

High Tech Federal & Multistate Tax Update

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R&D

Requirements for §174 Deduction: *Saykally v. Comm'r.*, 100 AFTR 2d 2007-XXXX (CA9) (unpublished), the court affirmed the tax court decision (TC Memo 2003-152) denying a §174 deduction to Mr. Saykally. Per the court:

“We have held that R&D expenses are not deductible under I.R.C. § 174 unless a taxpayer demonstrates a ““realistic prospect” of subsequently entering *its own business* in connection with the fruits of the research” by manifesting (1) the “objective intent” to enter such a business, and (2) the “capability of doing so.” *Kantor*, 998 F.2d at 1518 (citations omitted) (emphasis added). Saykally failed to demonstrate that he possessed the requisite objective intent at the time he incurred the R&D expenses. The record before us plainly indicates that Saykally engaged in the R&D efforts to create technology which could be licensed to another entity for use in that entity's existing business, not his own. *Id.* at 1519 (“In order to qualify for the section 174 deduction, a taxpayer's existing or prospective business must be its own and not that of another entity.”).”

S developed software for his wholly-owned corporation C. S deducted his costs on his tax return. The deduction was denied by the IRS as it was not incurred in connection with S's own trade or business and S did not “have the objective intent to prospectively enter into his own trade or business with the developed technology.”

Revised and Extended Credit: The following changes were made to the research tax credit (§41) by the Tax Relief and Health Care Act of 2006 (P.L. 109-432; 12/20/06):

1. The credit was extended to 12/31/07.

2. The percentages used in the alternative incremental credit of §41(c)(4) were increased to 3%, 4% and 5% (from 2.65%, 3.2% and 3.75%). This change is generally effective for tax years ending after 12/31/06. Transition rules are provided at Act §104(b)(3) and are relevant to taxpayers on a fiscal year.
3. An elective “alternative simplified credit” was added at §41(c)(5). The simplified credit is calculated as:

$$12\% \times [\text{QRE} - 50\%(\text{total QRE for 3 preceding tax years} \div 3)]$$

Thus, the credit is generated if current year QRE exceeds a rolling average base using QRE for the past 3 years. This will eliminate the need to know or track QRE and gross receipts for the 1984 – 1988 base used in the regular research tax credit. New taxpayers or those in their first year of having QRE may also use this credit under a special rule that allows the credit to equal 6% of QRE.

An election to use this simplified method is binding in the year made and all succeeding tax years unless revoked with the consent of the IRS. The simplified credit is effective for tax years ending after 12/31/06. Special transition rules are provided at Act §104(c)(2) & (4) for fiscal year taxpayers. An election may not be made if the taxpayer has already elected to use the alternative incremental credit. However, a transition rule provides that for an alternative incremental credit election that applies to a tax year that includes 1/1/07, that election is treated as revoked with IRS consent if the taxpayer makes an election to use the simplified credit for that year. See Act §104(c) for specifics.

Research Credit & Controlled Groups: In November 2006, final regulations were issued to address the computation and allocation of research credit within controlled groups (T.D. 9296, 11/08/2006; Reg. §1.41-6, Reg. §1.41-8).

LMSB Industry Directive on Research Credit Claims: In April 2007, the IRS LMSB Division issued a directive on handling research credit claims. <http://www.irs.gov/businesses/article/0,,id=169273,00.html>.

IRS Research Credit Website: <http://www.irs.gov/businesses/article/0,,id=101382,00.html>.

LMSB Directive on Biotech: In May 2007, the LMSB Division issued Industry Director Directive on the “Proper Treatment of Upfront Fees, Milestone Payments, Royalties and Deferred Income.” This directive describes a “Tier 2” issue warranting coordination in the field. The directive addresses tax issues related to collaboration agreements where a small biotech firm with research or a product not yet ready for market seeks funds from a larger biotech or pharmaceutical company to enable it to continue its work. The benefit to the larger company is obtaining some right to the final product. The IRS has found that some large funders have treated the non-refundable upfront payment as deductible under §174 and possibly qualified for the research credit. Some recipients of the upfront fees have tried to defer the revenue over the life of the agreement. Revenue Agents are to look for these fact patterns to determine if the proper tax treatment was applied. For further details, see the complete text at <http://www.irs.gov/businesses/article/0,,id=170719,00.html>.

Manufacturing

Use of Statistical Sampling Related to §199 Deductions: Rev. Proc. 2007-35, 2007-23 IRB ___, provides guidance on the use of statistical sampling in the filing of original returns, examination, litigation and claims for refund. “The appropriateness of using a statistical sample for purposes of §199 is a facts and circumstances determination. Factors used in determining whether a statistical sample is appropriate include, but are not limited to, the time required to analyze large volumes of data, the cost of analyzing data, the existence of verifiable information relevant to the taxpayer's §199 calculation, and the availability

of more accurate information. For purposes of §199, statistical sampling will generally be considered appropriate if the taxpayer can demonstrate a compelling reason for its use.”

IRS Auditing of §199 Deductions: An Directive on Domestic Production Deduction (DPD) was issued 12/06 (<http://www.irs.gov/businesses/article/0,,id=164979,00.html>). The directive is “intended to provide direction to effectively utilize examination resources in relation to the taxpayers who claim the domestic production deduction on their tax returns. It reflects a management decision that balances resources and workload priorities. The Directive is not an official pronouncement of law, and cannot be used, cited, or relied upon as such.” The directive includes a list of “minimum checks” that examiners should perform to determine whether the §199 deduction warrants more review. These checks are:

- § “Does the taxpayer’s business make sense with the activity requirements of the domestic production deduction?”
- § Comparison of the domestic production gross receipts (DPGR) reported on Form 8903 to the gross receipts or sales less returns and allowances on the taxpayer’s tax return, line 1c of the Form 1120.
- § Is the taxpayer required to allocate gross receipts to remove nonqualified embedded service income, or determine the qualified income portion of a component of an item? If so, how did the taxpayer determine an allocation method?
- § If the taxpayer is required to use the Section 861 method to allocate and apportion deductions has the taxpayer used it and is it consistent with the application of Section 861 for purposes of the foreign tax credit, if applicable?
- § Has the taxpayer applied the wage and taxable income limitations?”

The Directive should be reviewed for the details.

§199 and Software: Final regulations were issued under §199 to address the outstanding issue of whether and when software that is used online by customers falls under §199 (TD 9317; 3/20/07). The final regulation is similar to the temporary regulation. Final §1.199-3(i)(6) provides: (MPGE = manufactured, produced, grown or extracted)

“ (ii) Gross receipts derived from services. Gross receipts derived from customer and technical support, telephone and other telecommunication services, online services (such as Internet access services, online banking services, providing access to online electronic books, newspapers, and journals), and other similar services do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software.

(iii) Exceptions. Notwithstanding paragraph (i)(6)(ii) of this section, if a taxpayer derives gross receipts from providing customers access to computer software MPGE in whole or in significant part by the taxpayer within the United States for the customers' direct use while connected to the Internet or any other public or private communications network (online software), then such gross receipts will be treated as being derived from the lease, rental, license, sale, exchange, or other disposition of computer software only if--

(A) The taxpayer also derives, on a regular and ongoing basis in the taxpayer's business, gross receipts from the lease, rental, license, sale, exchange, or other disposition to customers that are not related persons (as defined in paragraph (b)(1) of this section) of computer software that--

- (1) Has only minor or immaterial differences from the online software;
- (2) Has been MPGE by the taxpayer in whole or in significant part within the United States; and
- (3) Has been provided to such customers either affixed to a tangible medium (for example, a disk or DVD) or by allowing them to download the computer software from the Internet; or

(B) Another person derives, on a regular and ongoing basis in its business, gross receipts from the lease, rental, license, sale, exchange, or other disposition of substantially identical software (as described in paragraph (i)(6)(iv)(A) of this section) (as compared to the taxpayer's online software) to its customers pursuant to an activity described in paragraph (i)(6)(iii)(A)(3) of this section.

(iv) Definitions and special rules--(A) Substantially identical software. For purposes of paragraph (i)(6)(iii)(B) of this section, substantially identical software is computer software that--

(1) From a customer's perspective, has the same functional result as the online software described in paragraph (i)(6)(iii) of this section; and

(2) Has a significant overlap of features or purpose with the online software described in paragraph (i)(6)(iii) of this section.

(B) Safe harbor for computer software games. For purposes of paragraph (i)(6)(iv)(A) of this section, all computer software games are deemed to be substantially identical software. For example, computer software sports games are deemed to be substantially identical to computer software card games.”

Examples from the regulations:

(1) “L is a bank and produces computer software within the United States that enables its customers to receive online banking services for a fee. Under paragraph (i)(6)(ii) of this section, gross receipts derived from online banking services are attributable to a service and do not constitute gross receipts derived from a lease, rental, license, sale, exchange, or other disposition of computer software. Therefore, L's gross receipts derived from the online banking services are non-DPGR.”

(4) “O produces tax preparation computer software within the United States. O derives, on a regular and ongoing basis in its business, gross receipts from both the sale to customers that are unrelated persons of O's computer software that has been affixed to a compact disc as well as from the sale to customers of O's computer software that customers have downloaded from the Internet. O also derives gross receipts from providing customers access to the computer software for the customers' direct use while connected to the Internet. The computer software sold on compact disc or by download has only minor or immaterial differences from the online software, and O does not provide any other goods or services in connection with the online software. Under paragraph (i)(6)(iii)(A) of this section, O's gross receipts derived from providing access to the online software will be treated as derived from the lease, rental, license, sale, exchange, or other disposition of computer software and are DPGR (assuming all the other requirements of this section are met).”

The regulations apply to tax years beginning on or after 3/20/07. Per §1.199-8(i)(4), taxpayers may apply the regulations dealing with software to tax years beginning after 12/31/04 and before 3/20/07 as well. The regulations also provide guidance on advertising income and product-placement income related to periodicals, software and films (§1.199-3(i)(5)).

§199 and Puerto Rico: The Tax Relief and Health Care Act of 2006 (P.L. 109-432; 12/20/06) modified §199(d)(8) to allow gross receipts from Puerto Rico to factor into domestic production gross receipts if all of the taxpayer's gross receipts from Puerto Rico sources are currently subject to U.S. income tax. This provision applies only for the first two tax years of a taxpayer beginning after 12/31/05 and before 1/1/08.

Accounting Methods

Fixing Depreciation Method Problems: Final and temporary regulations were issued to address when depreciation changes are accounting method changes. Generally, changes under §168 are changes in method of accounting. (T.D. 9307; 12/22/06). Also see Rev Proc 2007-16, 2007-4 IRB 358, superceding Rev. Proc. 2004-11, on procedures for depreciation method changes including waiver of the 2-year rule of Rev. Rul. 90-38.

Rotable Spare Parts: Rev. Proc. 2007-48 provides a safe harbor accounting method to treat rotatable spare parts as depreciable property per Rev. Rul. 2003-37 and the two key rotatable spare parts cases (*Hewlett Packard*, 71 F3d 398 (Fed. Cir. 1995) and *Honeywell*, 27 F3d 571 (8th Cir. 1994)). Various requirements to be met to qualify for the safe harbor method are specified including that sales of rotatable parts do not exceed 10% of total gross revenues less returns from the maintenance account each year. Generally, a change to the safe harbor method is an automatic change.

Timing of Expenditures: The following guidance was issued regarding the timing of when an item is incurred by accrual method taxpayers.

1. Rev. Rul. 2007-3, 2007-4 IRB 350 – provides guidance on when a liability for services or insurance should be treated as incurred under §461. Key points:
 - a. The entering into of a contract is not by itself enough to have met the all events test. “It is well established that an accrual basis obligor is not permitted to deduct an expense stemming from a bilateral contractual arrangement, that is, mutual promises, prior to the performance of the contracted for services by the obligee.”
 - b. “Although federal or state regulations may impose certain legal obligations on taxpayers, those obligations, without more, do not necessarily establish the fact of a taxpayer's liability under § 461.”
 - c. “Under § 461, all the events have occurred that establish the fact of the liability for services provided to the taxpayer when (1) the event fixing the liability, whether that be the required performance or other event, occurs, or (2) payment is due, whichever happens earliest.”
 - d. “The terms of a contract are relevant in determining the events that establish the fact of a taxpayer's liability.”
 - e. Guidance on how to change a method of accounting if required to be in compliance with this ruling is at Rev. Proc. 2007-14, 2007-4 IRB 357.
2. Rev Rul 2007-12 – “If the all events test and recurring item exception of § 461 are otherwise met, an accrual basis taxpayer may treat its payroll tax liability as incurred in Year 1, regardless of whether the compensation to which the liability relates is deferred compensation that is deductible under §404 in Year 2.” Per Rev. Rul. 2007-12, 2007-11 I.R.B. 685 which amplifies Rev. Rul. 96-51 which did not refer to §404. Rev. Rul. 2007-12 also revokes Rev. Rul. 69-587.
3. In AM2007-009 (5/11/07), the IRS stated that the 3 ½ month rule and the 8 ½ month recurring item exception rule are to take an all or nothing approach. That is, the rule will not apply to allow a portion of an expenditure to meet the economic performance standard. For example, on 12/31/06, X, an accrual method calendar year taxpayer prepays a service contract that is to start 1/1/07 and run through 6/30/07. X may not treat 3.5/6 of the contract as meeting the EP requirement in 2006 because all of the services are not provided within 3 ½ months of the payment date.

Mixed Service Costs and §263A: The IRS LMSB Division has issued directives on mixed service costs (MSC) under §263A due to what it believes is improper classification it has seen in some audits and in accounting change method requests. While the issue primarily stems from retailers asking to treat part of their purchasing costs as MSC, the directive is important in providing further insight into how the IRS views MSC. The directive asks agents to be concerned when there is either no M-3 item or a small one for §263A. It also notes that direct labor costs should be removed from MSC and MSC costs should be further reviewed to be sure they are MSC.

Negative Additional §263A Costs: A taxpayer might have a negative additional §263A adjustment if it is allowed to capitalize certain expenditures for book purposes, but not for tax purposes (and uses a simplified unicap accounting method). The IRS had questioned these negative amounts, but has now stated in Notice 2007-29 that it is studying the issue and in the meantime will not challenge such negative amounts solely for being negative.

FIN 48: The AICPA has a practice guide (11/06) at <http://tax.aicpa.org/NR/rdonlyres/8D2A444D-D158-4D5A-9F87-D8ED12A8A221/0/FIN48final.pdf>.

Compensation

MTC Benefit: The Tax Relief and Health Care Act of 2006 (P.L. 109-432; 12/20/06) allows for greater use of the minimum tax credit which should help many individuals who generated large MTCs when they exercised ISOs during a few years back when spreads tended to be large. IRC §53(e) now provides a special rule for individuals with “long-term unused credits” effective for tax years beginning after 12/20/06. The text of §53(e) follows:

(e) Special rule for individuals with long-term unused credits.

(1) In general. If an individual has a long-term unused minimum tax credit for any taxable year beginning before January 1, 2013, the amount determined under subsection (c) for such taxable year shall not be less than the AMT refundable credit amount for such taxable year.

(2) AMT refundable credit amount. For purposes of paragraph (1) —

(A) In general. The term “AMT refundable credit amount” means, with respect to any taxable year, the amount equal to the greater of—

(i) the lesser of—

(I) \$5,000, or

(II) the amount of long-term unused minimum tax credit for such taxable year, or

(ii) 20 percent of the amount of such credit.

(B) Phaseout of AMT refundable credit amount.

(i) In general. In the case of an individual whose adjusted gross income for any taxable year exceeds the threshold amount (within the meaning of section 151(d)(3)(C)), the AMT refundable credit amount determined under subparagraph (A) for such taxable year shall be reduced by the applicable percentage (within the meaning of section 151(d)(3)(B)).

(ii) Adjusted gross income. For purposes of clause (i), adjusted gross income shall be determined without regard to sections 911, 931, and 933.

(3) Long-term unused minimum tax credit.

(A) In general. For purposes of this subsection, the term “long-term” unused minimum tax credit” means, with respect to any taxable year, the portion of the minimum tax credit determined under subsection (b) attributable to the adjusted net minimum tax for taxable years before the 3rd taxable year immediately preceding such taxable year.

(B) First-in, first-out ordering rule. For purposes of subparagraph (A), credits shall be treated as allowed under subsection (a) on a first-in, first-out basis.

(4) Credit refundable. For purposes of this title (other than this section), the credit allowed by reason of this subsection shall be treated as if it were allowed under subpart C.

Example from the Joint Committee on Taxation (JCX-50-06): In 2010, X has AGI that results in an applicable percentage phaseout under §151(d)(3)(B) of 50%. X has regular tax of \$45,000, tentative minimum tax of \$40,000 and a MTC of \$1.1 million of which \$1 million is a “long-term unused MTC.” X’s AMT refundable credit amount is 20% of the \$1 million reduced by 50%, or \$100,000. The MTC allowable is \$100,000 (greater of AMT refundable credit amount or amount of credit otherwise allowable). The \$5,000 of MTC that would have been allowable without §53(e) (excess of regular tax over TMT) is nonrefundable and the remaining \$95,000 is allowed per §53(e). X has an overpayment of \$55,000

(\$45,000 regular tax less \$5,000 nonrefundable MTC less \$95,000 refundable MTC. X's remaining \$1 million MTC is carried forward. If X were not subject to the §151(d) phaseout, X's refundable MTC would have been \$200,000 resulting in an overpayment of \$155,000.

New Stock Option Reporting Rules: The Tax Relief and Health Care Act of 2006 (P.L. 109-432; 12/20/06) modified §6039 on reporting for certain options. Starting with tax years beginning after 12/20/06, employers must provide information by January 31 to the IRS and employees on the transfer of stock due to the exercise of an ISO (§422(b)) certain employee stock purchase plans §423(b)). Forthcoming regulations are to provide the details of the reporting.

Stock Options and Margin Loans: Courts continue to rule that taxpayers are to report the spread on the exercise of a stock option as income at the exercise date because that is when they became the beneficial owners of the shares, not when the associated margin loan was later repaid. See *Palahnuk*, 99 AFTR 2d 2007-794, 475 F.3d 1380 (Fed Cir), *Cidale*, 99 AFTR 2d 2007-411, 475 F.3d 685 (5th Cir.). Also see *Racine v. Comm'r.*, 100 AFTR2d 2007-5087 (7th Cir).

Stock Options and AMT: *Merlo*, 100 AFTR2d 2007-5205 (5th Cir.), affirming 126 TC 205 (2006), involved an exercise of ISOs on 12/21/00 with a spread of \$1,066,064, which is reportable in calculating AMT. However, M only included \$452,025 in AMT using the stock's FMV at 4/15/01. In 9/01, the company (Exodus) filed for bankruptcy and issued a statement in 11/01 that its stock was worthless. M generated a capital loss for AMT of \$1,075,289 in 2001. The IRS assessed a deficiency of \$169,510 on M's 2000 return. M argued that the capital loss limitations do not apply for AMT purposes and therefore his 2001 capital loss may be carried back to reduce 2000 AMTI.

The court held that the capital loss limitations do apply for AMT purposes and that no ATNOL is generated to be carried back to reduce 2000 AMTI. There is nothing in the statute to allow a different treatment of capital losses for AMT purposes; thus, they apply. The tax court referred to *Allen*, 118 T.C. at 8, which held that the wage limitation of §280C(a) applied for AMT purposes because there was not provision to add it back to taxable income in computing AMT. Thus, the court held that M could not carryback its AMT capital loss of 2001 to 2000 to reduce AMTI.

Attempts to Interpret Tax Laws in One's Favor: In *Kadillak*, 127 T.C. No. 13 (2006), the court held that the taxpayer's §83(b) was valid for both regular and alternative tax purposes despite taxpayer's later attempts to try to invalidate it when no longer beneficial to him. The court also held that the capital loss limitations of §§1211 and 1212 apply in calculating AMTI. Similarly, see *Guzak*, 2007-1 USTC ¶50,307 (Ct. Cls 2007).

Stock Options and Divorce: In PLR 200646003, ex-wife sought guidance on the effect of divorce agreement provisions where ex-husband was to exercise a portion of his vested non-statutory stock options at W's direction with the spread being income to her and used to pay related federal income taxes. The income and withholding were reported on H's W-2. The parties resided in a community property state. The IRS held that the income from the exercise was includible in W's gross income, she was entitled to a credit for income tax withheld from the exercise proceeds, and she was not entitled to a credit for any FICA tax withheld from the proceeds. (Note: PLR doesn't say whether the taxpayer seeking the ruling was the husband or the wife.)

Borrowing and Stock Options: Once again, a court has held that an employee recognized income on the date the option was exercised even though the purchase was made with borrowed funds. (*Cidale*, 99 AFTR 2d 2007-411, 475 F.3d 685 (5th Cir.)) Other similar cases include *U.S. v. Tuff*, 469 F.3d 1249 (9th Cir. 2006); *Facq v. U.S.*, 363 F. Supp. 2d 1288 (W.D. Wash. 2005); and *Palahnuk v. U.S.*, 70 Fed. Cl. 87 (Fed. Cl. 2006).

LMSB Directive on Back-dated Options: On 6/15/07, LMSB issued "Industry Director Directive on Backdated Stock Options Directive #1." It designates back-dated option tax issues as Tier 1 and explains

how they fall under §§162(m), 422 and 409A.
[<http://www.irs.gov/businesses/article/0,,id=171464,00.html>]

§409A and Back-dated Options: CCA 200728042 addresses the application of §409A to two employees how exercised non-qualified stock options on the same day that were received at the same time and with the same terms. At the time of exercise, employee A had terminated his employment (and exercised the options in the period 90 days following termination as allowed by the option contract) and employee B remains an employee. The Chief Counsel Office held that the options were “nonqualified “deferred compensation plans” to which §409A applies. However, A’s exercise in 2006 did not violate §409A, while B’s exercise did.

“The ability to exercise a stock option at any time during the option term, where the term extends over multiple years, does not meet the requirements of §409A(a)(2)(A). During the taxable year 2005, neither Employee A nor Employee B exercised his or her respective stock option. Thus during 2005, the plan was operated in reasonable, good faith, compliance with §409A(a)(2)(A), because neither employee made use in operation of the noncompliant provision of the plan (that is, the right to exercise the option at any time). In 2006, both Employee A and Employee B exercised their option. When Employee A terminated employment in 2006, the term of Employee A's stock option became limited and would expire 90 days later. Employee A exercised the stock option within those 90 days. Under a reasonable, good faith, interpretation of §409A, Employee A exercised the stock option under the option terms permitting exercise upon a separation from service, which complies with the requirements of §409A(a)(2)(A).

Accordingly, Employee A's stock option exercise did not violate the requirements of §409A. Employee B did not terminate employment in 2006, so the term of Employee B's stock option was not so limited. Employee B exercised Employee B's stock option under the option terms permitting exercise at any time after vesting and during the 10- year term of the option. This constitutes the use in operation of a plan term that is not consistent with a reasonable, good faith interpretation of the statute, or with the transition guidance, and accordingly violates the requirements of §409A.”

Valuation: In *Kimberlin*, 128 TC No. 13 (2007), the court found that warrants issued in a settlement were taxable when received (grant date) rather than when exercised. The court found that the valuation expert for the taxpayer was credible (not so for IRS’ expert). Because the court found that an “ascertainable fair market value for the warrants on the date of grant” existed, that was the date the receipt of the warrants was includible in income rather than at the exercise date two years later. “The fair market value of property is a question of fact and only in rare and extraordinary cases will property be considered to have no fair market value.” See §61 and Reg. §1.1001-1(a).

Worker Classification: Perhaps Congress will revisit the issues of classifying workers. On May 8, 2007, the House Subcommittee on Select Revenue Measures held a hearing on the “Effects of Misclassifying Workers as Independent Contractors.”

Administrative & Procedure & Miscellaneous

IRM Changes Regarding Resolution and Ranking of Industry Issues in LMSB: In April 2007, the IRS modified sections of the Internal Revenue Manual to explain how issues would be addressed. Three tiers are called for to address who will be involved in working various issues. The three tiers of issues are ranked as follows:

- § Tier I – Strategic/Significant Industry Issues – one unit will have nationwide jurisdiction over these issues
- § Tier II – Significant Compliance Risk Issues

§ Tier III – Industry Issues

The text of the revised IRM sections is at <http://www.irs.gov/irm/part4/ch45s01.html#d0e484349>.

IRS Industry Directives: For a list of directives of the past year with links, see

<http://www.irs.gov/businesses/corporations/article/0,,id=96915,00.html>.

Recent directives related directly to high tech, are mentioned elsewhere in this outline.

LMSB Audits and FIN 48 Documents: AM 2007-0012 issued 3/22/07 from Chief Counsel Donald Korb to LMSB Commissioner Deborah Nolan addresses whether documents prepared by taxpayers for FIN 48 compliance should be included in the IRS's interpretation of "Tax Accrual Workpapers" as discussed in IRM §4.10.20.2(2). The Chief Counsel concludes that "documentation resulting from the issuance of FIN 48 is considered tax accrual workpapers for purposes of IRM Section 4.10.20.2(2)." It also concludes that the issuance of FIN 48 does not change whether a document is considered a tax accrual workpapers as defined at IRM 4.10.20.2(2). The rationale is that FIN 48 doesn't call for any new documentation, but would rely on existing documentation on uncertain tax positions.

These *advice memorandums* are "issued to assist Service personnel in administering their programs by providing authoritative legal opinions on certain matters, such as industry-wide issues" and are signed by executives in the Chief Counsel Office. The list can be found at <http://www.irs.gov/foia/article/0,,id=162993,00.html>.

Workpapers and Privilege: In *Textron*, 100 AFTR 2d 2007-____, (DC RI), the court agreed with the taxpayer that its tax accrual workpapers prepared by Textron attorneys were protected from IRS summons under the attorney-client privilege: "since the tax accrual workpapers of Textron and TFC essentially consist of nothing more than counsel's opinions regarding items that might be challenged because they involve areas in which the law is uncertain and counsel's assessment regarding Textron's chances of prevailing in any ensuing litigation, they are protected by the attorney-client privilege." The court held the workpapers were not accounting work, but lawyer work as they addressed statutory interpretation and case law.

The court also found that the privilege under IRC §7525 applied: "Since TFC's tax accountants participated in advising Textron regarding its tax liability with respect to matters on which the law is uncertain and/or estimating the hazards of litigation percentages, they were performing "lawyers' work." Accordingly, that advice would qualify for the privilege conferred by §7525(a). See 26 U.S.C. 7525(a) (tax advice communications protected "to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.")." The court also found that the tax shelter exception of §7525 did not apply because the tax accountants were not "not 'peddlers of corporate tax shelters' or outside promoters soliciting TFC's participation in the SILO transactions. Rather, they were acting as tax advisers and the workpapers reflect their opinions regarding the foreseeable tax consequences of transactions that, already, had taken place, not future transactions they were seeking to promote."

The court also found that the workpapers were protected under the work product privilege because they were prepared in anticipation of litigation. Of Textron's past 8 audits, 7 resulted in unagreed issues that went to Appeals and 3 went to federal court.

However, the court found that Textron waived both its attorney-client privilege and §7525 privilege when it shared the workpapers with its outside accounting firm. The work product privilege was not waived though and the IRS did not have a "substantial need" to review them as they did not tie directly to the determination of tax liability. "While the opinions and conclusions of Textron's counsel and tax advisers might provide the IRS with insight into Textron's negotiating position and/or litigation strategy, they have little bearing on the determination of Textron's tax liability." The court also noted the outside firm's duties under the AICPA Code of Professional Conduct dealing with confidentiality (Rule 301) and that the firm "expressly agreed not to provide the information to any other party, and confirms that it has adhered to its promise."

More on FIN 48: LMSB also has a field examiner's guide on FIN 48 implications at <http://www.irs.gov/businesses/corporations/article/0,,id=171859,00.html>.

IRS and International Hybrid Instrument Transactions: LMSB has identified this as a Tier I issue and has issued guidance to auditors on the debt versus equity issues of these instruments (6/15/07). See <http://www.irs.gov/businesses/article/0,,id=171462,00.html>.

Patent Cross Licensing Arrangements: Rev. Proc. 2007-23, 2007-10 IRB 675, provides guidance under §1441 on withholding. Also see Notice 2006-34, 2006-14 I.R.B. 705.

Environmental Remediation Expenditures: In *Kerr-McGee*, 100 AFTR 2d 2007-XXXX, (Fed Cl), the court stated:

“taxpayers may be able to deduct environmental remediation costs if the taxpayer caused the contamination and remediated the contaminated property to return it to the state it was in prior to the contamination, regardless of whether the taxpayer continuously owned the property. On the other hand, ... remediation costs may more appropriately be capitalized if: (1) remediation allowed the taxpayer to put the property to a new and better use, whether or not the taxpayer caused the contamination or (2) the remediation was part of a general plan of renovation, rehabilitation, or improvement. The court finds that these general statements about the deductibility of remediation expenses comport with the dictates of IRC § 162 and IRC § 263. Expenditures incurred by a taxpayer in carrying on its trade or business to remediate property that it contaminated and that do not increase the value or change the use of the property may be classified by that taxpayer as ordinary and necessary business expenses instead of capital expenditures. Thus, if a taxpayer presents the appropriate factual circumstances, it may deduct its remediation expenses.” [footnotes omitted]

Enhanced Contribution Deductions of Scientific Property, Computers, Etc.: The Tax Relief and Health Care Act of 2006 (P.L. 109-432; 12/20/06) made the following changes to §170(e)(4) and (6) which allows an enhanced charitable contribution to corporations:

1. The special rule for contributions of scientific property used for research (§170(e)(4)(B) and contributions of technology for educational purposes (§170(e)(6)) were modified to cover property constructed or *assembled* by the taxpayer. The JCT report on this change (JCX-50-06) states: “It is not intended that old or used component assembled by the taxpayer into scientific property or computer technology or equipment are eligible for the enhanced deduction.”
2. The special rule for contributions of computer technology and equipment for educational purposes (§170(e)(6)) is extended for 2 more years to apply to contributions made during any tax year beginning after 12/31/05 and before 1/1/08.

Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28; 5/25/07)

In addition to providing war funding and raising the minimum wage, P.L. 110-28 also provides some tax law changes relevant to high tech businesses which are summarized below.

- § Work opportunity tax credit – extended from 12/31/07 to 8/31/11. Credit expanded regarding application to qualified veterans, high-risk youth and vocational rehabilitation referrals. A change was also made to allow this credit to offset AMT liability.
- § The §179 expensing limits are increased from \$100,000 to \$125,000 and \$400,000 to \$500,000 for tax years beginning in 2007 before 2011. These amount are indexed for inflation starting after 2007. Earlier §179 changes, such as having it apply to off-the-shelf software, are extended one year and so will last through 2010.

- § A few changes were made to the S corporation rules including not treating gains from sales of stock or securities as passive investment income, and provisions dealing with the treatment of the sale of an interest in a qualified S subsidiary.
- § The corporate estimated tax calculation for July, August and September 2012 is increased from 106.25% to 114.25%.
- § Return preparer penalties are expanded and can pose a higher obligation for disclosure of certain return positions than is required of the taxpayer to avoid penalties. Thus, the rules are also relevant to taxpayers in that preparers may be calling for disclosure of certain items even though it is not needed in order for the taxpayer to avoid a penalty. The return preparer penalties will also apply to employment, excise, estate and gift and returns of tax-exempt organizations. In addition, for undisclosed positions taken on the return, the realistic possibility standard is replaced with a more likely than not standard. For disclosed positions, the standard is raised from not frivolous to reasonable basis. The first tier penalty is increased from \$250 to the greater of (A) \$1,000, or (B) 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim. The second tier penalty (for willful or reckless conduct) is increased from \$1,000 to greater of--(A) \$5,000, or (B) 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim. These changes are effective for returns prepared after 5/25/07.

The IRS issued guidance and transitional relief in June 2007. *Notice 2007-54* applies to all returns, amended returns and refund claims that are due on or before 12/31/07 (including extension); “to 2007 estimated tax returns due on or before 1/15/08 and 2007 employment and excise tax returns due on or before 1/31/08.”

The transitional relief does not apply to willful or reckless standard leading to a penalty under §6694(b), as the IRS believes such relief is not appropriate.

The transitional relief provided: “For income tax returns, amended returns, and refund claims, the standards set forth under the previous law and current regulations under section 6694 will be applied in determining whether the Service will impose a penalty under section 6694(a). Generally, in applying transitional relief for income tax returns, amended returns or refund claims, disclosure would be adequate if made on a Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, attached to the return, amended return, or refund claim, or pursuant to the annual revenue procedure authorized in Treasury Regulation sections 1.6694-2(c)(3) and 1.6662-4(f)(2).”^{*} “For all other returns, amended returns and claims for refund, including estate, gift, and generation-skipping transfer tax returns, employment tax returns, and excise tax returns, the reasonable basis standard set forth in the regulations issued under section 6662, without regard to the disclosure requirements contained therein, will be applied in determining whether the Service will impose a penalty under section 6694(a).”

^{*} As of June 2007, that guidance was at Rev. Proc. 2006-48, 2006-47 IRB 934 and Rev. Proc. 2005-75, 2005-50 IRB 1137.

The Joint Committee on Taxation explanation is at <http://www.house.gov/jct/x-29-07.pdf>.

Telecommunications/Internet

Local 3% Phone Tax: In *USA Choice Internet Service*, 98 AFTR 2d 2006-7815 (Ct. Fed.Cl.), the court upheld allowance of a refund of the 3% excise tax refund in that the charges were not for “local telephone service” under §4252 or alternatively, that they were for “private communication services” excluded per §4252. USA also protested payment of the excise tax on certain long distance services that should not have been subject to the excise tax. USA had purchased the phone service to provide internet access to customers.

The case contains a fairly detailed explanation of the type of phone services USA received from various providers. The court agreed with USA: “digital circuits, the use of which was obtained by USA Choice from providers in a form that was configured as incoming-only for digital use, do not fall within the definition of “local telephone service” within the meaning of I.R.C. § 4252(a). Thus, they were not subject to the communications services excise tax imposed by I.R.C. § 4251.” The long distance claim was dismissed for taxpayer error in bringing the issue.

Clarification of Telephone Excise Tax Refund: Notice 2007-11, 2007-5 IRB 405, modifies and clarifies Notice 2006-50.

Multistate Developments

ISOs and CA Income: Nevada resident was found to have CA income from an ISO disqualifying disposition: In an unpublished decision – *Harb v. FTB*, Docket A109715; A110668, the California Court of Appeal First Appellate District, Division Four, (April 2007), the court held that the ordinary income resulting from the disqualifying disposition of ISO stock was taxable and CA-source income. “Revenue and Taxation Code specifically provides that disqualifying dispositions are to be treated as income for the taxable year in which the disposition occurred in accordance with the Internal Revenue Code sections 421 and 422. (Rev. & Tax. Code, §17502 ; cf. *Daks v. Franchise Tax Bd.* (1999) 73 Cal.App.4th 31, 34 [applying Rev. & Tax. Code, §17501 and Int.Rev. Code §401 et seq. to pension plan distributions].) And, there is no question that the income attributable to the disqualifying dispositions constituted wages within the meaning of the Revenue and Taxation Code. California’s Personal Income Tax Law provides that gross income is to be determined in accordance with the Internal Revenue Code. (Rev. & Tax. Code, §17081.) The Internal Revenue Code specifically defines wages as including all remuneration for services performed by an employee for his employer including the cash value of all remuneration paid in any medium other than cash. (Int.Rev. Code, §3401(a).) Wages, thus, include the income derived by an employee as a result of a disqualifying disposition of an incentive stock option. (*Sun Microsystems, Inc. v. Commissioner* (1995) 69 T.C.M. (CCH) 1884).” Nevada residency did not change the result as wages earned in CA are taxed in CA (taxpayer performed services in CA).

Tangible Personal Property: In *Smith v. Alabama Dep’t of Revenue*, Ala. Dept. of Rev., Admin. Law Div., No. S. 05-1240 (11/17/06), the digital photos sold by Smith, a professional photographer, were subject to Alabama sales and use tax. Smith was hired for special events, such as weddings, and took photos with a digital camera. The photos were then posted to a website for the customer. Customers could also get the photos via email or a CD. If the customer requested prints, Smith provided them and concedes that sales tax is owed on those items. Smith argued that the flat fee for covering an event was not contingent on the customer actually purchasing tangible photos so should not be part of the charge for the photos. Smith also argued that even if the digital photos could be viewed as tangible personal property, they should still not be subject to sales tax as they were provided incident to the personal photography services.

The judge first found that the digital photos were tangible personal property, relying on a case in which electricity, “the flow of electrons,” was found to be tangible property. Per the judge: “the internet and e-mail involve the transmission of electrical impulses, i.e., electricity, which, as indicated, constitutes tangible personal property. Consequently, the electronic transfer of digital photographic images from a seller to a purchaser for a price constitutes the sale of tangible personal property.”

The judge next considered whether the photos were just incident to the nontaxable photography services. The judge referred to rules on the taxation of software to guide this decision. In Alabama, only custom software is not subject to sales tax, with canned software being subject to tax regardless of how it is transferred to customers. The judge noted that the rationale for the custom software not being subject to sales tax is not that it is intangible, but because it represents a service with the software transferred incident

to that service. “All software is tangible in that it involves an “arrangement of matter, physically recorded on some tangible medium,...” *Wal-Mart*, 643 So.2d at 291 , citing *South Central Bell*, 643 So.2d at 1246.”

In determining whether the photos are incident to a service, the judge referred to an advertising agency case (*State v. Harrison*, 386 So.2d 461 (1980)) and ones involving lawyers. “Photography has never been held to be a learned profession for purposes of applying the sales tax law. The Taxpayer certainly uses skill and creativity in his business, but that skill and creativity goes into making the tangible photograph, which is sold at retail and sales tax is due thereon. Unlike a lawyer’s brief or a will, or a prescription prepared by a physician, or the catalogs and brochures in *Harrison*, which are only means by which professional services are provided, the final product provided by the Taxpayer is the tangible photograph.”

The judge also found it irrelevant how the photos were transferred to customers. “The Taxpayer is selling photographs at retail, albeit in digitized form. But the form in which tangible property is delivered by the seller to the purchaser should be of no consequence. Just as the sale of canned software is taxable “regardless of whether it is transferred to the purchaser in physical form, via telephone lines, or by another alternative form of transmission,” see, Reg. 810-6-1.37(3), the retail sale of photographs is taxable, whether delivered in final printed form or in digital form over the internet or by e-mail.”

The judge also found it irrelevant that after receiving the digital photo, the customer would still need to print it. The judge found this to be similar to a customer buying a chair that needs to be assembled – it is still subject to sales tax.

Michigan Broadens Sales Tax Base: Michigan enacted changes to its sales tax that expands it to cover 23 additional services starting 12/1/07 (HB 5198 signed 10/2/07). The services now subject to sales tax include:

- landscaping
- bail bonding
- balloon-o-grams
- astrology, palm reading, fortune-telling and numerology
- coin-operated blood pressure testing machines
- party planning
- house sitting
- shoe shining
- wedding planning
- packaging and labeling
- skiing
- travel and reservation
- courier and messenger
- personal care except hair care
- personal fitness trainer
- personal shopper

Thus, the state has recognized that the sales tax is a consumption tax and services are a type of consumption. They are also recognizing that as consumer spending on tangible goods decreases while consumption of services an intangibles (including digital downloads) increases, changes are needed to preserve the sales tax base. Michigan also raised its income tax from 3.9% to 4.35%. These changes were made to address a budget deficit.

Digital Property and Sales Tax: At its request, Apple Computer received an advisory opinion from the New York State Department of Taxation and Finance on the sales tax treatment of:

- § Electronically delivered codes that convey the right to download “specific audio files.”
- § Codes delivered on tangible media that convey the right to download “specific audio files.”

- § Sale of digital music downloaded from the Internet using a special code transferred to the customer on a plastic card.

Generally, the New York sales tax applies to the retail sales of tangible personal property. The tax agency ruled that sales tax was not owed on any of the transfers. It noted that customers in the first two transfers received the same digital music or file as in the situation where everything was done via the Internet. Thus, it ruled that the sales were of intangibles and were not subject to sales or use tax. TSB-A-07(14)S. 5/17/07; available at http://www.tax.state.ny.us/pdf/advisory_opinions/sales/a07_14s.pdf.]

Saying It Again – Quill Only Applies to Sales Tax: In *Tax Comm’r of the State of West Virginia v. MBNA America Bank*, 640 SE2d 226 (2006), the court held that the *Quill* decision requiring physical presence to establish nexus only applies for sales and use tax, not for franchise or income taxes. The court noted that franchise and income taxes do not pose the same compliance burden as do sales and use tax. The court ruled that significant economic presence test was appropriate for income taxes. The court noted: “although a substantial economic presence standard is by nature more elastic than the bright-line physical presence test, we are convinced that when properly applied, a greater nexus is required under the substantial economic presence standard than under the minimum contacts analysis.” The court also noted that it did not agree with *J.C. Penney Nat’l Bank v. Johnson*, 19 S.W.3d 831 (Tenn.Ct.App. 1999) and so would not be following it. Finally, the court, commenting on how the ways of doing have changed since the time the Commerce Clause was originally written, noted: “This recognition of the staggering evolution in commerce from the Framers' time up through today suggests to this Court that in applying the Commerce Clause we must eschew rigid and mechanical legal formulas in favor of a fresh application of Commerce Clause principles tempered with healthy doses of fairness and common sense. This is what we have attempted to do herein.” Thus, the court found that MBNA had nexus in the state due to its mail and phone solicitation of WV customers.

On March 8, 2007, MBNA filed a petition for certiorari with the U.S. Supreme Court. Several amicus briefs for MBNA have been filed including by TEI, the Tax Foundation, the Council on State Taxation (COST), and the American Bankers Association. Arguments raised include:

- § Without clear standards, it is difficult for businesses to determine where they may have tax obligations. This also makes compliance with FIN 48 challenging.
- § The holding violates the Commerce Clause by ignoring the impact on the national economy of uncertainty and difficult standards (such as subjecting a company to state income tax where they have no physical presence or employees). Businesses may decide not to expand their operations due to the uncertainty, complexity and compliance costs of the state tax obligations.
- § The ruling may encourage more states to “export” their tax burden by finding ways to impose taxes on non-residents.
- § The physical presence standard provides “clarity and predictability.” (COST)

The U.S. Supreme Court denied cert on 6/18/07 (Dkt. 06-1228). On the same day it also denied cert in *Lanco v. Director, NJ Division of Taxation* (Dkt. 06-1236) which had also found that the *Quill* physical presence standard did not apply for income tax purposes.

Comments: The West Virginia case illustrates the need for better guidance. P.L. 86-272 is greatly in need of updating (this 1959 law is way overdue for updating!). That law only provides guidance for income taxes and for sales of tangible personal property. Without federal clarification, states are deriving their own sets of rules that are not consistent or certain, thus resulting in litigation. While some of the groups filing amicus briefs for MBNA suggest a physical presence standard is needed, that has also resulting in litigation over how much physical presence warrants a finding of nexus.

Some states, such as Ohio, as well as the MTC, have advocated for a bright-line test based on using the sales or payroll in the state. For example, the Ohio commercial activity tax (CAT) applies to an out-of-state business if it meets any of the following: (a) has over \$500,000 of taxable gross receipts in Ohio; (b) has over \$50,000 of real or personal property in Ohio; (c) spends over \$50,000 in payroll for work done in Ohio; or (d) conducts more than 25% of its business activity in Ohio. Businesses have opposed this approach as well under due process arguments. Query – what would be a workable and constitutional standard? The key constitutional constraint is the Due Process clause since Congress has authority to dictate what satisfies the Commerce Clause.

BN and Nexus – It Depends on the Judge and the State (and perhaps the state statute and how the case is handled): In *Matter of Barnes & Noble.com* (Case ID 89872; 9/02), the CA State Board of Equalization found that the retail store’s distribution of discount coupons to its customers for credit when they buy books online created an agency and nexus. BN.com also paid to have its logo printed on shopping bags used in the retail store. The retail store’s distribution of the shopping bag with the discount coupon inside “served as a public statement that Booksellers had the authority to distribute the coupons on petitioner’s behalf. Such distribution was found to be beyond mere advertising. Similarly, the Board found that Borders.com had nexus in the state through its connection with the bricks and mortar store in that the physical store acted as an agent in handling returns and what it was doing constituted “selling” thus making the online store subject to sales tax collection (*Borders Online, LLC, v. State Board of Equalization*, 29 Cal Rptr 3d 176, 05/31/2005 and R&T §6203).

In 2007, in a case with similar facts, a district court in Louisiana (L) found that BarnesandNoble.com (Online) did not have nexus in the state (*St. Tammany Parish Tax Collector v. BarnesandNoble.com*, 05-5695, ED La, 03/22/2007). The facts indicated that Online had no physical presence in L and that goods purchased online were delivered to L customers via common carriers. From January 2001 to October 2003, Barnes & Noble, Inc. owned 40% of Online and then through May 2004, owned 80% of Online through a wholly-owned subsidiary. Thereafter, BN owned 100% of Online through B&N Holding Corp., a wholly-owned subsidiary. Despite being owned by the same parent, BN and Online did not share management, employees, offices or other business elements. BN did operate stores in L including in St. Tammany Parish.

The Tax Collector of St. Tammany Parish, where BN operates a store, sued Online for failure to collect sales and use taxes from its customers in the parish.

The court noted that to be subject to sales tax and within the Commerce Clause of the U.S. Constitution, L must show that Online’s activity has a substantial nexus with the state, the tax is fairly apportioned, the tax does not discriminate against interstate commerce, and that it is fairly related to the services provided by the state (the *Complete Auto Transit* standards (430 U.S. 274, 279 (1977))). At issue in the case was only the substantial nexus standard. The court noted two tests for substantial nexus: (1) physical presence as called for by the *Quill* decision (504 U.S. 298 (1992)) and (2) attributional nexus as articulated in *Scripto* (362 U.S. 207 (1960)) and *Tyler Pipe* (483 U.S. 232 (1987)). The court then went through the five business relationship factors that L argued proved that Online had substantial nexus for sales tax purposes.

1. Common membership program where customers of BN and Online get a discount on items purchased. Members pay a fee and Online received part of that revenue. BN and Online shared the database generated from the cards.
2. BN sold gift cards that could be used either in a store or with Online. Revenue was earned only by selling gift cards or accepting a gift card as payment. Neither BN nor Online derived revenue from sales made by other retailers participating in the program.
3. Online earned revenue via commissions for merchandise ordered at BN stores but shipped directly to customers.
4. BN and Online engaged in cross-promotional advertising. For example, Online’s website includes a store locator function. BN promoted Online via the gift card and membership programs. BN employees only provided information about Online if asked by customers.

5. BN gave preferential treatment for returns of items purchased from Online. Evidence indicated that BN stores would take returns from other stores including Online and non-BN stores, at the store manager's discretion.

Considering the above factors, the court found that Online did not have substantial nexus with Parish. It did not find that BN marketed Online's products. "The existence of a close corporate relationship between companies and a common corporate name does not mean that the physical presence of one is imputed to the other. *See, e.g., SFA Folio Collections, Inc. v. Bannon*, 217 Conn. 220 , 229-31 & 233-34 (1991) (refusing to impute nexus from bricks-and-mortar retailer to mail-order retailer when the retailers were separate corporate entities owned by the same parent company, sharing some directors and officers, using the same trademarks and logos, selling similar merchandise, and sharing financial and market information); *Bloomington's By Mail, Ltd. v. Pennsylvania*, 130 Pa. Cmwlth. 190, 198 (1989) (holding that affiliation alone was insufficient to create nexus); *SFA Folio Collections, Inc. v. Tracy*, 73 Ohio St.3d 119 , 122-23 (Ohio 1995) (rejecting unitary business entity argument that would impute nexus to affiliated, out-of-state retailer); *Current, Inc. v. State Board of Equalization*, 24 Cal.App.4th 382, 391 (Cal. App. 1 Dist. 1994) (holding that nexus could not be imputed between companies that did not have integrated operations or management and were organized as separate and distinct entities). Booksellers and Online were formally separate corporate entities that were wholly owned by the same parent company for only part of the period in issue. The two companies clearly shared a common name and brand identity under the "Barnes & Noble" banner, but there was no overlap between the companies' management or directors. There is no allegation that the companies intermingled assets or that they were underfinanced. And to the extent the companies may have shared financial or market data, that fact is not of independent significance. The companies did not hold themselves out as the same entity. Thus, the Court finds that attributional nexus does not apply merely by virtue of the affiliation between the companies."

The court also found that BN's activities performed on behalf of Online were not sufficient to treat BN as serving as a marketing presence for Online in the Parish. Unlike in *Scripto*, BN never took an order for Online and did not provide facilities to enable customers to place an order with Online. In addition, the gift card and membership program did not lead to nexus as they do not produce revenue for Online "by virtue of sales made or orders taken by the entity that is physically present in the Parish. That Online may have derived a benefit from [BN's] advertising of the program is not sufficient to impute its presence to Online." The court noted that in *SFA Folio Collections*, the mail-order retailers distributed their catalogs to local stores to be given to customers. The court found that situation to be a stronger case for a showing of nexus than what existed with Online, but that *SFA Folios* did not find nexus to exist. Finally, the court did not find the return practice to rise to the level of activity in *Scripto* or *Tyler Pipe* where contractors made sales on behalf of the out-of-state retailer. Neither was it comparable to the in-state sales support found in such cases as *Scholastic Book Clubs*, 207 Cal.App.3d 734.

Website Sales and Nexus: Taxpayer's websites sell a variety of tangible products at retail. When a customer buys a product, T arranges with a Distribution Center (DC) to obtain, label and ship the product via common carrier to the customer. DC has title to the goods, but upon delivery to the carrier, title temporarily transfers to T and then title and risk of loss passes to the customer (facts are not entirely clear on title passage). T does not operate any retail stores or distribution centers in Virginia (V), but is considering adding a DC in V and wants to know whether that will create nexus for either income or sales/use tax purposes.

Relying on P.L. 86-272, V ruled that the DC arrangement would not create income tax nexus for T in V. "[T]he activities in which [T] engages do not go beyond the mere solicitation of orders for sales of tangible personal property. [T] would not own inventory in Virginia other than when it is in the process of being shipped by the Distribution Center to the customer. The Distribution Center would not be an affiliated representative or an independent contractor acting on behalf of [T] in Virginia. All activities of the Virginia Distribution Center will be performed at the direction and control of the Virginia Distribution Center, as these services occur prior to [T] taking title to the property."

With respect to sales and use tax nexus, V found that T is a “dealer” under V law. However, for T to have sales and use tax nexus, it also had to find that T had an agent, such as the DC, in the state. “Under Virginia law, two factors are necessary in order for an agency relationship to be established. First, the agent must be subject to the principal's control, with regard to the work to be done and the manner of performing it. Actual control is not the test; it is the right to control that is determinative. Second, the work has to be done on the business of the principal or for his benefit. Based on the information you have furnished, I find that an agent relationship is not established between [T] and the Virginia Distribution Center retained to perform distribution services. While the work done by the Distribution Center is for the benefit of [T], it appears that [T] does not control the work to be done or the manner in which it is to be done. Accordingly, under the facts presented, the use of a Virginia Distribution Center (a separate legal entity) by [T] does not create retail sales and use tax nexus for the Taxpayer.” [Comm’r. Ruling P.D. 07-24 (3/27/07); available at <http://www.policylibrary.tax.virginia.gov/OTP/Policy.nsf/>.]

Note: Drop shipment rules should be reviewed to determine if DC is obligated to collect sales tax on its sales. In other states, nexus rules and title passage significance should be reviewed to see if a different result would be obtained.

Narrowness of P.L. 86-272: An S corporation (T) incorporated in Maryland, is a commission-based sales services. T has a sales representative employee (E) in Virginia who solicits sales of goods (tangible personal property) on behalf of T’s third party clients. E is paid a salary for the first six months and thereafter, only receives commissions. Other than an E residing in V, T has nothing else there (no property, advertising or bank account). E solicits sales from third-party client’s customers and then sends the orders back to the client’s office. T holds no title to products and does not approve sales orders. Some of T’s clients provide produce service agreements for which E provides the request to the client. T seeks advice from V as to whether it has income tax nexus in V.

In considering the application of P.L. 86-272, V ruled that E is not soliciting sales for T. “In the instant case, the Taxpayer's employee is selling tangible personal property on behalf of third party clients, not for his employer. As such, this activity for purposes of the Taxpayer constitutes a business service, not the mere solicitation of sales. If the employee were selling tangible personal property on behalf of his employer, then that activity would constitute the solicitation of sales protected by P.L. 86-272. Moreover, these services do not qualify for the de minimis exception in *Wrigley* [505 U.S. 214 (1992)], as the employee performs this service on a regular basis. As such, the Taxpayer has nexus with Virginia and is subject to Virginia income tax.” V also noted that the revenue department has a longstanding policy of narrowly interpreting P.L. 86-272. [Comm’r. Ruling P.D. 07-51 (4/26/07); available at <http://www.policylibrary.tax.virginia.gov/OTP/Policy.nsf/>.]

New View on Websites and Due Process: A non-tax case in Illinois indicates a change in thinking regarding when a person or entity has a connection with a state such that it can be subject to its rules without the state violating the Due Process clause of the U.S. Constitution. In *Howard v. Missouri Bone and Joint Center*, Ill App Ct, 2007 (Ill. Appellate Court, Fifth District), the court found that it was irrelevant whether an entity’s website was interactive in determining whether the website owner had purposefully directed activity toward the state (contrary to *Zippo Manufacturing*, 952 F. Supp. 1119 (W.D. Pa. 1997). The court found the interactive website to be no different from a phone or mail communication, which is not enough to find personal jurisdiction over the one initiating the communication. “Virtually every corporate defendant maintains some type of website, and that virtual presence does not indicate a deliberate intention to enter the market.” Instead, one must check to see if the defendant maintains continuous and systematic business contacts in the state. [<http://www.state.il.us/court/Opinions/AppellateCourt/2007/5thDistrict/April/5050476.pdf>]

Comment: This approach may not be taken in other courts. It seems to take a more modern view of what the Internet does and does not do. When *Zippo* was decided in 1997, it seemed a workable approach to say that a person with a website that could be viewed anywhere should not be viewed as the owner purposefully directing activity to the state. But, a website where people could interact with the site, might be viewed as

purposefully reaching out to everyone. Is there any relevance for tax purposes? At first blush, many might say no because the nexus issue today has been whether there can be a finding of nexus within the bounds of the Commerce Clause; the *Quill* decision seems to have left people thinking that the Due Process clause is not important. However, assume that Congress exercises its powers under the Commerce Clause and enacts a law saying that any state that has adopted the Streamlined Sales & Use Tax Act may collect sales tax from remote vendors. Such states will then go after all remote vendors selling into their state. Could there be some who could step forward and say that the collecting state does not have jurisdiction over them under the Due Process clause – that they have not purposefully directed activity to that state (even though they have customers in the state)? It is likely possible although at some level of sales and customers, it may be difficult to sustain. However, if there are only occasional sales and the website doesn't clearly solicit customers of that state, there could be a Due Process clause issue for the state.

In *Ginsburg v. Dinicola*, 2007 WL 1673533, Civil Action No. 06-11509-RWZ (DC Ma, 2007), the court held that the defendant's one sale to a customer in Massachusetts via EBay did not fall under the state's long-arm statute for the state to impose its jurisdiction over the New York defendant. The court referred to other cases involving sales on EBay noting that the mechanics of the system, particularly it selecting the high bidder, reduced the seller's contacts with the state (the "choice of the highest bidder is beyond the control of the seller"). A single transaction did not rise to the level of "sufficient minimum contacts" with the state. Because the defendant did not fall under the state's long arm statute, the court did not address a due process analysis. [<http://pacer.mad.uscourts.gov/dc/cgi-bin/recentops.pl?filename=zobel/pdf/ginsburg%20v%20dinicola%20jun07%20v3.pdf>]

Sourcing: In *Fluor Enterprises, Inc. v. Michigan Dep't of Treas.*, No. 129149 (Mich, 5/2/07), the court found that taxpayer was taxable in Michigan for receipts for services performed outside of Michigan, but related to construction projects in Michigan. The court determined that as written, the statute treated the receipts as Michigan gross receipts. The next question was whether that approach was constitutional. Reversing the lower court and applying the 4-part test of *Complete Auto Transit*, the court found that it was within the U.S. Constitution. [http://courtofappeals.mijud.net/documents/OPINIONS/FINAL/SCT/20070502_S129149_52_fluor12oct06-op.pdf]

Another Affiliate Nexus Proposal: Idaho introduced HB 67 to modify the meaning of affiliate nexus for sales and use tax purposes. This type of proposal failed in California, but has been enacted in a few other states including Arkansas. The state tax commission estimates that the potential revenue gain is \$500,000 (not clear as to what time period they are referring to). The text of the proposal follows:

“63-3615A. SUBSTANTIAL NEXUS. (1) A retailer has substantial nexus with this state if both of the following apply:

(a) The retailer and an in-state business maintaining one (1) or more locations within this state are related parties; and

(b) The retailer and the in-state business use an identical or substantially similar name, tradename, trademark or goodwill to develop, promote or maintain sales, or the in-state business provides services to, or that inure to the benefit of, the out-of-state business related to developing, promoting or maintaining the in-state market.

(2) Two (2) entities are related parties under this section if they meet any one (1) of the following tests:

(a) Both entities are component members of the same controlled group of corporations under section 1563 of the Internal Revenue Code;

(b) One (1) entity is a related taxpayer to the other entity under the provisions of section 267 of the Internal Revenue Code;

(c) One (1) entity is a corporation and the other entity and any party, for which section 318 of the Internal Revenue Code requires an attribution of ownership of stock from that party to the entity, own directly, indirectly, beneficially, or constructively at least fifty percent (50%) of the value of the outstanding stock of the corporation; or

(d) One (1) or both entities is a limited liability company, partnership, estate or trust, none of which is treated as a corporation for federal income tax purposes, and such limited liability company, partnership, estate or trust and its members, partners or beneficiaries own in the aggregate directly, indirectly, beneficially, or constructively at least fifty percent (50%) of the profits, capital, stock or value of the other entity or both entities.

(3) The provisions of this section shall not apply to a retailer that had sales in this state in the previous year in an amount of less than one hundred thousand dollars (\$100,000).

(4) The definition of "Internal Revenue Code" in section 63-3004, Idaho Code, shall apply to this section."

Proposals & Hearings & Expected Guidance

Treasury and IRS Guidance Expected: The following items relevant to high tech businesses are still on the current business plan (per 3/12/07 update):

- § Proposed research credit regulations on internal use software.
- § Guidance on whether the calculation of gross receipts under §41(f) includes transactions between members of the controlled group.
- § Guidance under §174 regarding change from an impermissible method.
- § Guidance under §174 regarding the treatment of inventory property. [Query – Is this a typo? Should it be §471?].

[<http://www.irs.gov/pub/irs-utl/2006-2007pgp.pdf>]

Senate Republican High Tech Agenda: Senate Republican High Tech Tax Force continues its efforts to promote a high tech agenda. That agenda includes:

- § Make the research credit permanent.
- § Make the Internet tax moratorium permanent.
- § Repeal the telephone excise tax.
- § Promote deployment of broadband.
- § Make depreciation rules for technology appropriate to encourage deployment of technology.
- § "Promote a sensible tax policy for interstate communications services and technologies by eliminating the discriminatory tax policies imposed by some state and local governments."

[<http://republican.senate.gov/httf/index.cfm?FuseAction=PolicyAgenda.Home>]

Research Credit Proposals: S. 41, the Research Competitiveness Act of 2007 (Baucus) would make the credit permanent. It would also make the new simplified alternative credit calculation the sole calculation approach, but with a 20% rate (rather than 12% rate). Modifications would also be made to the rules for basic research payments. A new research investment tax credit would be added and allow tax exempt facility bonds to be issued for research park facilities used in connection with research and experimentation.

S. 41 would also add a substantiation review: "Study of Compliance with Substantiation Requirements - The Secretary of the Treasury or his delegate shall, not later than 1 year after the date of the enactment of this Act, conduct a study of taxpayer compliance with the substantiation requirements for claiming the credit ..., including a study of--

- (1) whether taxpayers maintain adequate record keeping to determine eligibility for, and correct amount of, the credit,
- (2) the impact of failure to comply with such requirements on the oversight and enforcement responsibilities of the Internal Revenue Service, and
- (3) the burdens imposed on other taxpayers by failure to comply with such requirements."

H.R. 1712 is the comparable bill in the House to S. 41.

H.R. 2138, the Investment in America Act of 2007, would also make the research credit permanent. It would increase the rate for the alternative simplified credit from 12% to 20% and repeal the alternative incremental credit.

S. 2209, Research Credit Improvement Act of 2007, would phase-out the regular 20% credit through 2009 and increase the simplified credit to 20% by 2010. Start-ups would have a 10% credit rate. The bill also makes the credit permanent. Contract research expenses would be counted at 80% rather than 65%. It seems that the alternative incremental credit would be terminated. The bill also requires Treasury to issue a report within one year after enactment of the bill that covers:

“taxpayer compliance with the substantiation requirements for claiming the credit allowed under section 41 of the Internal Revenue Code of 1986, including a study of--

- (1) whether taxpayers maintain adequate record keeping to determine eligibility for, and correct amount of, the credit,
- (2) the impact of failure to comply with such requirements on the oversight and enforcement responsibilities of the Internal Revenue Service, and
- (3) the burdens imposed on other taxpayers by failure to comply with such requirements.”

The President’s budget proposal includes making the research credit permanent. The estimated cost is \$99 billion over 10 years. [<http://www.cbo.gov/ftpdocs/78xx/doc7878/03-21-PresidentsBudget.pdf> at page 10]

AB 751 in California would increase the credit rate to 20% and raise the alternative incremental percentages to match the federal ones, effective for tax years beginning after 12/31/06.

Senator Levin and Stock Options: On June 5, 2007, Senator Levin (Mich D) and Senator Coleman (Minn-R) held a hearing entitled - “Executive Stock Options: Should the IRS and Stockholders Be Given Different Information?” The hearing was held by a subcommittee on investigations of the Senate Committee on Homeland Security and Government Affairs. In his 6/4/07 press release about the hearing, Senator Levin noted that the hearing would “examine corporate accounting and tax rules that require corporations to report one set of stock option compensation figures to investors on their financial statements and completely different figures to the Internal Revenue Service (IRS) on their tax returns.” He notes that tax deductions for options are 2 – 10 times larger than the book expense. He notes that this is due to “outdated and overly generous stock option tax rule that produces tax deductions that often far exceed the companies’ reported expenses.” [<http://www.senate.gov/~levin/newsroom/release.cfm?id=275479>]

Also see hearing information at:

§ <http://www.senate.gov/~levin/newsroom/release.cfm?id=275480>

§ <http://hsgac.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=452>

In his testimony, acting IRS Commissioner Kevin Brown noted that stock option compensation was the third largest M-3 adjustment noted for 2004 (depreciation and reportable transactions were higher).

Query: Why is there no discussion on (1) the differences between book and tax (although Commissioner Brown noted this in his testimony), and (2) the fact that the corresponding employee compensation is subject to tax?

Mobile Workforce: H.R. 3359, The Mobile Workforce State Income Tax Fairness and Simplification Act of 2007, would cause a multistate worker’s wages to be treated as all sourced to the state where the employee resides and the state where the employee is physically present performing work duties for over 60 days during the year.

Offshoring: Senator Dorgan has introduced S. 1284 to address concerns about U.S. businesses moving jobs offshore. S. 1284 would provide “for the taxation of income of controlled foreign corporations attributable to imported property.”

Internet Tax Moratorium Fate: The moratorium on the right of state and local governments to impose tax on Internet access fees and against “multiple and discriminatory taxes” on e-commerce expires 11/1/07. S. 1453 would extend the moratorium to 2011 and clarify the definition of “Internet access fees.” Senator Feinstein is a co-sponsor of S. 1453.

H.R. 1077, the Internet Consumer Protection Act of 2007, H.R. 743, and S. 156 would make the moratorium permanent. It is not clear if H.R. 743 and S. 156 would also repeal the grandfather provision, but H.R. 1077 would repeal it.

On 10/16/07, H.R. 3678 passed in the House. This bill extends the moratorium for 4 years, with a definitional modification to the grandfather provision. The bill also changes “Internet access services” to “Internet access” and provides a definition. The definition of “telecommunications” is also modified.

Other Telecom Proposals: S. 166 would prohibit states from imposing a new discriminatory tax on cell phone services. “No State or political subdivision thereof shall impose a new discriminatory tax on or with respect to mobile services, mobile services providers, or mobile services property, during the 3-year period beginning on the date of enactment of this Act.”

S. 140 and H.R. 1194 would repeal the federal telecommunications excise tax. The President’s 2008 budget proposal also calls for repeal of this tax.

Carbon Tax: Congressmen Dingell and Stark (H.R. 2069) have proposed separate carbon tax proposals. In addition, presidential candidate Dodd has called for such a tax. Dingell’s proposal calls for a tax of \$50 per ton of carbon (<http://www.house.gov/dingell/carbonTaxSummary.shtml>). He would also increase the gasoline excise tax and reduce the mortgage interest deduction on homes greater than 3,000 square feet.

Virtual Economies: In October 2006, Joint Economic Committee Chairman Jim Saxton issued a press release expressing concern that the IRS might start taxing transactions taking place in virtual economies, such as Second Life or World of Warcraft. (10/17/06)

The Federal Trade Commission and banking regulators are also apparently looking at some of these virtual economies to see if regulation is needed or if any existing rules are being violated.

In a February 2007 interview with *Inc. Magazine*, Second Life CEO Philip Rosedale stated that what users create at Second Life belongs to them rather than to Second Life and that users could make money. One of the objectives of Second Life is to make the site a “real economy” where property has “real value.” [Michael Fitzgerald, “How I Did It: Philip Rosedale, CEO, Linden Lab,” *Inc.*, Feb. 2007, <http://www.inc.com/magazine/20070201/hidi-rosedale.html>]

Comment: On some sites, users may be selling or designing features via transactions that look more than virtual and where the tax consequences are clear. The IRS concern is likely focused on whether these transactions are being properly reported by those generating income. Another concern is to determine whether transactions that take place solely online with non-dollars are equivalent to bartering transactions that should be subject to tax in some manner.

Tax Gap Considerations: Various proposals have been made to require online auction sites, such as EBay, to issue 1099s to certain users. This was suggested in November 2006 by the Information Reporting Program Advisory Committee. This committee also suggested improved educational efforts to help inform users of Internet auction sites of tax obligations (http://www.irs.gov/pub/irs-utl/2006_irpac_public_meeting.pdf). The reporting idea was also noted in the President’s budget report for 2008. One of the revenue raisers in that budget report is to expand information reporting. This would include reporting by brokers who handle 100 or more transactions for a person totaling at least \$5,000. The Treasury Department would be allowed to provide exceptions where the information reporting would not be of value, such as where the items are used household ones that are likely to yield taxable gains. The

proposal specifically mentions auction house and Internet venues as examples of brokers.
[<http://www.house.gov/jct/s-2-07.pdf> at pages 153 – 157]

According to an A.C. Neilson survey, over 724,000 people in the U.S. report that sales on EBay represent their primary or secondary source of income. In addition, over 1.5 million people say that casual selling on EBay supplements their income. [“More Than 8,000 Milwaukee Residents Use EBay for Major Revenue Source,” *The Business Journal of Milwaukee*, 8/2/05;
<http://milwaukee.bizjournals.com/milwaukee/stories/2005/08/01/daily18.html> and “Using ABC’s of EBay: It’s increasingly a source of income,” *Tucson Citizen*, 1/2/06;
http://www.tucsoncitizen.com/news/business/010206d1_ebay. Also see EBay info at
<http://investor.ebay.com/releasedetail.cfm?ReleaseID=170073>.]

Global Considerations in How Businesses Are Taxed: In July 2007, the Treasury Department issued a report and held a conference on aspects of the federal tax system that were out of sync with today’s ways of doing business and what other countries do and how some rules might negatively impact the a US firm’s ability to compete internationally. The report and agenda are at:

<http://www.treas.gov/press/releases/hp500.htm>

California Proposals:

- § *Biotech NOLs:* AB 1370 would allow biotech companies to have a 20 year NOL carryforward rather than a 10 year one, effective for tax years beginning on and after 1/1/08 and before 1/1/28. Applicable to taxpayers with NAICS codes 325411 to 325414, inclusive, and 541710.
- § *California LLC:* AB 1546 “for taxable years beginning on and after January 1, 2007, would clarify that total income from all sources reportable to this state means gross income, as defined, plus the cost of goods sold, as specified, derived from or attributable to this state within the meaning of specified provisions of the Corporation Tax Law relating to apportionment and allocation, as provided. This bill would make legislative findings and declarations regarding the necessity for the equitable treatment of limited liability companies.” Per the legislative analysis, this bill “Provides that the phrase “total income from all sources derived from or attributable to this state” shall be determined using the rules for assigning sales for purposes of calculation the sales factor used in allocating income to California.” The bill addresses the constitutional concerns raised in taxpayer victories in *Northwest Energetic Services, LLC v. FTB, California Superior Ct for San Francisco County*, No. CGC-05-437721 (2006) and *Ventas Finance I, LLC v. FTB, California Superior Ct for San Francisco County*, No. CGC-05-440001 (2006).
- § *Manufacturer’s Sales Tax Exemption:* AB 1152 would provide a sales and use tax exemption for qualifying property of qualified persons – primarily equipment used by manufacturers.
- § *Apportionment of Corporate Income:* AB 1591 would allow certain taxpayers to elect to use an alternative apportionment formula that would increase the weight of the sale factor and perhaps allow new property investment or payroll to be treated as not in California.
- § *Research Tax Credit:* AB 751 increases the regular research tax credit to 20%, increases the percentages used in the alternative incremental research credit and allows a formula as recently adopted at the federal level for an alternative 3-year rolling average calculation with a 12% rate.