



Hartman Hits All the Right Notes

Navigating Local Labyrinths: Practitioners' Guide to Local Taxes

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In this article, the authors discuss some of the more significant locally imposed taxes that could cause unexpected issues for businesses entering a new jurisdiction.

While businesses entering a new jurisdiction may assume that they are prepared to handle local taxes, even sophisticated taxpayers can be caught off guard by the labyrinth of unfamiliar local taxes waiting to greet them when beginning to transact business in the different jurisdictions. Even with tax teams dedicated to making sure companies comply with all their filing obligations, businesses are often unaware of the taxes imposed by the counties, towns, cities, or districts where they operate.

Chicago Personal Property Lease Transaction Tax

For taxpayers unfamiliar with Chicago, the most troubling discovery when beginning to transact business in the city can be the personal property lease transaction tax. It's imposed upon: (1) the lease or rental in the city of personal property or (2) the privilege of using in the city personal property that is leased or rented outside the city.¹ The lease transaction tax is the city's version of a lease or rental tax on personal property.²

Effective January 1, 2016, Chicago expanded its lease transaction tax to "clarify" its position on the taxability of non-possessory computer leases.³ This expansion was to address advances in how software is conveyed to customers today — that is, primarily through the cloud. However, instead of drafting a new tax to accomplish its goals, the city shoehorned new tax policy into old tax language. And although the term "non-possessory lease" had been in the ordinance since 1994, its extension to cloud-based products was a new application. The result is that since 2016 the lease tax is imposed on

¹ Municipal Code of Chicago section 3-32-030.

² M.C.C. section 3-32, et seq.

³ See Chicago Department of Finance, Personal Property Lease Transaction Tax Ruling No. 12.

cloud-based software. And while the tax is generally imposed at a rate of 9 percent, charges for the non-possessory lease⁴ of a computer to input, modify, or retrieve data or information that is supplied by the customer are subject to a lower 5.25 percent rate.⁵

What Else to Know About the Lease Transaction Tax

An exemption exists (Exemption 11)⁶: If the non-possessory lease of a computer in which the customer's use or control of the computer is de minimis and the related charge is predominately for the information transferred to the customer rather than for the customer's use or control of the computer, then the lease is exempt from tax.⁷

The lease transaction tax applies to perpetual licenses of computer software.⁸ Historically, Chicago did not impose the tax on perpetual licenses of computer software because it equated those licenses to sales rather than leases.⁹ But to extend the reach of the lease transaction tax, the city began to tax any license of computer software that qualifies as a nontaxable license under the Illinois retailers' occupation tax (ROT) software regulations.¹⁰ Because non-perpetual licenses of software that qualify as nontaxable licenses under the ROT regulations have always been subject to the lease transaction tax, the tax has been expanded to those perpetual licenses of software that are likewise nontaxable under the ROT.¹¹

⁴ A "non-possessory lease" is a lease or rental under which use but not possession of the personal property is transferred. *Id.* A non-possessory lease includes a non-possessory computer lease. *Id.*

⁵ *Id.*

⁶ Additional exemptions apply: (1) when the use is to "effectuate the execution, clearing, processing, matching or recording of a trade" of securities or commodities (M.C.C. section 3-32-050(9) or Exemption 9); (2) when the use is to "effectuate the deposit, withdrawal, transfer or loan of money or securities, including any related review of accounts or investment options by the account owner" (M.C.C. section 3-32-050(10) or Exemption 10); and (3) for new small businesses within the city provided they meet specific qualifications. *See* City of Chicago Info. Bulletin Nov. 2015.

⁷ M.C.C. section 3-32-050(A)(11).

⁸ Chicago Department of Finance, Personal Property Lease Transaction Tax Ruling No. 5. For purposes of the lease transaction tax, the words "lease" or "rental" originally included a transfer of the use of software only if, for purposes of the retailer's occupation tax and Illinois use tax, the software was not custom software and the transfer was an exempt license of software. M.C.C. section 3-32-020(l).

⁹ *Id.*

¹⁰ *See* Ill. Admin. Code tit. 86, section 130.1935(a)(1).

¹¹ *Id.*

In addition to "clarifying" its application of the lease transaction tax to non-possessory computer leases, the Chicago Department of Finance's Ruling No. 12 further clarified Exemption 11. Ruling No. 12 explained that exempt uses may be demonstrated by either (1) access to information or data that is entirely passive (such as streaming data), without interactive use, or (2) access to materials that are primarily proprietary, such as copyrighted newspapers, newsletters, or magazines. In addition to explaining what types of transactions are taxable, Ruling No. 12 also provides that when a customer enters into a transaction subject to the lease transaction tax, but uses the service in and outside Chicago, the tax should be apportioned.

The lease transaction tax includes a "lease for re-lease" exception.¹² Consequently, a lessee is not subject to the lease transaction tax provided the lessee supplies written verification to the lessor that the property is being re-leased and it is in fact the same property, and provides either a re-lease certificate or documentary evidence.¹³

A lease of personal property is deemed to take place where the lessee takes possession or delivery of the property.¹⁴ The place of the lease or rental is treated as the location of the terminal or other device by which a user accesses the computer.¹⁵ As a result, liability for the tax is triggered when a customer in Chicago makes remote use of a provider's computer or software, even if the provider's software is located outside Chicago. If the customer's location is not otherwise clear or when the user accesses the provider's computer from a mobile device, the Chicago Department of Finance will apply the rules set forth in the Illinois Mobile Telecommunications Sourcing Conformity Act, 35 Ill. Comp. Stat. 638.¹⁶ As a result, the transaction tax will generally apply to customers whose residential or primary business street address is in Chicago, as reflected by credit card billing address, ZIP code, or other reliable information.

¹² M.C.C. section 3-32-060.

¹³ *Id.*

¹⁴ M.C.C. section 3-32-030(C).

¹⁵ M.C.C. section 3-32-010(I).

¹⁶ *Id.*

San Francisco Local Taxes

California localities have been heavily experimenting with various types of taxes lately, and the locality leading this charge is the city and county of San Francisco. Previously known for intentionally building a tax-friendly environment for business taxpayers, particularly in the technology industry, San Francisco has recently switched gears by proposing or enacting a litany of taxes targeting its business community. Following is a summary of San Francisco's most notable local taxes.

San Francisco imposes a payroll expense tax (PET) on the compensation earned for work performed within the city. Compensation includes salaries, wages, bonuses, commissions, and property issued or transferred in exchange for the performance of services, including but not limited to stock options. Before 2014, San Francisco imposed this tax on businesses operating in the city at the rate of 1.5 percent and was the only city in California to base its business tax on payroll expense. Starting in 2014, this tax was intended to be phased out over the course of five years and replaced with San Francisco's gross receipts tax (GRT), but because of the GRT collecting less revenue than anticipated, the PET remains in effect at the rate of 0.38 percent.

In 2012 San Francisco voters approved the shift from the one-size-fits-all PET to a GRT with a progressive rate structure ranging from 0.69 to 0.74 percent based on business activity classification (for example, retail or manufacturing). The GRT is imposed on all receipts that constitute gross receipts for federal purposes. Effective January 1, 2019, an economic nexus standard also applies, subjecting all businesses to the GRT with \$500,000 or more in annual gross receipts from sales to customers in San Francisco.

In 2018 San Francisco enacted three new special local taxes via the voter initiative process (as opposed to being directly proposed by a mayor or board of supervisors). They received more than 50 percent of the vote but not a two-thirds supermajority. The validity of these three taxes and similar measures passed in other California localities like Fresno, Mountain View, and Oakland, and whether these taxes were required by the California Constitution to pass

with a two-thirds supermajority, is a hot issue that is working its way through the state court system. At the trial court level there has been a split of opinion, with a San Francisco judge deciding for the city and the validity of the taxes, and a Fresno judge issuing a decision for taxpayers and invalidating the tax at issue there.

The three San Francisco taxes at issue are:

- In June 2018 the commercial rent tax to fund universal healthcare, childcare, and early education programs passed with a 50.87 percent vote, authorizing a GRT on the lease of commercial property for landlords with annual gross receipts over \$1 million. The tax imposes a 1 percent rate on gross receipts for warehouse space and 3.5 percent for other commercial properties.
- Also in June 2018, a school parcel tax initiative passed with a 60.76 percent vote, authorizing an annual tax of \$298 per parcel of taxable real property in the city for 20 years to fund the San Francisco Unified School District's educators' salaries, staffing, professional development, technology, charter schools, and oversight of funding.
- In November 2018 an initiative for a GRT to fund homeless services passed with a 61.34 percent vote, authorizing a tax on businesses' San Francisco gross receipts above \$50 million at rates between 0.175 to 0.69 percent (depending on the business activity type), or an annual tax on businesses with administrative offices in San Francisco, at least \$1 billion in gross receipts, and at least 1,000 employees nationwide at a rate of 1.5 percent of payroll expenses. Revenue received by this tax would fund the Our City, Our Home Fund and be used for specified purposes dedicated to combating homelessness in San Francisco.

San Francisco has more potential new local taxes in the pipeline. For instance, a proposed mental health tax has been deferred to the March 2020 ballot. It would fund mental health services by imposing an additional GRT on businesses based on the ratio of the compensation of a business's highest-paid employee (anywhere) to median compensation paid to the business's employees based in San Francisco that exceeds

100:1. Also, a proposition has been deferred to the November 2020 ballot (to be submitted as a general tax), and if passed would impose an additional 1.12 percent tax on stock-based compensation payroll expenses (that is, any compensation in the form of or dependent on the value of equity interests including without limitation stock and stock options).

New York City Commercial Rent Tax

While commercial leases are typically tax free in most states, including New York, some areas of New York City are an exception. The city commercial rent tax (CRT) is a 6 percent levy on annual commercial rents over \$250,000 imposed on tenants who occupy or use a property for commercial activity in Manhattan, south of the center line of 96th Street.¹⁷ All taxpayers are entitled to a 35 percent base rent deduction, which reduces the 6 percent rate to an effective tax rate of 3.9 percent. Further, a sliding scale credit applies for annual rents between \$250,000 and \$300,000.

New York City provides a fairly limited number of exemptions from the CRT. For example, beginning in 2005, the city provided an exemption for any tenant in the World Trade Center area, which is a precisely defined geographic area within Manhattan south of 96th Street. Other exemptions exist for:

- governmental, religious, or charitable organizations;
- a premises used for a “dramatic or musical arts performance” for less than four weeks when there is no indication when the performances commence that they will continue for less than four weeks; and
- a premises used for a “production and performance of a theatrical work” if the period for which the tenant pays rent does not exceed 52 weeks from the date that production commences.¹⁸

A CRT trap for the unwary involves billboards. The city’s Department of Finance maintains that rent paid for a billboard is subject

to CRT if the billboard is located south of the center line of 96th Street in Manhattan, the annual gross rent for the billboard exceeds \$250,000, and the tenant does meet any other exemption criteria.¹⁹

Jersey City, New Jersey, Payroll Tax

In New Jersey, some localities are authorized to enact payroll taxes. Effective January 1, 2019, Jersey City imposed a payroll tax on employers conducting business within the city if the employer (1) has payroll exceeding \$2,500 in any calendar quarter and (2) employs nonresident employees working within Jersey City or *supervises employees from within Jersey City*.²⁰ A 2018 amendment to the Local Tax Authorization Act enabled Jersey City to enact a payroll tax that previously was only afforded to Newark. Jersey City based its tax on Newark’s ordinance.

The Jersey City payroll tax has been challenged and upheld in New Jersey Superior Court. The judge upheld the provision that permitted taxing the payroll of employees who are located outside Jersey City and are supervised from within Jersey City. The judge concluded that the internal consistency and external consistency tests of U.S. constitutional fair apportionment are not violated because a taxpayer can sue competing jurisdictions to resolve a dispute and because the case challenged the law by action in lieu of prerogative writs rather than as an appeal from imposition of tax flowing from a specific set of facts.²¹ However, an appeal is pending at the Appellate Division of the Superior Court.

New Jersey Local Property Tax

Appealing local property tax assessments in New Jersey can be an adventure. In a recent municipal property tax appeal before the New Jersey Tax Court, the taxpayer proffered as a real estate appraisal expert someone who was employed as a local property assessor in a neighboring municipality. The court held that the appraisal expert is barred from acting as an expert

¹⁷ Admin. Code of the City of New York sections 11-701 through 11-719.

¹⁸ N.Y.C. Admin. Code section 11-704.

¹⁹ N.Y.C. Department of Finance, “Commercial Rent Tax — Billboards” (May 28, 2014) (rev. July 7, 2014).

²⁰ Jersey City, N.J., Ordinance 18-133 (Nov. 20, 2018).

²¹ *Mack-Cali Realty Corp. v. State of New Jersey* (N.J. Super. Ct. Law Div. Mar. 15, 2019).

in a taxing district if the appraiser is employed as a local property assessor in another New Jersey taxing district because it creates an undeniable and impermissible conflict of interest that would be an impairment of public trust arising from an appearance of impropriety that would call into question the public's perception of his or her involvement in outside employment.²²

New Jersey Income Tax Credits

A final New Jersey issue to be aware of is that Gov. Phil Murphy (D) signed an executive order in January establishing a task force on the tax incentives programs of the New Jersey Economic Development Authority.²³ The task force's mission is to "conduct an in-depth examination of the deficiencies in the design, implementation, and oversight" of the tax incentive programs.²⁴ Under the umbrella of ascertaining the best way to fix the incentives system, the governor went outside the attorney general's office and hired as special counsel a team of former federal criminal prosecutors to investigate.

The special counsel is conducting investigations using subpoena powers for documents and to compel testimony. Its first published report, issued June 17, asserted that special interests prevailed for tax credits and that the authority lacked procedures and training to audit for deficiencies. However, the authority of the task force is already being challenged in New Jersey Superior Court.²⁵

Wacky Interest

Be careful entering new territories. They can bite! What if you failed or were late to pay a local tax you did not know existed? For example, the city of Gretna, Nebraska, imposes an occupation tax on businesses operating in the city (the tax operates as a piggyback on Nebraska's state sales tax).²⁶ The city imposed a penalty at a rate of 1 percent per month and interest at a rate of 10

percent per month, compounded quarterly, for late payment — with no cap!²⁷ However, Nebraska law limits interest by the state or by political subdivisions to no more than 14 percent per year.²⁸ The city asserted that the interest is actually a penalty so the statutory limit does not apply. Even if the interest imposed is actually a penalty, the U.S. Supreme Court has recently held that the excessive fines clause of the Eighth Amendment to the U.S. Constitution applies to states.²⁹ Such uncapped, compounded penalties would arguably constitute an excessive fine for U.S. constitutional purposes.

Tennessee Business Tax

The Tennessee business tax is a local tax on steroids. For decades the tax was imposed, collected, and enforced by the counties and cities where a business operated. As a result, the business tax was sporadically and inconsistently imposed and, often, not enforced at all. In 2009 the General Assembly addressed this issue by giving the Department of Revenue authority to administer and enforce the tax.³⁰ From that time, the department has made a concerted effort to ensure that companies comply with the business tax laws, and business tax is now a routine part of any Tennessee audit. Because the tax was underenforced for so long, these audits often result in surprisingly large assessments for multiple years of unreported tax. At this point, if a business operates in Tennessee or sells services or products to Tennessee customers, it needs to be aware of its business tax obligations.

The business tax is a broad-based GRT imposed on all persons³¹ selling taxable goods or services to Tennessee customers.³² The tax is imposed primarily on a location-by-location basis, with each "physical location, outlet, or other place of business" in Tennessee required to

²² VNO 1105 State Hwy. 36 LLC v. Township of Hazlet (N.J. Tax Court Apr. 2, 2019), reconsideration denied (N.J. Tax Court June 10, 2019).

²³ Exec. Order No. 52 (N.J. Jan. 24, 2019).

²⁴ *Id.*

²⁵ *Norcross v. Murphy* (N.J. Super. Ct., Mercer County).

²⁶ Gretna, Neb., Ordinance No. 1025 (Mar. 19, 2013).

²⁷ *Id.*

²⁸ Neb. Rev. Stat. section 45-104.01.

²⁹ *Timbs v. Indiana*, 139 S. Ct. 682, 687 (2019).

³⁰ 2009 Tenn. Pub. Acts, c. 530, sections 69-93.

³¹ The definition of person for business tax purposes "includes any individual, firm, partnership, joint venture, association, corporation, estate, trust, business trust, receiver, syndicate, or other group or combination acting as a unit." Tenn. Code Ann. section 67-4-702(a)(13).

³² Tenn. Code Ann. section 67-4-704(a).

register for, calculate, and remit business taxes based on its activities at that location.³³ If a location is inside a city's limits, it will typically be taxed twice, once for the county-imposed business tax enforced by the state and once for the same tax imposed by the city.³⁴ As an exception to these general rules, all sales to Tennessee customers made from outside the state are treated as though they were made from a single location, and only the county-level tax is imposed on the gross receipts from that out-of-state "location."³⁵

The business tax is imposed on nearly all sales of tangible personal property delivered to Tennessee customers. It is also imposed on nearly all sales of services delivered to Tennessee customers. In this way, the business tax is the opposite of Tennessee's sales tax, which is imposed only on a relatively narrow scope of specific services.³⁶ For this reason, it is common for businesses selling services in Tennessee to be subject to the business tax but not the sales tax, even if they sell their services to affiliated entities.³⁷

The good news is that the business tax rates are very low.³⁸ The bad news is that it is often difficult to determine what rate applies to a specific business location. To make that determination, a business must first identify its classification at each location, which is based on its dominant business activity.³⁹ The business must then determine whether it is a wholesaler or a retailer at that location, also based on its dominant business activity.⁴⁰ For both purposes, the dominant business activity is determined by

identifying the kinds of sales that comprise the "largest proportion of taxable gross sales" from the location when compared with other items sold.⁴¹ Based on that analysis, the tax rate provided by statute for the applicable classification is imposed on all of the gross receipts derived from the location.

As this suggests, the Tennessee business tax leaves a lot of room for confusion and dispute, and this summary has barely scratched the surface. For instance, this article has not mentioned the various issues regarding the proper treatment of sales of software for business tax purposes or the sourcing of sales of digital goods, software as a service, or any other of the way "items" are routinely sold and delivered through today's technology. Despite these issues, or perhaps because of them, businesses should carefully review their operations in Tennessee to ensure they are registered for and are reporting business taxes correctly. ■

³³ See, e.g., Tenn. Comp. R. & Regs. section 1320-04-05-.28, .53.

³⁴ Cities are authorized to impose copycat city business taxes on businesses within their borders. Unsurprisingly, most cities have chosen to do so, including Tennessee's four largest cities: Nashville, Memphis, Knoxville, and Chattanooga. The Tennessee Department of Revenue maintains a comprehensive list of cities imposing a business tax.

³⁵ See Tenn. Code Ann. section 67-4-717(b)(1).

³⁶ See Tenn. Code Ann. section 67-6-205(c).

³⁷ See Tenn. Code Ann. section 67-4-702(a)(21). For sales of services to affiliates, the business tax is imposed only on any markup above the costs incurred to provide those services. See Tenn. Code Ann. section 67-4-702(a)(19).

³⁸ See Tenn. Code Ann. section 67-4-709.

³⁹ There are 10 principal classifications (classes 1A, 1B, 1C, 1D, 1E, 2, 3, 4, 5A, and 5B) defined based on the kinds of businesses included in each classification, and with a specific tax rate applicable to each classification. Tenn. Code Ann. section 67-4-708 and 67-4-709.

⁴⁰ Tenn. Code Ann. section 67-4-702(a)(27).

⁴¹ Tenn. Comp. R. & Regs. section 1320-04-05-.15; see also Tenn. Code Ann. section 67-4-702(a)(27).