

**31st Annual TEI-SJSU High
Tech Tax Institute
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**Domestic and
Multistate
Update**

Latest Dirt from DC: Federal Tax Legislative Update

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On the tax agenda in 2015. . .

- What's done?
 - New partnership audit regime
- What's next?
 - Extenders
 - Tax reform or IP box?

What's done?

Budget agreement

- Two tax offsets included in sweeping 2-year budget agreement:
 - Dramatic rewrite of the audit and assessment rules for partnerships
 - Pension funding relief and increase in PGBC premiums

New partnership rules

- TEFRA and ELP replaced with new regime that will shift the burden from IRS to partnerships:
 - Why? IRS claims its too hard to drive adjustments thru to every partner
 - Partnerships are 33 times less likely to be audited than same sized C corps
 - New regime raises \$9.3 billion in new revenue

New partnership rules

- What partnerships are covered by new regime?
 - More than 100 partners
 - OR**
 - Any of the following types of partners:
 - Another partnership
 - Trust
 - Tax-exempt

New partnership rules

- Who escapes?
 - 100 partners or fewer
 - AND**
 - Only the following types of partners:
 - Individuals
 - C corps (REITs and foreign corps okay)
 - Estates
 - S corps, BUT each shareholder counts toward 100 partner threshold

New partnership rules

- Must opt out annually
- If you opt out, covered by the small partnership rules:
 - IRS must audit each partner
 - Harder for IRS to audit partnerships with 11-100 partners who used to be covered by TEFRA?

New partnership rules

Covered partnership requirements

- Must designate a representative:
 - Does not have to be a partner
 - If you don't, IRS can choose anyone
 - More authority than TEFRA tax matters partner
- Partners lose rights:
 - No rights in administrative hearing
 - Representative's decisions are binding
 - Can still take inconsistent position with disclosure

New partnership rules

Covered partnership requirements

- **ASSESSMENTS – Two options:**
 - Pay the assessment at the partnership level
 - Pay at top rate unless demonstrate tax-exempts and partners paying lower rates
 - Issue statements within 45 days to all partners to reflect their share of adjustment
 - Each partner then pays adjustment
 - Partners for year of adjustment pay
 - Partners **NOT** jointly and severally liable

New partnership rules

- What does this all mean?
 - Nearly every partnership or operating agreement will need to be amended
 - Affects not just partnerships, but also C corps, tax exempts, and other entities who are partners
 - Statute leaves details and mechanisms to IRS
 - Will need guidance quickly because effective for partnership tax years beginning in 2018

What's next?

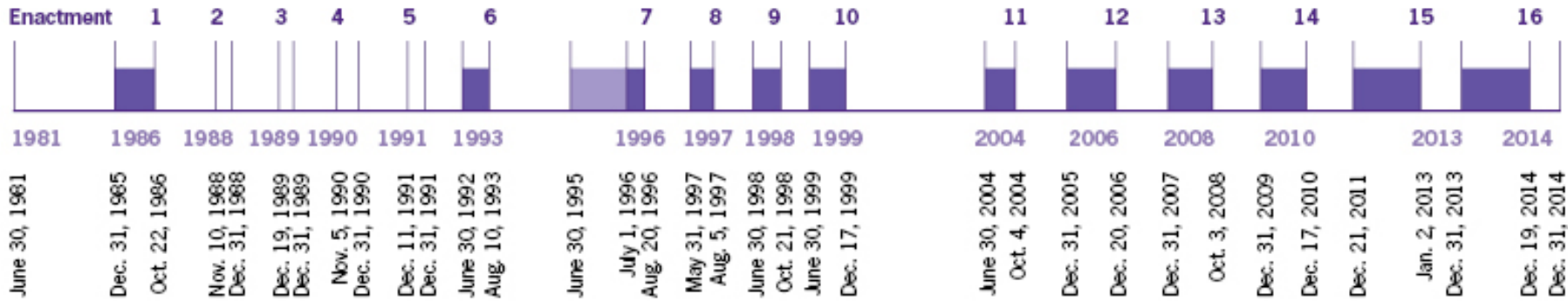
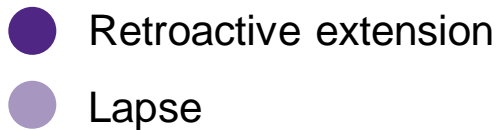
Extenders

- Over 50 provisions expired at the end of 2014:
 - R&D credit
 - Bonus depreciation
 - Increased §179 limits
 - WOTC
 - 15-year life for leaseholds, retail, and restaurant
 - 5-year holding period S corp built-in-gain
 - Active financing and CFC look-thru exceptions

Extenders: The history

- Congress has bad record of passing these on time

Timeline on research and credit legislation



Extenders: Congressional progress

- Why'd they wait so long this year?
 - In past years they've fought over whether to pay for the extenders or not, but no one's arguing for offsets this year
 - Delay was over whether to make any of these provisions permanent

Extenders: Can we get a better deal?

- House:
 - Make 8-10 provisions permanent, enhance the R&D credit by increasing ASC rate
- Senate:
 - Extend everything for 2 years, enhance the R&D credit by making it refundable

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Extenders: Making them permanent is expensive

Ways and Means Permanent Extenders	Cost
Research credit (20% ASC)	\$182 billion
Section 179 expensing	\$77 billion
Election to deduction state and local sales tax	\$42 billion
5-year BIG holding period after S Conversion	\$1.5 billion
Tax-free IRA distributions for taxpayers 70½	\$8.8 billion
S corporation basis reduction for charitable gifts	\$0.6 billion
Conservation easement charitable gifts	\$1.2 billion
Enhanced charitable deduction for food inventory	\$2.2 billion
Total	\$315 billion

Extenders: Time is running out

- Legislative logjam clears up:
 - Oct. 28: House Speaker elected
 - Oct. 30: Congress approves 2-year debt limit and government funding deal
- With the most contentious year-end issues off the table, can Congress finish the rest sooner?
 - Nov. 20: Highway funding expires
 - Extenders

Extenders: Most likely outcomes

- **Scenarios:**
 - Congress resurrects parts of 2014 permanent deal and we all rejoice (highway bill rider?)
 - A big deal eludes them and we get a 1- or 2-year extension in late Dec. or (gasp) Jan.
- **Implications:**
 - Can't take them for financial statement until president signs

What happened to tax reform?

- President made clear that an individual rate cut is off the table

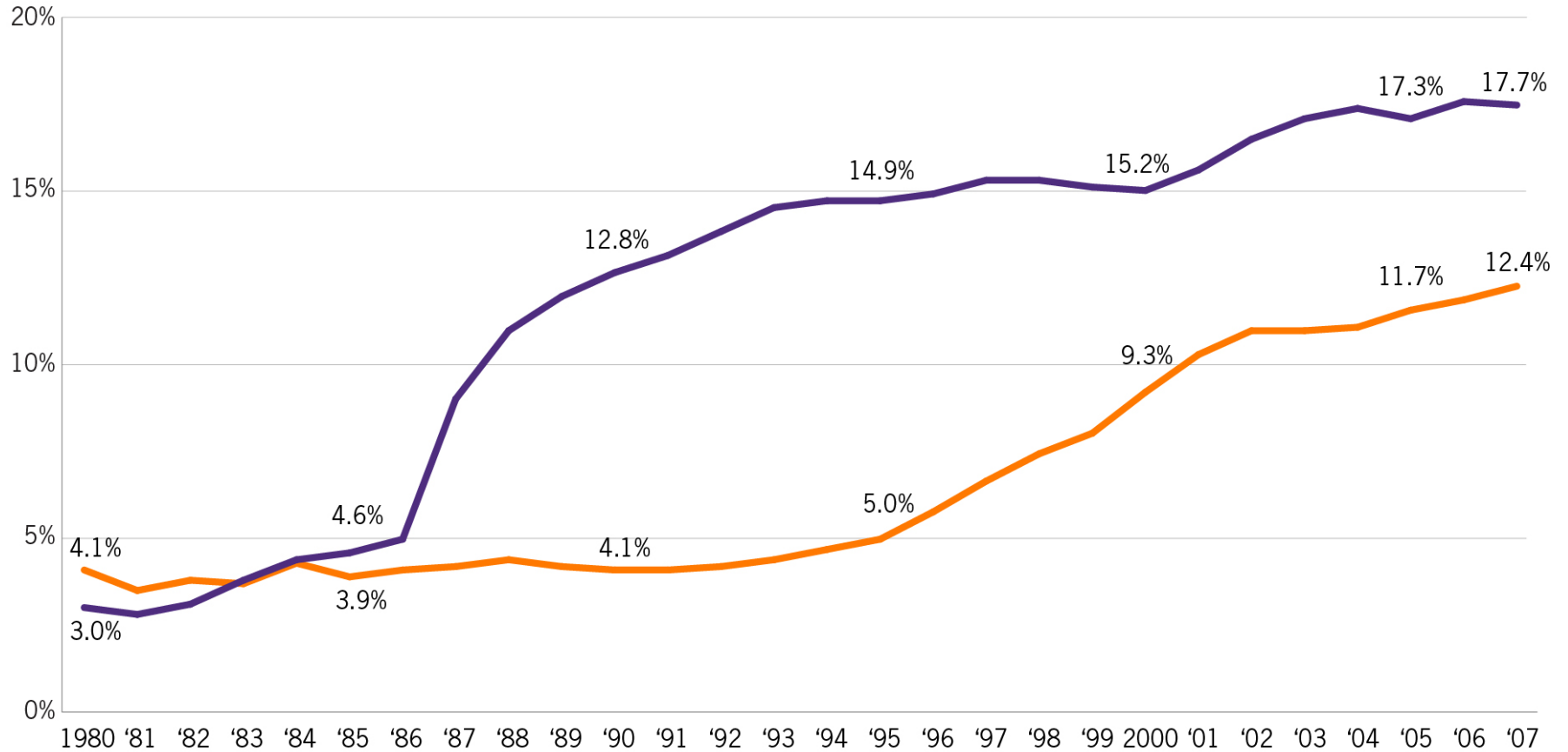
What happened to tax reform?

- Hatch and Ryan explored business-only reform:
 - Couldn't figure out what to do about pass-throughs
 - Why is this so important?

Sub S and Partnership Share of Total Business Receipts, 1980-2007

- Subchapter S corporations
- Partnerships

% of total



Source: IRS, Statistics of Income division, Integrated Business Data, Table 1, available at <http://www.irs.gov/taxstats/bustaxstats/article/0,,ID=152029,00.html>.

If business reform doesn't work, how about international reform?

- Final tax reform Hail Mary:
 - International-only tax reform used to fund highways

International reform

- What would this actually look like?
 - Convert worldwide to territorial
 - Mandatory tax on unrepatriated earnings
 - Leave corporate rate at 35%, but establish a "innovation box" with a significantly lower rate
 - Include anti-inversion, anti-offshoring provisions

International reform

- Neal-Boustany "innovation box" proposal:
 - 71% deduction for a 10.15% rate
 - Qualifying income: Patents, inventions, formulas, processes, designs, patterns, know-how, software, and video, plus any property using these
 - Very broad for goods: (What product isn't tied to some form of this IP?)
 - Includes domestic and foreign income

What happened to tax reform?

- Neal-Boustany 'IP Box' limits:
 - No services
 - No pass-throughs (only C corps)
 - Limited by ratio of R&D costs to other costs

What happened to tax reform?

- Neal-Boustany 'IP Box' problems:
 - \$280 billion cost (§174 expensing repeal to pay for it?)
 - Will divide business: Basically a rate cut for certain segments while doing nothing for other

So is international reform possible?

- Probably not:
 - Highway funding good through summer 2016
 - Ryan now the House Speaker
 - Portman/Schumer agreed on a framework but couldn't agree on details
 - McConnell and Hatch don't think it's good policy to use repatriation for highway spending
 - Grover Norquist says it violates 'no tax' pledge

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Trends & State Taxes: Apportionment, Nexus, and Gross Receipts

Presenter: John Clausen

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OUTLINE

- “Factor Presence” economic nexus is a clear trend
- “Market Based” sourcing is a clear trend, and states have adopted a variety of methods
- California Water’s-Edge Impact
- New Developments with Gross Receipts Based Taxes – WA B&O and Nevada

FACTOR PRESENCE ECONOMIC NEXUS

- State Adopting some type of “Factor Presence” economic nexus include:
- **California:** For 2014, economic nexus exists when taxpayer has \$52,956 of California property or payroll, or \$529,562 in California sales are present, or, if less, 25% of total payroll, property, or sales.
- **Connecticut:** adopted a bright-line “substantial economic presence” test under which a company will trigger nexus by generating \$500,000 or more in annual receipts that are attributable to the company’s economic contacts with the state. [Connecticut Informational Publication IP 2010(29.1) (Dec. 28, 2010)].
- **Colorado:** Economic nexus is established when taxpayer has \$50,000 of Colorado property or payroll, or \$500,000 in sales, or, if less, 25% of total payroll, property, or sales.
- **Michigan:** nexus established for purposes of the corporate income tax or business tax if active solicitation generates Michigan gross receipts of \$350,000 or more. [Mich. Comp. Laws §206.621(1)].

FACTOR PRESENCE ECONOMIC NEXUS (CONT'D)

- **New York:** nexus is established for corporations deriving \$1 million or more in receipts during a taxable year.
- **Ohio:** conforms to the MTC's model law under Ohio Rev. Code Ann. § 5751.01(I). Filing is required when receipts exceed \$150,000.
- **Tennessee:** Effective January 1, 2016, Economic nexus is established when taxpayer has \$50,000 of Tennessee property or payroll, or \$500,000 in Tennessee sales, or if less, 25% of total payroll, property, or sales.
- **Washington:** partially conforms to the MTC's model law for purposes of the state's Business and Occupation Tax. The annual sales threshold is \$267,000 [250,000 prior to September 1, 2015]. [Wash. Admin. Code § 458-20-19401 and Wash Rev. Code § 82.04.067].

NEW YORK CITY DID NOT IMPLEMENT THE ECONOMIC NEXUS STANDARD

- Unlike NY state, NY City did not implement an economic nexus standard.
- Effective for taxable years beginning on or after Jan. 1, 2015, NY state imposes tax on corporations that have \$1 million or more in NY source receipts (based on market-based apportionment).
- NY City did not adopt this economic nexus standard. The city generally retains a physical nexus standard and conforms to the state economic nexus standard (except for certain credit card corporations).

NY CITY DID NOT IMPLEMENT THE ECONOMIC NEXUS STANDARD (CONT'D)

- New York City is continuing to phase in the single-sales factor, with 2018 being the first year with a single-receipts factor. Until then, taxpayers are using a weighted three-factor formula, gradually eliminating the property and payroll factors.
- Beginning in 2018, New York City will allow a modified three-factor apportionment formula election for a taxpayer or a combined group of taxpayers with \$50 million or less of receipts allocated to the city.

MARKET-BASED STATES

- Other States: AL, CT, DC, DE, GA, IA, IL, MA, MD, ME, MI, MN, NE, NY, OK, PA, RI, UT, and WI

MARKET SOURCING TRENDS

- Variations for sourcing receipts from services in “Market” states:
- California – Mandatory for years beginning on or after January 1, 2013 - Source to location where Benefit Received [Regulation 25136-2].
- Massachusetts – Market Sourcing rules – Enacted Market Sourcing rules effective January 1, 2014. Rules require “reasonable approximation” for professional services delivered to business customers, though a “safe harbor” allows for use of billing address when there are more than 250 customers and not more than 5% of sales of services are derived from a particular customer [830 CMR 63.38.1(9)(d)4.d.iii.(A)].

MARKET SOURCING TRENDS (CONT'D)

- New York State – Effective for years beginning on or after January 1, 2015. Services income is sourced to the location where the customer receives benefit of the service. Special rules for “digital products” look first to the customer’s “primary use location” of the digital product, then to location where “product is received by the customer.” Definition of “digital product” is very broad. [Section 210-A, Tax Law].
- Pennsylvania – Enacted Market Sourcing rules effective January 1, 2014. Sources services to location where service is “delivered.” [Information Notice 2014-01].

CALIFORNIA WATER'S-EDGE ELECTION

- Any foreign corporation with average property, payroll, and sales within U.S. of 20% or more should be included in the Water's-Edge combined filing group. [Cal. Code Regs. 25110(d)(2)(B)].
- For purposes of computing its total property, payroll or sales factors within the U.S., an individual corporation should sum the percentage calculated for each factor under the rules of each of the individual states. [Cal. Code Regs. 25110(d)(2)(B)(3)].
- States without taxes or factors: if a corporation has receipts in a state which does not impose an income tax, the amount assignable to a state of any factor not used by such state should be determined pursuant the market-based approach set forth by the CA Regs. [Cal. Code Regs. 25110(d)(2)(B)(3)(b)].
- For example, if a foreign entity whose only sales of other than tangible personal property in NV were, prior to tax year 2013, sourced under the COP rules, are now sourced under the market-based approach pursuant to Cal. Code Regs. 25136-2.

CA WATER'S-EDGE ELECTION (CONT'D)

- ➔ For CA Water's-Edge election purposes, it is critical to source receipts of a foreign entity based on the rules of each individual state. If the sourcing rule of a state is COP, then the receipts are considered to be without the U.S. If a state is a market-based, then a more thorough analysis should be performed.
- ➔ It is also critical to understand the market-based definition for each state (services delivered Vs. benefit received.) For example, PA is a market-based state; however, based on PA Information Notice Corporation Taxes 2014-01, the sourcing of services is based on where the services are delivered.
- ➔ It is also important to update the state-by-state analysis on an annual basis for purposes of crossing the 20% threshold. As an example, with the NY market-based sourcing rules taking effect in tax year 2015, a foreign entity with NY sales could result in the foreign entity crossing the 20% threshold and be included in the CA Water's-Edge combined group; whereas the prior to tax year 2015, the foreign entity NY sales were not considered to be U.S. sales since NY was a COP state.

WASHINGTON STATE B&O - NEXUS

- Physical nexus: taxpayers engaged in nonapportionable activities, such as retailing and wholesaling, are deemed to have physical nexus in the state only if they have a physical presence in the state.
- Economic Nexus: beginning September 1, 2015, taxpayers engaged in apportionable activities, such as service and other activities, are deemed to have economic nexus in WA if they meet any of the following economic nexus thresholds during the prior year calendar year:
 - They have more than \$267,000 of WA receipts.
 - They have more than \$53,000 of WA property.
 - They have more than \$53,000 of WA payroll.
 - At least 25 percent of their total receipts, payroll, or property are in WA.

WA B&O – NEXUS (CONT'D)

What has changed? Now that the bright-line test includes not only apportionable activities but also wholesaling activities, taxpayers making wholesale sales to WA no longer need a physical presence in the state to be subject to wholesaling B&O. This means that out-of-state businesses making wholesale sales into WA will be subject to the wholesaling B&O tax on wholesale sales delivered into WA for the current year if they meet any of the economic nexus thresholds mentioned above.

This change from physical nexus to economic nexus only affects businesses making wholesale sales taxed under RCW 82.04.257(1) and RCW 82.04.270 and reported under the “general” Wholesaling B&O tax classification.

In determining whether a wholesale business exceeds the nexus threshold of \$267,000, both apportionable income attributable to WA and wholesale sales delivered to WA are to be included.

WA B&O – NEXUS (CONT'D)

- Please also note that the new nexus standards enacted in September 1, 2015 include “click-through” presumption of nexus standard for both retailing B&O tax and retail sales tax purposes. Under these provisions, out-of-state retailers are presumed to have physical nexus with WA if they:
 - Enter into agreements with WA residents and pay a commission or other consideration for referrals (such as linking on a website), and
 - Gross more than \$10,000 in sales into WA state during the prior calendar year under this type of agreement.
- The definition of “WA resident” includes, but is not limited to, business entities physically located in WA and individuals maintaining a residence in WA. In addition to online or other referral arrangements, an out-of-state retailer may engage in other activities in WA through a resident or nonresident agent or other representative that establish nexus with this state.

NEVADA COMMERCE TAX

- Effective July 1, 2015, business entities “engage in business” in NV, with NV annual gross revenue in excess of \$4 million are subject to NV Gross Receipts Commerce Tax.
- Gross revenue is the total amount of revenue a business entity recognizes that contributes to the production of gross income without deductions for the cost of goods sold or other expenses incurred.
- Specific rules apply for allocating a business entity’s gross revenue to NV:
 - Gross rents and royalties from real property are sourced to NV if the real property is located in NV.
 - Gross revenue from the sale of tangible personal property is sourced to NV if the property is delivered to a buyer in NV.
 - Gross revenue from the sale of services is sourced to NV to the extent the purchaser’s ultimate benefit is received in NV.

NV COMMERCE TAX (CONT'D)

- To calculate the amount of commerce tax to be paid, you subtract \$4 million from the NV gross revenue of an entity for the taxable year and multiply that amount by the rate. The tax rate varies from 0.051% to 0.331%, depending on the industry in which the business entity is engaged.
- The taxable year for commerce tax returns runs from July 1 through June 30 for all taxpayers. The returns are due on or before the 45th day following the end of that taxable year. The first commerce tax returns and payments will be due August 15, 2016. Taxpayers may request a 30-day extension to pay the tax.
- NV does not provide a clear nexus standard applicable to the Commerce Tax and does not address the applicability of the Quill physical presence nexus standard and Public Law 86-272. Since the commerce tax is not an income tax, PL 86-272 might not apply.

NV COMMERCE TAX (CONT'D)

- Effective on October 1, 2015, the new law creates the “click-through” nexus, which is a presumption that a retailer is required to impose, collect, and remit NV sales and use taxes if:
 - The retailer enters into an agreement with a NV resident under which the resident receives certain consideration for referring potential customers to the retailer through a link on the resident’s Internet website or otherwise.
 - The cumulative gross receipts from sales by the retailer to customers in NV through all such referrals is in excess of \$10,000 during the preceding four quarterly periods ending on the last day of March, June, September, and December.
- A retailer may rebut this presumption by providing proof that each resident with whom the retailer has an agreement did not engage in any activity that was significantly associated with the retailer’s ability to establish or maintain a market in NV for the retailer’s products or services during the preceding four quarterly periods.

END

QUESTIONS?

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