Domestic and Multistate Updates

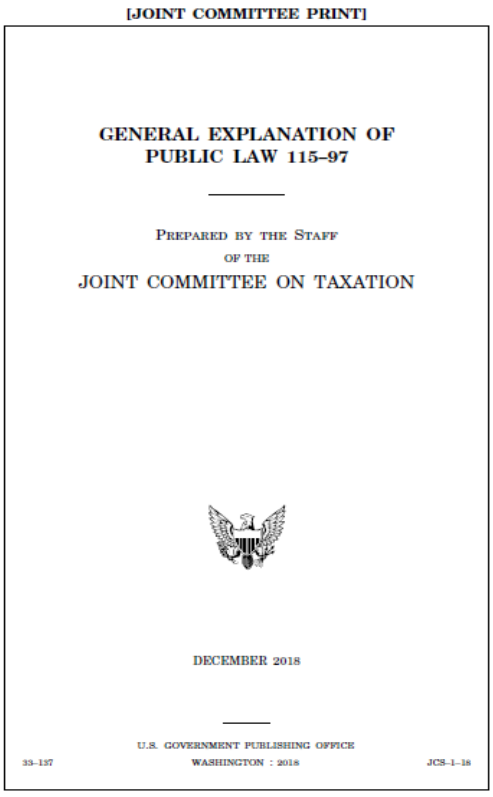
35th Annual TEI-SJSU High Tech Tax Institute
November 5, 2019

Annette Nellen, CPA, CGMA, Esq.
Professor
San Jose State University
Graduate Tax (MST) Program Director
http://www.sjsu.edu/people/annette.nellen/

Greg Abbott
Senior Director
Alvarez & Marsal Taxand, LLC
https://www.alvarezandmarsal.com/our-people/greg-abbott

Joint Committee on Taxation (JCT) Bluebook Released on 12/20/18

(457 pages)



[JOINT COMMITTEE PRINT]

GENERAL EXPLANATION OF
PUBLIC LAW 115–97

PREPARED BY THE STAFF
OF THE
JOINT COMMITTEE ON TAXATION

DECEMBER 2018

U.S. GOVERNMENT PUBLISHING OFFICE
33–137 WASHINGTON : 2018 JCS–1–18

https://www.jct.gov/publications.html?func=startdown&id=5152

Technical Corrections

JCT Bluebook on TCJA

- "A technical correction may be needed to carry out this intent." This phrase or similar shows up …

74 times!

https://www.jct.gov/publications.html?func=startdown&id=5152

Policy Statement on the Tax Regulatory Process

- Released by Treasury Dept on 3/5/19
- To explain and "reaffirm their commitment to a tax regulatory process that encourages public participation, fosters transparency, affords fair notice, and ensures adherence to the rule of law."
- Desire to follow APA even when not required for interpretive regulations.
- Limited use of temp regs
- Factors for issuing subregulatory guidance which while doesn't have force and effect of law that statute and regulations have, will be followed by the IRS.

https://home.treasury.gov/system/files/131/Policy-Statement-on-the-Tax-Regulatory-Process-3-4-19.pdf

Notice 2019-58 (10/11/19) – IRS Allowing Taxpayers to Follow Prop §385 Regs When Temp Regs Expire 10/13/19

- Final and temp regs issued 10/21/16 – TD 9790
- §7805(e) requires that temp regs expire after 3 years and must also be issued as proposed regs
- 10/21/16 – also issued prop §385 regs – REG-130314-16
  - That reg states: "The text of the temporary regulations also serves as the text of these proposed regulations."
- Notice 2019-58 – "A taxpayer may rely on the 2016 Proposed Regulations for periods following the expiration of the Temporary Regulations until further notice is given, provided that the taxpayer consistently applies the rules in the 2016 Proposed Regulations in their entirety."
- *Query*: Is this the intent of 7805(e) added in 1988?

https://www.irs.gov/pub/irs-drop/n-19-58.pdf

More Info On Draft of W-4 for 2020 (6/6/19)

Form **W-4** Department of the Treasury Internal Revenue Service

Employee's Withholding Certificate

▶ Complete Form W-4 so that your employer can withhold the correct federal income tax from your pay.
▶ Give Form W-4 to your employer.
▶ Your withholding is subject to review by the IRS.

OMB No. 1545-0074

2020

Step 1: Enter Personal Information

(a) First name and middle initial | Last name | (b) Social security number

Address

City or town, state, and ZIP code

▶ Does your name match the name on your social security card? If not, to ensure you get credit for your earnings, contact SSA at 800-772-1213 or go to www.ssa.gov.

(c) ☐ Single or Married filing separately
☐ Married filing jointly (or Qualifying widow(er))
☐ Head of household (Check only if you're unmarried and pay more than half the costs of keeping up a home for yourself and a qualifying individual.)

Complete Steps 2 through 4 ONLY if they apply to you. To see if you are exempt from withholding or if you have concerns about your privacy, see page 2. Everyone must complete Step 5. See instructions on page 2.

Step 2: Multiple Jobs or Spouse Works

Complete this step if you (1) hold more than one job at a time, or (2) are married filing jointly and your spouse also works. The correct amount of withholding depends on income earned from all of these jobs.

Do **only one** of the following.

(a) Use the estimator at *www.irs.gov/W4App* for most accurate withholding; **or**

(b) Use the Multiple Jobs Worksheet on page 3 and enter the result in Step 4(c) below for roughly accurate withholding; **or**

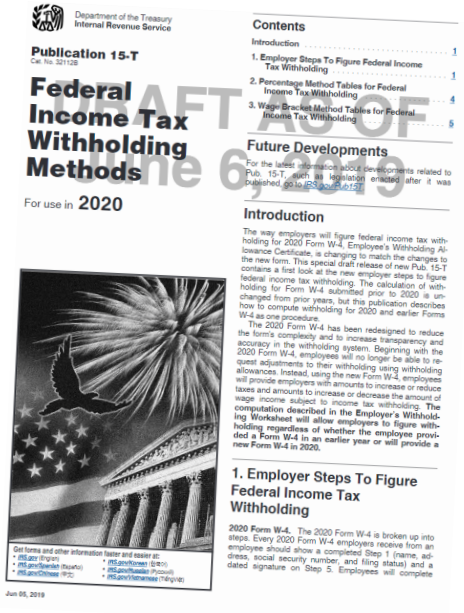
(c) If there are only two jobs total, you may check this box. Do the same on Form W-4 for the other job. This option is accurate for jobs with similar pay; otherwise, more tax than necessary may be withheld . . . . . ▶ ☐

CAUTION: If you have privacy concerns, choose **(a)** or **(b).** If you and/or your spouse have income from self-employment, including as an independent contractor, choose **(a).**

Complete Steps 3 through 4(b) on Form W-4 for only one of these jobs. Leave those steps blank for the other jobs. (Your withholding will be most accurate if you complete Steps 3 through 4(b) on the Form W-4 for the highest paying job.)

DRAFT AS OF June 6, 2019

https://www.irs.gov/pub/irs-dft/fw4--dft.pdf



Department of the Treasury Internal Revenue Service

Publication 15-T

Cat. No. 32132B

Federal Income Tax Withholding Methods

For use in **2020**

DRAFT AS OF June 6, 2019

Contents

Future Developments

For the latest information about developments related to Pub. 15-T, such as legislation enacted after it was published, go to IRS.gov/Pub15T.

Introduction

The way employers will figure federal income tax withholding for 2020 Form W-4, Employee's Withholding Allowance Certificate, is changing to match the changes to the new form. This special draft release of new Pub. 15-T contains a first look at the new employer steps to figure federal income tax withholding. The calculation of withholding for Form W-4 submitted prior to 2020 is unchanged from prior years, but this publication describes how to compute withholding for 2020 and earlier Forms W-4 as one procedure.

The 2020 Form W-4 has been redesigned to reduce the form's complexity and to increase transparency and accuracy in the withholding system. Beginning with the 2020 Form W-4, employees will no longer be able to request adjustments to their withholding using withholding allowances. Instead, using the new Form W-4, employees will provide employers with amounts to increase or reduce taxes and amounts to increase or decrease the amount of wage income subject to income tax withholding. **The computation described in the Employer's Withholding Worksheet will allow employers to figure withholding regardless of whether the employee provided a Form W-4 in an earlier year or will provide a new Form W-4 in 2020.**

1. Employer Steps To Figure Federal Income Tax Withholding

2020 Form W-4. The 2020 Form W-4 is broken up into steps. Every 2020 Form W-4 employers receive from an employee should show a completed Step 1 (name, address, social security number, and filing status) and a dated signature on Step 5. Employees will complete

Get forms and other information faster and easier at:
• IRS.gov (English)
• IRS.gov/Spanish (Español)
• IRS.gov/Korean (한국어)
• IRS.gov/Russian (Русский)
• IRS.gov/Vietnamese (Tiếng Việt)
• IRS.gov/Chinese (中文)

Jun 05, 2019

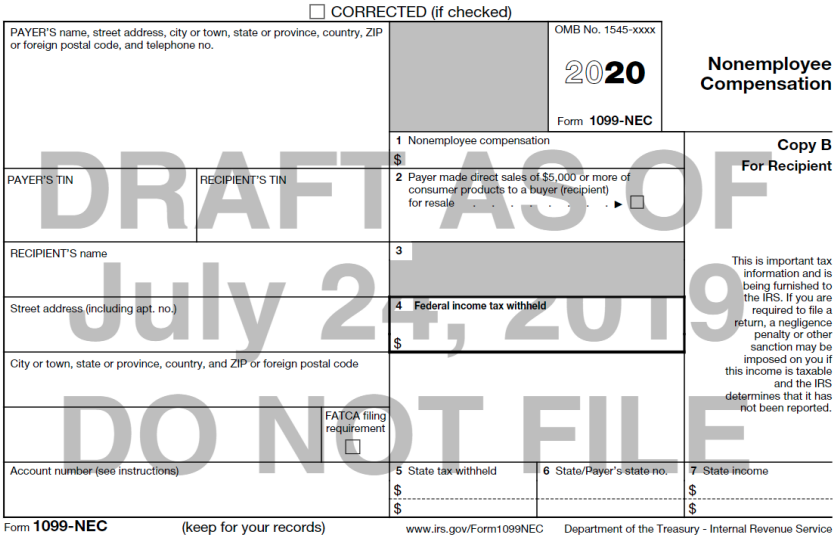
https://www.irs.gov/pub/irs-dft/p15t--dft.pdf

Final Regs on Truncating SSN on Form W-2

- TD 9861 (7/3/19) finalizes prop. regs (REG-105004-16 (9/20/17)) that modified regs under §§6051 and 6052 in response to Protecting Americans from Tax Hikes (PATH) Act of 2015, Public Law 114– 113 (12/18/15)
- Ok to truncate employee SSN on Form W-2 for forms required to be furnished after 12/31/20.
  - So, for 2020 Forms W-2
  - As with other truncating, is optional.
- Check if state conforms.

Draft Form 1099-NEC (7/24/19)

- Likely to address reality that today, Form 1099-MISC with box 7 is due 1/31 while balance is due 1/31



☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

OMB No. 1545-xxxx

2020

Form 1099-NEC

Nonemployee Compensation

1 Nonemployee compensation

$

Copy B For Recipient

PAYER'S TIN | RECIPIENT'S TIN

2 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ▶ ☐

RECIPIENT'S name

3

Street address (including apt. no.)

4 Federal income tax withheld

$

City or town, state or province, country, and ZIP or foreign postal code

This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

FATCA filing requirement ☐

Account number (see instructions)

5 State tax withheld

$

$

6 State/Payer's state no.

7 State income

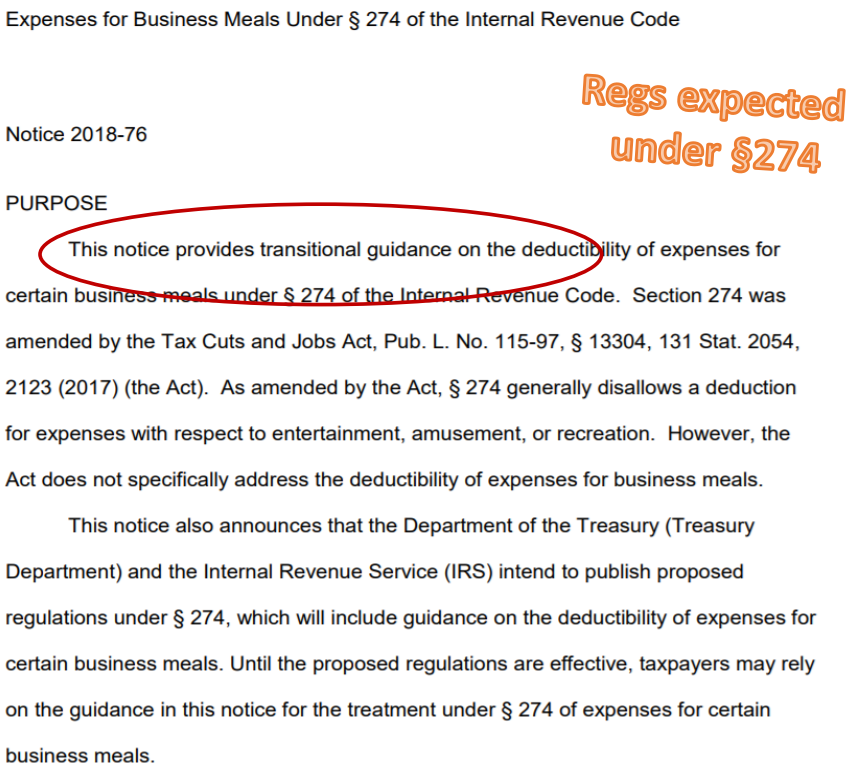
$

$

Form 1099-NEC (keep for your records) www.irs.gov/Form1099NEC Department of the Treasury - Internal Revenue Service

Client Meals Survive TCJA!

- Notice 2018-76 (10/3/18)
  - 50% deductible
  - Not considered entertainment
  - 5 requirements must be met:
    - 1) ordinary and necessary under 162
    - 2) not lavish or extravagant
    - 3) taxpayer or employee is present
    - 4) provided to current or potential business customer, client, consultant, or similar business contact; and
    - 5) if provided during or at entertainment activity, must be purchased separately or separately stated on the invoice; can't inflate the cost of the food/drink to try to deduct entertainment
- https://www.irs.gov/pub/irs-drop/n-18-76.pdf



Expenses for Business Meals Under § 274 of the Internal Revenue Code

Regs expected under §274

Notice 2018-76

PURPOSE

This notice provides transitional guidance on the deductibility of expenses for certain business meals under § 274 of the Internal Revenue Code. Section 274 was amended by the Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13304, 131 Stat. 2054, 2123 (2017) (the Act). As amended by the Act, § 274 generally disallows a deduction for expenses with respect to entertainment, amusement, or recreation. However, the Act does not specifically address the deductibility of expenses for business meals.

This notice also announces that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to publish proposed regulations under § 274, which will include guidance on the deductibility of expenses for certain business meals. Until the proposed regulations are effective, taxpayers may rely on the guidance in this notice for the treatment under § 274 of expenses for certain business meals.

Meals Rulings - TAM 201903017 (1/18/19)

- https://www.irs.gov/pub/irs-wd/201903017.pdf
  - **50 pages! But worth reading!**
- What is meal provided for convenience of employer?
  - IRS can't substitute its judgment for employers, but can determine if employees actually follow stated business policies and practices
    - IRS even noted that with meal delivery services today, how inconvenient can it be for employee to get a meal?
  - "Employers who provide specific business policies as substantial noncompensatory business reasons for furnishing meals to employees **must** be able to substantiate that such policies exist in substance not just in form by showing they are enforced on the specific employees for whom the employer claims these policies apply and must demonstrate how these policies relate to the furnishing of meals to employees."
  - IRS found that employer had "little factual support related to its claim that its employees could not safely obtain meals off business premises under usual circumstances."
    - And IRS considered availability of mobile meal delivery service.
  - Also found no policies related to employee health for the meals, or protection of intellectual property or safety.
    - Did find that a few employees needed meals to be available for emergencies.
  - IRS found t/p unable to show that at least half of all employees were furnished meals for convenience of employer.
  - IRS did not find employer met reasonable belief test that meals were excludible so were wages to employees subject to withholding, FICA and FUTA.

What about snacks in the breakroom all the time – de minimis?

IRS statements in CCA 200219005

- "The smaller in value and less frequently a particular benefit is provided, the more likely that such a benefit is properly characterized as a de minimis fringe benefit."
- "section 1.132-6(b)(2) provides that, where it would be administratively difficult to determine frequency with respect to individual employees, the frequency with which the employer provides similar fringe benefits is determined by reference to frequency with which the employer provides the fringe benefits to the workforce as a whole ("employer-measured frequency"). Therefore, under this rule, the frequency with which any individual employee receives such a fringe benefit is not relevant and in some circumstances, the de minimis fringe exclusion may apply with respect to a benefit even though a particular employee receives the benefit frequently."
- "The method chosen by the employer of accounting for benefits provided to employees is not determinative of whether accounting for the value of the benefits is administratively impracticable."

https://www.irs.gov/pub/irs-wd/0219005.pdf

What about snacks in the breakroom all the time? – more …

IRS statements in CCA 201903017

- "According to the facts in this instance, Taxpayer provides snacks, such as _____, and beverages to all of its employees, contractors, and escorted guests. There's no indication in the facts provided that these snacks are offered in unusually large portions or are of unusually high value. Generally, quantifying the value consumed by each employee of these types of snacks that come in small, sometimes difficult to quantify portions and are stored in open-access areas is administratively impractical given the low value of each snack portion, even if the employer offers the snacks on a continual basis. Therefore, the value of the snacks Taxpayer furnishes to its employees is excludable from gross income as a de minimis fringe benefit under section 132(e)(1)."

Notice 2018-99 (12/10/18) – Calculating Disallowed Parking QTF

- Interim guidance for 2018 on reasonable methods to measure parking.
- If employer pays 3rd party for employee parking – that amount is the disallowed cost.
- "Until further guidance is issued, if a taxpayer owns or leases all or a portion of one or more parking facilities where its employees park, the §274(a)(4) disallowance may be calculated using any reasonable method. The methodology described in Steps 1-4 of this section B is deemed to be a reasonable method."
- Several examples are provided.
- https://www.irs.gov/pub/irs-drop/n-18-99.pdf

Notice 2018-99 - "Total Parking Expenses" Includes:

- repairs,
- maintenance,
- utility costs,
- insurance,
- property taxes,
- interest,
- snow and ice removal,
- leaf removal,
- trash removal,
- cleaning
- landscape costs (if on or in the parking location)
- parking lot attendant expenses,
- security,
- **rent or lease payments or a portion of a rent or lease payment (if not broken out separately).**

Depreciation is not considered a parking expense.

Cost, not Value

"Although the value of a QTF is relevant in determining exclusion under §132(f) and whether the §274(e)(2) exception applies, the deduction disallowed under §274(a)(4) relates to the expense of providing a QTF, not its value."

Using "value" as §274(a)(4) measure is not a reasonable method.

Notice 2018-99 Reasonable method offered

- Parking area owned or leased by taxpayer: 1st determine % of spaces reserved for employees. Expenses attributed to this % of parking costs are not deductible by employer.
- For the balance of spaces, employer determines primary purpose (over 50% usage) – customers or employees. If over 50% for customers, then no other disallowed parking expenses. If primary purpose is employee parking, employer next allocates a portion of the costs of these spaces to any that are reserved for customer use or for partners, sole proprietors, and 2% S corp shareholder use (this amount is deductible).
- Any reasonable method is used to allocate expenses of remainder of spaces between deductible customer use and non-deductible employee use based on normal business hours.
- Employers had until 3/31/19 to change number of spaces reserved for employees, if desired, with such change treated as made 1/1/18.

Research Credit Case – Is there 1984-1988 Data?

- *Quebe*, No. 3:15-cv-294 (SD OH 1/17/19)
  - S corp with 3 companies that design and develop electrical systems for large commercial buildings
  - Hired 3rd party to do research credit study for 2008-2011
  - 3rd party found qualified for research credit for 2009 and 2010
    - Amended returns
    - IRS issues the refunds of about $250K
    - Gov't sues in 2015 to get erroneous refund back
  - Gov't argues Quebe not entitled to start-up company fixed base percentage because one of the companies had gross receipts and QRE in base period 1984-1988

Quebe - continued

- Court – Q has burden of proof that it did not have GR and QRE in base period
  - Testimony of 3rd party not sufficient as they had no knowledge of that time period.
  - "Government has the ultimate burden of proving its claim, which it may do by proving that Defendants have not substantiated their right to the claimed tax benefit."
- Observations:
  - So, should be able to use 1984-1988 period, but
    - Might not have sufficient data to do so.
    - Might result in no research credit
  - Should be able to use alternative simplified credit method.
  - Generally, IRS audits research credit claims on amended returns.

Defining Qualified Research

- *Siemer Milling Co.*, TC Memo. 2019-37 (4/15/19)
  - Mills and sells wheat flour since the 1950s.
  - Claimed research credit for 2011 and 2012 based on studies done in 2014 by its long-time CPA firm.
  - Two key employees helped: VP Production and CFO who had been with company for decades.
  - Some contemporaneous records existed, but not all were dated or stated who the author was
  - 9 projects for which credit was claimed
  - IRS denied saying many requirements for the credit were not met
  - IRS won – court agreed that all 9 failed "process of experimentation" requirement

https://ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=11930

Siemer Milling Co. – cont'd

- 4 requirements for qualified research (§41(d))
  1. meets §174 definition of R&E
  2. undertaken for the purpose of discovering information technological in nature,
  3. undertaken for the purpose of discovering information the application of which is intended to be useful in the development of a new or improved business component, and
  4. substantially all (at least 80%) of the activities of which constitute elements of process of experimentation

  Court disagreed with IRS interpretation of tests 1-3 but agreed with 4 and found that none of the 9 projects met #4.

1. §174

- "Siemer could have faced the same uncertainties for several years in a row; not all uncertainties are neatly resolved within the confines of a single taxable year. There is no requirement under the statute or regulations that the taxpayer face different uncertainty each year, only that the taxpayer face uncertainty concerning "the development or improvement of a product" in the year for which he wishes to claim the credit."

2. Technological in nature

- "Nothing requires a taxpayer to employ or contract with someone with a specialized degree to prove that research relied on the physical or biological sciences, engineering, or computer science. While the degrees held by those conducting the research for which a credit is claimed may be a factor in determining whether the technological information test is satisfied, no specific set of degrees is required." The court also declined "to apply an adverse inference" where the IRS had not called any of S's employees to testify. Also, court noted that measuring bacteria in flour involves field of biology.

3. Business component

"At trial Mr. Tegeler described the projects as "processes that we worked with * * * to develop products." This description is not at odds with Siemer's representation on brief that each of the projects is "either process improvements, product improvements, or some combination of both." While inconsistency in the record may weigh against a party's credibility, we find that this particular turn of phrase does not bar Siemer from meeting its burden with respect to the business component test on each of the projects presented at trial. Commissioner argues that because several of the projects spanned several years, the business components to which they relate were not new during the years in issue. We also find this argument unpersuasive. Like uncertainties under the section 174 test, the development or improvement of a business component can span more than one tax year."

4. Process of experimentation

"While Siemer states that it engaged in a process of experimentation, there is little in the record to support this assertion. Even the credit studies for the years in issue, which were admitted to the record subject to the Commissioner's hearsay objections, included very little evidence of Siemer's asserted process of experimentation. Had Siemer been able to rely on the credit studies for the truth of the matter asserted, that would not have been enough to establish that Siemer had engaged in a process of experimentation." …

"Because Siemer has not shown that it engaged in a process of experimentation, it also cannot show that substantially all of the activities for which it claimed the credits were part of a process of experimentation. Consequently, where Siemer has not shown that it engaged in a process of experimentation to begin with, it has also not met the "substantially all" requirement of this test"

4. Process of experimentation - more

Court applied this test to all 9 projects and all failed.

Example – Hydration project

- Did not state the steps of the process.
- Did not explain how the process was scientific.
- "We have insufficient evidence in the record to conclude that Siemer had a "methodical plan involving a series of trials to test a hypothesis, analyze the data, refine the hypothesis, and retest the hypothesis so that it constitutes experimentation in the scientific sense."

Siemer Milling Co. – cont'd

- No credit allowed.
- No penalty – reasonable cause as relied on competent tax adviser.

- *Observations*:
  - Why wasn't research credit addressed each year when there appears to be a variety of research activity at S?
  - If all that was missing was a process of experimentation, was that just not documented well enough?
  - Note how IRS seems to prefer seeing folks with titles and/or degrees in science and engineering fields.

New Cryptocurrency Guidance – Rev. Rul. 2019-24 (10/9/19)

- Long-awaited as people had questions beyond Notice 2014-21 (March 2014) + new types of transactions post-2014 such as hard forks and airdrops
- Rev. Rul. 2019-24
- FAQs (non-binding)
- IR-2019-167
  - Links here - https://www.irs.gov/newsroom/virtual-currency-irs-issues-additional-guidance-on-tax-treatment-and-reminds-taxpayers-of-reporting-obligations

- Issues still remain with Notice 2014-21 and the new ruling.
- New question added to 2019 draft Schedule 1 of From 1040 – "At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?"

Author's website on virtual currency:
http://www.21stcenturytaxation.com/virtual-currency-and-tax.html

California AB 5 Broadening Use of ABC Worker Classification Test Enacted

- Signed into law 9/18/19
- Effective 1/1/20
- Adopts the 2018 California Supreme Court classification approach in *Dynamex* beyond wage orders (rather than the longstanding *Borello* approach (common law / economic realities)).
  - To apply under the CA Labor Code, Unemployment Insurance Code, and wage orders of Industrial Welfare Commission
- Worker presumed to be employee unless "hiring entity demonstrates" A, B & C -------→

https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201920200AB5

ABC Classification Test

Worker is employee unless "hiring entity" shows A,B & C met:

A. The person is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.
B. The person performs work that is outside the usual course of the hiring entity's business.
C. The person is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

AB 5 - more

- Several exceptions included.
- Generally, if exception applies, use the *Borello* factors (common law) rather than ABC.
- Read exceptions carefully
  - Wording and intent not always clear
  - Example: Enrolled Agents excepted, but several conditions must be satisfied for the exception to apply.
  - Check with labor law attorney for help with:
    - Is ABC test satisfied?
      - Yes – Contractor
      - No – See if an exception applies
        - No – Employee
        - Yes – likely requires application of *Borello* factors

AB 5 exemption example

- CPAs and attorneys:
  - " Subdivision (a) and the holding in Dynamex Operations West, Inc. v. Superior Court of Los Angeles (2018) 4 Cal.5th 903 (Dynamex), do not apply to the following occupations as defined in the paragraphs below, and instead, the determination of employee or independent contractor status for individuals in those occupations shall be governed by Borello.
    - (3) An individual who holds an active license from the State of California and is practicing one of the following recognized professions: lawyer, architect, engineer, private investigator, or accountant."

Observations on the CPA and attorney exceptions

- The active license has to be from the State of California.
- What is "practicing?"
  - No reference to any law.
  - Is an active rather than inactive license enough?
    - Likely not because then why add "practicing"?
      - See California Business & Professions Code and case law

Federal Tax Still Uses Common Law

- Possible after AB 5 that a worker is an employee for California but a contractor for federal.
- Cautions:
  - Be sure you aren't putting contractor into qualified plans as that may make them unqualified.
  - Avoid having worker complete W-4 and don't issue a W-2 or if do, file it only with the FTB and EDD.
  - FTB and EDD need to get guidance out and forms to enable the state only to get a W-2 or state equivalent.
    - NOTE: AB 5 doesn't state that it applies for California Revenue & Taxation Code.
      - FTB's 7/11/19 analysis noted this, but not included in FTB's final analysis.
        - 7/11 Analysis: "This bill does not specify its intention regarding whether the classification of an individual as an employee would also apply for income and corporate franchise tax purposes under the Revenue and Taxation Code (R&TC). For clarity and ease of administration, it is recommended that the bill be amended."
        - https://www.ftb.ca.gov/tax-pros/law/legislation/2019-2020/AB5-032119-050119-052419-071119.pdf
        - https://www.ftb.ca.gov/tax-pros/law/legislation/2019-2020/AB5.pdf

EDD Form DE-4

Employment Development Department
State of California

https://www.edd.ca.gov/pdf_pub_ctr/de4.pdf

EMPLOYEE'S WITHHOLDING ALLOWANCE CERTIFICATE

Type or Print Your Full Name	Your Social Security Number
Home Address (Number and Street or Rural Route)	Filing Status Withholding Allowances ☐ SINGLE or MARRIED (with two or more incomes) ☐ MARRIED (one income) ☐ HEAD OF HOUSEHOLD
City, State, and ZIP Code	

1. Number of allowances for Regular Withholding Allowances, Worksheet A — 0
   Number of allowances from the Estimated Deductions, Worksheet B — 0
   Total Number of Allowances (A + B) when using the California Withholding Schedules for 2019 — 0
   OR
2. Additional amount of state income tax to be withheld each pay period (if employer agrees), Worksheet C
   OR
3. I certify under penalty of perjury that I am not subject to California withholding. I meet the conditions set forth under the Service Member Civil Relief Act, as amended by the Military Spouses Residency Relief Act. (Check box here) ☐

Under the penalties of perjury, I certify that the number of withholding allowances claimed on this certificate does not exceed the number to which I am entitled or, if claiming exemption from withholding, that I am entitled to claim the exempt status.

Signature _____ Date _____

Instructions imply only use DE-4 along with W-4 if worker wants different CA withholding – EDD will need to update - https://www.edd.ca.gov/pdf_pub_ctr/de71.pdf

EDD Will Need to Create a California only W-2

Don't file W-2 with IRS and SSA if the worker is a contractor for federal purposes.

Query: Who explains all of this to the worker?

More on ABC from the *Dynamex* Case

- *Dynamex Operations West, Inc. v. Superior Court*, S222732 (CA S Ct., 4/30/18)
  - Court applied ABC test on issue involving California wage orders, rather than *Borello* factors.
  - Per footnote 3: "In California, wage orders are constitutionally-authorized, quasi-legislative regulations that have the force of law."

https://www.courts.ca.gov/opinions/archive/S222732.PDF

More on *Dynamex* and wage orders from California Dept. Of Industrial Relations – see 5/3/19 memo - https://www.dir.ca.gov/dlse/opinions/2019-05-03.pdf

Part A: Is the worker free from the control and direction of the hiring entity in the performance of the work, both under the contract for the performance of the work and in fact?

"as under *Borello*, … depending on the nature of the work and overall arrangement between the parties, a business need not control the precise manner or details of the work in order to be found to have maintained the necessary control that an employer ordinarily possesses over its employees, but does not possess over a genuine independent contractor. The hiring entity must establish that the worker is free of such control to satisfy part A of the test."

Observation: Seems if are a contractor under common law and Borello factors, meet A.

Part B: Does the worker perform work that is outside the usual course of the hiring entity's business?

"Workers whose roles are most clearly comparable to those of employees include individuals whose services are provided within the usual course of the business of the entity for which the work is performed and thus who would ordinarily be viewed by others as working in the hiring entity's business and not as working, instead, in the worker's own independent business. …

Accordingly, a hiring entity must establish that the worker performs work that is outside the usual course of its business in order to satisfy part B of the ABC test.[29]"

Observation: This is likely the challenging one for many employers and workers to meet both in fact and in interpretation.

For example, what exactly is the work of a textbook publishing company? Does that include authors and editors that produce content?

Footnote 29 on "B"

- *McPherson Timberlands v. Unemployment Ins. Comm'n* (Me. 1998) 714 A.2d 818 – worker hired to cut and harvest timber. Found to be in usual course of M's timber mgmt. company even though M did not own any harvesting equipment. Per court, the work was an integral part of M's business rather than merely incidental to it.
- *Great N. Constr., Inc. v. Dept. of Labor*, 161 A.3d at page 1215 – specialized historic restoration work done by worker was outside of usual course of general construction company's business. Worker needed special equipment and expertise that G did not have or usually need for most of its work.
- See footnote 29 for a few more cases, plus text of decision + other ABC decisions.

Part C: Is the worker customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity?

"C - As a matter of common usage, the term "independent contractor," when applied to an individual worker, ordinarily has been understood to refer to an individual who independently has made the decision to go into business for himself or herself. … Such an individual generally takes the usual steps to establish and promote his or her independent business —for example, through incorporation, licensure, advertisements, routine offerings to provide the services of the independent business to the public or to a number of potential customers, and the like. When a worker has not independently decided to engage in an independently established business but instead is simply designated an independent contractor by the unilateral action of a hiring entity, there is a substantial risk that the hiring business is attempting to evade the demands of an applicable wage order through misclassification. A company that labels as independent contractors a class of workers who are not engaged in an independently established business in order to enable the company to obtain the economic advantages that flow from avoiding the financial obligations that a wage order imposes on employers unquestionably violates the fundamental purposes of the wage order. The fact that a company has not prohibited or prevented a worker rom engaging in such a business is not sufficient to establish that the worker has independently made the decision to go into business for himself or herself.

Accordingly, in order to satisfy part C of the ABC test, the hiring entity must prove that the worker is customarily engaged in an independently established trade, occupation, or business."

Observations: Employer needs to look for evidence that the worker has his own business. Perhaps look for website, business cards, business license, owns necessary equipment, has other customers, etc.

Footnote 30 – "Courts in other states that apply the ABC test have held that the fact that the hiring business *permits* a worker to engage in similar activities for other businesses is not sufficient to demonstrate that the worker is "'customarily engaged in an independently established . . . business'" for purposes of part (C) of that standard."

In contrast …

In 2018, 7 states enacted laws to treat platform workers (marketplace contractors) as independent contractors.

- Florida (HB 7087), Indiana (HB 1286), Iowa (SF 2257), Kentucky (HB 220), Tennessee (HB 1978), Utah (HB 364).
  - Example: https://www.legis.iowa.gov/legislation/BillBook?ga=87&ba=SF2257

Texas Workforce Commission similar in 2019

- https://www.sos.state.tx.us/texreg/archive/April262019/Adopted%20Rules/40.SOCIAL%20SERVICES%20AND%20ASSISTANCE.html

1. A marketplace contractor shall be treated as an independent contractor, and not an employee of a marketplace platform, for all purposes under state or local law, including but not limited to chapters 87 and 96, if the following conditions are met:

a. The marketplace contractor and marketplace platform agree in writing that the marketplace contractor is engaged as an independent contractor and not an employee of the marketplace platform.

b. The marketplace platform does not unilaterally prescribe specific hours during which the marketplace contractor must be available to accept service requests submitted through the marketplace platform's digital network.

c. The marketplace platform does not prohibit the marketplace contractor from engaging in outside employment or performing services through other marketplace platforms.

d. The marketplace contractor bears its own expenses incurred in performing services.

What is the best model?

- AB 5 states: "It is also the intent of the Legislature in enacting this act to ensure workers who are currently exploited by being misclassified as independent contractors instead of recognized as employees have the basic rights and protections they deserve under the law, including a minimum wage, workers' compensation if they are injured on the job, unemployment insurance, paid sick leave, and paid family leave. By codifying the California Supreme Court's landmark, unanimous Dynamex decision, this act restores these important protections to potentially several million workers who have been denied these basic workplace rights that all employees are entitled to under the law."
- Observations: Will AB address this?
  - Maybe
  - But many platform workers work < 10 hours per week and for only a few months.
    - Will an employer want to hire that person as an employee?
  - Will wages be greater than minimum wage? Will benefits beyond FUTA, minimum wage, overtime and FICA/HI be provided?
  - What about low paid employees including gov't employees who work part time and even with long unpaid breaks (for example, school crossing guards) – where are the laws to help these workers?

California AB 5 – To Do List For Any Employer with a California Contractor

- Read AB 5
- Determine if ABC test met
- If not met, see if any exception applies
- If worker no longer a contractor, determine what you plan to do after 2019 (keep person and reclassify as employee (and consider if want to exercise control over them and make them employee for federal purposes too), stop using that person's services, change your operations is enables meeting ABC test, something else?)
  - If employee for CA but contractor for federal, see if DE-4 works for figuring CA withholding. Watch for guidance from EDD and FTB.
    - https://www.edd.ca.gov/pdf_pub_ctr/de4.pdf
    - Also likely need EDD form for when *employee* hired:
      - DE 43 - https://www.edd.ca.gov/pdf_pub_ctr/de34.pdf
- If still a contractor under AB 5, need new documentation to show that (that either meet ABC test or an exception).
- Consult with attorney familiar with CA Labor Code.

Wayfair and its Aftermath

South Dakota v. Wayfair, 138 S.Ct. 2080 (2018)

- The U.S. Supreme Court issued its decision in *Wayfair* on June 21, 2018 overturning *Quill* and prior US Supreme Court precedent.
- The Court considered whether South Dakota's S.B. 106 established nexus against remote sellers with $100,000 in annual gross revenue from sales delivered to the State or 200 separate transactions delivered to the State violated *Quill* and the Commerce Clause.
- In its decision, the Court held:
  - *Quill* was "unsound and incorrect."
  - It established a new test that is more or less parallel to the Due Process Clause.
  - New test for sales and use tax nexus is "**economic or virtual**" presence.

State Reactions to *Wayfair*

Adoption of South Dakota – Style Thresholds*

Updated July 22, 2019

• **AL** – 10/1/2018 -- $250K plus an activity in Ala. Code § 40-23-68(b) • **AR** – 7/1/2019 • **AZ** – 9/30/2019 -- $100K[1] • **CA** – 4/1/2019 -- $500K • **CO**[2] – 6/1/2019 -- $100K • **CT** – 12/1/2018 -- $250K & 200 ($100K/200 beg. 7/1/2019) • **DC** – 1/1/2019 • **FL** – S.B. 1112** • **GA** – 1/1/2019 -- $250K/200 (collect or report); ($100K/200 beg. Jan. 1, 2020) • **HI** – 7/1/2018	• **ID** – 6/1/2019 -- $100K • **IL** – 10/1/2018 • **IN** – 10/1/2018 • **IA** – 1/1/2019; 7/1/2019 --$100K • **KS** – H.B. 2352/S.B. 22 -- $100K** • **KY** – 10/1/2018 • **LA** – 7/1/2020 • **MA** – 10/1/2017 -- $500K & 100 • **MD** – 10/1/18 • **ME** – 7/1/18 • **MI** – 10/1/2018 • **MN** – 10/1/2018 -- $100K in 10 transactions/100 transactions ($100K/100 beg. 10/1/2019)	• **MO** – S.B. 189/H.B. 701/H.B. 548** • **MS** – 9/1/2018 -- $250K plus systematic solicitation • **NC** – 11/1/2018 • **ND** – 10/1/2018; 1/1/2019 --$100K • **NE** – 1/1/2019 • **NJ** – 11/1/2018 • **NM** – 7/1/2019 -- $100K • **NV** – 10/1/2018 • **NY** – 6/21/2018 -- $500K & 100 • **OH** – 7/18/2019 • **OK** – 07/01/2018 -- $10K (collect/notice); 11/1/2019 -- $100K • **PA** – 4/1/2018 -- $10K (collect/notice); 07/1/2019 -- $100K	• **RI**[3] – 8/17/2017 • **SC** – 11/1/2018 -- $100,000 (includes marketplace sales) • **SD** – 11/1/2018 • **TN** – 7/1/2019 --$500K • **TX** – 10/1/2019 -- $500K • **UT** – 1/1/2019 • **VA** – 7/1/2019 • **VT** – 7/1/2018 • **WA**[4] – 10/1/2018 • **WI** – 10/1/2018 • **WV** – 1/1/2019 • **WY** – 2/1/2019

***Unless otherwise noted, states adopt South Dakota style threshold of $100,000/200**

****State "doing business" statute applies to the extent allowed under the US Constitution**

[1] The threshold is $200,000 for 2019, $150,000 for 2020, and $100,000 beginning in 2021 and beyond.
[2] Effective December 1, 2018 with grace period until May 31, 2019 for collection requirement (not for notice requirement); threshold from December 1, 2018 to April 13, 2019 was $100K/200.
[3] Collection/notice requirements until June 30, 2019; collection requirement after July 1, 2019.
[4] Collection required for $100K/200 threshold from October 1, 2018 to December 31, 2019; $100K threshold effective March 14, 2019.

Thresholds – Kansas

- Kansas Notice 19-04 issued August 1, 2019 was supposed to take effect October 1, 2019, had no sales thresholds.
  - Remote Sellers who are not already registered with the Kansas DOR must register and begin collecting and remitting sales and/or use tax by October 1, 2019.
- Kansas Attorney General Schmidt on September 30, 2019 issued Opinion 2019 -8 which basically offered legal opinion nullifying Notice 19-04. AG's Synopsis noted that:
  - Kansas has no legally adopted standard by which the Department of Revenue may comply with the command of KSA 79-3702(h)(1)(F) that the statute be applied only to those retailers required "to collect and remit tax under the provisions of the constitution and laws of the United States". The Department's new policy interpreting the scope of KSA 79-3702(h)(1)(F) as described in Notice 19-04, is of no force or legal effect because it was not lawfully adopted in compliance with Kansas law.

Thresholds – Kansas Cont.

- Kansas Revenue Secretary Mark Burghart says the department "cannot select which laws it enforces." In his response to the AG's opinion, Mr. Burghart explained that "Kansas statutes are presumed to be constitutional, and unless deemed otherwise by a court of competent jurisdiction, the Department is obligated to enforce the statutes enacted by the Legislature."
- According to Secretary Burghart, more than 3,200 out-of-state retailers have registered to collect and remit Kansas sales and use tax since the June 2018 Wayfair decision. Close to 600 of those did so after the department published Notice 19-04.

Thresholds (Nontaxable v. Resale v. All)

- Illinois provides that as part of the threshold determination, a remote seller must exclude sales for resale.
- In New Jersey, a remote seller that is over the economic threshold, but only makes sales that are for resale or otherwise nontaxable must register, but may request to be placed on a non-reporting basis for Sales Tax. In order to be placed on a non-reporting basis for Sales Tax purposes, Form C-6205-ST, Request to Be Placed on a Non-Reporting Basis, must be completed and mailed to the Division of Revenue and Enterprise Services.

Administration – (When to File)

- Colorado – The first day of the month after the ninetieth day the retailer made retail sales in the current calendar year that exceed $100,000.
- North Carolina – Sixty days after a remote seller meets the threshold.
- Texas – The first day of the fourth month after the month in which the seller exceeded the safe harbor threshold.

Wayfair Impact on Income Taxes

- Several states have adopted economic thresholds for corporate income tax purposes post-*Wayfair*
  - Oregon
    - Has a statutory factor presence standard for its new gross receipts tax
  - Hawaii
    - Recently enacted statute that provides a sales threshold based on $100,000 or more in annual gross receipts or 200 or more annual transactions in the state
  - Massachusetts
    - Recently finalized a regulation that presumes an out-of-state corporation is subject to the corporate excise tax if sales in the state exceed $500,000
  - Pennsylvania
    - Recently released guidance setting forth a rebuttable presumption for corporate net income tax based on an annual $500,000 threshold
  - Washington
    - Recently enacted a statute that reduced the economic nexus threshold for the B&O tax to $100,000 in annual gross receipts
  - Texas
    - The Comptroller has released proposed regulations that would apply a franchise tax nexus threshold of $500,000 in annual receipts

Marketplace Collection – The Next Frontier

Marketplace Collection – Pre-*Wayfair*

- Before *Wayfair*, states targeted marketplaces because they were unable to require remote sellers without a physical presence to collect and remit sales/use tax.
- Even if a third-party seller had a collection and remittance obligation, compliance and enforcement are challenging, especially for smaller sellers.
- Some of the pre-*Wayfair* laws contained a notice and reporting requirements option in order to avoid violating *Quill.*

Marketplace Collection – Post-*Wayfair*

- With the overturn of *Quill*, states are no longer restricted in pursuing remote sellers for sales tax collection.
- However, states have not slowed interest in requiring marketplaces to collect tax in lieu of remote sellers.
- The pace of marketplace legislation in 2019 has increased dramatically.
- States eye administrative ease of enforcing collection and remittance obligations on less entities.

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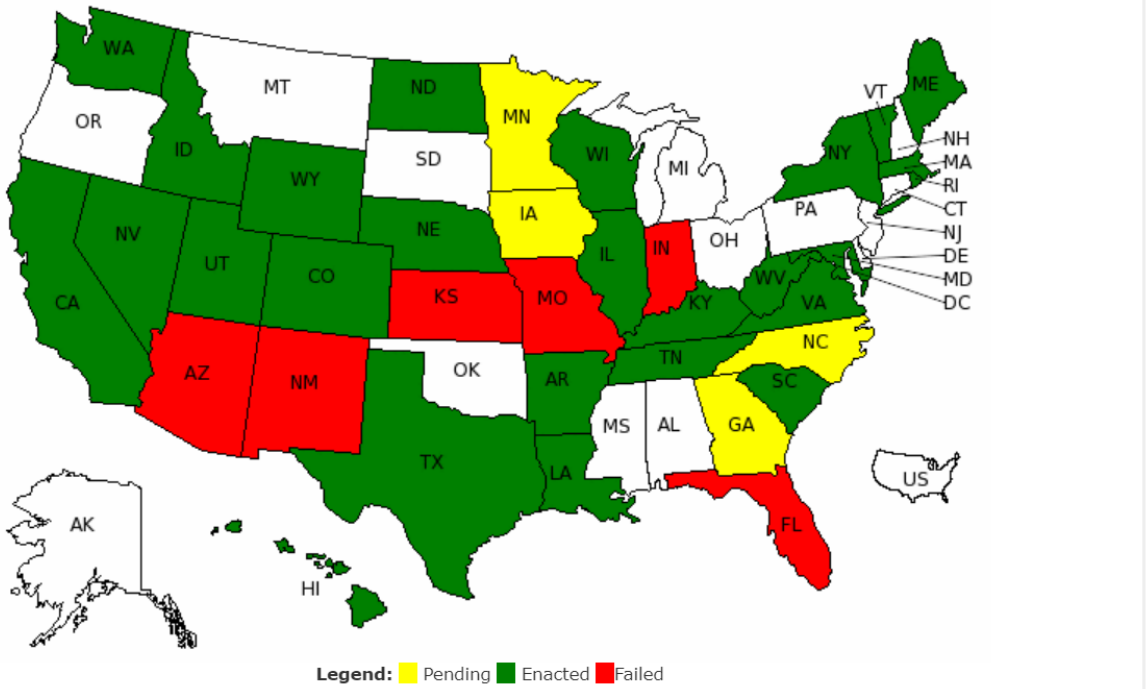
Marketplace Facilitator Laws



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Marketplace Collection – Post-*Wayfair*

- Marketplace collection laws generally contain the following provisions:
  - Require marketplaces to collect and remit sales tax on behalf of marketplace sellers.
  - Require marketplaces to report and remit sales tax collected on the marketplaces' sales tax return.
  - Audit of marketplaces for sales tax collected on marketplace seller sales.
  - Provide marketplaces some relief if the marketplace incorrectly determines taxability based on information provided by marketplace sellers.
  - Provide marketplaces some relief from liability – subject to certain annual caps – for failure to collect sales tax.
  - Limit class action lawsuits against marketplaces for over collection of sales tax.

Marketplace Collection Laws – Broad Definition (e.g. New Jersey)

- A "marketplace facilitator" is a person who facilitates taxable retail sales by satisfying both (1) and (2) (summarized below):
  1. Either:
     - Lists, makes available, or advertises property, products or services for sales by a marketplace seller;
     - Facilitates the sales of marketplace sellers' products; **OR**
     - Provides or offers fulfillment or storage services for marketplace sellers, **AND**
  2. Either:
     - Collects the sales price of taxable merchandise or products;
     - Provides payment processing services;
     - Charges, collects, or otherwise receives selling fees, listing fees, referral fees, closing fees, fees for inserting or making available taxable products;
     - Collects payment and transmits it to the seller through an arrangement with a third party; **OR**
     - Provides virtual currency that purchasers may or are required to use.

Marketplace Collection Laws – Narrow Definition (e.g. Pennsylvania)

- A "marketplace facilitator" is a person that "facilitates the sale at retail of tangible personal property. For purposes of this section, a person facilitates a sale at retail if the person or an affiliated person:
  1. lists or advertises tangible personal property for sale at retail in any forum; and
  2. either directly or indirectly through agreements or arrangements with third parties, collects the payment from the purchaser and transmits the payment to the person selling the property.

Marketplace Collection Laws – Additional Considerations

- A number of questions surround marketplace collection requirements:
  - Industry carve-outs
  - Waivers for in-state sellers?
  - Requirements limited to Sales & Use Tax?
  - Protections for sellers whose collection responsibilities have been ceded to marketplace facilitators?
  - Additional vendor compensation for marketplace facilitators?
  - Do *Wayfair* type thresholds apply to marketplace facilitators?
  - Do sales on a marketplace count towards the threshold?
  - Who is in the better position to collect and remit taxes?
  - What are the contractual realities between marketplace facilitators and third-party sellers?

Marketplace Facilitator Laws – MTC & NCSL Activity

- **MTC** has announced it will reinitiate discussions with the states on marketplace facilitator laws.
  - Still unlikely to come out with model legislation
- **NCSL SALT Taskforce** is reviewing RILA model
  - Can consensus be reached that current state laws need revised to more uniformly address these issues?
  - Will MTC endorse certain concepts to provide guidance to states looking at clarifying existing laws?

New York – Marketplace Operators are Vendors

Advisory Opinion, TSB A 19(1)S (N.Y.S. Dep't of Taxation & Fin., Mar. 7, 2019, released Mar. 8, 2019)

- The New York Department of Taxation and Finance determined that an online marketplace operator that facilitates taxable software sales is a "vendor" liable to collect sales tax.
- The Department relied on a rarely-used portion of the definition of "vendor," which states that "when in the opinion of the commissioner it is necessary for the efficient administration of [the sales tax law] to treat any salesman, representative, peddler or canvasser as the agent of the vendor . . . the commissioner may, in his discretion, treat such agent as the vendor jointly responsible . . . for the collection and payment of the tax."

Louisiana – Online Marketplace Required to Collect

Normand v. Wal-Mart.com USA LLC, No. 18-CA-211 (La. Ct. App. Dec. 27, 2018)

- The Fifth Circuit Louisiana Court of Appeals affirmed a trial court judgment holding Walmart.com liable for approximately $1.8 million in unpaid taxes on sales made by third parties on Walmart.com's online marketplace, finding the trial court correctly determined the legislative intent was clear and statute was unambiguous.
  - The trial court found Walmart.com was liable as a "dealer" within the meaning of La. R.S. 47:301(4)(1) because providing the marketplace constituted "regular or systematic solicitation of a consumer market."
- Walmart.com argued it was not a "dealer" because it never had title or possession of the property being sold.
- Walmart.com also argued that the parish imposes a discriminatory tax on electronic commerce that violates federal Internet Tax Freedom Act ("ITFA") because the Collector does not require operators of similar offline marketplaces to collect local sales taxes.
  - For example, the owner of a shopping mall is not required to collect tax when a store that leases space in the mall makes a sale to its customer.
  - Nor is a newspaper required to collect tax when a seller advertising in the classified ads section makes a sale to a customer.
- Walmart.com petition for writ of review was accepted by the Louisiana Supreme Court – oral argument scheduled for September 4, 2019 was delayed – rescheduled to October 22, 2019.

Delaware – Class Action on Food Delivery

Moore v. DoorDash, Inc., No. 1:19-cv-00636-UNA (D. Del. Apr. 5, 2019)

- Plaintiffs brought a class action against DoorDash alleging that the company unlawfully collected sales tax from customers located in states that do not have a sales tax on prepared food, i.e., Delaware, New Hampshire and Montana.
  - The complaint notes that Oregon and Alaska also do not have sales tax on prepared food and it appears that DoorDash does not charge sales tax to Oregon and Alaska customers.
- Doordash operates an app that allows customers to order food from local restaurants and have it delivered by the company's "dashers."
- The price charged to customers includes the cost of the meal, a service fee, a delivery fee, an optional driver tip, and sales tax.
- Increased potential for False Claims Act suits in the *Post-Wayfair* world.

Little Rock – Lawsuit Against Uber Eats

Little Rock Advertising and Promotion Commission v. Portier LLC D/B/A Uber Eats, Dock. No. 60CV-19-1865 (Pulaski Cty. Cir. Ct.)

- On Mar. 19, 2019, the City of Little Rock Advertising and Promotion Commission filed a complaint against Uber Eats for failure to collect city tax on restaurant gross receipts.
- On May 13, 2019, Uber Eats filed a motion to dismiss, claiming that imposition of the tax on the marketplace results in double-taxation and that the DFA has held that platforms such as Uber Eats are operating as couriers and therefore not responsible for collecting the appropriate taxes.
- On July 18, 2019, the Pulaski County Circuit Court granted Uber Eats' motion to dismiss.

South Carolina – Amazon ALJ Ruling

Amazon Services LLC v. Department of Revenue, Dock. No. 17-ALJ-17-0238-CC (S.C. Admin. Law Ct. Sept. 10, 2019)

- The S.C. DOR argued that Amazon Services, like a consignment store or auction house, is the retailer legally liable for taxes on 3rd-party sales made into the state through its online marketplace.
- ALJ found that the most important consideration is who accepts money in exchange for the product at the point of sale and that "Amazon Services completely controls the point of sale".
- Without Amazon Services collecting the sales tax at the point of sale, the ALJ found that it is unlikely the tax would ever be collected.

Digital Goods – Expanding the Tax Base

Consumer Digital Goods

Overview

- Sellers of retail consumer digital products, including music, movies, books, and software-related products like video games.
- Digital retailers sell products under various channels, terms, and conditions.
  - Delivery methods: streaming or cloud-based, downloads, or combination thereof
  - Rights of use transferred: permanent rights of use (purchases)or less than permanent (rentals)
  - Payment streams: A la carte (one-time) payment, subscription
- Limited store fronts, but may have brick-and-mortar affiliates.
- Content creators (e.g., movie studios) have begun selling direct-to-consumer.

Consumer Digital Goods
Sales Tax Issues

- **Characterization of Transaction**
  - "Products transferred electronically" or "specified digital products"
  - Tangible personal property
  - Taxable services
- **Tax Consequences of Characterization (or Mischaracterization)**
  - Bundled Transactions
  - Sourcing
  - Exemption Certificate Issues
  - Trials or "free samples" and use tax accrual
- **…and Non-Tax Consequences**
  - Communications service provider
  - False Claims Acts/Qui Tam
  - Class actions

Highlight on the District of Columbia
B22-1070, the Internet Sales Tax Emergency Amendment Act of 2018

- As of January 1, 2019, the District of Columbia now subjects digital goods to the 6% sales tax rate.
- Includes digital books, digital audio books, digital music downloads and streaming, digital video downloads, and streaming video services electronically or digitally delivered, streamed, or accessed and whether purchased singly, by subscription, or in any other manner.
- The District already imposed sales tax on applications, software, digital news, and digital periodicals under separate imposition statutes.
- As noted by the Office of Tax and Revenue in Notice 2019-01, the Emergency Act does not change the District's taxation of software.

Other Proposed Digital Goods Taxation

Arizona (S.B. 1460)	•Creates a TPT classification for digital goods. •TPT imposed on prewritten software and specified digital goods. •Exempts digital services.
Connecticut (H.B. 7410/S.B. 877)	•Expands the tax base to additional services and digital goods.
Kansas (H.B. 2352)	•Imposes sales tax on digital audio-visual works, digital audio works, digital books, digital code and digital property.
Maryland (H.B. 426)	•Imposes sales tax on digital products, which includes digital music, digital video, e-books, and e-periodicals, and the sale of digital code. •Use tax also would apply to the use of digital products, but not the use of digital codes.
Nevada (A.B. 447)	•Imposes a broad excise tax on retail sales of specified digital products, effective January 1, 2020. •Creates an entirely new section of the code rather than expand the sales and use tax laws.
Oklahoma (H.B. 2531)	•Imposes sales tax on digital products to end users including digital audio-visual works, digital audio works and digital books transferred electronically.
Rhode Island (H.B. 5151)	•Imposes sales tax on specified digital products. (Enacted July 5, 2019).

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Highlight on Washington
B&O Tax Surcharge Enacted

H.B. 2158 imposes a three-tiered surcharge to the B&O tax:

- 20% B&O surcharge on the income from 44 categories of services and activities, including, among others, financial services, insurance carriers, software services, online marketplaces, telecommunications services, electricity generators, and many others;
- 33.33% percent B&O surcharge on the service income of "advanced computing businesses" with gross revenue between $25 to $100 billion; and
- 66.67% B&O surcharge on advanced computing businesses with revenue of more than $100 billion.

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Indirect Tax Case Developments - Software

Sales Taxation of Software

- ***Petitioner v. Texas Comptroller of Public Accounts*, SOAH Docket No. 04-19-3723.26** (July 19, 2019)
  - The Texas Comptroller issued a final Comptroller Decision finding that a company owed sales tax on its sales of online gaming services to Texas residents.
  - The company, who had at least one employee in Texas, developed and maintained online interactive social gaming experiences for its registered users, including those allowing for the adoption of virtual pets. The Comptroller determined that the company had sufficient nexus with the state and that the company provided taxable amusement services in Texas because in-state residents used its website services.
  - The Comptroller rejected the company's argument that its services were provided at its out-of-state headquarters, and not where the Texas residents used the service.
  - The Comptroller ruled that an electronic game amusement service transaction "is consummated where the amusement service is provided or delivered, not at the seller's place of business," and that the company provided taxable amusement services in Texas.

Sales Taxation of Software – Manufacturing Exemption?

- ***Texas: Previous Pending Administrative Hearing Nos. 110,988 & 114,584***
  - Petitioner sells a massive online multiple player game.
  - The Hearings Division took the position that the taxpayer was selling amusement services and therefore could not qualify for the manufacturing exemption for software and equipment used to write the game under Texas Tax Code 151.318.
  - Hearings took this position even though software is defined under the Texas Tax code as being tangible personal property and had allowed other software manufacturers to qualify for the manufacturing exemption.
  - Case settled.

Sales Taxation of Software – Chicago

- ***Labell v. City of Chicago, 2019, IL App (1st) 181379***
  - On September 30, 2019, the Illinois Appellate Court upheld the City of Chicago's imposition of its amusement tax on streaming video, streaming audio and online gaming services.
  - A group of Chicago Streaming services customers sued asserted the amusement tax (1) exceed Chicago's home rule authority (2) violated the uniformity clause of the Illinois Constitution (3) violated the ITFA.
  - The court rejected all arguments the most interesting of which was the determination that ITFA and uniformity clause did not apply because it was not established that streaming services were different than live performances which were exempt.

Sales Taxation of Software – Utah

- **Utah Tax Commission, Private Letter Ruling 18-002 (April 10, 2019)**
  - The Utah Tax Commission issued a private letter ruling to a video streaming provider ("Taxpayer") finding that the Taxpayer's sales of subscriptions entitling subscribers to enhanced features on the Taxpayer's streaming platform, are not subject to sales and use tax.
  - On its internet-based platform, the Taxpayer provides a free video streaming service. The Taxpayer also sells subscriptions to its platform allowing subscribers to have access to chat functions and save videos without ads.
  - The Commission determined the subscriptions were not taxable given none of the additional services provided through a subscription are separately subject to Utah sales and use tax. The Commission focused on the "essence of the transaction" doctrine to find that even though some of the transactions involved use of the Taxpayer's software and hardware, the Taxpayer was not selling prewritten computer software or tangible personal property to its subscribers.

Sales Taxation of Software – Alabama

- ***Ex parte Russell County Community Hospital LLC v. Dep't of Revenue*** (Alabama May 2019)
  - The Alabama Supreme Court ("Court") on May 19 determined all software is taxable tangible personal property, regardless of whether it is custom or canned software.
  - Denied refund claim for sales tax paid on software purchased and then customized by the seller for a hospital's specific needs.
  - The Court, however, noted, separately stated and invoiced charges for services rendered that "accompany the conveyance of software," including customization and implementation services, are nontaxable.
  - "The pertinent distinction," the Court said, "is how the transaction is documented and invoiced, and that is left strictly in the hands of the seller and purchaser."

Sales Taxation of Software

- ***Citrix Systems, Inc. v. Commissioner of Revenue***, ATB Dkt Nos. C321160, C325421 (Massachusetts, Nov. 2, 2018)
  - Subscription fee charges for use of remote-desktop access services were held to be sales of software subject to sales/use tax.
  - While the Massachusetts statute taxes only "transfers" of standardized software, the Massachusetts Appellate Tax Board ("ATB") followed the Commissioner's regulation in deeming the remote access of vendor-hosted software to be transfers.
  - The ATB concluded that the "true object" of the transaction was to sell the right to use Citrix's prewritten software, and not to provide a service, notwithstanding the fact that Citrix's:
    - On-line products could not function without the services of numerous employees, who operate and maintain the systems;
    - Employees view the company as a provider of services and not software; and
    - Sales agreements and marketing materials refer to the online products as "services".

Sales Taxation of Software – MPUs

- ***Oracle USA, Inc. et al. v. Commissioner of Revenue***, ATB Docket Nos. C318441, C318442, and C327798 (Massachusetts, Rule 33 Order dated May 25, 2019, reversing decision dated May 22, 2017)
  - Vendors sought sales tax refunds on behalf of Massachusetts-based customers who purchased software for use in multiple states.
  - In a 2017 decision, the Massachusetts Appellate Tax Board ("ATB") initially ruled in favor of the Commissioner, who argued that unless the seller obtains a Multiple Points of Use ("MPU") certificate on or before the date the sale is reported for sales tax purposes, no refund is available and sales tax is due on the entire purchase, regardless of where the software is used.
  - In 2019, the ATB issue an order on its own initiative reversing its earlier decision, and allowing the refund with respect to software used outside Massachusetts. The ATB noted that nothing in the statute or regulation bars taxpayers from establishing multiple points of use at a later date.

Texas Data Processing Update

- Statutory definition of "data processing service" was enacted in 1987.
- ***Hegar v. CheckFree Services Corp***. – The taxpayer provided payment processing services. While the services had components of data processing, the essence of the transactions was a bill pay services that involved numerous professionals with specials skills and the essence of the transaction was the purchase of bill payment services – data processing was only "ancillary" to the provision of that service.
- Agency is taking a hardline in response to *Checkfree* – declining to follow the case unless the facts are exactly the same.
- ***Instill Corp. v. Hegar*** – Taxpayer's creating of online management solutions by gathering raw data from customers and customers' vendors and using algorithms to process and present the data in a user-friendly manner that customers could access via a secure website constituted taxable data processing. The facts were distinguishable from *CheckFree* because Instill's data processing was not "ancillary" to its provision of other professional services, and the essence of the transactions was the conveyance of data processing services.
- In a very recent Comptroller Hearing (not yet published), the Comptroller determined that Interactive Voice Response Services, previously characterized by the agency as nontaxable virtual call center services, were taxable as data processing despite evidence that (1) the taxpayer's service was to provide a platform for the routing of electronic information between its clients and those clients' customers, (2) no information was stored on the taxpayer's servers, and (3) the information remained in a digital format throughout.

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Overview of State Tax Conformity with the Tax Cuts and Jobs Act

The Unintended Consequences of State Conformity with the Tax Cuts and Jobs Act (TCJA)

- **Potential Impact of the TCJA on Corporations:**
  - A federal corporate tax cut of about 10%.
  - A state corporate tax increase of about 12% (assuming conformity with TCJA based on pre-federal tax reform (FTR) linkage to IRC).
    - State Tax Research Institute (STRI) March 2018 study, "The Impact of Federal Tax Reform on State Corporate Income Taxes".
- The state outcome is **inadvertent and arbitrary**.
- **Biggest potential state corporate tax increases**
  - IRC §965 repatriation tax: generally 1 to 4 percent
  - GILTI (IRC §951A): 5.5 percent (or 2.9 percent with IRC §250 deduction)
  - IRC §163(j) interest expense limitation: 6.4 percent
- **The general absence of state regulatory guidance on key TCJA provisions well into the 2018 filing season is troubling.**

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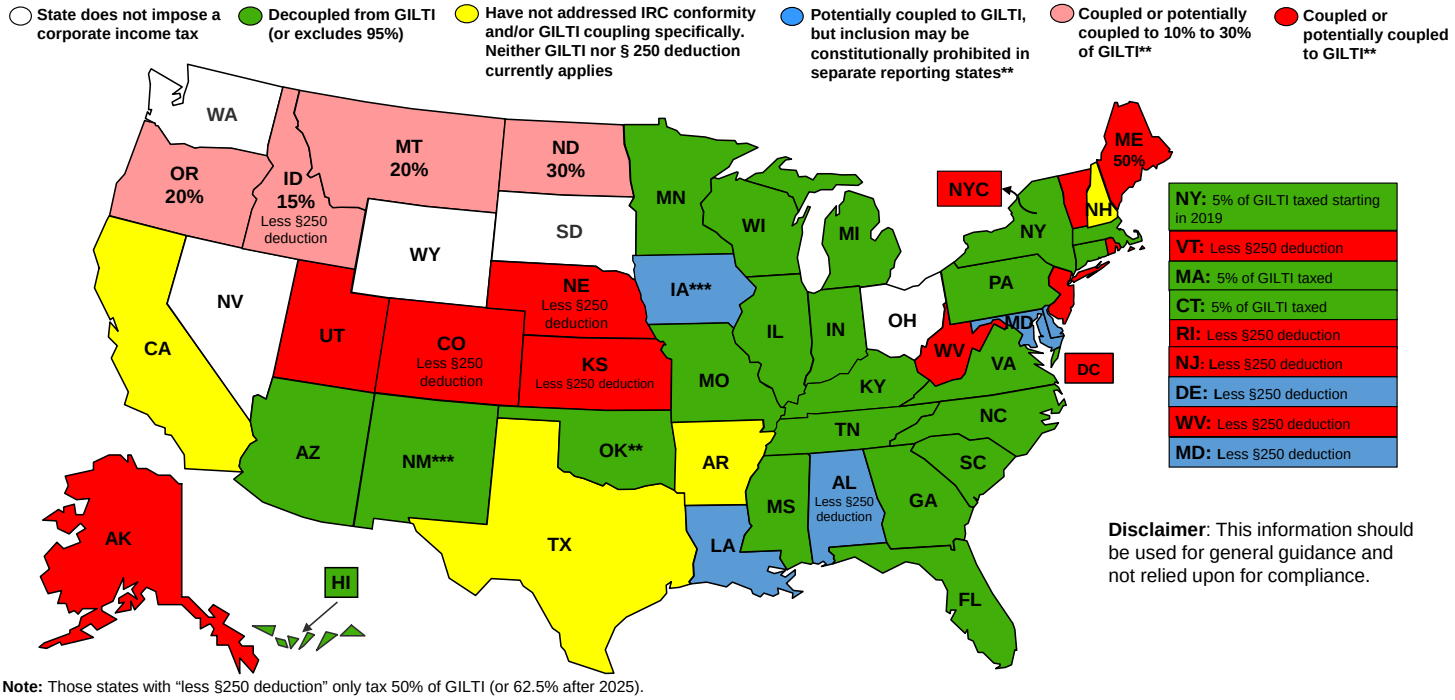
State Corporate Income Tax Conformity to GILTI*



Disclaimer: This information should be used for general guidance and not relied upon for compliance.

Note: Those states with "less §250 deduction" only tax 50% of GILTI (or 62.5% after 2025).
***** Based generally on 80% or more direct corporate ownership of foreign corporations. Other rules may apply for smaller % ownership or state personal income tax (PIT) purposes.
****** GILTI is not specifically referenced in many state conformity statutes so some states may still decouple from some or all of GILTI by administrative/legislative action.
******* Iowa conformity begins in 2019. New Mexico decouples starting in 2020.

Source: Council On State Taxation

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Is the Impact of GILTI the Same for State Tax Purposes as It Is for Federal Tax Purposes?

- **Global:** Yes, its starting point is all of the global income earned by the taxpayer's foreign subsidiaries.
- **Limited to Intangibles**: This is a misnomer – GILTI (global intangible low-taxed income) includes income from services, digital products, financial services, a sizable portion of tangible property sales, and intangibles.
- **Low-Taxed:** No, the states do not conform to the (80%) foreign tax credit allowed for federal tax purposes to offset the GILTI income. In addition, many of the states may not conform to IRC Section 250 that allows for a 50% deduction (reduced to 37.5% after 2025) for GILTI income.
- **Offset by Corporate Tax Cuts:** No, states do not conform to federal corporate tax cuts (Congress is raising $324 billion over 10 years from the international tax provisions to help pay for $654 billion in business tax cuts).
- **Favor Domestic Commerce over Foreign Commerce:** No, the states are limited by the Constitution's Commerce Clause and cannot treat foreign commerce differently than domestic.
- **Displaced US domestic income**: Proponents of state taxation of GILTI are making broad and unsubstantiated assertions that GILTI is all or primarily "**displaced US domestic income**"?
- **On why states should decouple from GILTI,** see generally: Joseph X. Donovan, Karl A. Frieden, Ferdinand S. Hogroian, and Chelsea A. Wood, "State Taxation of GILTI: Policy and Constitutional Ramifications," *State Tax Notes*, October 22, 2018.

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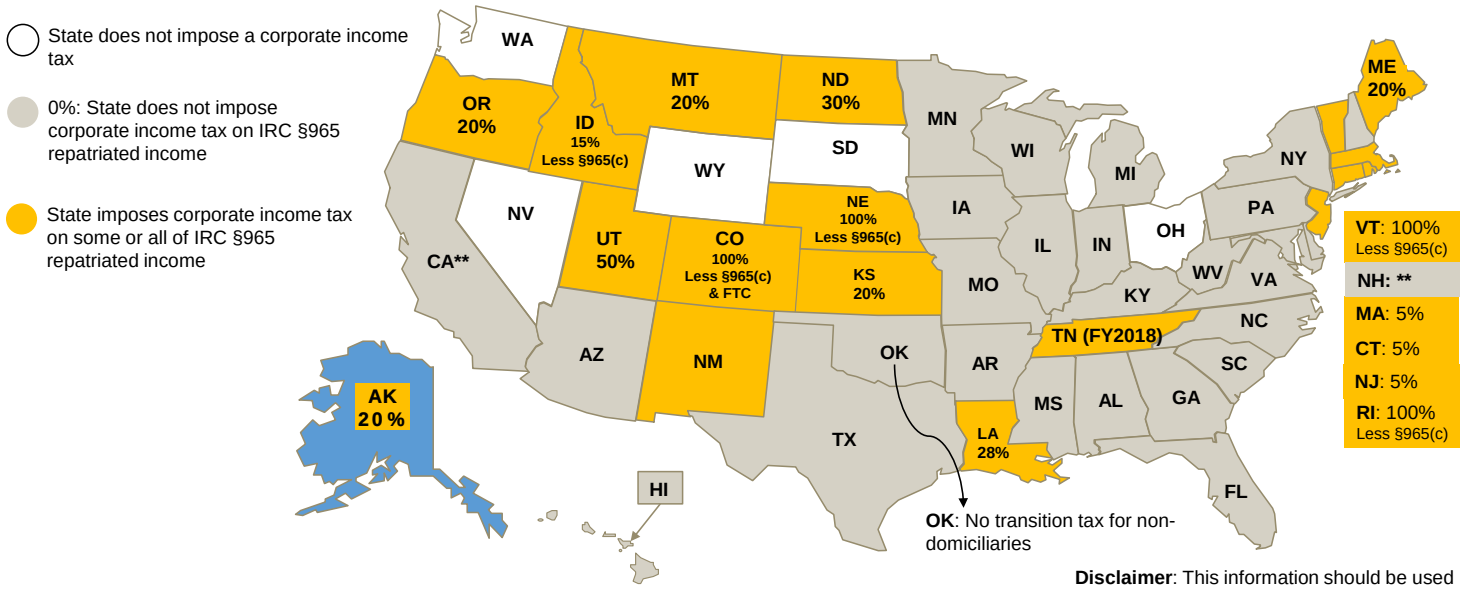
One Time Issue: State Corporate Income Tax Conformity to IRC §965 Repatriated Income*



***** Based generally on 80% or more direct corporate ownership of foreign corporations. Other rules may apply for smaller % ownership or PIT purposes.

******No conformity update but taxes a portion of foreign dividends (when distributed) for water's edge filers.

Disclaimer: This information should be used for general guidance and not relied upon for compliance.

Source: Council On State Taxation

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Foreign Derived Intangible Income (FDII): IRC §250

- **General Overview**: Provides a 37.5% deduction (decreased to 21.875% after 2025) for certain income earned by a U.S. domestic corporation attributed to foreign sales relating to U.S. production.
  - Results in a reduced federal effective tax rate on covered income of 13.125%, subject to a taxable income limitation (16.40625% after 2025).
  - FDII is calculated in a manner similar to GILTI. Returns in excess of 10% of fixed assets form the basis for the calculation. Conformity may depend on whether a state's starting point for calculation of state taxable income is Form 1120 line 28 or line 30.
- **State Tax Issues**:
  - Modest State Conformity – approximately one dozen states have conformed to FDII.
    - Selective decoupling – FDII, as enacted, is designed to work with GILTI.
  - The impact of FDII will be affected by a taxpayer's state income tax filing method.
  - Planning opportunities with FDII.
  - How will states apportion FDII.
    - See onerous New Jersey apportionment rule for FDII.

Factor Representation and Constitutional Issues Relating to State Taxation of Foreign Source Income

Factor Representation: GILTI and IRC §965 Repatriated Income

- While most of the attention has been focused on state-by-state conformity to or decoupling from GILTI, a less noticed but disturbing trend has developed regarding state guidance on the other key element of the state income tax equation: Apportionment.
- **Shockingly, only one of the 18 states taxing a portion of IRC Section 965 repatriated income and the 23 states taxing a portion of GILTI has provided written guidance that the taxpayer is permitted to include an appropriate percentage of the payroll, property and sales of the foreign CFCs in the denominators of the respective factors.**
- The vast majority of the states are arguably allowing only the **net taxable foreign source income**, and not the gross receipts (or other factors) to be included in the denominators of the respective factors.
  - **New Jersey** has adopted factor representation that does not allow inclusion of foreign factors and does not bear any rational relationship whatsoever to the taxpayer's actual business activity in the state.

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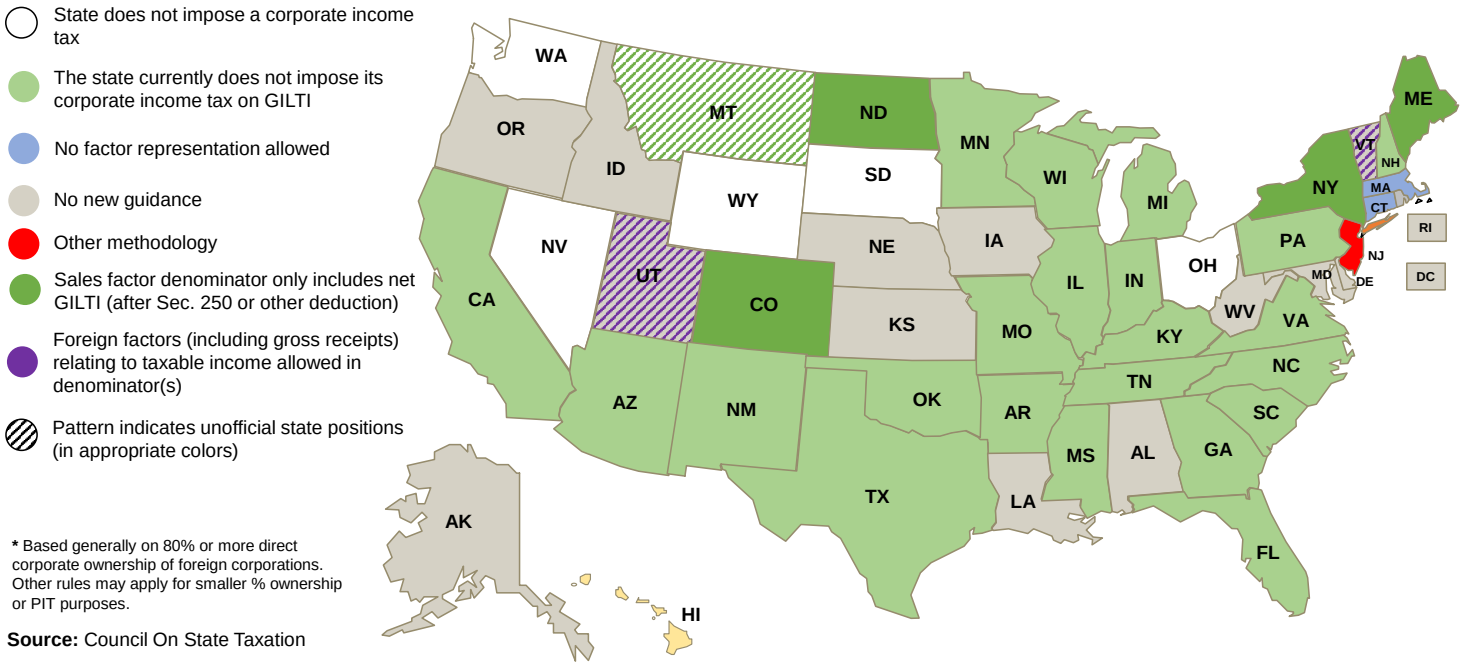
GILTI State Factor Representation*



***** Based generally on 80% or more direct corporate ownership of foreign corporations. Other rules may apply for smaller % ownership or PIT purposes.

Source: Council On State Taxation

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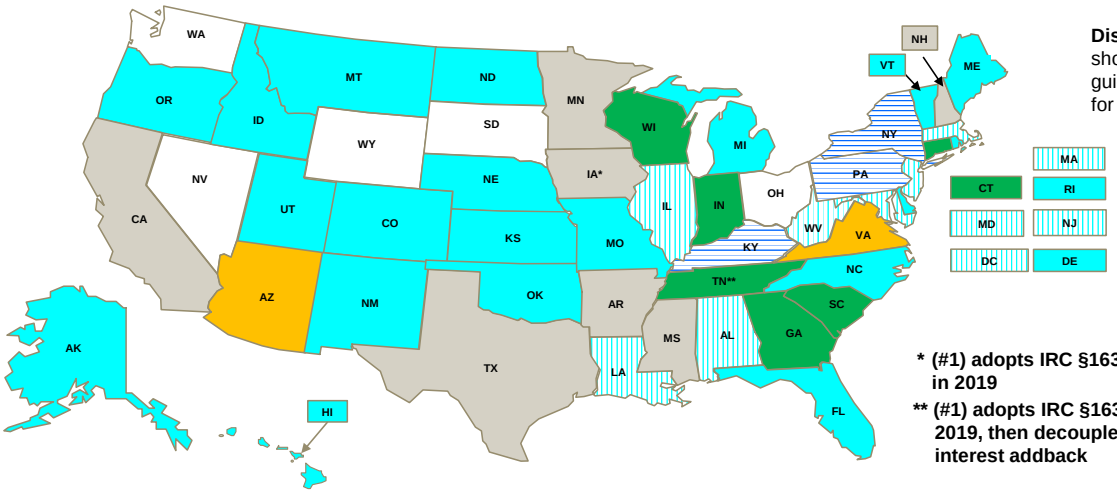
Future Litigation over State Taxation of GILTI and IRC §965 Repatriated income

- **Separate reporting states: Can the foreign source income be taxed at all?**
  - See *Kraft General Foods Inc. v. Iowa Department of Revenue*, 505 U.S. 71 (1992). A separate reporting state may not tax dividends from a controlled foreign corporation if it does not tax dividends from a controlled domestic corporation.
  - Seven separate reporting states are still coupled to GILTI (down from 11 in late 2018).
- **Combined reporting states: Can the foreign source income be taxed without appropriate factor representation (or a unitary relationship)?**
  - The state taxation of GILTI (and IRC §965 Repatriated income) in combined reporting states likely violates Commerce Clause limitations unless appropriate foreign "factor representation" is allowed.
  - The argument will likely focus on "discrimination" and not on "undue burden" – improving the taxpayers chances of prevailing. See *Oregon Waste Systems Inc. v. Department of Environmental Quality of Oregon,* 511 U.S. 93 (1994)
  - See contra:
    - *E.I. du Pont de Nemours & Co. v. State Tax Assessor*, 675 A.2d 82 (Maine 1996); and
    - *Appeal of Morton Thiokol, Inc.*, 864 P.2d 1175 (Kan. 1993).

Key Domestic Tax Provisions Impacting the States

State Conformity to 30% Interest Expense Limitation



Disclaimer: This information should be used for general guidance and not relied upon for compliance.

*** (#1) adopts IRC §163(j) in 2019**

**** (#1) adopts IRC §163(j) in 2018 and 2019, then decouples. State has interest addback**

5 **No General Corporate Income Tax**

20 **Adopts IRC §163(j) as of 1/1/18**

3 **Adopts IRC §163(j) with interest addback related to intangible income**

8 **Adopts IRC §163(j) and has general interest addback provisions**

Source: Council On State Taxation

6 **Enacted Legislation Decoupling from IRC §163(j) [Note – some of these states did not decouple as of 1/1/2018 but decoupled at a later date and some states may still have an intercompany interest expense adjustment]**

2 **For 2018 tax year – IRC adopted as of 1/1/2017 effectively decoupling from IRC §163(j)**

7 **Does not adopt IRC § 163(j) as of 1/1/18**

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Interest Expense Limitation – IRC § 163(j)

- **General Overview:**
  - Business interest expense cannot exceed **30% of adjusted taxable income** (ATI) exclusive of business interest income
  - ATI is an EBITA (**earnings before interest taxes and amortization**) concept through 2021 and then EBIT (earnings before interest and taxes) thereafter
  - Limitation is applied at the **consolidated group level** in the case of consolidated federal filers w/elimination of intercompany activity
  - Subject to **carryforward**
  - Unlike most states, TCJA coupled the interest expense limitation at the federal level to 100% expensing for cost of capital

Interest Expense Limitation – IRC § 163(j)

- **State Tax Issues:**
  - How is the limitation computed for state purposes when state and federal filing methodologies differ? **When will state guidance be issued?**
  - Will state allow indefinite carryforward of disallowed interest expense?
  - External vs. internal debt (especially for separate return jurisdictions).
  - How will the federal limits interact with state related party interest expense disallowance statutes?

- **Traps to Watch For:**
  - CFC Group Elections
  - Debt to Equity Characterization Rules
  - Forced Combination and §482 type Discretionary Powers

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Other State Tax Issues Related to the TCJA

- **100 Percent Expensing**
  - The TCJA allows 100 percent expensing for most capital investments for 5 years; however, most states decouple from this provision just as the states decoupled from bonus depreciation.

- **Alternative Minimum Tax**
  - Do AMT adjustments still need to be tracked for state purposes? What is the compliance cost?

- **Net Operating Loss Limitations and Carryforwards**
  - Numerous differences between Federal and State rules continue

- **State Conformity with the Deduction for Pass Through Entities**
  - Impact limited to a minority of states with PIT tied to federal “taxable income”

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Other State Tax Compliance and Planning Considerations

- **Elective state filing methodologies** may provide benefit (separate, consolidated, world-wide, waters-edge, etc.)
- Changes in **accounting methods** may create opportunities (timing of income recognition, etc.)
- Established **transfer pricing** methodologies and documented intercompany agreements continue to be important
- **M&A** – Buyer Beware
- Data volume and complexity is creating need to leverage **advanced technologies**

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