expected to generate $76.5 million and $183.4 million in fiscal years 2016 and 2017, respectively.

This proposal has generated significant controversy. *The Plain Dealer* reported that in light of the looming June 30, 2015, budget deadline, lawmakers have bought themselves time by sending the issue for study by way of a proposed Ohio 2020 Tax Policy Study Commission. This means that the budget will not contain these taxes, though it is now unclear how Gov. Kasich’s proposed income tax cuts will be funded. The commission will present its findings in October.

Pennsylvania

Ohio is not the only state grappling with a fracking tax. StateImpact NPR reported that during Pennsylvania Gov. Tom Wolf's election efforts last year a central component of his campaign was his criticism of his predecessor's handling of Marcellus Shale gas development. At the time, Wolf pledged to impose a 5 percent severance tax on the industry and to eliminate the impact fee for each well drilling for gas in the Marcellus Shale formation.

StateImpact NPR explained that the actual amount of Pennsylvania's impact fee, which is based upon natural gas prices and the consumer price index, changes each year. In 2013, gas companies paid $50,000 for each new well, and in the four years of 2011 through 2014, this fee generated $853.5 million of revenue for the state. From the impact fee revenue, 60 percent stays with the municipalities and counties in which the wells are located. The rest goes to certain state agencies that are involved in the regulation of gas drilling and to the Marcellus Legacy Fund, which spreads its funds around the state for environmental and infrastructure projects.

Many oppose Gov. Wolf's bill, **HB 1142**, which proposes utilizing the approximate $1 billion raised from the tax, and the 4.7 cents charge per thousand cubic feet of volume on the ground for education reinvestment.

For example, PennLive described testimony from the Independent Fiscal Office which contends that Gov. Wolf's tax, which amounts to an effective tax rate of 7.3 percent, would catapult Pennsylvania from last to first among major gas-producing states. Ohio's rate is 0.8 percent, West Virginia's is 5 percent, and Texas's rate ranges from 3.1 to 3.5 percent.

Gov. Wolf asserted that the 7.3 percent effective tax rate is artificially high because that estimate does not properly account for production costs. Similarly, the president of the Marcellus Shale Coalition opined that the effective tax rate on the industry is 5.9 percent, or an annualized figure of about 4 percent, given fluctuations in gas prices. Even so, he suggested that the severance tax would cause many firms to invest elsewhere, because they are already operating at a loss and are not in a position to pay an additional tax.

Lawmakers are also concerned about the tax. One representative warned that it would hurt both the gas companies and the ancillary beneficiaries, like the local contractors who service the wells and the communities that rely on impact fees for infrastructure.

In a study titled "The Economic Impacts of the Proposed Natural Gas Severance Tax in Pennsylvania," the author, a distinguished professor of energy economics at the University of Wyoming, concluded that a parade of horribles would befall the state if the tax were to take effect, including the following:

1. Reducing the number of wells, leading to a cumulative investment loss of $11.5 billion between 2016 and 2025.
2. During that same time, cumulative losses in natural gas and liquids production amounts to about $11.2 billion.
3. Reducing supported employment by nearly 18,000 by 2025 as compared with levels without the tax.
4. Reducing Pennsylvania's natural gas output by over 900 million cubic feet per day by 2021.

The author opines that because the new oil and gas production technologies offer more flexibility, producers can move their equipment to more profitable areas relatively easily, if and when costs rise. The American Petroleum Institute funded the study, but the author states that his findings and conclusions are his alone.

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