The Next Generation of SALT Issues

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Trending Topics in SALT
Taxation of Streaming Services

ABA Tax Midyear Meeting

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City of Chicago’s Amusement Tax

— The Amusement Tax applies to “admission fees or other charges paid for the privilege to enter, to witness, to view or to participate in such amusement.” Mun. Code of Chicago § 4-156-020(A).

— Amusement Tax Ruling No. 5 – The City interpreted the Code to apply not only to “in person” admissions, but also to amusements delivered electronically.

• The City specifically notes the following charges:
  • Charges for the privilege of watching electronically delivered television shows, movies or videos;
  • Charges for the privilege of listening to electronically delivered music;
  • Charges for the privilege of participating in games, on-line or otherwise.

• The Amusement Tax applies only to rentals (not sales), including subscription fees and per-event fees.
City of Chicago’s Amusement Tax

  - Circuit Court of Cook County affirmed the administrative law judge’s holding that the City of Chicago’s Amusement Tax applied to internet-based streaming services.
  - The court also held that the Amusement Tax does not violate the Internet Tax Freedom Act, the federal commerce clause or the state’s uniformity clause.
  - Finally, the court found that the tax did not apply to extraterritorial values because it follows rules in the Mobile Sourcing Act.

— Apple has also filed a declaratory judgment action against the City arguing that the application of the Amusement Tax on Apple’s music streaming service is prohibited by the Internet Tax Freedom Act and that that the tax violates the state constitution and the federal commerce and due process clauses.
Excise Tax on Cable Services

— District of Columbia
  • Gross receipts tax imposed on companies that sell or charge for television, video, and radio services to customers.
  • Netflix litigation
    • Netflix argued its internet-based streaming service was neither a cable or satellite television service.

— City of Creve Coeur, Missouri
  • In 2007, the City passed the Video Services Provider Act, imposing a fee on a provider of video service if its programming is delivered over wireline facilities even partly located in the public right-of-way.
  • The City sued Netflix and Hulu alleging that the companies are “video service providers” subject to the City’s gross receipts tax. The City asserts that Netflix and Hulu provide video service via the Internet using wireline facilities.
Tax on the Sale of Tangible Personal Property

— Arizona Transaction Privilege Tax

• Arizona argued that Netflix’s streaming service is a rental of tangible personal property.

• The administrative law judge stated: “The manner in which the content is delivered, through ‘packets of digital data’ is not the determining factor in whether the subscriber has paid a fee to see available video content. The subscriber pays for access to video content which happens to be delivered through streaming; the subscriber could easily, as some do, pay a fee for renting a DVD to view the content they want to watch . . . it is the available content for which the subscribers are paying a monthly consideration to be able to watch.”
Other Considerations

— Sourcing
  • Where is the service (or property) received?
  • Service may often be received outside of the taxing jurisdiction due to mobile devices.

— Other taxes
  • Provider of streaming services may also be subject to additional taxes if found to be present in the taxing jurisdiction (e.g., license taxes).
What's Next?

— Continued Litigation
  • Internet Tax Freedom Act
  • Federal and state constitutional concerns

— EU Approach
  • European Parliament voted in December 2018 to impose a “Digital Services Tax” on the gross receipts of digital services, including streaming services.
  • Effective January 1, 2019 France will impose a Digital Services Tax. Spain and the United Kingdom are also exploring a Digital Services Tax.

— OECD
  • Forthcoming OECD proposals will reallocate taxing rights/nexus and potentially include some minimum tax similar to GILTI.
What’s Next?

— Legislation

• Arizona – Arizona constitutional amendment passed that prohibits imposing a transaction privilege tax on any services that were not taxed on December 31, 2017. Amendment could preclude taxation of streaming services, but note the attempt by the state to tax streaming services as a rental of tangible personal property.

• Iowa – Iowa specifically amended the definition of “pay television,” an enumerated taxable service, to include “streaming video, video on-demand, and pay-per view.”

• Other states in 2019?
Questions?
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WHEN KEEPING IT REAL GOES WRONG:
THE ECONOMIC SUBSTANCE DOCTRINE
IN STATE TAXATION

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YOUR PRESENTERS

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“We shall never get any order in this subject if we rest in the word ‘sham’” and similar “meaningless chatter”

THE ECONOMIC SUBSTANCE DOCTRINE

- *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957) (Hand, J., dissenting)
  - Creates the Economic Substance Doctrine
  - Two-step analysis
    - 1) Did the transaction occur for nontax purposes, and, if so,
    - 2) Did the taxpayer intend the transaction to appreciably affect his beneficial interest other than to reduce tax
  - Articulates the justification for the economic substance doctrine
    - To prevent a taxpayer from construing a jurisdiction’s tax statutes in a self-defeating manner
    - That is, the purpose of the Code is not to provide an escape from the liabilities it imposes
  - Significance
    - Changes the analysis from a “question of law” (what did Congress intend) to a “question of fact” (did the taxpayer intend the transaction to appreciably affect his beneficial interest)
      - Expands *Gregory v. Helvering* (applies to structural provisions of tax code) and limits *Gregory v. Helvering* (avoids purposeful statutory interpretation)
      - Shifts the burden of proof to the taxpayer
    - Adopted by the U.S. Supreme Court in *Knetsch v. United States*, 364 U.S. 361 (1960)
SCOPE OF THE ECONOMIC SUBSTANCE DOCTRINE

- It is easier to define the scope of the Economic Substance Doctrine by determining when it cannot apply.
• **Question:** Why can I predict the results of federal economic substance cases but not state economic substance cases?

• **Answer:** State tax administrators and courts raise economic substance challenges to multi-jurisdiction capital competition.

• **Reason this doesn’t work for the states:**
  
  – Economic Substance Doctrine was never intended to apply to avert the threat of another jurisdiction’s tax laws to a state’s public fisc.
    
    • More appropriate tools include **addback statutes, combined reporting, and transfer pricing**

  – Applying the Economic Substance Doctrine in this context cannot produce predictable results.
LOOK, MA, NO HANDS! (CONT.)

RELEVANT STATE TAX CASES

• Syms Corp. v. Comm’r of Revenue, 436 Mass. 505 (2002)
LOOK, MA, NO HANDS! (CONT.)

- Perplexing paradoxes in recent state cases
  - A corporation that lacks the economic substance to exist as a separate business entity but that exists for tax purposes?
  - A subsidiary that owns its parent?
  - A partnership that is its own partners?

- Risks and Opportunities
  - Federal and state decoupling
    - Debt for federal tax purposes but equity for state law (tax and otherwise?) purposes
      - Bankruptcy consequences
    - Different federal and state combined or consolidated groups?
    - An LLC that is a partnership for federal income tax but treated as a disregarded entity for state tax?
WHEN KEEPING IT REAL GOES WRONG: CASH MANAGEMENT EXAMPLE

- Cash management scenario where Parent sweeps cash and uses the cash to pay Sub’s expenses as well as its own expenses
  - Parent records loan from Sub A and pays interest since Sub A’s cash exceeds its expenses
  - Sub B records loan from Parent and pays interest since Sub B’s cash less than its expenses
WHEN KEEPING IT REAL GOES WRONG: CASH MANAGEMENT EXAMPLE (CONT.)

• Court holds debt not “bona fide”

  Solution One – Loans considered capital contributions and distributions
  – Sub A’s excess cash swept by parent considered a distribution (dividend, then return of capital, then capital gain) and the “interest” payments from Parent to Sub A considered contributions of capital
  – The cash “borrowed” by Sub B to fund its expenses is considered a capital contribution from Parent and the “interest” payments by Sub B to Parent are considered distributions.
WHEN KEEPING IT REAL GOES WRONG: CASH MANAGEMENT EXAMPLE (CONT.)

• Court holds debt not “bona fide”

  Solution Two – Loan to Sub A creates an equity interest in Parent
  – Sub A’s excess cash swept by parent considered contribution of capital to Parent and the “interest” payments from Parent to Sub A considered distributions
  – The cash “borrowed” by Sub B to fund its expenses is considered a capital contribution from Parent and the “interest” payments by Sub B to Parent are considered distributions.
LOOK, MA, NO HANDS! (CONT.)

• Meaningless key words that create uncertainty, risk or opportunity
  – “Sham”
  – “Bona Fide” or “Not Bona Fide” anything
  – “Substantial economic reality”
  – “Substantial economic risk”
  – “Legitimate” or “Not legitimate” anything
Texas Franchise Tax: Current Trends and Issues

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Texas Franchise Tax - History

- Dates back to early 1900s
- Prior tax base was combined capital (net worth) and surplus (net income) of corporations and LLCs
- In 2005, Governor Rick Perry established the Texas Tax Reform Commission
- This led to sweeping changes in the Texas Franchise Tax calculation and application
Texas Franchise Tax - What is it?

► Not a Net Income Tax
  ► Not every business expense can be deducted
  ► Taxpayers incurring a loss could owe tax
► Not a Gross Receipts Tax
  ► Significant deductions are available
► “Margin” Tax

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Texas Franchise Tax - Who must pay?

“Taxable Entities” include:
- Corporations
- LLCs
- Partnerships with at least one partner that is **not** a natural person

“Taxable Entities” do not include:
- Sole Proprietorships
- Partnerships owned exclusively by natural persons
- Grantor Trusts
- Approximately 46 different types of exempt entities
Texas Franchise Tax - What is taxable?

- Taxable Margin is equal to the total revenue of the business, adjusted by one of four calculations
  - Taxable Margin = Total Revenue * 0.7
  - Taxable Margin = Total Revenue - COGS
  - Taxable Margin = Total Revenue - Compensation
  - Taxable Margin = Total Revenue - $1,000,000
- The calculation that results in the least amount of taxable margin is used.
Base rate = 0.75%
Reduced tax rate (0.375%) available for retailers or wholesalers
However, no tax is due if:
- The total tax due is less than $1,000; or
- Total revenue is less than or equal to $1,000,000, adjusted for inflation
Texas Franchise Tax - Single-Member LLCs

- Single-member LLCs are **not** disregarded for the Texas franchise tax, even if they are disregarded for federal income tax.
- This includes single-member LLCs owned by exempt entities.
Texas Franchise Tax - Public Law 86-272

- Public Law 86-272 does not apply to the Texas franchise tax because it is not a net income tax
- Legislative declaration in 2007
Texas Franchise Tax - Nexus

- The Comptroller currently applies a physical presence test to establish franchise tax nexus.

- *Wayfair* may cause the State of Texas to take another look at physical presence for the Texas franchise tax
Texas Franchise Tax-2017 Legislation

2017 Legislative Session:

- HB 2126 - Sellers of prepaid telephone cards eligible for reduced tax rate
- HB 3992 - Added an exemption for certain farmers’ cooperatives

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Texas Franchise Tax-2019 Legislation

- Bills pre-filed for the 2019 Legislative session:
  - HB 52 - Pilot program for tax credits for dependent care flexible spending account
  - HB 276 - Additional deduction for costs related to the sale of goods to the federal government
  - SB 66 - Phase-out and repeal

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Texas Franchise Tax - Litigation

- Graphic Packaging Corp. v. Hegar, 538 S.W.3d 89
- Lockheed Martin Corp. v. Hegar, 550 S.W.3d 855
- Sirius XM Satellite Radio v. Hegar
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