



# 2015 COST Annual Meeting Chicago, Illinois

## Hidden Taxes & Fees

Traps for the Unwary and How to Avoid Them

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# Agenda

- ✓ Local Gross Receipts Taxes
- ✓ Transfer Taxes
- ✓ City Special Sales/Use Taxes
- ✓ Incentives (or lack there of)
- ✓ Business License Fees
- ✓ Tax vs Fee



# Learning Outcomes

After presentation attendees should be able to:

- Gain an understanding relating to specialized state and local taxes that, although often overlooked, can have a significant financial impact on an organization.
- Understand some of the current efforts on behalf of state and local authorities to broaden the base of taxation in the following areas, transfer taxes, gross receipts taxes and local “home rule” authority granted to municipalities.
- Understand the implications of entering into special incentive arrangements and best practices to protect a company from costly clawbacks.
- Understand the multitude of state and local fees and licenses imposed on companies wishing to conduct business in a jurisdiction.



# Hidden Taxes & Fees

## Local Gross Receipts Taxes



# City of San Francisco Gross Receipts tax

- City has a long and storied history with respect to its business tax
  - In the 1990's, it imposed two taxes—a payroll expense tax and a business tax
  - Taxpayers paid the higher of the two
  - Regime held to violate the Commerce Clause
  - In 2001, after repealing the two taxes, the City enacted a payroll expense tax



# City of San Francisco Gross Receipts tax

- In 2013, a new tax was approved by the voters
- Beginning 1/1/14, a gross receipts tax is now imposed on taxpayers engaged in business in the City
  - Tax is measured by gross receipts from all taxable business activities attributable to the City
  - Gross receipts tax combines features of California's unitary tax, combined reporting and apportionment formulas with an expansive definition of gross receipts
  - Gross receipts tax is being phased in over 5 years, while the payroll expense tax is being phased out over the same period
  - Over the next several years, taxpayers will be subject to both taxes



# Transfer Taxes

## Transfer Taxes



# Transfer Taxes

## Real estate transfer taxes

- Imposed on documents that convey an interest in real property from one person or legal entity to another person or legal entity (i.e., a real estate transfer tax).
- Approximately 40 states assess some form of a real estate transfer tax. Tax is often assessed by the state, county and in some instances, local cities.
  - The tax rate varies from 0.1% up to 4 or 5% of the value of the real property (e.g., rate in Colorado is .01% while the tax rate for property in the City of Philadelphia is approximately 4%).
- In recent years, some states have expanded their real estate transfer tax laws to impose real estate transfer tax on transfers of a “controlling-interests” in a “real estate entity”.
  - A controlling-interest is generally defined as more than 50% of the fair market value of the ownership interests, and the definition of a “real estate entity” varies but generally applies to entities whose assets substantially consist of real estate.
  - The states that impose a transfer tax on the controlling-interest of a real estate entity include Connecticut, Delaware, the District of Columbia, Florida, Illinois, Maine, Maryland, New Hampshire, New York, Pennsylvania and Washington. There are also some cities that assess the controlling-interest real estate transfer tax, including New York City and Philadelphia.





# Transfer Taxes

## Isolated or Occasional Sale

- Majority of states exempt from tax bulk or occasional sales of assets. Only Colorado, New York, Oklahoma and Wyoming do not provide some form of exemption
- Per many impose restrictions:
  - **Texas & Idaho** “entire operating assets of business’ or of a separate division, branch, or identifiable segment of the business” **California** does not exempt sale of assets used in a business that is required to hold a “sellers permit”. Only applies to assets NOT held or used in the business not requiring a sellers permit. (eg sale of hotel with restaurant, assets used in hotel is exempt, not restaurant)
  - **Florida** “isolated sale” exemption only applies to dealers engaged in business of selling TPP or taxable services (permitted businesses). “Occasional Sales Exemption” may apply but limited to two times within 12 month period. (excludes sale of aircraft, vehicles, recreational equipment, RV’s)
  - **Alaska** No state sales tax, but local tax may apply
  - **Maryland** Exemption limited to \$1,000
  - **Missouri** Exemption limited to \$3,000, unless “liquidation or cessation of seller business. Seller cannot remain in the “same” business (*Dir. of Revenue, State of Mo. V Loethen Amusement, Inc.*, No. Rs-86-0130)



# Transfer Taxes

- *926 North Ardmore Avenue, LLC v. County of Los Angeles*, California Supreme Court No. S222329
  - County seeking to apply change in ownership rules of California's property tax (Proposition 13) to the documentary transfer tax
  - Specifically, County attempting to impose transfer tax with respect to transfers of entities owning realty, rather than simply transfers of the realty itself
  - County's position flies in the face of over 40 years of transfer tax law in California



# Transfer Taxes

- *The Roman Catholic Archbishop of San Francisco, A Corporation Sole v. City and County of San Francisco*, SFSC No. CGC-10-498795 (2012)
  - City sought to impose over \$20 million in documentary transfer taxes against the Archdiocese in connection with an internal reorganization between two church corporations
  - Potentially significant ramifications for both non-profits and for-profit corporations
  - Trial court ruled against the City on the basis that no realty had been sold under California law



# Hidden Taxes & Fees

## City Special Sales/Use Taxes



# City “Home Rule” Taxes

***Special authorization granted to some cities  
(and sometimes counties) to levy and  
administer own sales tax***

States authorizing Home Rule Status:

- Alabama
- Arizona
- Colorado
- Illinois
- Louisiana



# City “Home Rule” Taxes (con’t)

## Examples Include:

- Chicago Lease Transaction Tax (*Chi. Mun. Code § 3-32-020*)
- Denver Information Services Sales/Use Tax (*City Ordinance Law § 53-25*)



# Chicago Lease Transaction Tax

- Illinois Treats Lessor as End User Subject to Tax
- Lease Stream is not subject to state level tax
- Chicago Home Rule Imposes City Tax on Lease Stream
- Original Lease Tax Dates Back to 1987
  - Original tax applied to “time sharing” on computers
  - Extended to use of personal computers to access information with search engines (Personal Property Lease Transaction Tax No. 9, 06/01/2004)
  - Transfer of software (5 part test) not taxed by state, subject to city lease tax (*Personal Property Lease Transaction Tax Amended ruling* 09/01/2013)



# Chicago Lease Transaction Tax

- Old Law new Interpretation: Ruling #12
  - Tax applies to “non-possessory computer leases”, (effective 7/1/2015)
  - Requires sourcing to location of “user’s” own computer or access terminal rather than location of actual computer and software deemed to be used (*Chi. Mun. Code § 3-32-020.1*)
- Taxpayers impacted include:
  - Providers of information service
  - Software as a service (SaaS) providers
  - Infrastructure as a service (IaaS)
  - Nexus with City of Chicago
  - Companies with location in city liable if providers do not collect tax





# Non-Possessory Lease

## Definition of Non-Possessory Lease included charges for:

*“use of the computer and its software to input, modify or retrieve data or information” without human intervention (Chi. Mun. Code § 3-32-020.1)*

Exemption from tax includes:

- **“De Minimus”** use or control of providers computer and
- **“Related charge”** must be predominantly for information transferred to the customer rather than use or control of the computer (*Chi. Mun. Code § 3-32-020.1*)

(e.g.) use of computer to receive price quote or other information having fleeting or transitory character



# Take-Aways from Ruling #12

- Broad (some say unconstitutional) interpretation of what constitutes “control” and narrow review of object being information versus use of computer
- Searchable databases or websites with search features deemed within scope of tax – e.g. more than de minimus
- “Proprietary” information can qualify for exception even if includes search component. Public information, legal cases, stock quotes more likely subject to tax.
- Allows for allocation based on “use” of non-possessory lease
- Effective date deferred until January 2, 2018.



# Denver Information Services Tax

Colorado (similar to most states) taxes sales of “tangible personal property”

- Sales of Services, unless specifically enumerated are exempt), (*Colo.Rev. Stat. §39-26-104(1)(a)*)
- Information services are exempt from CO tax unless “true object” of the transaction is sale or lease of TPP....but under Colorado home rule provisions
- City of Denver imposes Information Services Sales/Use Tax, upon furnishing or sale to customers within the city “information or entertainment services” where relay or transmission is ...through any medium, including, but not limited to:
  - Pay television
  - *Purchase price or charge for data processing equipment and data processing programs*
- City conducting audit imposing tax on “cloud delivered services”, based on use or access of information services within the City of Denver.



# Local Sales and Use Taxes

- California cities and counties are authorized to impose a total tax of 1% on the sales or use of tangible personal property
- Generally speaking, if transactions are taxable or exempt at the state level, the same treatment applies at the local level
- Similarly, if the sales or use tax is applicable at the state level, the same tax will generally apply at the local level



# Local Sales and Use Taxes

- In recent years, a major issue has arisen with respect to how local sales or use taxes should be allocated among cities and counties
- The California State Board of Equalization (SBE) has a set of rules that essentially allocates the local taxes to the place of sale
  - Different rules exist depending on whether a sales or use tax is applicable and whether the taxpayer has one or multiple places of business in the State
- Controversy arises in connection with incentive agreements entered into between the taxpayer and a city whereby the taxpayer agrees to set up or relocate a place of business in the city and allocate all local taxes to that city, in exchange for the city refunding a certain portion of the local taxes to the taxpayer



# Local Sales and Use Taxes

- Disputes arise between cities as to how the local taxes should be allocated
- Procedures for resolving these disputes are elaborate and time consuming
- Pit city against city with the taxpayer stuck in the middle
- If a decision is rendered granting, in whole or in part, a petition to reallocate, the city which originally received the local taxes may be required to disgorge those local taxes going back a number of years—a potentially devastating effect
- Depending on the terms of the incentive agreement, taxpayer may as well be adversely affected



# Hidden Taxes & Fees

Incentives



# Incentives?

**Incentives:** *a deduction, exclusion or exemption from a tax liability, offered as an enticement to engage in a specified activity for a certain period.*

Timing is everything

Incentive oversight?

What are you asking for?

Tax credits versus tax refund

Reporting

Beware of Clawbacks





# Incentives

## Be Aware of Clawback

- Many (most) state and local incentive agreements include clawback provisions
- Required reimbursement of property, sales, income tax incentives paid over term of incentive agreement
- Examples include:
  - Some states publish “clawback list” of violators, (e.g.) Ohio, NY
  - For list of state clawback provisions
    - [http://www.goodjobsfirst.org/sites/default/files/docs/pdf/clawbacks\\_chart.pdf](http://www.goodjobsfirst.org/sites/default/files/docs/pdf/clawbacks_chart.pdf)
  - Removal of “substantially” all equipment requiring reimbursement of \$4.3 million property taxes
    - <http://www.lansingstatejournal.com/story/news/local/2015/02/04/supreme-court-denies-owens-brockway-tax-dispute-appeal/22861345/>



# Incentives

## Clawback: Best Practices

- ***Clearly define and understand all key terms***, devil is in the details (e.g.) “substantially all”, “person” vs “position”, level of capital expenditures “assessed value” vs “taxable”, “NBV” or fair value, “company”, do proximate related parties count?
- ***Establish realistic project time lines***
  - flexibility in timing in the event there are items outside the company’s control that affect the start of operations, hiring of employees or purchase of assets
- ***Include “Act of God” (Force Majeure) provisions***, in event of flood, hurricane, unforeseen circumstances (broadly defined)
- ***Negotiate pro-rata clawbacks***, incentive specific
- ***Include renegotiation clause*** in event of internal operations, fluctuations in economy, merger or acquisition, broadly defined



# Hidden Taxes & Fees

## Business License Fees



# Business Licenses

- Federal licenses and permits (alcohol, firearms, transportation)
- Initial license – “doing business”
- Annual renewals
- Posting licenses (3<sup>rd</sup> party auditors)
- Audits (CA)
- Unusual practices



# Hidden Taxes & Fees

## Tax vs Fee



# Tax versus Fee

- In California, at the local level, Proposition 13 requires a two-thirds voter approval for special taxes, such as parcel taxes
- After Proposition 13 passed in 1978, local governments turned to fees to raise revenue to make up for the reduced property tax revenue—thus avoiding the two-thirds vote requirement
- In 1997, the California Supreme Court decided *Sinclair Paint v. SBE* and held that a fee imposed to mitigate a burden created by the feepayer was a valid regulatory fee and not a tax subject to the two-thirds vote requirement
- In 1996, voters approved Proposition 218 to attempt to reduce the flow of “fees” which looked like disguised taxes



# Tax versus Fee

- In 2010, Proposition 26 was passed to further clarify what is a tax versus a regulatory fee
- Broadened definition of a tax to be any levy, exaction and certain charges imposed by a local government that result in any taxpayer paying a higher tax
- Governmental entity has the burden of proving by a preponderance of evidence that the charge is not a tax
  - Charge must be reasonable and not exceed the necessary cost of the governmental activity
  - Charge must bear a reasonable relationship to the payer's burden on or benefits received from the governmental entity
  - If the charge provides a benefit, the charge must specifically benefit the individuals/entities that pay the charge



# Tax versus Fee

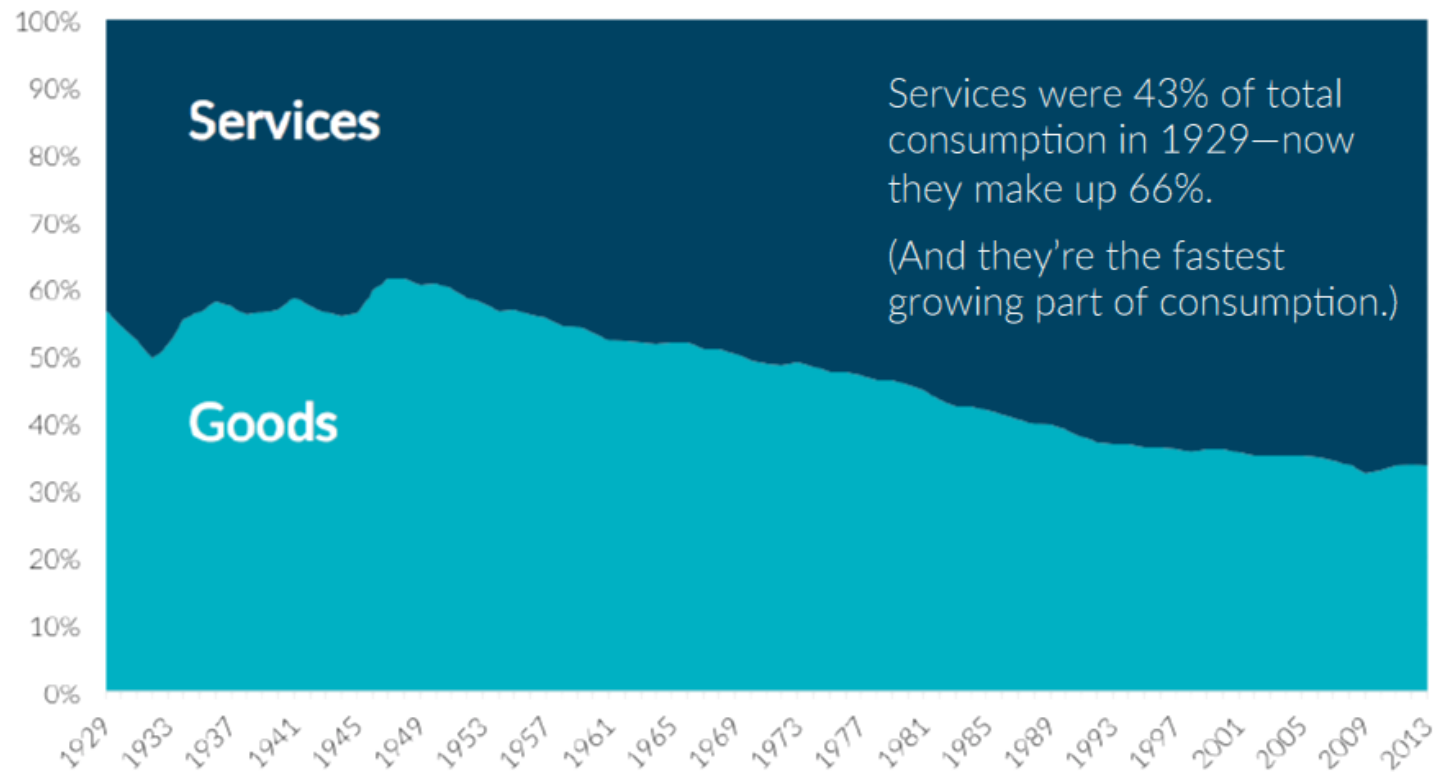
- Numerous challenges to fees as violating Proposition 26
  - *Howard Jarvis Taxpayers Assn. v. California Dept. of Forestry and Fire Protection*, Sacramento Superior Court, Case No. 34-2012-00133197-CU-MC-GDS (class action involving the Fire Prevention Fee enacted by AB X1 29)
  - *Citizens for Fair REU Rates v. City of Redding*, Cal. Supreme Court, Case No. S224779 (pending case over issue whether a payment in lieu of taxes transferred from the city utility to the city general fund is a tax under Proposition 26)
  - *Eck v. City of Los Angeles*, Los Angeles Superior Court, Case No. BC577028 (class action challenging City's electric utility fees)
  - *Schmeer v. County of Los Angeles*, 213 Cal. App. 4th 1310 (2013) (County ordinance requiring stores to charge customers ten cents for each paper bag was upheld as not a tax violating Proposition 26)





# Into the Future

U.S. total, by percent of total PCE (1929-2013)



Source: Council of State Taxation



# The Next Frontier?

## Continued Expansion of Tax Base

**Most states' sales tax is based on TPP (with notable exceptions):**  
Collections have more than doubled since 2008.

Likely targets for taxation include:

**Reward and Loyalty Points:** States moving towards treating loyalty points as consideration subject to tax. (See WA, Interim Statement (Nov.12, 2014), Det.No. 11-036R (unpublished 06/09/2015) GA, MN, Revenue notice No. 03-15 (rev.Nov.5,2012) and *Garden Party, Inc., Commissioner of Rev.*, No.7924 R (Minn.Tax Ct. Nov.24, 2008))

**Cloud Based Goods/Services:** Hosted websites, SaaS, IaaS, “Apps” developed for business use, data/customer analytics

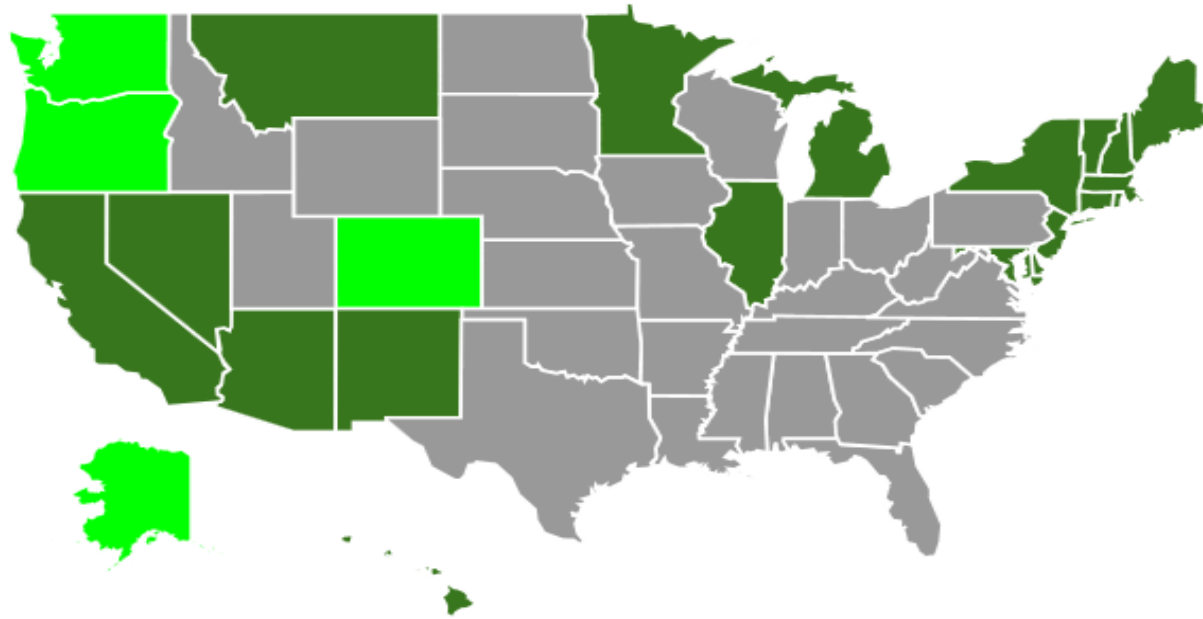
**Gaming Activities:** FanDuel, DraftKings, On Line Video Games

**Increased Business License Fees:** pollution control, transportation, hospitality, certification

**Marijuana:** Potential revenue base larger than most goods/services, CO tax rate can exceed 30%, WA 25%, OR 20% *Tax Foundation, August 25, 2014*



# Marijuana Tax



## Marijuana Legalization Status

- Medical marijuana legalized
- Marijuana legalized for recreational use
- No laws legalizing marijuana

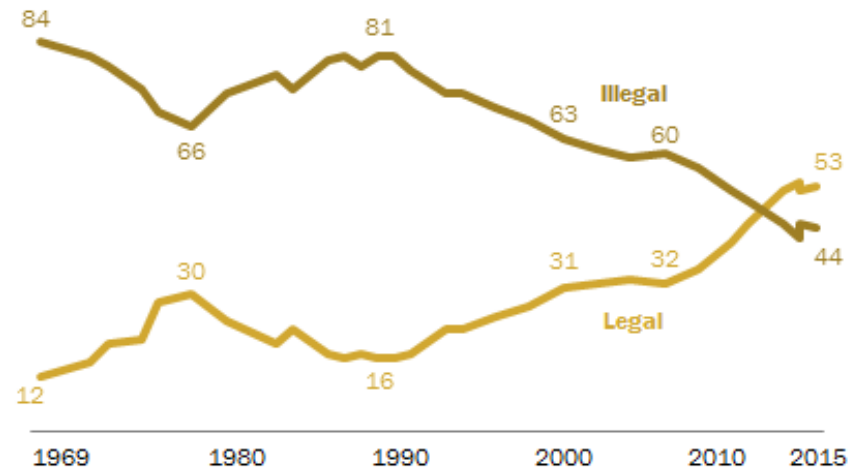
Source: US Census Bureau of Statistics



# Marijuana Tax

## Slim Majority Supports Marijuana Legalization

*% saying the use of marijuana should be ...*



Survey conducted March 25-29, 2015.

1973-2008 data from General Social Survey; 1969 and 1972 data from Gallup.

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# Marijuana Tax

## The Facts

- Twenty-three states and DC currently have laws legalizing marijuana in some form
- Four states and DC allow recreational use ( AK, CO, WA, OR)
- Colorado sales tax collections in 2014 on sale of marijuana approximately doubled alcohol sales tax collections (\$70 million v. \$40 million) *Source: Time Magazine September 2015*
- Oregon sales in first month doubled Colorado sales (\$11 million v. \$5 million) *Source: KGW.com Portland, OR*
- Estimates of annual sales tax revenue exceed \$3.1-\$6.8 billion on annual basis *Source: The Institute on Taxation & Economic Policy, Richard Phillips, May, 2015*
- Public acceptance has dramatically shifted over the years

***Marijuana sales presents a compelling revenue raising opportunity, with reduced resistance that many (most) states will find hard to ignore***



# Questions?

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