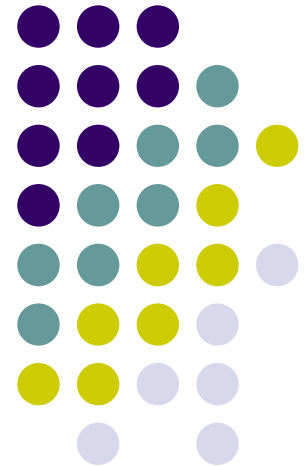


# Federal Domestic and State Tax Updates

Annette Nellen – SJSU

Kim Reeder - KPMG

November 10, 2009



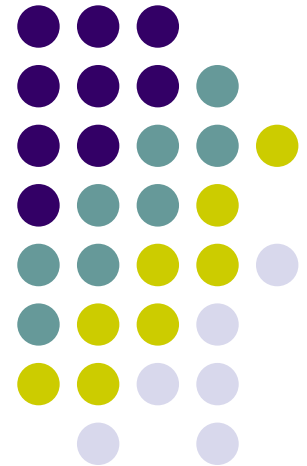


# Agenda

- ARRA Guidance
- Federal research tax credit
- Property transactions and accounting methods
- Miscellaneous federal items
- On the horizon

# American Recovery and Reinvestment Act of 2009

Selected business-related items

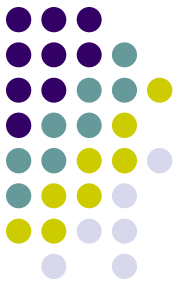


# ARRA Guidance for Businesses



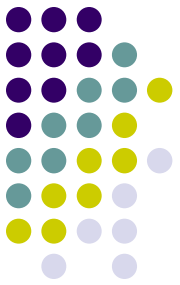
- FAQ from IRS on COBRA subsidy:
  - <http://www.irs.gov/newsroom/article/0,,id=205364,00.html>
- Grants in lieu of certain energy credits
  - Treasury guidance -  
<http://www.treas.gov/recovery/1603.shtml>
- IRS website on energy incentives for businesses
  - <http://www.irs.gov/newsroom/article/0,,id=209564,00.html>

# Advanced Energy Manufacturing Credit



- IRC §48C - Qualifying advanced energy project credit
- Need to apply to get the credit
- Preliminary applications were due 9/16/09
- Whether 2nd round of apps will occur depends on whether \$2.3 billion assigned is allocated in 1st round (2009-2010)
- See “Handing Out Credits” by Nellen - [http://www.cpa2biz.com/Content/media/PRODUCER\\_CONTENT/Newsletters/Articles\\_2009/CorpTax/Manufacturing\\_Credit.jsp](http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2009/CorpTax/Manufacturing_Credit.jsp)

# ARRA Guidance



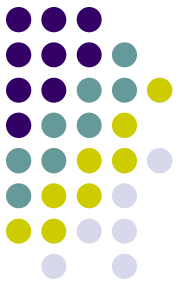
- Additional guidance on expanded Work Opportunity Tax Credit (§51) - unemployed veterans and disconnected youth
  - Notice 2009-69 clarifying Notice 2009-28 regarding two new groups added by ARRA - unemployed veterans and disconnected youth
- Election to accelerate certain credits in lieu of bonus depreciation – more guidance:
  - Rev. Proc. 2009-33
- COD Exclusion - §108(i)
  - Rev Proc 2009-37

# ARRA Guidance – IRS info



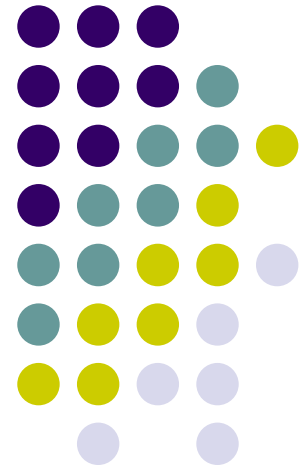
- IRS website with info for businesses:
  - <http://www.irs.gov/newsroom/article/0,,id=208318,00.html>
  - <http://www.irs.gov/newsroom/article/0,,id=204335,00.html>

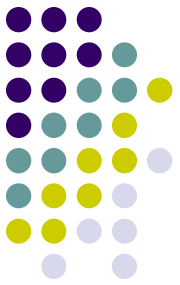
# Add'l Energy Incentive Guidance



- What is available at federal and state and local levels for individuals and businesses?
  - <http://www.dsireusa.org/>
  - [http://www.energystar.gov/index.cfm?c=tax\\_credits.tx\\_index](http://www.energystar.gov/index.cfm?c=tax_credits.tx_index)
  - <http://www.energy.gov/taxbreaks.htm>
  - <http://www.irs.gov/newsroom/article/0,,id=211307,00.html>
  - <http://www.irs.gov/newsroom/article/0,,id=209564,00.html>
  - <http://energytaxincentives.org/>
  - *Journal of Accountancy* article 8/09 at <http://www.journalofaccountancy.com/Issues/2009/Aug/20091640.htm>

# Federal research tax credit

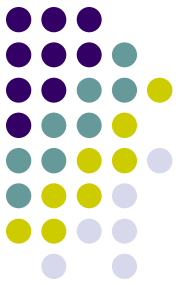




# Research credit claims

- *McFerrin*, 103 AFTR 2d 2009-2566 (5<sup>th</sup> Cir.)
  - IRS brought suit against the McFerrins, shareholders in four S corporations, for a refund claim that the IRS declared it paid erroneously due to a clerical error
    - Claim was for a research credit of \$472,092 plus interest of \$129,136 related to an 1120S where no credit was originally claimed.
    - 2003, one of the S corps contracted with a consultant for a research credit study for 1999 through 2002.
    - Court agreed with IRS that records not sufficient to indicate that research and amounts claimed were valid.
      - While court acknowledged that some research occurred, records could not prove it was qualified research and the court declined to apply the *Cohan* doctrine.
      - Court described this doctrine as allowing a court to "estimate the allowable credit" but "only when it is clear that qualifying expenses were actually incurred in the relevant tax year."
  - On appeal, 5th Circuit stated with respect to application of *Cohan* doctrine:
    - "If McFerrin can show activities that were "qualified research," then the court should estimate the expenses associated with those activities. The district court need not credit McFerrin's reconstruction of expenses from years after the fact. ... But the court should look to testimony and other evidence, including the institutional knowledge of employees, in determining a fair estimate."
    - Court also noted that lower court had applied some definitions of qualified research incorrectly.
- Ruling is contrary to LMSB Audit Techniques Guide on Research Credits Claims
  - <http://www.irs.gov/businesses/article/0,,id=183208,00.html>
  - Claims are a Tier I issue - <http://www.irs.gov/businesses/corporations/article/0,,id=200567,00.html>

# Research Credit Guidance

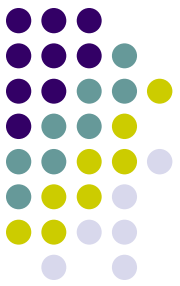


- *FedEx Corp v. U.S.*, 103 AFTR 2d 2009-2722 (DC TN)
  - Involved \$11 million of research credit claimed on a failed software project over 1997-2000
  - Issue: which “discovery test” to use – old strict one or its replacement finalized 12/31/03?
    - IRS – older regs
    - Fedex – final ones
  - Ct – granted summary judgment to Fedex
    - “Treasury and the IRS have explained that the revised “discovery” test reflects Congressional intent. Although the 2003 Final Regulations apply only to taxable years ending on or after December 31, 2003, the Regulations themselves provide that the IRS will not challenge return positions consistent with the 2003 Final Regulations for taxable years ending before December 31, 2003.”
    - F can rely on the earlier internal use software final regs because IRS never issued replacement regs – it “never amended the definition of “internal use software” contained in the 2001 Final Regulations.”

# *Union Carbide, TC Memo 2009-50*



- 298 pages with Table of Contents!
  - <http://www.ustaxcourt.gov/InOpHistoric/UCC.TCM.WPD.pdf>
- T claimed research credit on timely filed return then filed claim for add'l credit amount mainly from manufacturing activities
- Ct examined 5 of 106 projects; found that 2 qualified partially for credit
- Some key points from this case:
  - “If only one alternative is tested, for that alternative to constitute a process of experimentation the taxpayer should conduct a series of experiments with the alternative in order to develop the business component.”
  - “where a taxpayer seeks research credits for plant processes but not for the products produced, we apply the qualified research tests only to activities related to the development of the process without taking into account the activities related to the production or development of the product.”



# *Union Carbide* - continued

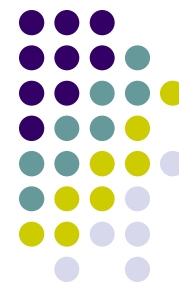
- A few more points:
  - “Section 174 does not require that the technology be in the very beginning stages of development, only that the taxpayer be uncertain as to whether the technology will improve its product or process.”
  - “Section 174 test is an objective test, and a taxpayer may not turn its back on the available information in order to create uncertainty.”
  - When research is conducted during a manufacturing process, even though raw materials are needed, they do not become supplies. Supplies must be used in the qualified research process.
  - Ok to consider *Cohan* case (39 F2d 540 (1930)) regarding documentation – is there enough to show intent and what taxpayer did?

# Research Credit Claims - more

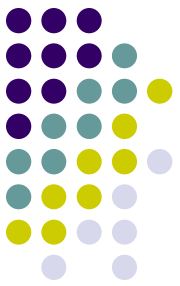


- IRS LMSB Directive #2 (1/09)
  - “This directive supplements the guidance provided in Industry Director Directive #1 dated April 4, 2007. Directive #2 addresses:
    - the definition of a claim covered under the Tier I designation,
    - the issuance of the Mandatory Research Credit Claim Information Document Request ("Mandatory IDR") under certain circumstances,
    - the notice of centralized filing, and
    - the assertion of penalties under I.R.C. §6676.”
  - <http://www.irs.gov/businesses/corporations/article/0,,id=202712,00.html>

# Reduced Research Credit Election

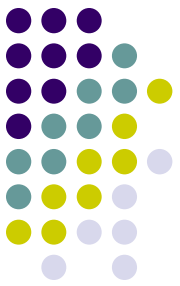


- Proposed regulations issued under §1.280C-4 (REG-130200-08, 7/16/09)
  - Simplify the election procedure
  - Make on Form 6765
  - “In order for the election to be effective, the Form 6765 must clearly indicate the taxpayer’s intent to make the section 280C(c)(3) election”
  - Make on original return filed by extended due date
  - Once made, election is irrevocable
  - “each member of a controlled group may make the election under section 280C(c)(3) after the group credit is computed and allocated under §§ 1.41-6(b)(1) and 1.41-6(c) and 1.41-6T(b)(1) and 1.41-6T(c)(2).”



# IRS Ruling on §59(e)

- CCA 200908014
  - Taxpayer may not make §59(e) election in closed years.
  - T had deducted R&D per §174(a) and produced NOL. Later wanted to amend to amortize all or part of that R&D over 10 years. T noted that it would not cause any change in tax liability for prior years (would just reduce the NOL).
  - IRS – “Rev. Rul. 74-61, Rev. Rul. 82-49, Rev. Rul. 56-285, Rev. Rul. 81-88 and *Springfield Railway Co. v. U.S.*, 312 F.2d 754 (Ct. Cl.) 1963 ... merely stands for proposition that Service is not precluded from making adjustments to arrive at correct taxable income in closed years in order to properly determine a taxpayer's liability for open years (and thus no corrections for taxable income in closed years). A's only apparent motive for such an election is to avail itself of a tax planning opportunity with the benefit of hindsight.”

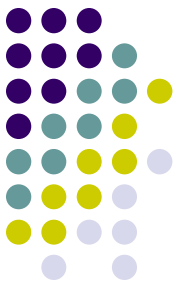


# Research Credit Data - 1

- From IRS SOI data
  - Types of credit formula claimed for 2006 by corporations
    - Regular 8,719,000 returns
      - \$4,599.6 million
    - AIRC 1,069,000 returns
      - \$475.8 million
    - Alternative simplified credit 192,000 returns
      - \$277.6 million claimed

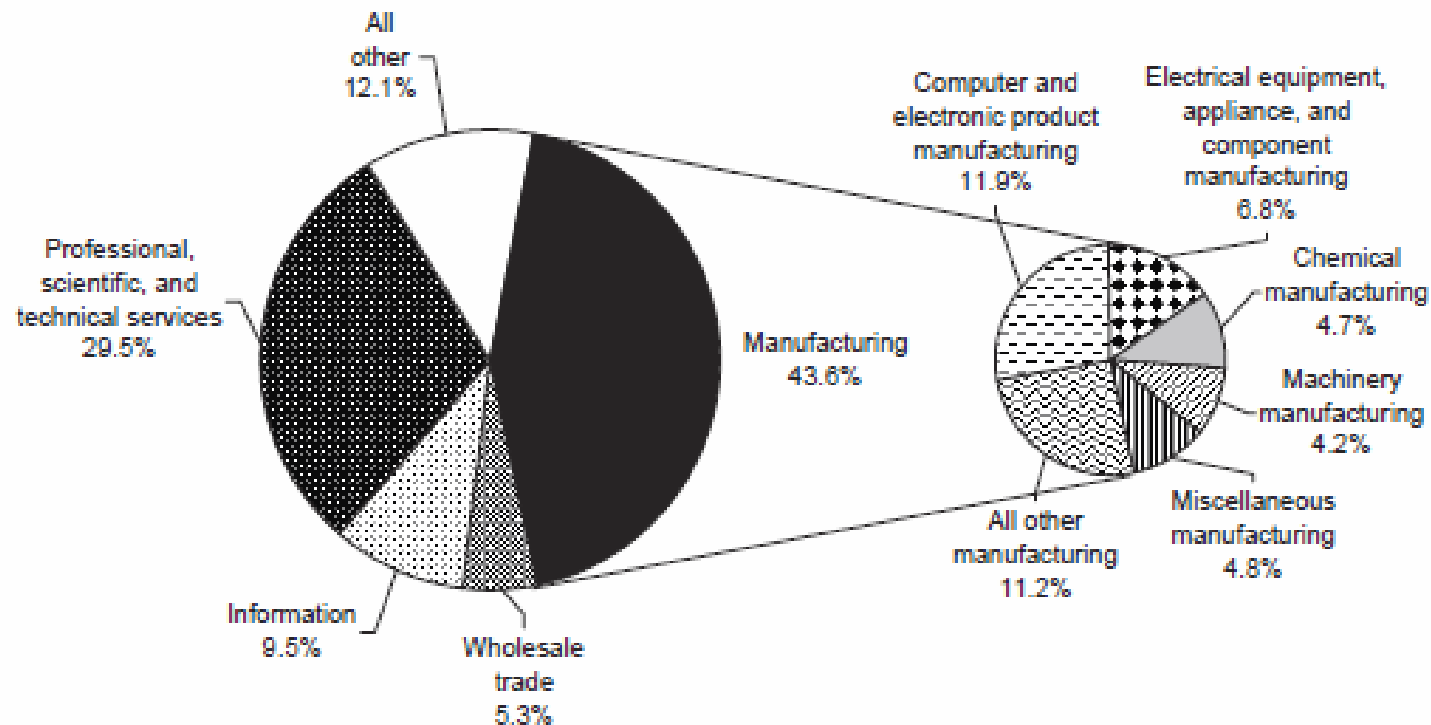
<http://www.irs.gov/taxstats/article/0,,id=164402,00.html>

Report - *The Credit for Increasing Research Activities: Statistics from Tax Years 2004–2005*;  
<http://www.irs.gov/pub/irs-soi/04-05crreac.pdf>

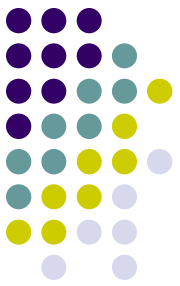


# Research Credit Data - 2

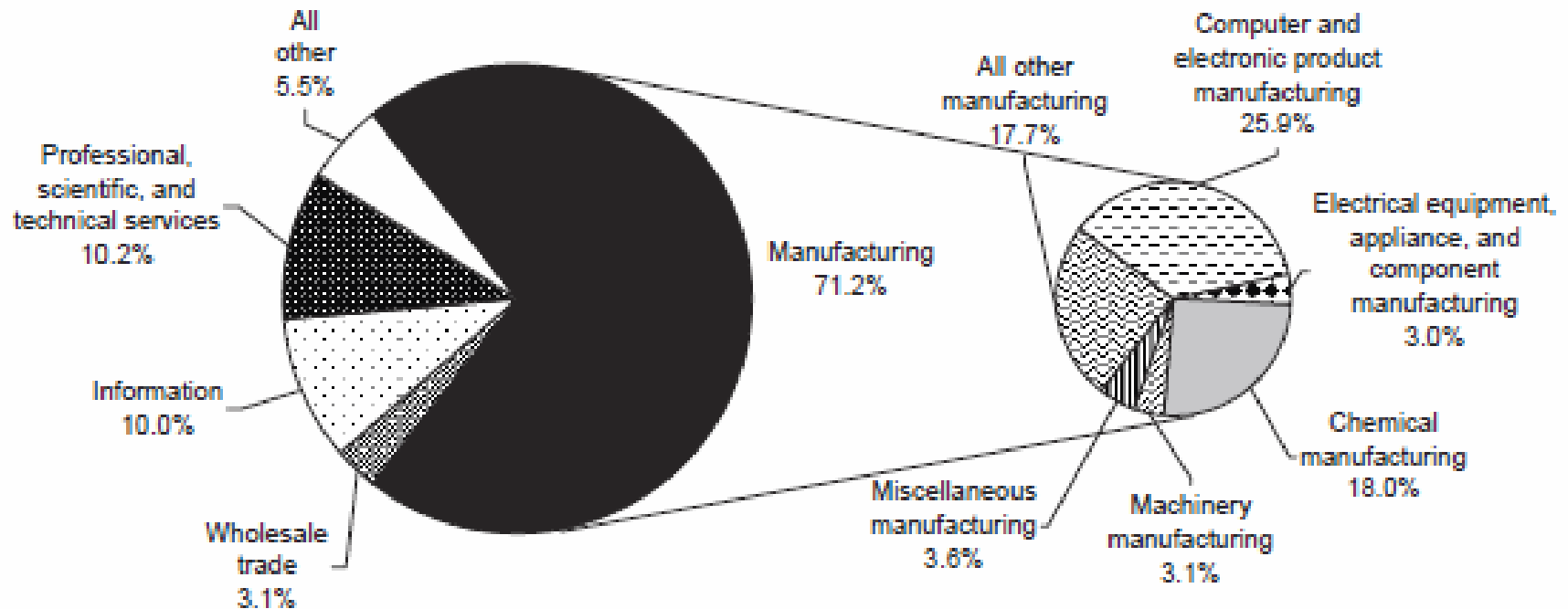
Number of Credit Claimants for Increasing Research Activities, by Industrial Sectors, Tax Year 2005



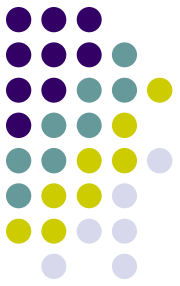
# Research Credit Data - 3



Credit Amounts Claimed for Increasing Research Activities, by Industrial Sectors, Tax Year 2005



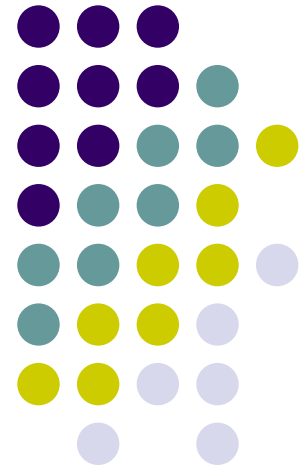
# Legislative activities wrt §41



- S. 1203 –
  - Extend research credit through 2010 and increase simplified credit to 20% (from 14%) and 10% (from 6%) if no research expenditures in any of prior 3 years.
  - After 2010, repeal regular credit and credit for basic research payments (41(e)) and energy research consortium payments and make simplified credit the calculation method and make the credit permanent.

# Property Transactions and Accounting Methods

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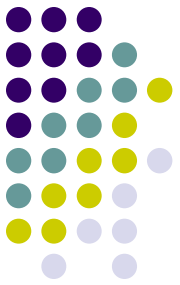


# Capitalization v expensing

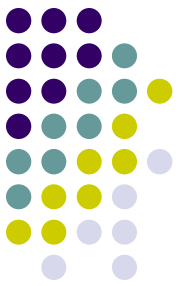


- *Santa Fe Pacific Gold Company and Subsidiaries*, 132 T.C. No. 12 (2009)
  - Treatment of white knight fees to avoid hostile takeover
  - Competitor C initiated hostile takeover of SF.
  - SF entered merger agreement with white knight H.
    - Provided for \$65 million fee should agreement be terminated.
  - Then C raised its offer which SF's board accepted.
  - SF paid a \$65 million termination fee to H.
  - SF deducted the \$65 million and IRS disallowed
  - C primarily acquiring SF because wanted its land and was only way to get it; fired employees and did not follow SF's strategic plans

# Santa Fe – cont'd



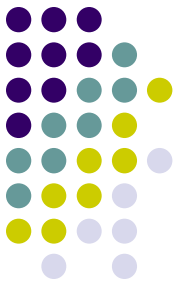
SF	IRS
No future benefit from the payment	Enabled a merger transaction to occur
Origin of claim is agreement with white knight which terminated	Origin of claim is SF's desire to merge



# Santa Fe – cont'd

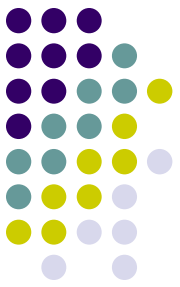
- Court
  - Record doesn't indicate a desire by SF to merge business operations
  - Payment of termination fee did not lead to any future benefits for SF
  - Not like Indopco fact pattern
  - Deductible under §162
  - Alternatively, deductible as §165 loss – the 2 possible mergers were not part of an overall plan
  - Key – look at facts and circumstances of what happened and why payments were made

# Repair vs. capitalization issue

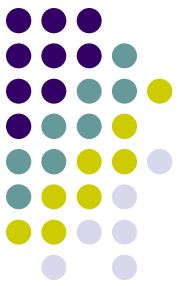


- LMSB directive noting that since 12/08, IRS has received several Forms 3115 seeking permission to change acctg method related to “unit of property” and (1) network assets, (2) store remodeling, or (3) general issues related to real property.
- Notes that further review is needed that likely involves an engineer and resources.

# Building v. Land Improvement



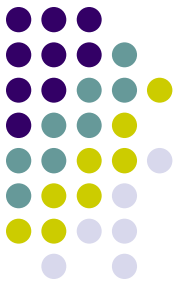
- Open air parking structure is a building (39 years) rather than a land improvement (15 years)
  - Walls not essential for a building
  - §6662 negligence penalty appropriate as there is no reasonable basis for taxpayer position that parking structure is a land improvement. T/p argument is frivolous.
  - “The fact that a taxpayer consulted an independent tax advisor is not, standing alone, conclusive evidence of reasonable cause and good faith if additional facts suggest that the advice is not dependable.” (even if got an opinion letter)
  - LMSB Coordinated Issue Paper
    - <http://www.irs.gov/businesses/article/0,,id=211507,00.html>



# §1031 and intangibles

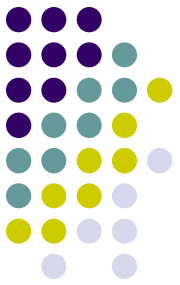
- CCA 200911006
  - IRS changed its position from TAM 200602034
  - Current view: “intangibles such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued apart from goodwill qualify as like-kind property under §1031.”
  - Position supported by *Newark Morning Ledger Co. v. U.S.*, 507 U.S. 546 (1993).

# Inventory & §263A



- Treatment of royalties – inventory or period cost?
  - *Robinson Knife Manufacturing*, TC Memo 2009-9
  - Royalties paid under agreements to allow manufacturer to use trademarks of others for manufacturing, advertising and packaging are indirect costs required to be capitalized under §263A.
  - Some of RKM’s licensors require that RKM show it a sample item produced so the licensor can be sure it meets their quality standards.
  - §1.263A-1(e)(3)(ii)(U) lists licensing as an example of an indirect cost required to be capitalized.
  - RKM also argued that the cost should not be included in the simplified production cost method calculation because it distorts income. The court noted that the simplified method was designed to lessen administrative burden, not to be accurate.

# Stock option levy



- **Chief Counsel Advice 200926001**

- “The IRS can seize and sell executive stock options held by the Taxpayer regardless of restrictions on the transferability of the options.”

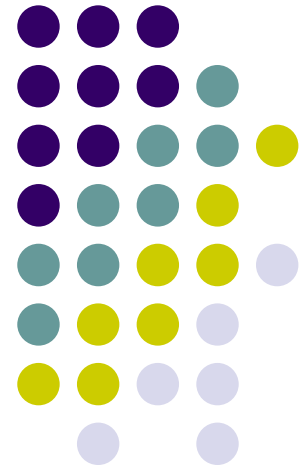
# Changes in Method of Accounting



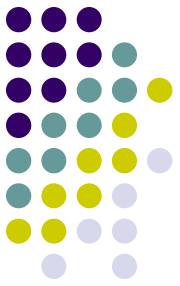
- Rev. Proc. 2009-39, 2009-38 IRB 371
  - Modifies both RP 97-27 and RP 2008-52
    - Modifications include to definitions of “under exam” and “issue under consideration” + to Appendix of RP 2008-52 that lists changes that do and do not qualify for automatic method change procedure
  - Ann. 2009-67, 2009-38 IRB 388 – modified RP 2009-39 for a “taxpayer that has a refund or credit under review by the Joint Committee on Taxation”

# Miscellaneous federal tax updates

- Software – royalties v operating income
  - Worker Classification
  - Procedures
  - Tax Gap
  - More



# Software income and §165(g)



PLR 200924040

- Issue – Are sub’s gross receipts from licensing specialized software developed for its clients excluded from definition of “royalties” as used at §165(g)(3)(B) so that sub is treated as an operating company and its worthlessness leads to ordinary loss rather than capital loss for parent?
- Answer – yes. Treat the software receipts as ordinary type income rather than royalties. Treat as “fees arising from sources that are integral to the development, manufacture, production or support of customized software applications.” Thus, sub is operating company with active gross receipts (rather than royalties).

# Employee vs. Independent Contractor



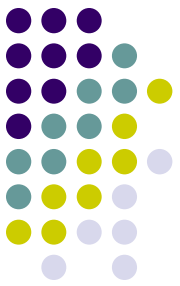
- IRS Summertime Tip 2009-20 provides list of 10 things a business owner should know
  - Focus on control – does ER have right to control means of doing the work?
  - Substantial penalties for misclassification.
  - ER and worker should consider filing SS-8 to get input from IRS.
  - <http://www.irs.gov/newsroom/article/0,,id=173423,00.html>

# Upcoming employment tax audits



- Will audit about 6,000 US employers starting Feb 2010 (rather than Nov 2009)
- To gather research for statistical analysis
- Look at worker classification, benefits, non-filing, executive pay, and more
- Will last for a few years.
- Estimated payroll tax gap is \$15 billion per year.

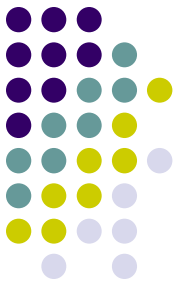
[“IRS to Audit 6,000 Companies for Employment Tax Compliance,” *Tax Notes*, 9/28/09, p. 1318]



# More – worker classification

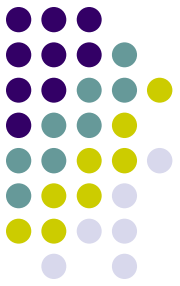
- IRS website:
  - <http://www.irs.gov/businesses/small/article/0,,id=9921,00.html>
- GAO study (9/09)
  - Suggestions to Dept of Labor and Treasury on how to do better at finding misclassifications including better sharing of info among agencies + combined outreach to employers and workers to provide guidance
    - <http://www.gao.gov/new.items/d09717.pdf>

# Worker classification proposed legislation



- HR 3408 - Taxpayer Responsibility, Accountability and Consistency Act of 2009
  - 1099 reporting of payments of \$600 or more to corporations
  - Worker classification clarifications including repeal of Section 530 safe harbors
  - Increase penalties for failure to file proper information (§6721) or comply with information reporting rules

# Retirement Security Guidance from IRS



- Various guidance “to make saving and choosing a retirement plan easier” such as how to save tax refunds and increase opportunities for automatic enrollment.
  - Can direct tax refund for purchase of savings bonds (Series I bonds)
- Notices 2009-65, -66, -67, - 68, Rev. Ruls. 2009-30, -31, 32
- See IRS website – (lots of links and info here)
  - <http://www.irs.gov/retirement/article/0,,id=212061,00.html>
  - <http://www.irs.gov/retirement/index.html>
  - NEW website approach – Retirement Plans Navigator (IR 2009-91) - <http://www.retirementplans.irs.gov/>
- Internal Revenue Bulletin (IRB) 2009-39 - <http://www.irs.gov/pub/irs-irbs/irb09-39.pdf>
- *Journal of Accountancy* summary article - <http://www.journalofaccountancy.com/Web/20092130.htm>



Internal Revenue Service

## IRS RETIREMENT PLANS NAVIGATOR

An easy retirement plan guide for small employers

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CHOOSE A PLAN

MAINTAIN A PLAN

CORRECT A PLAN

PLAN COMPARISON TABLE

HELPFUL LINKS

GLOSSARY



**Get the information you need quickly.**

Looking for the right retirement plan for you and your employees? We'll help make your decision easier. Already have a plan? You can keep it compliant with the help of our checklists and guides. And should you find a mistake, we'll help you correct it.

### Help your employees plan ahead.

There are [Lots of Benefits](#) (.pdf file) for you and your employees in setting up a retirement plan. Get information on common retirement plan options to help you choose a plan right for your business. If you already have a retirement plan, get information on maintaining that plan and correcting common plan errors.

#### [CHOOSE A PLAN](#)

Narrow your search for the right plan for your business.

#### [MAINTAIN A PLAN](#)

Get the information you need to ensure your company's retirement plan stays tax law compliant.

#### [CORRECT A PLAN](#)

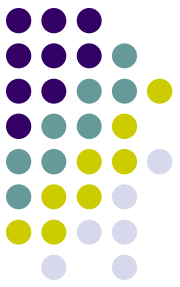
If you've found a mistake in your plan, we can help you correct it.



# Automatic Enrollment Easier

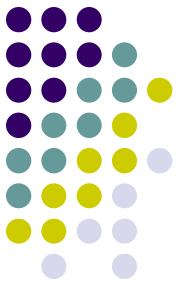


- Revenue Ruling 2009-30 - techniques for 401(k) plan sponsor to include automatic contribution increases in the plan.
- Notice 2009-65 - sample automatic enrollment plan language for a 401(k) plan sponsor.
- Notice 2009-66 - guidance for small employers to allow automatic enrollment to their SIMPLE IRA plans.
- Notice 2009-67 - sample automatic contribution language for SIMPLE IRA plan sponsor.



# E-commerce

- Canada Revenue Agency
- 7/30/09 News Release – “eBay sellers must declare all income for tax purposes,” states Minister Blackburn”
  - Correct mistakes as soon as possible
  - A court ruled that eBay was to disclose info on eBay sellers
  - Encouraging sellers to take advantage of the Voluntary Disclosure Program to avoid penalties and prosecution
  - <http://www.cra-arc.gc.ca/nwsrm/rlss/2009/m07/nr090730-eng.html>
- IRS info for online auction sellers
  - <http://www.irs.gov/businesses/small/industries/article/0,,id=163622,00.html>



# Schedule M-3

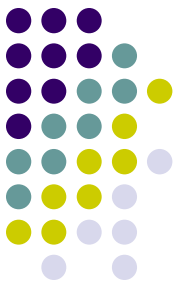
- Draft Schedule B

- <http://www.irs.gov/pub/irs-dft/f1120sb--dft.pdf>

- New questions

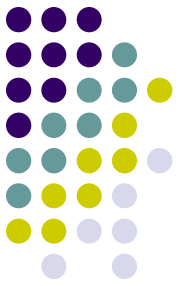
- 8 At any time during the tax year, did the corporation use an allocation method for indirect costs capitalized to self-constructed assets that varied from its financial method of accounting? . . . . .
- 9 At any time during the tax year, did the corporation treat for tax purposes indirect costs, as defined in Regulations sections 1.263A-1(e)(3)(ii)(F), (G), and (H), as mixed-service costs, as defined in Regulations section 1.263A-1(e)(ii)(C)? . . . . .
- 10 Did the corporation, under section 118 or 362(c) and the related regulations, take a return filing position characterizing any amount as a contribution to the capital of the corporation during the tax year by any non-shareholders? Amounts so characterized may include, without limitation, incentives, inducements, money, and property . . . . .

# Economic substance

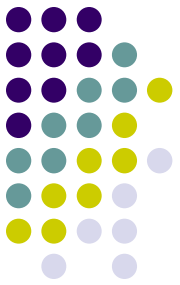


- *Klamath Strategic Investment Fund LLC, et al. v. US*, 103 AFTR 2d 2009-2220\_(5th Cir. 2009)
  - Used this interpretation of economic substance requirement: “if a transaction lacks economic substance compelled by business or regulatory realities, the transaction must be disregarded even if the taxpayers profess a genuine business purpose without tax-avoidance motivations.” Court stated was in line with USSC opinion in *Frank Lyon*, 435 U.S. 561 (1978)
  - Otherwise, courts would be rewarding “a “head in the sand” defense where taxpayers can profess a profit motive but agree to a scheme structured and controlled by parties with the sole purpose of achieving tax benefits for them. We therefore agree with the district court that since the loan transactions lacked economic substance, they must be disregarded for tax purposes.”

# Tax accrual workpapers



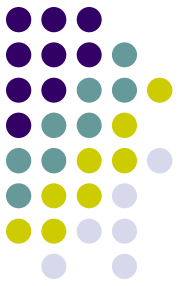
- *U.S. v. Textron*, 104 AFTR 2d 2009-5719 (1<sup>st</sup> Cir, 8/13/09)
  - En banc reversal (3-2)
  - Tax accrual workpapers were prepared for financial statement purposes, but have info useful to IRS - well known fact. Some lawyers were involved in prep of the workpapers.
  - Generally, IRS only seeks the workpapers if there is a listed transaction. Ann. 2002-63 – if multiple listed transactions, will ask for all workpapers rather than only those for the listed transaction
    - IRS review of a 2001 sub indicated 9 listed transactions – so asked for all workpapers + some prepared by EY on reserves
    - Summons issued. T claimed documents privileged
    - District Ct found papers not protected by attorney-client privilege or IRC §7525 privilege because had been shown to EY. But ct found papers were protected by work product privilege – T had expected litigation with IRS over certain tax return items (reason for a reserve being created).
      - Workpapers “prepared “because of” the prospect of litigation”
  - En banc – “work papers were independently required by statutory and audit requirements” thus work-product privilege n/a
    - Described situation as “one in which a document is not in any way prepared “for“ litigation but relates to a subject that might or might not occasion litigation.”
    - “It is not enough to trigger work product protection that the subject matter of a document relates to a subject that might conceivably be litigated.”
    - “Nor is it enough that the materials were prepared by lawyers or represent legal thinking.”
    - “work product protection does not extend to “documents that are prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation.” *Maine*, 298 F.3d at 70 (quoting *United States v. Adlman*, 134 F.3d 1194, 1202 (2d Cir. 1998))”
    - Conclusion – “work product privilege is aimed at protecting work done for litigation, not in preparing financial Statements.”
    - Dissent – should instead follow “because of” test – “document can be fairly said to have been prepared or obtained because of the prospect of litigation” – rather than the “prepared for” any litigation test. Also majority ignored that the workpapers included legal analysis on litigation outcome risks.



# Travel reimbursement rules

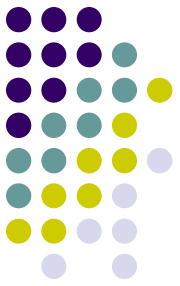
- Domestic per diem rates for upcoming fiscal year starting 10/1/09
  - [http://www.gsa.gov/Portal/gsa/ep/contentView.do?contentType=GSA\\_BASIC&contentId=17943](http://www.gsa.gov/Portal/gsa/ep/contentView.do?contentType=GSA_BASIC&contentId=17943)
- Rev. Proc. 2009-47, 2009-42 IRB \_\_\_
  - High-low substantiation method and related rules

# Efforts to reduce the tax gap - 1



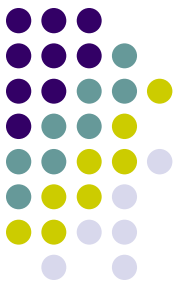
- Treasury/IRS issue updated report on how to reduce it (7/8/09)
  - [http://www.irs.gov/pub/newsroom/tax\\_gap\\_report\\_final\\_version.pdf](http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf)
  - Notes progress on past plans, current enforcement efforts and proposals of the Administration such as information reporting on payments to corporations

# Efforts to reduce the tax gap - 2

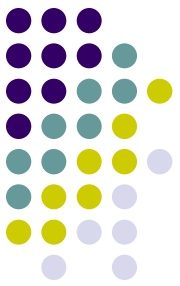


- GAO report - *Opportunities Exist to Improve Tax Compliance of Applicants for State Business Licenses* (6/15/09)
  - Reporting on plan in California that applicants for business license must show in compliance with employment taxes
  - “7,194 businesses that applied for a California business license one or more times from calendar years 2006 through 2008 about 24 percent had to file employment tax returns or pay overdue taxes to come into compliance with federal employment taxes. California businesses filed 441 employment tax returns and IRS collected nearly \$7.4 million in current dollars in employment taxes in calendar year 2006 and in 8 months of calendar year 2007.”
    - With low cost of operation, is a 22:1 ROI
  - <http://www.gao.gov/products/GAO-09-569>

# Efforts to reduce the tax gap - 3

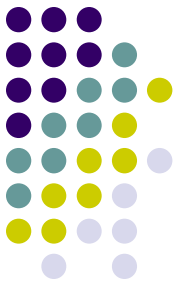


- Response of Senator Baucus to IRS report:
  - “the plan lacks specifics on long-term goals on improving the voluntary compliance rate and reducing the size of the tax gap. With an ongoing economic recession, these billions of dollars in lost tax revenue could help relieve undue tax burdens paid by honest families, and contribute to long-term economic stability”
  - Ants 90% tax compliance by 2017
  - <http://finance.senate.gov/press/Bpress/2009press/prb070809.pdf>
- Response of Senators Baucus and Grassley to GAO report:
  - “This report confirms my initial thinking that we can improve tax compliance through better cooperation between the IRS and state licensing boards. Checking to ensure that taxpayers seeking a business license are up to date on their tax obligations is a common sense approach to improving tax compliance. These are taxes already legally owed, so it’s not raising taxes on anyone. Partnering with state authorities could begin to reduce the burden on honest taxpayers who shoulder the billions of legally owed but unpaid dollars every year and help to fund priorities like health care,” Baucus said. “I am encouraged by the GAO’s findings and fully expect the IRS to follow up on recommendations to evaluate state licensing requirements and work with states to expand these arrangements as needed.”
  - <http://finance.senate.gov/press/Gpress/2009/prg071609b.pdf>



# More on tax gap

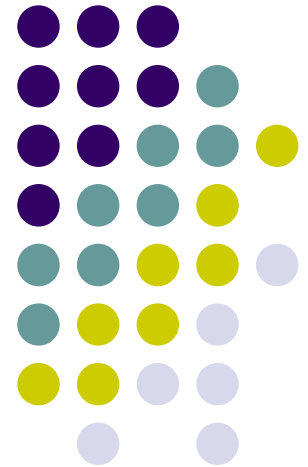
- IRS tax gap info on SE tax and international income -
  - <http://www.irs.gov/businesses/article/0,,id=211508,00.html>
- Entire int'l tax gap alerts at -  
<http://www.irs.gov/businesses/article/0,,id=180259,00.html>
- IRS Tax Gap page -  
<http://www.irs.gov/newsroom/article/0,,id=158619,00.html>



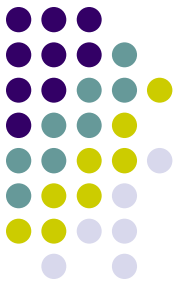
# ISO and ESPP Reporting

- IRS likely to continue to delay information reporting of ISO and ESPP info on new Forms 3921 and 3922 as required by IRC §6039
  - IRS Announcement expected to be issued
  - Source: RIA *Federal Taxes Weekly Alert Newsletter* 10/8/09

# On the horizon



# Obama's revenue proposals - 1



## Tax Cuts for Families and Individuals:

- Provide the making work pay tax credit 3/ .....
- Expand the earned income tax credit 3/ .....
- Expand the refundability of the child tax credit 3/ .....
- Expand the saver's credit and provide for automatic enrollment in IRAs 3/ .....
- Provide the American opportunity tax credit 3/ .....
- Subtotal, tax cuts for families and individuals .....**

## Tax Cuts for Businesses:

- Eliminate capital gains taxation on investments in small business stock .....
- Make the research & experimentation tax credit permanent .....
- Expand net operating loss carryback .....
- Subtotal, tax cuts for businesses .....**

## Modify Federal Aviation Administration Financing .....

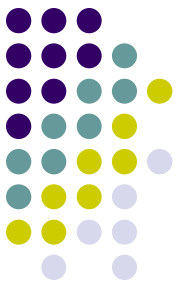
## Continue Certain Expiring Provisions Through Calendar Year 2010 3/ .....

## Other Revenue Changes and Loophole Closers:

- Reinstate Superfund excise taxes .....
- Reinstate Superfund environmental income tax .....
- Tax carried (profit) interests as ordinary income .....
- Codify economic substance doctrine .....
- Repeal LIFO method of accounting for inventories .....
- Reform U.S. international tax system:*
  - Reform business entity classification rules for foreign entities .....
  - Defer deduction of expenses, except R&E expenses, related to deferred income ..
  - Reform foreign tax credit: Determine the foreign tax credit on a pooling basis .....
  - Reform foreign tax credit: Prevent splitting of foreign income and foreign taxes ....
  - Limit shifting of income through intangible property transfers .....
  - Limit earnings stripping by expatriated entities .....
  - Prevent repatriation of earnings in certain cross-border reorganizations .....
  - Repeal 80/20 company rules .....
  - Prevent the avoidance of dividend withholding taxes .....
  - Modify tax rules for dual capacity taxpayers .....
  - Combat under-reporting of income through use of accounts and entities in offshore jurisdictions .....

<http://ustreas.gov/offices/tax-policy/library/grnbk09.pdf>

May 2009



# Obama's revenue proposals - 2

Require information reporting for rental property expense payments .....

*Eliminate oil and gas company preferences:*

Levy tax on certain offshore oil and gas production .....

Repeal credit for enhanced oil recovery projects 4/ .....

Repeal credit for production from marginal wells 4/ .....

Repeal expensing of intangible drilling costs .....

Repeal deduction for tertiary injectants .....

Repeal passive loss exemption for working interests in oil and gas properties .....

Repeal percentage depletion .....

Repeal domestic manufacturing deduction for oil and gas production .....

Increase the amortization period for geological and geophysical costs to seven years...

*subtotal, eliminate oil and gas company preferences* .....

Eliminate the advanced earned income tax credit 3/ .....

**Upper-Income Tax Provisions Dedicated to Deficit Reduction:**

Reinstate the 39.6% rate .....

Reinstate the 36% rate for taxpayers with income over \$250,000 (married) and \$200,000 (single) .....

Reinstate the limitation on itemized deductions for taxpayers with income over \$250,000 (married) and \$200,000 (single) .....

Reinstate the personal exemption phaseout (PEP) for taxpayers with income over \$250,000 (married) and \$200,000 (single) .....

Impose a 20% rate on dividends and capital gains for taxpayers with income over \$250,000 (married) and \$200,000 (single) .....

**Subtotal, upper-income tax provisions dedicated to deficit reduction** .....

.. -

# Obama revenue proposals to fund health care reform - 1



Limit the tax rate at which itemized deductions reduce tax liability to 28% .....

*Reduce the tax gap and make reforms:*

*Expand information reporting:*

- Require information reporting for private separate accounts of life insurance companies ....
- Require information reporting on payments to corporations .....
- Require a certified Taxpayer Identification Number from contractors .....
- Require increased information reporting for certain government payments .....
- Increase information return penalties .....
- subtotal, expand information reporting* .....

*Improve compliance by businesses:*

- Require E-filing by certain large organizations .....
- Implement standards clarifying when employee leasing companies can be held  
liable for their clients' Federal employment taxes .....
- subtotal, improve compliance by businesses* .....

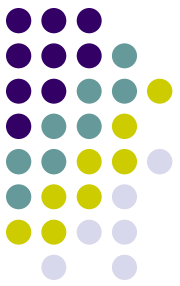
*Strengthen tax administration:*

- Allow assessment of criminal restitution as tax .....
- Revise offer-in-compromise application rules .....
- Expand IRS access to information in the National Directory of New Hires for tax  
administration purposes .....
- Make repeated willful failure to file a tax return a felony .....
- Facilitate tax compliance with local jurisdictions .....
- Extension of statute of limitations where state adjustment affects federal tax liability .....
- Improve investigative disclosure statute .....
- Expand required electronic filing by tax preparers .....
- subtotal, strengthen tax administration* .....

*Expand penalties:*

- Clarify that bad check penalty applies to electronic checks and other payment forms .....
- Impose a penalty on failure to comply with electronic filing requirements .....

# Obama revenue proposals to fund health care reform - 2



## *Make reforms to close tax loopholes:*

### *Financial institutions and products:*

- Require accrual of income on forward sale of corporate stock .....
- Require ordinary treatment for certain dealers of equity options and commodities .....
- Modify the definition of control for purposes of section 249 deduction limit .....
- subtotal, financial products* .....

### *Insurance companies and products:*

- Modify rules that apply to sales of life insurance contracts .....
- Modify dividends-received deduction for life insurance company separate accounts .....
- Expand pro rata interest expense disallowance for corporate-owned life insurance .....
- subtotal, insurance companies and products* .....

### *Tax accounting methods:*

- Deny deduction for punitive damages .....
- Repeal lower-of-cost-or-market inventory accounting method .....
- subtotal, tax accounting methods* .....

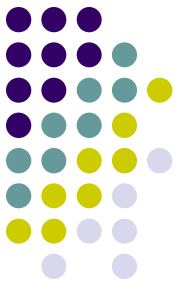
### *Modify estate and gift tax valuation discounts and make other reforms:*

- Require consistency in value for transfer and income tax purposes .....
- Modify rules on valuation discounts .....
- Require a minimum term for grantor retained annuity trusts (GRATs) .....
- subtotal, modify estate and gift tax valuation discounts and make other reforms* .....

### *Subtotal, make reforms to close tax loopholes* .....

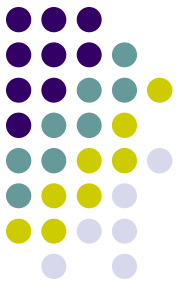
- Modify alternative fuel mixture credit .....

# Observations on President's proposals



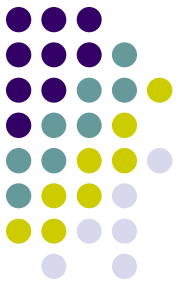
- Codifying economic substance
  - Included in H.R. 3200 Health Reform Bill
- 10/12/09
  - President Obama stated he would not pursue the int'l provisions of his proposals opposed by business community (such as deferral), but they could return as part of overall tax reform
    - *Wall Street Journal*, "Business Fends Off Tax Hit," 10/13/09
- More information:
  - Joint Committee on Taxation analysis (JCS-2-09; JCS-3-09 and JCS-4-09)
  - Treasury explanation (green book) - <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>

# Clean Water Trust Fund and possible taxes



- GAO report on expected shortfall for wastewater infrastructure and possible funding sources for a Clean Water Trust Fund
  - <http://www.gao.gov/products/GAO-09-657> (5/09)
- H.R. 3202 includes tax proposals:
  - Sale of water-based beverage of 4¢/container if container is 5 gallons or less and is at least 50% water by weight
  - Sale of water disposal product of 3% of sales price (includes soaps and detergents, toiletries, toilet tissue, water softeners, and cooking oils)
  - Pharmaceutical tax of 0.5% of the sales price
  - Clean water restoration tax on corps – 0.15% of excess of AMTI over \$4 million
- 7/15/09 hearing in House Transportation and Infrastructure Committee
  - <http://transportation.house.gov/hearings/hearingDetail.aspx?NewSID=947>

# Provisions expiring 12/31/09



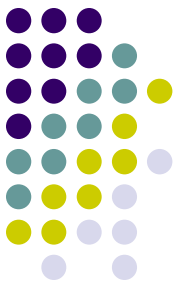
- Per Joint Committee on Taxation (JCS-20-09) 73 provisions expire 12/31/09 including –
  - Increased personal exemption amount for AMT
  - Increased §179 expensing to \$250,000/\$800,000
  - New markets tax credit
  - R&D credit
  - Add'l 50% first year depreciation
  - Election to accelerate AMT and research credits in lieu of additional first-year depreciation (sec. 168(k)(4))
  - Enhanced deduction for corporate contributions of computer equipment for educational purposes (sec. 170(e)(6)(G))
  - Suspension of applicable high-yield debt obligation rules for debt issued in an exchange or as a result of modification (sec. 163(e)(5))
  - FUTA surtax of 0.2 percent
  - 65% subsidy for payment of COBRA health care coverage continuation premiums

# President Obama Tax Reform Task Force



- Tax subgroup of the President's Economic Recovery Advisory Board (PERAB)
- Focused on
  - Simplification
  - Corporate reform and closing loopholes
  - Enforcement and reducing tax gap
- A new tax system is not the goal
- Report due 12/4/09
- Public hearing on 9/30/09
  - <http://www.whitehouse.gov/blog/Streaming-at-1230-PERAB-Meeting-on-Tax-Reform/>

# Fiscal Woes - 1



Under the alternative fiscal scenario, by contrast, expiring tax provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) would be extended, and the AMT would be indexed to inflation. As a result, revenues would grow only slightly faster than the economy, equaling 22 percent of GDP by 2080. Slowly growing revenues combined with sharply rising expenditures would create an explosive fiscal situation. Under the spending and revenue policies incorporated in this scenario, federal debt would surpass 100 percent of GDP in 2023 and exceed 200 percent of GDP by the late 2030s.

Congressional Budget Office, *The Long-Term Budget Outlook*, June 2009, pg. 5; <http://www.cbo.gov/doc.cfm?index=10297>

- Deficit for first 9 months of FY09 = \$1.1 trillion
- <http://www.cbo.gov/ftpdocs/104xx/doc10433/07-04-mbr.htm>

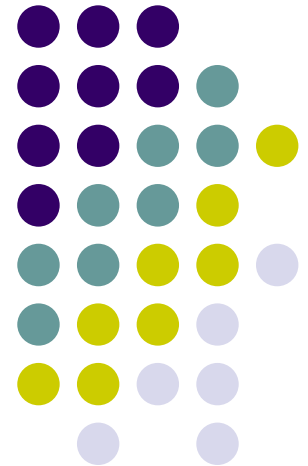


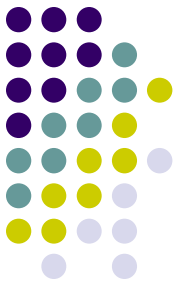
# Deficits and \$trillions

- “CBO estimates, in its latest Monthly Budget Review, that the federal budget deficit was about \$1.4 trillion in fiscal year 2009, nearly \$1 trillion greater than the shortfall recorded in 2008. Relative to the size of the economy, the 2009 deficit was equal to 9.9 percent of GDP (the highest since 1945), compared with 3.2 percent in 2008.”
  - <http://cboblog.cbo.gov/?p=385>

# Multistate Tax Developments

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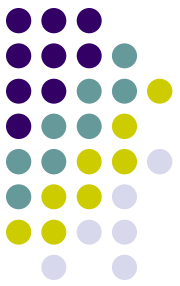




***ANY TAX ADVICE IN THIS COMMUNICATION IS NOT INTENDED OR WRITTEN BY KPMG TO BE USED, AND CANNOT BE USED, BY A CLIENT OR ANY OTHER PERSON OR ENTITY FOR THE PURPOSE OF (i) AVOIDING PENALTIES THAT MAY BE IMPOSED ON ANY TAXPAYER OR (ii) PROMOTING, MARKETING OR RECOMMENDING TO ANOTHER PARTY ANY MATTERS ADDRESSED HEREIN.***

***You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.***

***The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.***



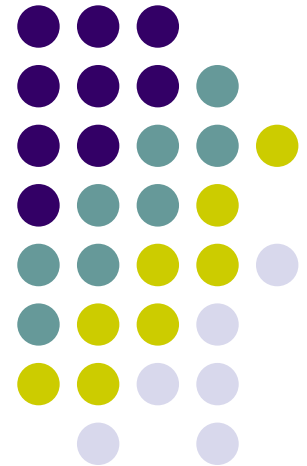
# Agenda

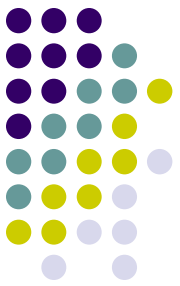
- California Franchise Tax Developments
- Multistate Income/Franchise Tax Developments
- Multistate Sales & Use Tax Developments
- Commission on the 21<sup>st</sup> Century Economy

# California Franchise Tax Developments

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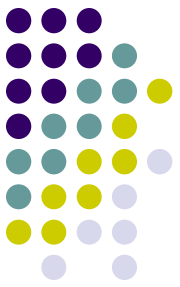
- Legislation
- Administrative Guidance
- Decisions





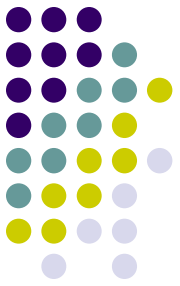
# Legislation

- Budget Bill (signed 9/30/08, unless otherwise noted)
  - Net operating losses suspended for taxable years beginning on or after January 1, 2008 but before January 1, 2010
    - Extends carryforward provisions to 20 years for NOLs incurred in tax years beginning on or after January 1, 2008
    - NOLs attributable to tax years beginning on or after January 1, 2011 may be carried back to the preceding two taxable years
  - Limits use of certain business credits for the 2008 and 2009 tax year
    - Cannot reduce tax below 50 percent of the tax due
    - Credits may be assigned to a member of the taxpayer's unitary group and applied to the assignee's tax liability in tax years beginning on or after January 1, 2010



# Legislation

- New penalty provisions (signed 10/1/08)
  - New 20 percent understatement penalty
- Revised percentages of estimated tax due (signed 10/1/08)
- Use tax presumption
  - Rebuttable presumption that certain vehicles, vessels, and aircraft brought into California within 12 months of purchase were purchased for use or consumption in California
- LLC fee acceleration
  - Fee must be estimated and paid by 15<sup>th</sup> day of sixth month of current taxable year



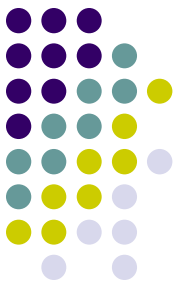
# Legislation

- AB 3X – 3 (signed 2/20/09)
  - State sales tax rate increased by one cent
    - Effective April 1, 2009 through June 31, 2011
- SB 3X – 15 (2/20/09)
- All provisions effective for tax years beginning on or after January 1, 2011
  - General corporations can elect SSF
  - Factor presence nexus test
  - Market-based sourcing rules
  - Return to *Finnigan*
  - Gross receipts defined to exclude treasury function receipts



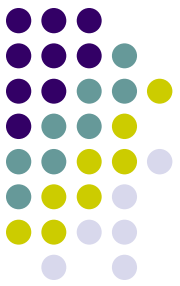
# Legislation

- ABx4 17, ABx4 18 (signed 7/28/09)
  - Accelerated estimated corporate income tax payments for taxable years beginning on or after January 1, 2010
    - 30%/40%/-0-/30%
  - Increased wage withholding rates commencing Nov, 2009
  - Requires backup withholding of 7 percent (when required by federal law – although CA excludes withholding on interest and dividends)
  - Certain non-retailers with \$100,000+ receipts must register with the Board of Equalization and file annual use tax returns



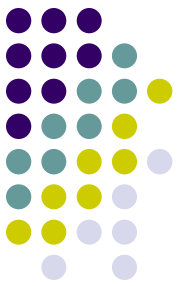
# Administrative Guidance

- California FTB Notice 2009-06 (7/20/09)
  - Because there are various methodology that can be used to calculate taxable margin, the FTB cannot determine for every taxpayer whether the Texas Margin Tax is an income tax, or a deductible gross receipts tax
  - Appears to conclude that if a taxpayer deducts COGS or compensation in computing margin, will be considered an income tax
- Missouri Private Letter Ruling No. LR 5309 (12/12/08)
  - Texas Margin Tax and Michigan Business Tax are income taxes and taxpayers can take a credit for taxes paid on their Missouri returns
- See also: FTB Notice 2009-08 and 2009-09



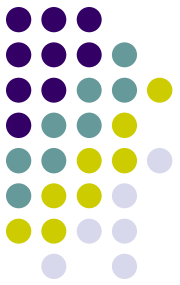
# Decisions

- *Matter of Personal Selling Power, Inc. (3/16/09)*
  - Out-of-state seller of magazine advertising was selling a service and was not protected from taxation under Public Law 86-272
    - The taxpayer argued that P.L. 86-272 applied because the magazines were tangible personal property
  - The Board noted the sale transactions related to the right to have a customer's words and images appear in the taxpayer's magazine, not the purchase by the advertisers of the magazines themselves



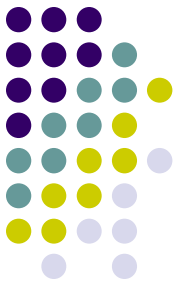
# Decisions

- *Abbott Laboratories v. Franchise Tax Bd.* (Cal. App. 8/6/09)
  - A statute allowing a dividends-received deduction was properly struck down because it was unconstitutional in its entirety and could not be judicially reformed
    - Taxpayer argued that only the portion of the statute providing that only dividends received from a corporation subject to California tax were deductible was struck
      - Thus, another subsection imposing limitations on the amount of such dividends that could be deducted was still operable
  - Court rejected taxpayer's contention



# Decisions

- Gross Receipts vs. Net Gains
  - *In re Home Depot* (12/18/08)
    - California State Board of Equalization ruled that the FTB did not demonstrate by “clear and convincing” evidence that including gross receipts from the redemption of marketable securities in the taxpayer’s sales factor created distortion
    - Thus, taxpayer not required to use alternative apportionment formula
    - Board did not provide analysis of its decision; however, the facts differed significantly than the taxpayer’s in *Microsoft*

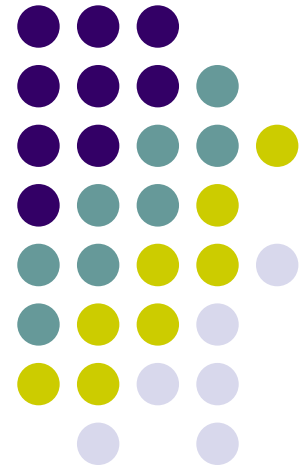


# Decisions

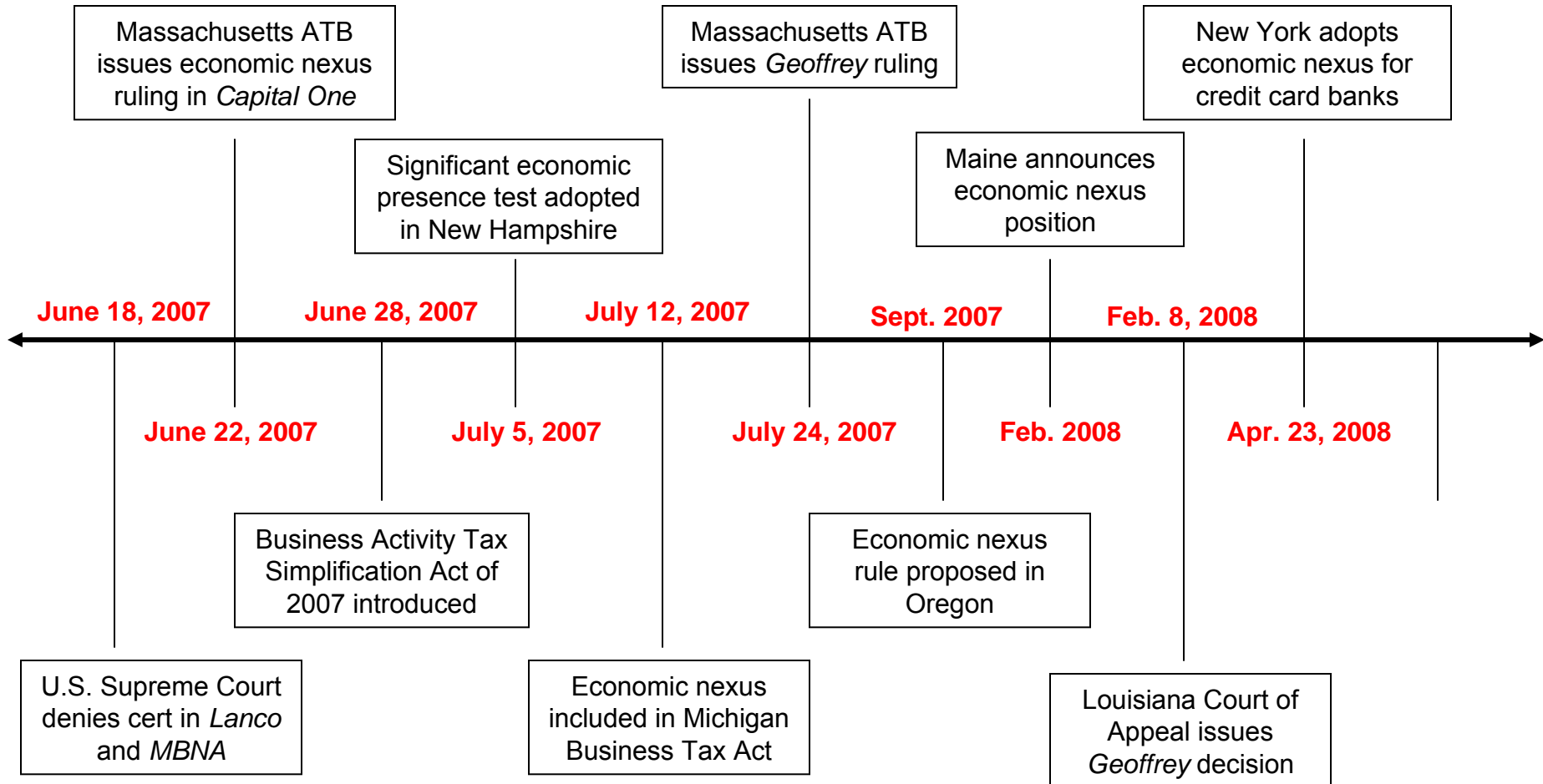
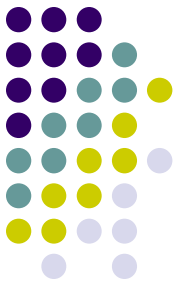
- Gross Receipts vs. Net Gains
  - *General Mills v. Franchise Tax Board* (Cal. App. 4/15/09)
    - Court held that gross receipts from commodity futures sales should be included in the taxpayer's California sales factor
      - Rejected FTB's contention that receipts should be excluded entirely or only net gains should be included
    - Remanded to determine whether including the full amount of the contracts created distortion so that the FTB could apply an alternative apportionment formula
  - Definition of gross receipts effective for tax years beginning on or after 1/1/2011 excludes receipts from hedging transactions

# Multistate Income/ Franchise Tax Developments

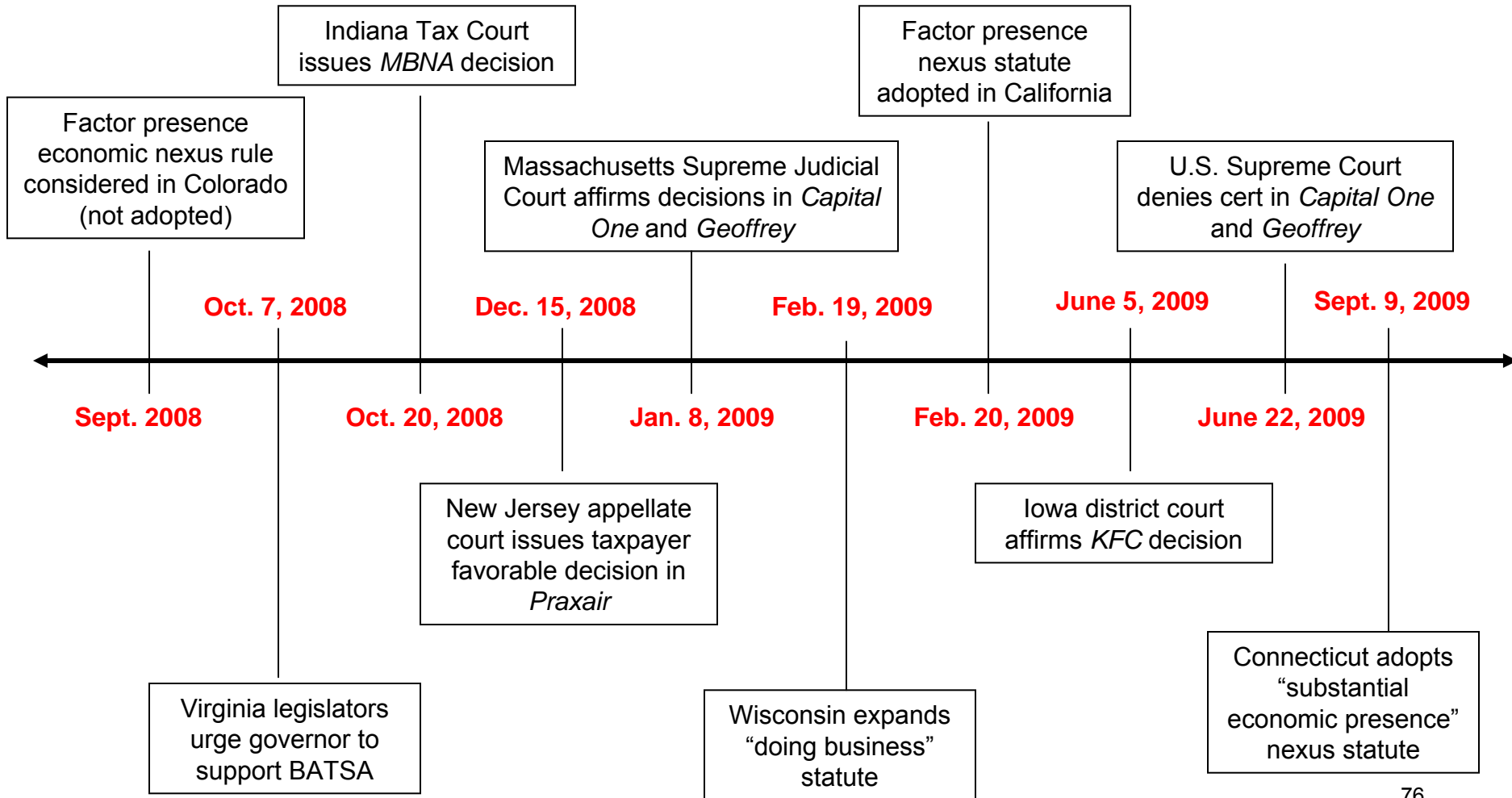
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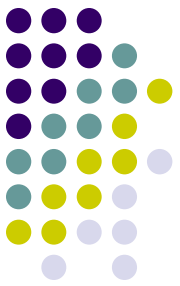


# Nexus - Post *Lanco* and *MBNA*



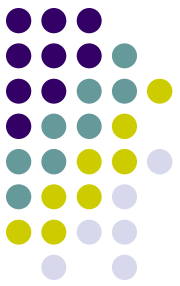
# Nexus - Post *Lanco* and *MBNA*





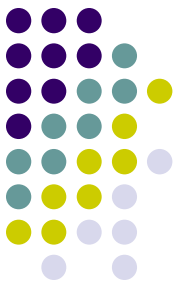
## P.L. 86-272 and Throwback

- *Accuzip Inc. v. Division of Taxation* (N.J. Tax Ct. 8/13/09)
  - Two out-of-state taxpayers sold copyrighted software on CD-ROM or diskettes to New Jersey customers
    - Division asserted that taxpayers were licensing intangibles, not selling tangible personal property
  - Court held that selling software in hard copy not licensing intangibles in state (i.e., *Lanco* nexus situation did not exist)
    - As the taxpayers were selling tangible personal property, P.L. 86-272 applied
  - Court also rejected Division's argument that the *MBNA* significant economic presence test should be applied in New Jersey



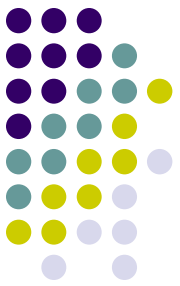
# Allocation and Apportionment

- Allocable or Apportionable?
  - *McKesson v. Division of Taxation* (N.J. Super. App. Div. 7/16/09)
    - Gain from 338(h)(10) deemed asset sale is nonoperational (nonbusiness) income
    - New Jersey law only incorporates the “functional test”
      - Requires that acquisition, management, and disposition must all be integral to the taxpayer’s business operations
    - Sale was an extraordinary event, proceeds were distributed to parent, no operational function continued after sale and parent did not reinvest proceeds in similar business



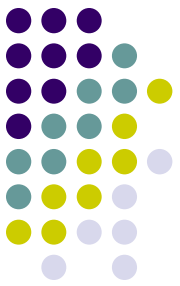
# Use of Discretionary Authority

- *Wal-Mart Stores East, Inc. v. Hinton* (N.C. App. 5/19/09)
  - Secretary of Revenue forcibly combined taxpayer, holding company, and a REIT
    - Assessed \$30 million in taxes, interest, and fees
    - Taxpayer argued that the Secretary could not forcibly combine the parties unless there were transactions in excess of fair compensation
  - Court upheld ruling that the Secretary was permitted to force combination
    - Statutory support for authority to combine the entities
    - Taxpayer's return did not reflect its true earnings
      - Court looked to *Mobil* and *Allied-Signal* and held that when taxpayers are unitary "true earnings" distortion can exist even if transactions between the entities are arm's length
  - 25 percent understatement penalties applied regardless of whether taxpayer was negligent



## Pass Through Entities

- *Kmart Michigan Property Services, LLC v. Department of Treasury* (Mich. App. Ct. 5/12/09)
  - A single-member limited liability company (SMLLC) treated as a disregarded entity for federal tax purposes was not required to file a Single Business Tax (SBT) return as a division of its owner
  - Neither the SBT nor federal regulations require an entity be consistently classified for state and federal taxation

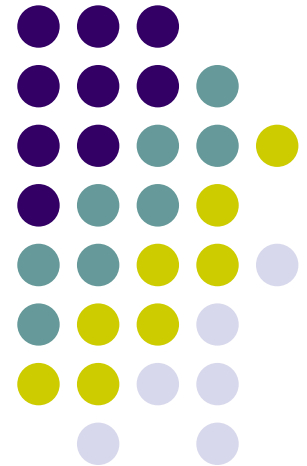


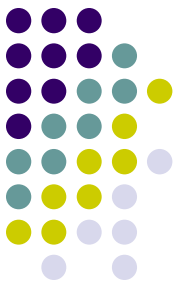
# Amnesty Programs

- Oregon
  - October 1 – November 19, 2009
  - Applies to income, inheritance and mass transit taxes
  - Waiver of penalty and 50 percent interest
  - To qualify, must have been required to file return for a year prior to 2008, complete amnesty application, and within 60 days of amnesty completion, file and pay all tax and one half of interest due
  - Amnesty may not be claimed for any year for which DOR has issued notice of deficiency or assessment
  - Taxpayer may not file refund claim and must forego appeal rights on amounts paid under amnesty
  - Additional 25 percent post-amnesty penalty, but does not apply to deficiencies resulting from federal adjustment unless certain federal penalties applied

# Multistate Sales & Use Tax Update for High-Tech Companies

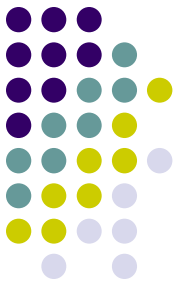
## Nexus Issues





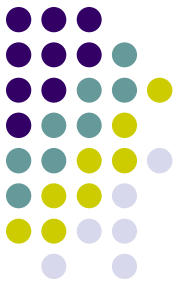
# Nexus – Attribution, Other

- *Amazon.com* (N.Y. Sup. Ct. 1/12/09)
  - Amazon.com challenged New York’s revised law requiring it to collect sales and use tax on sales to New York customers
  - Under the statute, nexus exists because Amazon contracts with New York residents who have a link to Amazon.com on their own Web sites
    - Presumption that nexus is created can be rebutted by demonstrating that no New York residents actively solicit sales of Amazon’s products
  - Trial court rejected Amazon’s facial and as applied constitutional challenges to the revised vendor statute
    - “Amazon should not be permitted to escape tax collection indirectly, through use of an incentivized New York sales force to generate revenue, when it would not be able to achieve tax avoidance directly through use of New York employees engaged in the very same activities.”



## Nexus – Attribution, Other

- Other states have considered similar Amazon tax legislation
  - Enacted in North Carolina and Rhode Island
  - Passed by the legislature, but vetoed in California and Hawaii
  - Considered but not passed by the legislature in Connecticut, Minnesota, and Tennessee
- More states to consider next legislative session?

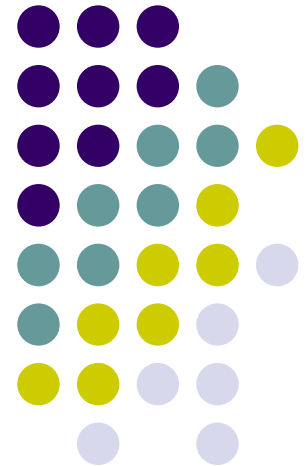


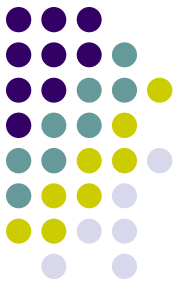
# New York Legislation

- Budget Bill (signed 4/7/09)
  - Affiliate nexus provisions
    - Effective June 1, 2009, the definition of “vendor” includes sellers who are affiliated with a New York business if one of two conditions is met:
      - The New York business is a sales tax vendor that uses a trademark, service mark or trade name in New York that is the same as that used by the affiliated remote seller, or
      - There is more than fifty percent direct or indirect common ownership between the in-state and out of state affiliates and the in-state affiliate performs certain activities in New York that benefit the remote affiliate in its development of a market for its goods and services

# Multistate Sales & Use Tax Update for High-Tech Companies

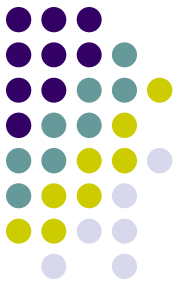
Sales and Use Taxes –  
Software, Digital Goods





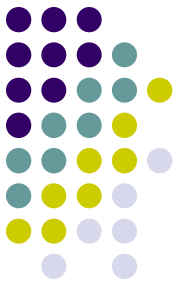
# Digital Goods

- Over the last few years, states have considered the taxation of the growing digital products market
- In addition, the SSUTA requires that member states tax digital goods specifically, rather than via the state's definition of tangible personal property
- In 2008, provisions taxing digital equivalents transferred electronically were adopted in IN, NE, SD, TN, UT
- In 2009, proposals adopted in KY, MS, NC, VT, WA, WI
  - Other proposals considered in CA, NY



# North Carolina Legislation

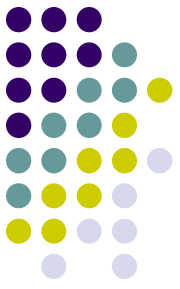
- S.B. 202 (signed 8/7/09)
  - Expands sales tax base to include digital goods
  - 1 percent sales and use tax increase through July 1, 2011
  - Repeals exemptions for certain computer software delivered electronically or by load and leave
  - 3 percent corporate income tax surcharge for 2008 and 2009



# Wisconsin Legislation

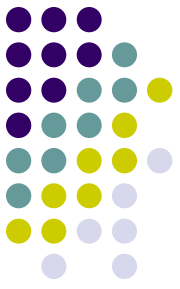
- S.B. 62 (signed 2/19/09) (cont'd)
  - Imposes sales and use taxes on digital goods
  - Effectively fixes Menasha decision by defining prewritten computer software
  - Wisconsin positioned to become Associate Member of Streamlined Sales and Use Tax Governing Board on July 1, 2009; Full Member status as of October 1, 2009

# Sales and Use Taxes – Software, Digital Goods



- Missouri LR5058 (8/29/08)
  - Sales of photographs downloaded over the Internet, when no transfer of tangible personal property was made to the purchaser, are not subject to Missouri sales and use tax
- Missouri LR5532 (3/13/09)
  - Sales of architectural images transmitted electronically subject to sales tax
    - Original architectural images were created in the form of formal watercolor paintings and then scanned and sent to customers
  - True object of the transaction was to acquire the tangible original drawings and thus the transaction was subject to sales tax

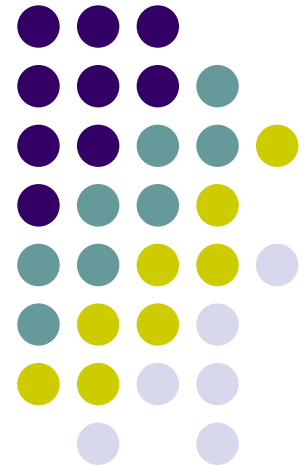
# Sales and Use Taxes – Software, Digital Goods

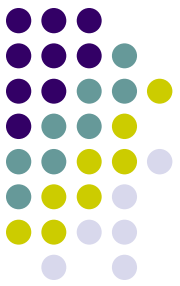


- *Bakewell v. Comm’r of Revenue* (Minn. Tax Ct. 2/19/09)
  - Transfer of photographs on DVD subject to sales and use tax because customer paid for the ease of portability and retrievability of the DVD
    - If transmitted electronically, photos would not be subject to tax
- Nebraska – Rev. Rul. 01-08-3 (8/25/08)
  - Digital goods are subject to tax when delivered electronically if the products are taxable when delivered on tangible storage media
- New York – TSB-A-08(22)S (5/2/08); TSB-A-07(11)S (4/12/07)
  - Videos delivered electronically not subject to sales and use tax

# Multistate Sales & Use Tax Update for High-Tech Companies

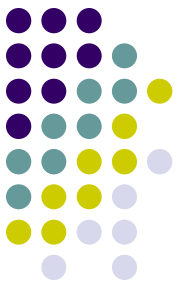
## Sales and Use Taxes – Taxability





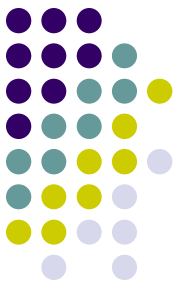
# Sales and Use Taxes – Taxability

- *City of Peoria v. Brinks Home Security, Inc.* (12/8/08)
  - Arizona court held that a taxpayer was liable for municipal transaction privilege tax on its sale of property monitoring services in certain Arizona cities
    - The taxpayers alarms were attached to Arizona properties, but signals related to fire or intruders were sent to its employees located in Texas
  - Issue was whether the services were interstate in nature because of the presence of the taxpayer's employees in Texas
    - If so, tax could not be imposed
  - The court held that the monitoring services were primarily intrastate in nature because most of the time there was no activity detected at the property and thus, no signals were sent out of state



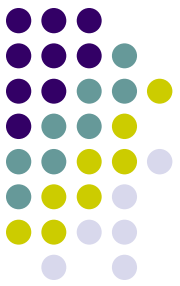
# Sales and Use Taxes – Taxability

- *In re Easylink Services International, Inc* (N.Y. Tax App. Trib. 7/27/09)
  - Taxpayer provided certain types of electronic data services
  - Following an audit, the Department issued a sales tax assessment on the basis that the taxpayer’s services were “telephony” or “telegraphy” services subject to tax in New York State
    - ALJ concluded the taxpayer’s services did not fit within the narrow and antiquated definitions of telephony and telegraphy services subject to sales and use tax
  - On appeal, Tribunal held that taxpayer was providing the service of acceptance and delivery of data, which resembled the role of a traditional telephone or telegraph company
  - Taxpayer’s services were taxable as telephony or telegraphy.



# Sales and Use Taxes – Taxability

- *Global Knowledge Training v. Levin* (Bd. Tax. App. 7/28/09)
  - Board of Tax Appeals held that certain computer related training services met the definition of computer services subject to sales and use tax
    - Computer services includes “training of computer programmers and operators, provided in conjunction with and to support the sale, lease, or operation of taxable computer equipment or systems.”
  - Board rejected taxpayer’s argument that it was providing professional services because the training was not provided in conjunction with the sale or operation of computer equipment or systems
  - Also, held that taxpayer’s customers generally had technical expertise required to be treated as a computer programmer or operator

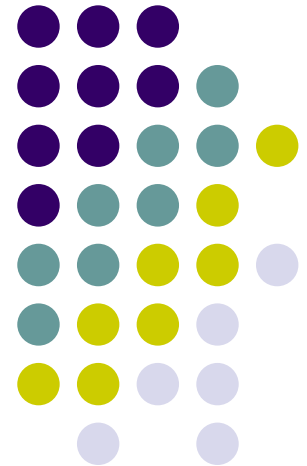


# Sales and Use Taxes – Taxability

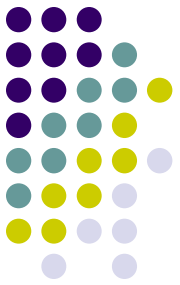
- *Wisconsin Department of Revenue v. Menasha Corp.* (Wis. 7/11/08)
  - Two keys issues
    - First, what level of deference should be given a Tax Appeals Commission ruling
    - Second, was the Commission correct in applying the Department's rule and concluding that the software at issue was custom software exempt from sale and use tax
  - Court held that controlling weight deference should be given to the Commission's interpretation of the rule
    - The Commission was not required to give deference to the Department's interpretation of its own rules
  - Furthermore, the Commission properly determined the software at issue was exempt custom software

# Commission on the 21<sup>st</sup> Century Economy

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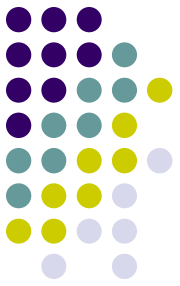


# 21<sup>st</sup> Century Tax Reform Commission



- Charged with adopting recommendations to update and improve California's tax system
- In its final report, 9 out of 14 members signed a report recommending the following:
  - The adoption of a business net receipts tax (BNRT) on all businesses – *a form of value-added tax, not a modified GRT*- at a rate not to exceed 4 percent
    - Tax base would be total receipts minus purchases from other firms
    - Capital purchases would be fully deductible in the year of the purchase (immediate expensing)
    - Water's edge, economic nexus, single sales factor, *Finnegan* approach

# 21<sup>st</sup> Century Tax Reform Commission



- The Commission also recommended:
  - Eliminating the corporate income tax and state general purpose sales tax
  - Lowering overall personal income taxes by creating 2, instead of 6, brackets
- Still under discussion: taxation of financial institutions, carryovers of NOLs and unused credits from corporate income tax, BNRT credits
- CA VAT tax base could generate \$10 billion at a 1 percent tax rate, but real concern about uncertainty of the revenue estimates

# 21<sup>st</sup> Century Tax Reform Commission



- After the report was issued, Governor announced intent to call special session
  - However, certain legislators reacted to the plan with more caution
    - Indicated additional analysis is needed before action can be taken
  - Other legislators denounced the plan as shifting the tax burden to California's middle classes
- Remains to be seen if “judgment day” is coming soon in California