Selected High Tech Tax Developments 2008

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R&D

Existence – The research tax credit expired 12/31/07, but was extended to 12/31/09 by the Tax Extenders and Alternative Minimum Tax Relief of 2008 (P.L. 110-343). A few bills had been introduced to extend it. H.R. 6049 called for extending the credit until 12/31/08. It also extended about 30 other credits as well. This bill passed in the House on 5/21/08, but was held up in the Senate. Part of the hold up was due to the issue of whether there should be revenue offsets for the extenders. These issues were resolved when various bills (extenders, energy incentives and AMT relief) were combined into the Emergency Economic Stabilization Act of 2008 (H.R. 1424), which was signed into law on October 3, 2008 (P.L. 110-343).

President Bush's FY2009 Budget Proposal called for making the research credit permanent. Reasons cited to support this proposal included:[1]

- Economists tend to agree that government intervention can improve overall economic efficiency when it comes to research.
- The current level of research spending in the US and worldwide is "too little to maximize society's well-being."

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[1] Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2009 Budget Proposal*, page 245 – 263; available at http://www.house.gov/jct/s-1-08.pdf.

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- U.S. R&D expenditures represent 2.6% of GDP for 2005 and 2006. While that is greater than in the EU and the average of all countries in the OECD, it is less than that of Japan.
- While an incremental credit can be complex relative to a flat credit, it is less likely to reward research that would have been undertaken even without a credit.
- There is evidence that the credit has led to increased research activity in the U.S.

Research Credit Legislative Changes – Changes made by the Tax Extenders and Alternative Minimum Tax Relief of 2008 (P.L. 110-343):

- The credit was extended to 12/31/09.
- The AIRC was terminated for tax years beginning after December 31, 2008 (P.L. 110-343, 10/3/08).
- The percentage for the ASC was increased from 12% to 14%. For tax years ending before January 1, 2009, 12% applies. No change was made in the 6% rate applies if the taxpayer has no QRE in the prior 3 years.
- §41(h)(3) on how to compute the credit for a tax year in which the credit terminates was modified, effective for tax years beginning after 12/31/07. The new language states:

> COMPUTATION FOR TAXABLE YEAR IN WHICH CREDIT TERMINATES- In the case of any taxable year with respect to which this section applies to a number of days which is less than the total number of days in such taxable year--
>
> `(A) the amount determined under subsection (c)(1)(B) with respect to such taxable year shall be the amount which bears the same ratio to such amount (determined without regard to this paragraph) as the number of days in such taxable year to which this section applies bears to the total number of days in such taxable year, and
>
> `(B) for purposes of subsection (c)(5), the average qualified research expenses for the preceding 3 taxable years shall be the amount which bears the same ratio to such average qualified research expenses (determined without regard to this paragraph) as the number of days in such taxable year to which this section applies bears to the total number of days in such taxable year.'.

GAO Study Underway – At the request of the Senate Finance Committee, the GAO is studying the research tax credit. They have interviewed practitioners and companies.

IRS Data Report – In 2008, the IRS Statistics on Income Bulletin included a report on the research tax credit. For 2005, C corporations claimed $6.4 billion of research credit, which was almost 15% more than for 2004. In addition, there was a 10% increase in the number of corporations claiming the credit in 2005 compared to 2004. While corporations of all sizes claim the credit, in 2005, about 80% of the dollar amount of the credit was claimed by corporations with $250 million or more of receipts. For 2005, manufacturers claimed about 71% of the aggregate C corporation credit amount. [*The Credit for Increasing Research Activities: Statistics from Tax Years 2004-2005,* IRS Statistics of Income Bulletin, 2008; http://www.irs.gov/pub/irs-soi/04-05crreac.pdf.]

Gross Receipts – The measure of gross receipts is important for both the standard credit and AIRC calculations. Confusion exists as to how to measure gross receipts, particularly, how to treat sales between members of a group. IRC §41(f) provides that "all members of the same controlled group of corporations shall be treated as a single taxpayer." In CCA 200620023, the IRS concluded that a corporation must include revenues from foreign subsidiaries in gross receipts for research credit purposes. This Chief Counsel Advice notes that there are several field examinations with similar fact patterns involving calculation of the research credit. In this CCA, a domestic corporation (T) owned more than 50% of

certain foreign subsidiaries per §1563(a)(1). T received royalty income from the subs for licensing of intangibles. T's originally filed return included T's receipts from the foreign subs in gross receipts for §41(c) purposes. T then filed amended returns removing the foreign receipts and consequently increasing its research credit.

The IRS ruling relies on the "aggregation rule" of §41(f) and the incremental nature of the credit (to reward increases in research) to reach its conclusion. IRC §41(f) provides that members of a controlled group are treated as a single taxpayer in calculating the credit. The credit is then allocated to the members per each member's proportionate share of the increase in qualified research expenditures that gave rise to the credit. The IRS notes that per the 1981 legislative history, this aggregation rule was provided to be sure that the credit was only allowed for actual increases in research expenditures and to "prevent artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons. H.R. Rep. No. 97-201, 1981-3 C.B. (Vol. 2) 364; S. Rep. No. 97-144, 1981-3 C.B. (Vol. 2) 442."

The IRS notes: "Temp. Treas. Reg. §1.41-6T and former Treas. Reg. §1.41-6(e) continue to require that a controlled group of corporations or trades or businesses under common control only disregard generally intra-group transfers with respect to research expenditures, not gross receipts." The CCA notes that "treatment of gross receipts attributable to intra-group transactions is on the 2005-06 Priority Guidance Plan." This item is also on the 2008-2009 Priority Guidance Plan (http://taxprof.typepad.com/taxprof_blog/files/guidance_plan_2008_2009.pdf).

In contrast, in CCA 200233011 an opposite result was reached, although the IRS notes it is based on the particular facts of the situation. Per this CCA: "Given the particular facts and circumstances of this case, Taxpayer should exclude the sales to its majority-owned foreign subsidiaries when computing gross receipts for purposes of determining its base amount under section 41(c). For the years at issue, Taxpayer should consistently exclude such sales from gross receipts for purposes of both the fixed-base percentage and the average annual gross receipts for the four taxable years preceding the credit year."

Reg. §1.41-3(c) defines gross receipts broadly: "gross receipts means the total amount, as determined under the taxpayer's method of accounting, derived by the taxpayer from all its activities and from all sources (e.g., revenues derived from the sale of inventory before reduction for cost of goods sold)." A few items are noted as excluded such as returns, sales tax collected, and receipts not in the ordinary course of the trade or business (such as sale of a business).

In September 2008, Proctor & Gamble filed an action in District Court seeking a refund where it disagreed with the IRS audit positions including the treatment of intra-group gross receipts in calculating the research credit.[2] Of the total tax deficiency of $435 million (for 2001 – 2005), the tax related to the gross receipts aspect of the research credit disallowance represents $20.8 million.

Note: Another tech issue involved in the Proctor & Gamble suit was whether the company overvalued technology donated to educational institutions. For example, "fiber fractionation" dealing with manufacturing of paper was donated to North Carolina State University in 2001. P&G valued it at $132.2 million but the IRS only allowed a $4.5 million deduction.[3]

Section 280C(c)

- **Background** - Section 280C(c) denies a taxpayer a deduction for the portion of its QRE or basic research expenses equal to the amount of its research credit, unless it instead elects to take a reduced credit determined for the tax year. If the taxpayer has elected under §174(b) to capitalize R&E expenditures, the capitalized amount is reduced by the amount of the research credit. The election to claim a reduced credit must be made on a timely filed return including extension and is irrevocable.

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[2] Keith T. Reed, "P&G sues IRS over $435M tax bill - Company says government calculations, valuations wrong," 9/20/08; http://news.cincinnati.com/apps/pbcs.dll/article?AID=/20080920/NEWS0107/809200318/1167/NEWS.

[3] *Id.*

The calculation of the reduced credit (when elected in lieu of reducing §174 expenditures by the amount of the credit) involves the following three steps:

1st - compute the §41 credit

2nd - multiply the credit by 35 percent (maximum corporate tax rate)

3rd - reduce the §41 credit by the amount from step 2[4]

Example: Assume X Corporation is in the 34% corporate tax bracket and calculated a research credit of $1,600 for 2004 based on QRE of $16,000. X may either reduce its §174 deduction for 2004 by $1,600, or elect to take a reduced research credit of $1,040 calculated as follows:

$1,600 credit x 35% = $560

Actual credit = $1,600 - $560 = $1,040

A company might elect to take a reduced research credit rather than reduce its §174 amount by the amount of the credit if it is in an AMT position because the research credit is not usable against AMT. The election for a reduced research credit may also be desired if the company has other types of credits it is using and does not need a large research credit. Some states that start with federal taxable income in computing state taxable income may not allow for the §280C(c) amount to be subtracted in deriving state taxable income. In such cases, the reduced credit would be preferable to a reduced R&D deduction.

A company might reduce its §174 amount by the amount of the credit rather than elect to take a reduced research credit if it is in a net operating loss (NOL) position and does not want to make it larger, thus it prefers a smaller §174 amount.[5] A full credit may also be the desired choice if a company is in a net operating loss (NOL) position for state tax purposes and the state does not allow the entire NOL to be carried back or carried forward. A taxpayer in a tax bracket less than 35 percent may wish not to take a reduced credit because the credit must be reduced using a 35 percent tax rate.

- **AM 2008-002** (http://www.irs.gov/pub/irs-utl/am2008002.pdf) – For corporations in AMT or that file in states that do not allow for the §280C(c) amount to be subtracted in computing state taxable income, they will generally prefer a reduced credit. A reduced credit must be elected on a timely filed return including extension. The IRS has found that some taxpayers are electing a reduced credit even though they have not claimed a research tax credit or claimed a nominal credit. For example, a taxpayer might include a Form 6765 on its return that is blank other inserting "section 280C" next to the line that would otherwise show the amount of the reduced credit. Or, a taxpayer has made the notation and claimed a $1 credit.[6] It has also found that some taxpayers attempt to make the reduced credit election by indicating on a statement attached to their timely filed return that they are reserving or deferring the decision to elect the reduced credit. The likely rationale for such treatment is that the taxpayer has not been able to accurately compute its research credit by the due date of the return or is keeping its options open should analysis likely already underway to see if it qualifies for the research credit is completed.

In AM 2008-002, the IRS National Office is advising field agents that if the taxpayer clearly indicates on the timely filed return its intent to make an election to claim a reduced credit, it should be treated as having made a valid election. However, a taxpayer is not treated as having made a timely election for a reduced research credit if has only noted on the return that it reserves or defers the making of the election.

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[4] These three steps are the equivalent of the 0.13 multiplier on line 26 of Form 6765, Credit for Increasing Research Activities.

[5] This company should consider switching from the §174(a) method to the §174(b) method or utilizing §59(e) to spread out the deductions for current R&E expenditures.

[6] AM 2008-002 must be referring to pre-2006 Forms 6765 because since 2006, the form includes a yes/no question with boxes to check to indicate if the taxpayer is electing to take a reduced credit.

The position in AM 2008-002 regarding making the election on a blank or nominal credit Form 6765 is contrary to the IRS' audit guide issued in 2005 which stated that such treatments did not constitute a valid election for a reduced credit meaning that the taxpayer would not be able to claim a reduced credit on an amended return that claimed a research credit. [http://www.irs.gov/businesses/article/0,,id=156864,00.html]

New ASC Regulations – On 6/17/08, final, temporary and proposed regulations were issued under §41 (TD 9401 and REG-149405-07). These regulations cover the election and calculation of the alternative simplified credit that was added at §41(c)(5) by the Tax Relief and Health Care Act of 2006 (PL 109-432). The new guidance on the ASC calculation are at Reg. §1.41-9T, but TD 9401 also makes changes to other areas of the §41 regulations including §1.41-6 and -6T on aggregation of expenditures and §1.41-8 on electing the AIRC (alternative incremental research credit) and revoking an AIRC election. Highlights:

- ASC transitional rules are not addressed in the regulations because they only covered a limited time period and were explained on Form 6765 for 2006.
- The election and revocation rules are mostly similar to those for the AIRC at §1.41-8, as modified by §1.41-8T(b).
- The text of §1.41-9T(b)(2) and (3) on electing and revoking the ASC calculation follow.

  "(2) *Time and manner of election*. An election under section 41(c)(5) is made by completing the portion of Form 6765, ''Credit for Increasing Research Activities,'' (or successor form) relating to the election of the ASC, and attaching the completed form to the taxpayer's timely filed (including extensions) original return for the taxable year to which the election applies. An election under section 41(c)(5) may not be made on an amended return. An extension of time to make an election under section 41(c)(5) will not be granted under § 301.9100–3 of this chapter.

  (3) *Revocation*. An election under this section may not be revoked except with the consent of the Commissioner. A taxpayer is deemed to have requested, and to have been granted, the consent of the Commissioner to revoke an election under section 41(c)(5) if the taxpayer completes the portion of Form 6765 (or successor form) relating to the credit determined under section 41(a)(1) (the regular credit) or the alternative incremental credit (AIRC) and attaches the completed form to the taxpayer's timely filed (including extensions) original return for the year to which the revocation applies. An election under section 41(c)(5) may not be revoked on an amended return. An extension of time to revoke an election under section 41(c)(5) will not be granted under § 301.9100–3 of this chapter."

- In determining the three years of QREs for the ASC computation, the definition of QREs for the credit year must be used (§1.41-9T(c)(2) and §41(c)(6)).
- If any of the 3 tax years that proceed the credit year is a short tax year, the QREs for that year are annualized in making the ASC calculation. "If a credit year is a short taxable year, then the average QREs for the three taxable years preceding the credit year are modified by multiplying that amount by the number of months in the short taxable year and dividing the result by 12." (§1.41-9T(c)(4))
- Reg. §1.41-6T on aggregation of expenditures provides the following example of a controlled group calculation of the ASC.

"*(e) Example.* Group alternative simplified credit. The following example illustrates a group computation in a year for which the ASC method under section 41(c)(5) is in effect. No members of the controlled group are members of a consolidated group and no member of the group made any basic research payments or paid or incurred any amounts to an energy research consortium.

Example. (i) *Facts*. Q, R, and S, all of which are calendar-year taxpayers, are members of a controlled group. The research credit under section 41(a)(1) is not allowable to the group for the 2008 taxable year (the credit year) because the group's aggregate QREs for the credit year are less than the group's base amount. The group does not use the AIRC method of section 41(c)(4) because its aggregate QREs for the credit year do not exceed 1 percent of the average annual gross receipts for the four years preceding the credit year. The group credit is computed using the ASC rules of section 41(c)(5).

Assume that each member of the group had QREs in each of the three years preceding the credit year. For purposes of computing the group credit for the credit year, Q, R, and S had the following:

	Q	R	S	Group aggregate
Credit Year QREs	$0x	$20x	$30x	$50x
Average QREs for 3 Years Preceding the Credit Year	10x	20x	10x	40x

(ii) *Computation of the group credit*. The research credit allowable to the group is computed as if Q, R, and S are one taxpayer. The group credit is equal to 12 percent of so much of the QREs for the credit year as exceeds 50 percent of the average QREs for the three taxable years preceding the credit year. The group credit is 0.12 x ($50x - (0.5 x $40x)), which equals $3.6x.

(iii) *Allocation of the group credit*. Under paragraph (c)(2) of this section, the stand-alone entity credit for each member of the group must be computed using the method that results in the greatest stand-alone entity credit for that member. The stand-alone entity credit for Q is zero under all three methods. Assume that the stand-alone entity credit for each of R ($1.2x) and S ($3x) is greatest using the ASC method. Therefore, the stand-alone entity credits for each of R and S must be computed using the ASC method. The sum of the stand-alone entity credits of the members of the group is $4.2x. Because the group credit of $3.6x is less than the sum of the stand-alone entity credits of all the members of the group ($4.2x), the group credit is allocated among the members of the group based on the ratio that each member's stand-alone entity credit bears to the sum of the standalone entity credits of all the members of the group. The $3.6x group credit is allocated as follows:

	Q	R	S	Total
Stand-Alone Entity Credit	$0x	$1.2x	$3x	$4.2x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	0/4.2	1.2/4.2	3/4.2	
Muliplied by: Group Credit	$3.6x	$3.6x	$3.6x	
Equals: Credit Allocated to Member	$0x	$1.03x	$2.57x	$3.6x

Research Credit Claims

- Notice 2008-39, 2008-13 IRB __ – corporate taxpayers "with claims for credit or refund attributable, in whole or in part, to the research credit that (1) were not reported on an original return or an amended Income Tax Return, filed on or before the due date of the original Form 1120, including extensions, and (2) were not filed with the Internal Revenue Service on or before March 31, 2008" are to file the claims with the Ogden Service Center. The claims should include the Form 6765 filed with the original return (if one was filed with the return) and the amended 6765. The claim should note: "Refund-Research Credit" at the top. This notice supersedes Notice 2002-44.
- *U.S. v. McFerrin*, 102 AFTR 2d 2008-6269 (DC TX) – The IRS brought suit against a married couple, shareholders in four S corporations, for a refund claim for 1999 that IRS says was paid erroneously. The claim was for research credit of $472,092 plus interest of $129,136 related to an 1120S where no credit was originally claimed. The IRS notes that the refund was issued due to a clerical error. The S corps are involved in manufacturing chemicals. In 2003, one of the S corps contracted with a consultant for a research credit study for 1909 through 2002. The court described the work as follows:

  > "The Government proved convincingly that alliantgroup's work and resulting report were fundamentally flawed and unreliable. The report is entitled to no weight. Performance of this engagement consisted largely of alliantgroup staff conducting superficial on-site meetings with personnel from KMCO, KMTEX, and SC Terminals and reviewing various records of the companies. There is no evidence that alliantgroup had engineers, chemists, or anyone with meaningful scientific experience or training on staff, or that skilled or knowledgeable individuals conducted the study, did any investigation, or rendered conclusions for the client, KMCO. In its interviews with employees of KMCO and its affiliates, alliantgroup did not give the employees a definition of "research" for purposes of the research tax credit. As a

result, each employee was forced to answer the questions based on that employee's own personal interpretation of what qualified as "research.""

The research credit calculation included a bonus paid to McFerrin of $6.4 million. M conceded at trial that this bonus was based on profits rather than research. In addition, per the court, supplies was apparently determined "simply by subtracting the entities' costs of labor from the entity's costs of good sold, then multiplying the result by an arbitrary fixed percentage."

The court found that the records were not sufficient to indicate that research and that amounts claimed were valid. It did acknowledge that some qualified research may have occurred, but the records could not prove it, in the opinion of the court and IRS.

In describing the research credit, the court used language from *United Stationers*, 163 F.3d 440, 444, 82 AFTR 2d 98-7488 (7th Cir. 1998) on the "discovery test" rather than the later issued regulations on "discovery" which are not as strict. It did provide the correct regulation citation to the "discovery" requirement, but didn't use it, instead using old language from old court cases. It is puzzling why the court ignored the text of the final regulations. There was also no mention of the *Apple Computer* case (98 TC 232 (1992)) which clarified that as long as payment to the person doing the qualified research constitutes wages under §3401, it counts towards the credit (so it would not matter if paid for profits, such as are stock options, rather than solely for research).

The case has been appealed to the 5th Circuit. Hopefully that will produce a more worthwhile opinion that considers the proper law.

- Penalty for Erroneous Refund Claims - §6676, added by the U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act, 2007 (P.L. 110-28; 5/25/07), created a new penalty for erroneous refund claims effective for claims filed or submitted after 5/25/07. Under this rule, a person filing an erroneous refund claim without any reasonable basis is subject to a penalty equal to 20% of the "excessive amount." 6676(b) defines "excessive amount" as "the amount by which the amount of the claim for refund or credit for any taxable year exceeds the amount of such claim allowable under this title for such taxable year." This penalty does not apply to any EITC claim or to any part of the excessive amount which is subject to a penalty under §6662 – §6664 (substantial understatement of tax and fraud penalties).

  Per the IRS audit guidelines for research credit claims, examiners are to determine if the 20% penalty of §6676 applies to the research credit claim under audit.

- Research Credit Claims Audit Techniques Guide (RCCATG): Credit for Increasing Research Activities § 41 (May 2008)
  - http://www.irs.gov/businesses/article/0,,id=183208,00.html
  - Amended returns or claims for refund to claim a research credit are Tier I claims at the IRS meaning that they must be examined and one unit in the IRS has jurisdiction over the claims. In May 2008, the IRS issued an audit guide for examiners to use in reviewing research credit claims. Per the IRS, the Guide "provides guidance on how IRS examiners can more efficiently and effectively evaluate RC claims, particularly those that are prepared under the most common approach, Prepackaged RC Claim Studies."

    The Guide clearly indicates the IRS concern with "packaged" claims. "There is a growing trend among taxpayers, and their representatives, to submit prepackaged material to support research credit claims. These submissions are usually delivered to examiners in multiple binders. While the submissions often set forth the methodology employed in preparing the research credit claim, the submissions frequently fail to substantiate that the taxpayer paid or incurred qualified research expenses ("QREs") as claimed. In addition, audits may have been restricted to evaluating the taxpayer's methodology for capturing QREs found in the prepackaged submission, as opposed to examining the research credit claimed on the amended return."

> Another issue noted is that some claims do not indicate a “nexus between QREs and qualified research activities (QRAs). Also, most accounting systems contain information to identify and measure expenditures without considering whether research and development activities meet the statutory requirements under § 41.” … “Since project based accounting captures research costs at the “business component” level, it generally establishes the required nexus, whereas cost center accounting does not always provide the nexus between qualified activities and their related costs. Taxpayers have employed a number of methodologies in reconstructing the amount claimed for the research credit. Most RC studies reflect a combined hybrid approach. The hybrid method may be a combination of Project and Cost Center methods, adopting portions of each approach for which records are most easily available. The manner in which the information is compiled typically does not support the relationship between the accounting records and the research activities or QREs. Studies lacking this relationship have failed to establish nexus, and therefore are not auditable. In other words, the nexus problem is the inability to connect specific research project(s) and the underlying activities to the qualified expenses.”
>
> The Guide provides an example of wages where a manager at a company estimates the percentage of time spent in qualified activities and then that percentage is multiplied by wages of particular individuals or departments.
>
> The Guide also notes that preparer penalties should be considered in some instances. It also give guidance for IDRs and questioning and notes that documentation should be contemporaneous.
>
> The Guide should be consulted to help a client through a research claim audit to get an idea of what the revenue agents will be looking for and accepting and not accepting.

Contract Research Expenses - TAM 200811020 – A US and foreign corporation formed a C corporation in the US with each owning 50% of the stock. The purpose of the joint venture was to develop and bring to market inventions. Each shareholder contributed capital, in-process R&D and other intangibles. JV began research in its first year. JV has ownership of all the production and marketing rights to inventions developed. Before it knows if its R&D will be successful, JV grants exclusive licenses to its shareholders to use the inventions for manufacturing and sales of products in their countries. The shareholders pay royalties to JV for their exclusive manufacturing and distribution rights. JV also generates royalties from licenses granted to third parties in geographic areas not covered by other licenses. JV maintains right to further develop inventions that have been licensed.

Within a few years, JV generated royalty income greater than its expenditures and started funding its own R&D. JV does not pay dividends.

The IRS held that JV’s contract research expenses incurred in carrying on a trade or business that involves licensing of research results are qualified research expenditures per §41(b)(1) and §1.41-2(a)(1). The National Office also noted that §41(b)(1) does not impose any limit as to the types of businesses a taxpayer can be carrying on to claim the credit. Thus, a business of licensing research results can benefit from §41. The National Office also noted that JV uses its research results for future R&D activities

The National Office also referred to legislative intent as carried out in the regulations:

> “Consistent with the legislative history underlying §41, 1.41-2(a)(1) provides that a contract research expense is not a QRE if the ' product or result of the research is intended to be transferred to another in return for license or royalty payments and the taxpayer does not <u>use</u> the product of the research in the taxpayer's trade or business. This provision was intended to prevent the abusive use of QREs by individuals or tax shelter partnerships. However, this language was not directed toward situations in which there is no tax avoidance motive, and in which the research results are used by the taxpayer in carrying on the taxpayer's trade or business.” (emphasis added)

“Neither the statute, nor the legislative history or regulations underlying §41(b)(1) define the term “use” for purposes of §41(b)(1) and 1.41-2(a)(1). We, ' however, believe that a reasonable interpretation of this

term involves the type of uses that Taxpayer undertakes by continuing to use and develop Inventions even after it has licensed them."

IRS Website on Research Credit Resources – The IRS maintains a website with links to its industry directives, audit manuals and other internal guidance at:
http://www.irs.gov/businesses/article/0,,id=101382,00.html

However, not all papers are listed there. For example, the Coordinated Issue Paper on self-constructed supplies and the research tax credit is not listed. That paper can be found at:
http://www.irs.gov/pub/irs-utl/qualified_research_expense_cip_final.pdf

Bonus Depreciation Alternative –In 2001, §168(k) was created providing bonus depreciation as an economic stimulus tool (P.L. 107-147). It applied to property placed in service after 9/10/01 in tax years ending after 9/10/01, and acquired before 9/10/04. In 2003, 1/1/05 was substituted for 9/10/04 (P.L. 108-27). In 2008, P.L. 110-185 (see Appendix A of this outline) changed 1/1/05 to 1/1/09 and made various other changes, including changing 30% bonus depreciation to 50% bonus depreciation. After these changes, the bonus depreciation ("special allowance) applied to certain property acquired after 12/31/07 and before 1/1/09. This special allowance for 2008 is allowed for both regular tax and AMT purposes.

"Qualified property" (§168(k)(2)) must be property with a recovery period of 20 years or less, computer software, water utility property or qualified leasehold improvement property. The original use of the property must begin with the taxpayer after 12/31/07 and before 1/1/09 and be placed in service before 1/1/09, with limited specified exceptions. There are many special rules and definitions.

The Housing Assistance Act of 2008 (P.L. 110-289) provides an alternative to corporations that do not benefit from or prefer not to claim bonus depreciation. The alternative at §168(k)(4) allows corporations to elect to accelerate AMT and research credit carryforwards from years beginning before 1/1/06. If an election is made (§168(k)(4)), bonus depreciation may not be claimed and the eligible property must be depreciated using the straight-line method for both regular tax and AMT purposes. To determine the amount of accelerated credits, the "bonus depreciation amount" must be calculated. The calculation applies to property placed in service after 3/31/08. The accelerated credit amounts are treated as refundable.

This new election is quite lengthy and is further explained in Rev. Proc. 2008-65, 2008-44 IRB __. The IRS also has a worksheet posted to its website at http://www.irs.gov/pub/irs-utl/amtresearchworksheet.pdf.

Accounting Methods

Upfront Fees, Milestone Payments, Royalties and Deferred Income - 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 II" 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. [http://www.irs.gov/businesses/article/0,,id=170719,00.html]

Accounting Method Changes - Rev. Proc. 2008-52, 2008-36 IRB 587 replaces Rev. Proc. 2002-9 on the procedures and types of changes eligible for automatic consent. Additional transitional guidance is provided in Announcement 2008-84, 2008-38 IRB 748.

Cost Plus Contracts – In TAM 200803017, taxpayer (T) had various contracts with the government (G) to produce hardware, provide technical services or both. The service contracts include R&D, design, IT, engineering, consulting, training and operational services. Some contracts were fixed-price and others were cost-plus. Under the cost-plus contracts, G reimburses T for its costs plus a negotiated profit. T had been using the percentage of completion method for book and tax purposes, but obtained permission of the IRS to use the accrual method for the contracts instead. The ruling did not specify how the accrual method was to be applied to the service income.

The revenue agent (RA) took the position that all of T's unbilled receivables for the service contracts should be included in income. T argued that such income was not required to be accrued until the amounts become due per the contract terms. T took the issue to Appeals, but in the meantime, RA modified its position to only apply to the cost-plus contracts and to income from reimbursable costs of these contracts. Therefore, the RA is fine with treating the profit element of the cost-plus contracts as reportable when due.

These contracts are governed by federal law that addresses various aspects of these contracts. For example, if G terminates a contract, T is still entitled to reimbursement for its costs incurred to date and a percentage of the fee.

The issue taken to the National Office was whether T must recognize income on the reimbursable contracts as the costs are incurred or when the amounts are billed per the contract terms.

Per §451, "all the events that fix a right to receive income occur when (1) the required performance occurs, (2) payment is due, or (3) payment is made, whichever happens first. See, e.g., Rev. Rul. 2004-52, 2004-1 C.B. 973; Rev. Rul. 2003-10, 2003-1 C.B. 288; Rev. Rul. 84-31, 1984-1 C.B. 127. The terms of an agreement are relevant in determining when the all events test is met. Decision, Inc. v. Commissioner , 47 T.C. 58 (1966), acq. 1967-2 C.B. 2."

"Generally, under most service contracts, income accrues when performance of the services is complete, not as the taxpayer engages in the activity. See, e.g., Decision, Inc ., 47 T.C. at 63." In Decision, the Tax Court held that performance of part of the services was not enough to find that there was a fixed right to all of the income prior to the agreed upon billing or payment date.

As held in Rev. Rul. 79-195, income from a service contract is includible when all of the services are performed unless the services are divisible in which case income is allocated to each divisible part of the contract. This ruling dealt with lessons delivered by a correspondence course. Payment for all courses completed was due within nine months of graduating. The IRS ruled that the income for each class was to be reported upon completion of the class rather than upon completion of the program.

The National Office distinguished the divisibility of the services in Rev. Rul. 79-195 from T's situation. Dividing individual courses into separate earning points is not the same as separating a contract into the reimbursable cost and profit components – such components are not divisible services. "For both amounts, the required performance has not occurred prior to the time the amounts under the contract are due. Therefore, Taxpayer does not have a fixed right to receive income under its Government contracts until the amounts become due." Thus, the National Office held that T did not have to recognize income from cost-plus service contracts as reimbursable costs were incurred.

Rolling Average Inventory Method – In Revenue Procedure 2008-43, the IRS announced that it had changed its position and will now accept the rolling average method for inventory valuation. "However, if inventory is held for several years or costs fluctuate substantially, a rolling-average cost method may or may not clearly reflect income, depending on the particular facts and circumstances." Two safe harbors are provided, which if used, are considered as clearly reflecting income. If the method is not used for

financial reporting purposes, then the method may not clearly reflect income for tax purposes. Rev. Rul. 71-234, 1971-1 C.B. 148, and Rev. Rul. 77-480, 1977-2 C.B. 186, are modified.

§§195, 248 and 709 Guidance – Final and temporary (TD 9411) and proposed regulations (REG-164965-04) were issued to address changes made to §§195, 248 and 709 by the American Jobs Creation Act of 2004 (P.L. 108-357). This Act changed the amortizable life of amounts capitalized under these rules form 60 months to 15 years and allowed expensing of up to $5,000 if the total amount under any section was $50,000 or less. The $5,000 limit reduces dollar-for-dollar by expenditures over $50,000 (so no expensing if expenditures are $55,000 or more). The regulations are intended to simplify compliance under these provisions. Per TD 9411 (9/8/08): "Under these regulations, taxpayers are no longer required to file a separate election statement to deduct costs under sections 195, 248, and 709. The manner of filing these elections is changed because of various electronic return filing initiatives and in acknowledgment that the vast majority of taxpayers that incur costs that may be deducted under sections 195, 248, and 709 elect to deduct those costs. The change also reduces the administrative burden of making the elections."

Under the regulations, taxpayers are deemed to have made the appropriate election in the year they are eligible to do so. Taxpayers may choose to forgo the deemed election if they clearly elect to capitalize the expenditures on their timely filed return (including extension). Either election (the deemed one to amortize or the actual one to capitalize) is not revocable. Any change in the characterization of an expenditure is a change in method of accounting if the taxpayer treated the item consistently for two or more tax years. A change in the determination of the year an active trade or business begins is also considered a change in method of accounting if the taxpayer amortized expenditures for two or more tax years.

The temporary regulations apply to amounts paid or incurred after 9/8/08. Taxpayers may, though, apply the rules to amounts paid of incurred after 10/22/04 if the statute of limitations has not expired for the year any election under these code sections is deemed made.

Compensation

IRS and Backdated Stock Options – In April 2008, the IRS changed this issue from Tier I to Tier II. [http://www.irs.gov/businesses/article/0,,id=181735,00.html]

ISO AMT Relief

Many individuals face significant tax liabilities in that they exercised ISOs during the dot.com boom, owing lots of AMT. The stock prices later plummeted generating capital losses for AMT, which are only usable against up to $3,000 of income. While the AMT paid in the year of the ISO exercise generated a large minimum tax credit (MTC), it is so large that it is unlikely to be usable during the lifetime of many of the individuals in this situation. Various proposals have been offered to assist these individuals many of whom owe AMT from the year of exercise. Some relief was provided by Congress in 2008. Following is a brief overview of some actions and descriptions of this problem and the change enacted by P.L. 110-343 (10/3/08).

- The IRS National Taxpayer Advocate described the problem in her June 2008 report to Congress. See pages xxxiv - xxxix at http://www.irs.gov/pub/irs-utl/fy09objectivesreport.pdf. She notes that the legislative change made in 2006 did not fully address the problem as it did not address assessed penalties and did not apply to all taxpayers. She called upon Congress to pass legislation to provide relief and for the IRS to consider its ability to abate interest and penalties and to enter installment agreements with affected taxpayers.
- In an 8/26/08 letter to Senator Grassley, IRS Commissioner Shulman stated that the IRS would, as requested by Grassley, stop pursuit of AMT ISO liabilities pending legislative activity in Congress. Per the letter:

You note that legislation with broad bipartisan consensus is pending in the Congress to provide additional relief to taxpayers who incurred AMT on the exercise of ISOs. H.R. 3861 and its companion bill, S. 2389, would accelerate the minimum tax credit associated with AMT items and remove the current phase out when a taxpayer's adjusted gross income exceeds the section 53(e) threshold amount. The legislation would also abate unpaid AMT liabilities, including interest and penalties, attributable to the exercise of ISOs and would not allow a refundable credit for any underpayment that is abated. Because of Congress' determination to act on the pending legislation, you asked me to suspend efforts to collect ISO AMT liabilities and to consider the pending relief legislation in allocating limited collection resources this year.

- The Tax Extenders and AMT Relief Act of 2008 (P.L. 110-343, 10/3/08) provides long-awaited relief to individuals in the ISO/AMT/MTC problem. The Act language states:

"(a) In General- Paragraph (2) of section 53(e) is amended to read as follows:

`(2) AMT REFUNDABLE CREDIT AMOUNT- For purposes of paragraph (1), the term `AMT refundable credit amount' means, with respect to any taxable year, the amount (not in excess of the long-term unused minimum tax credit for such taxable year) equal to the greater of--

`(A) 50 percent of the long-term unused minimum tax credit for such taxable year, or

`(B) the amount (if any) of the AMT refundable credit amount determined under this paragraph for the taxpayer's preceding taxable year (determined without regard to subsection (f)(2)).'.

(b) Treatment of Certain Underpayments, Interest, and Penalties Attributable to the Treatment of Incentive Stock Options- Section 53 is amended by adding at the end the following new subsection:

`(f) Treatment of Certain Underpayments, Interest, and Penalties Attributable to the Treatment of Incentive Stock Options-

`(1) ABATEMENT- Any underpayment of tax outstanding on the date of the enactment of this subsection which is attributable to the application of section 56(b)(3) for any taxable year ending before January 1, 2008, and any interest or penalty with respect to such underpayment which is outstanding on such date of enactment, is hereby abated. The amount determined under subsection (b)(1) shall not include any tax abated under the preceding sentence.

`(2) INCREASE IN CREDIT FOR CERTAIN INTEREST AND PENALTIES ALREADY PAID- The AMT refundable credit amount, and the minimum tax credit determined under subsection (b), for the taxpayer's first 2 taxable years beginning after December 31, 2007, shall each be increased by 50 percent of the aggregate amount of the interest and penalties which were paid by the taxpayer before the date of the enactment of this subsection and which would (but for such payment) have been abated under paragraph (1).'.

(c) Effective Date-

(1) IN GENERAL- Except as provided in paragraph (2), the amendments made by this section shall apply to taxable years beginning after December 31, 2007.

(2) ABATEMENT- Section 53(f)(1), as added by subsection (b), shall take effect on the date of the enactment of this Act."

This new provision replaces the benefit that had been added by the Tax Relief and Health Care Act of 2006 (P.L. 109-432; 12/20/06), by changing the language of §53(e)(2) and adding (f). That Act had added §53(e) which allowed the "long-term unused MTC" to be used 20% per year, or $5,000 if greater. If AGI was greater than the §151(d) limits, the AMT refundable credit amount phased out by the §151 percentage amount. The 2008 Act removes the AGI limitation, allows the long-term unused

MTC to be used over two years and provides relief for outstanding penalties and interest or a refund for such penalties and interest previously paid.

Attempts to Interpret Tax Laws in One's Favor: In *Kadillak*, 127 T.C. 184 (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 it was no longer beneficial to him. The court ruled that K's non-vested shares were property for §83 purposes. The court also held that the capital loss limitations of §§1211 and 1212 apply in calculating AMTI. This decision was affirmed in 2008 – 102 AFTR2d 2008-5402 (9th Cir.).

Stock Options and Relevance of §16(b): *Strom v. U.S.,* 102 AFTR 2d 2008-XXXX (DC WA) - In 1998, T, president of Infospace, was granted stock options with an exercise price of $15 per share. In early 2000, the stock price was over $1,000/share. Between 9/99 and 7/00, T exercised her stock options on various dates.

On her 1999 return, T reported as gross income the excess of the market value of the stock on the exercise dates and the option price. T did not report any spread income for 2000. However, I withheld Medicare tax from T's 1999 and 2000 wages measured as if she had recognized income form exercising options in both years. T seeks a refund of income and Medicare taxes. T argued that no income was reportable because the stock was not transferable and was subject to a substantial risk of forfeiture until 1/01.

Per §83 and 1.83-7, the receipt of stock is not taxable when received if it is not transferable or if it is subject to a substantial risk of forfeiture. Instead, it becomes taxable in the year in which it becomes transferable or is no longer subject to risk of forfeiture.

These rules also hold that if sale of the stock could make the seller liable under §16(b) of the Securities Exchange Act of 1934, it is not transferable and is subject to substantial risk of forfeiture. Compliance with §16(b) generally requires that stock be held for 6 months prior to sale. The SEC rules provide that acquiring an option is a "purchase" under §16(b) rather than the exercise of the option.

T argued that the SEC rule only applied if the stock was vested. The court stated that "[b]ased on the legal landscape as it existed in 2000, the Court finds that [T] could have been subjected to suit under § 16(b)." Thus, the court ruled that T was not required to report any income until 6 months after the last vesting date – 12/00.

T next argued that pooling-of-interest rules for GAAP posed a substantial risk of forfeiture allowing deferral of the income to 2001. The court disagreed. Thus, the income should have been reported in 2000, rather than 1999.

AMT and NOL: The 2nd Circuit affirmed the decision in *Palahnuk*, 102 AFTR 2d 2008-6366 (2nd Cir.), aff'g 127 TC 118 (2006). It held that "(1) the rules governing the calculation of net operating loss for regular income tax purposes also apply to the alternative tax net operating loss except where otherwise indicated; (2) sections 172(c) and (d) of the Internal Revenue Code effectively preclude net capital losses from inclusion in net operating loss, and section 1211(b) limits capital loss deductions to $3000 per year; and (3) nothing in section 56(d) of the Internal Revenue Code alters the rules for calculating net operating losses such that petitioners may include net capital losses in the calculation of the alternative tax net operating loss." The court noted that unless expressly stated otherwise, the rules for calculating regular tax apply in computing AMTI. AMT was primarily owed due to exercise of an ISO.

Section 162(m) and Termination Payments – In PLR 200804004, an agreement between Company and Executive provided that if E were terminated for reasons other than "cause" or "good reason" as defined in the agreement, the performance goals would be deemed to be achieved and appropriate compensation would be awarded. C sought a ruling that the compensation paid under such a plan would be considered performance-based compensation under §162(m)(4)(C) if it otherwise meets the requirements of that section.

Reg. §1.162-27(e)(2)(v) provides that the performance goal requirement is not met if the employee would receive all or a portion of the compensation regardless of whether the performance goal was achieved. The IRS ruled that the compensation paid to E is not performance-based compensation under §162(m)(4)(C).

This ruling apparently caught many practitioners and corporations by surprise. The IRS subsequently issued Rev. Rul. 2008-13. Per this ruling compensation is not qualified performance-based compensation under §162(m) if the plan agreement provides that the compensation will be paid upon attaining a performance goal or for termination without "cause" or for "good reason" or voluntary retirement.

The IRS provided a delayed effective date for this ruling. The holding of the ruling will not be applied to a plan with payment terms similar to those described in the ruling "if either (i) the performance period for such compensation begins on or before January 1, 2009 or (ii) the compensation is paid pursuant to the terms of an employment contract as in effect (without respect to future renewals or extensions, including renewals or extensions that occur automatically absent further action of one or more of the parties to the contract) on February 21, 2008."

Section 162(m) and Outside Director – Rev. Rul. 2008-32 explains the classification of a corporate director who served as interim CEO. Per the ruling:

"The determination of whether an individual is or was an officer is based on all of the facts and circumstances in the particular case, including without limitation the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties. Director A was in regular and continued service from January 7, 2008 through December 11, 2008. Company X did not employ Director A for a special and single transaction and Director A did not merely have the title of officer. Instead, Company X employed Director A for an indefinite period to serve as interim CEO with the full authority vested in that office. Accordingly, under the facts and circumstances analysis, Director A was an officer of Company X."

Thus, the IRS held that the director was not an "outside director) under §162(m)(4)(C)* and §1,162-27(e)(3) and could not be involved in setting performance goals.

> "Section 162(m)(4)(C) provides that applicable employee remuneration does not include any remuneration payable solely on account of the attainment of one or more performance goals, but only if (i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of 2 or more outside directors, (ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before payment of such remuneration, and (iii) before any payment of such remuneration, the compensation committee referred to in clause (i) certifies that the performance goals and other material terms were in fact satisfied."

Continued Concern Over Stock Options – Senator Levin - In a 4/21/08 press release (http://levin.senate.gov/newsroom/release.cfm?id=296455), Senator Levin (Mich) expressed concern over IRS data that indicated that companies expensed $61 million more of option expense on their tax returns than on their financial statements. He also noted his bill S. 2116 which would limit the tax deduction for options to what was expensed on financial statements filed with the SEC.

The IRS obtained the data from M-3 forms. The stock option expense book-tax difference was the largest difference for 2005. "The IRS also found that 66% or two-thirds of the $61 billion book-tax difference is attributable to just 250 companies."

"My bill would end the double standard of companies deducting more from their taxes than the stock option expenses shown on their books. By eliminating this outdated and overly generous corporate tax deduction, we would eliminate a tax incentive that encourages corporate boards to hand out huge executive stock option pay which, in turn, fuels the growing chasm between executive pay and the earnings of rank and file workers," said Levin. "The tycoon J.P. Morgan said about a century ago that CEO pay should not exceed 20 times average worker pay. But right now, in the United States, average CEO pay is nearly 400 times average worker pay. Stock options are a major factor in that pay gap, and

one reason companies keep handing out stock options is because they can generate huge corporate tax deductions that are 2, 3, even 10 times larger than the stock option expense shown on the company books."

Proposed Regulations Under Section 6039 - On 7/17/08, proposed regulations (REG-103146-08) were issued under §6039 to address reporting obligation changes made by the Tax Relief and Health Care Act of 2006. Under this Act, 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)). Notice 2008-8, 2008-3 IRB 276, waived the filing obligation for 2007 stock transfers.

For ISOs, Form 3921, Exercise of an Incentive Stock Option Under Section 422(b), is to be filed. This form calls for details of the grant date, exercise price, exercise date, FMV at exercise date and number of shares transferred upon exercise. Form 3922, Transfer of Stock Acquired Through an Employee Stock Purchase Plan Under Section 423(c), is required for ESPPs. These forms must also be issued to the option holder. These forms are due to the IRS and option holder on or before January 31 of the year following the exercise. See the proposed regulations for the details on the content and filing procedures.

Effective date: The regulations "are proposed to apply to any stock transfer occurring on or after January 1, 2007. However, corporations are not required to comply with the return requirements of § 1.6039–1(a) and (b) for stock transfers that occur during the 2007 and 2008 calendar years. Notwithstanding the waiver of the return requirements for 2007 and 2008 stock transfers, corporations must furnish information statements to employees for such 2007 and 2008 stock transfers. For purposes of furnishing information statements for 2007 and 2008 stock transfers, corporations may rely on §1.6039–1 of the 2004 final regulations (TD 9144) or §1.6039–2 of these proposed regulations."

ESPP Proposed Regulations - REG-106251-08 (7/29/08) provide rules for options granted under employee stock purchase plans (§423). The proposed regulations also provide some guidance under §421 and §422.

Practice & Procedure

Tax Accrual Workpapers – In *Regions Financial Corp. v US*, 101 AFTR2d 2008-2179 (ND Ala) – the IRS issued a summons to taxpayer's adviser, Ernst & Young seeking certain documents related to two listed transactions. R reviewed the requested documents and told EY to keep 20 documents (151 pages) back. EY then transferred about 260,000 pages of documents to the IRS. The documents withheld related to a transaction R entered into with the European Bank for Reconstruction and Development. R claims that these documents are privileged and thus not attainable via IRS summons.

The court held: "the contested documents are protected by the work product privilege, regardless of whether this court applies the "primary motivating purpose" test or the "because of litigation" test. Furthermore, Regions has not waived the privilege by its disclosure to E & Y. Accordingly, Regions' Motion to Dismiss its Petition to Quash the IRS Summons as Moot is due to be granted."

See the following short article **–** Feeney and Wechter, "Is the 'Work' in Tax Accrual Workpapers Considered Work Product?, *AICPA Tax Insider*, 8/14/08, for helpful insights to this case as well as the earlier one – *Textron*, and the relevance of developments subsequent to the years involved in these cases, such as FIN 48, SOX and PCOAB. Article is available at http://www.cpa2biz.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2008/Tax/workproduct.jsp.

IRS Guidance on Certain State and Local Location Tax Incentives – In May 2008, the IRS LMSB Division issued a Coordinated Issue Paper to provide guidance to agents on a possible fact pattern they may encounter. The IRS has found some corporations argue that certain location tax incentives received, such as a credit, are really an incentive payment to the corporation combined with a tax payment by the corporation. The tax effect is that the corporation takes advantage of the tax break, and then argues that the incentive payment received is excluded from income as a contribution to capital under §118. The corporation then reduces its property basis by the exclusion under §362(c). The IRS disagrees with this position. The Coordinated Issue Paper provides the IRS rationale and legal support for its view. The IRS explanation includes the position that a tax break is not considered an accession to wealth (income) but a reduction to tax owed. The paper can be found at http://www.irs.gov/businesses/article/0,,id=183193,00.html.

Tier Issues – As of 10/15/08, the following issues relevant to high tech firms are ones the IRS will look at during an examination. [http://www.irs.gov/businesses/article/0,,id=180721,00.html]

Tier I

- §199 domestic production deduction
- Research credit claims
- Transfer of intangibles offshore/cost sharing

Tier II

- Back-dated stock options
- Stock options/compensation and cost sharing arrangements
- Upfront, milestone and royalty payments in biotech

Tier III

none

Preparer Penalty Guidance – On 6/16/08, the IRS issued proposed regulations (REG-129243-07) under §6694 and 6695 on the changes made by the Small Business and Work Opportunity Act of 2007 that broadened the application of the preparer penalty.

The Tax Extenders and AMT Relief Act of 2008 (P.L. 110-343, 10/3/08) modified §6694 as many preparers had hoped for in order to alleviate the problems of the mismatched preparation standards between taxpayers and their preparers. With this change, the "more likely than not" language of §6694(a) is replaced with "substantial authority" language which matches the taxpayer standard at §6662. For disclosed positions, a "reasonable basis" is required. For tax shelters and reportable transactions, the standard remains "more likely than not." The changes are effective back to the effective date of the Small Business Act of 2007.

Privacy Update to IRC §7219 – While §7219, *Disclosure or use of information by preparers of returns,* has been around since 1971, and is not related solely to high technology industries, its regulations were recently updated primarily to reflect new privacy considerations related to changes in technology. IRC §7219 provides a criminal penalty for certain disclosures by return preparers; §6213 provides a civil penalty. The text of both of these provisions follows.

§7216 Disclosure or use of information by preparers of returns

(a) General rule. Any person who is engaged in the business of preparing, or providing services in connection with the preparation of, returns of the tax imposed by chapter 1, or any person who for compensation prepares any such return for any other person, and who knowingly or recklessly—

(1) discloses any information furnished to him for, or in connection with, the preparation of any such return, or

(2) uses any such information for any purpose other than to prepare, or assist in preparing, any such return,

shall be guilty of a misdemeanor, and, upon conviction thereof, shall be fined not more than $1,000, or imprisoned not more than 1 year, or both together with the costs of prosecution.

(b) Exceptions.

(1) Disclosure. Subsection (a) shall not apply to a disclosure of information if such disclosure is made—

(A) pursuant to any other provision of this title, or

(B) pursuant to an order of a court.

(2) Use. Subsection (a) shall not apply to the use of information in the preparation of, or in connection with the preparation of, State and local tax returns and declarations of estimated tax of the person to whom the information relates.

(3) Regulations. Subsection (a) shall not apply to a disclosure or use of information which is permitted by regulations prescribed by the Secretary under this section. Such regulations shall permit (subject to such conditions as such regulations shall provide) the disclosure or use of information for quality or peer reviews.

§6713 Disclosure or use of information by preparers of returns

(a) Imposition of penalty. If any person who is engaged in the business of preparing or providing services in connection with the preparation of, returns of tax imposed by chapter 1, or any person who for compensation prepares any such return for any other person, and who—

(1) discloses any information furnished to him for, or in connection with, the preparation of any such return, or

(2) uses any such information for any purpose other than to prepare, or assist in preparing, any such return,

shall pay a penalty of $250 for each such disclosure or use, but the total amount imposed under this subsection on such a person for any calendar year shall not exceed $10,000.

(b) Exceptions. The rules of section 7216(b) shall apply for purposes of this section.

(c) Deficiency procedures not to apply. Subchapter B of chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise taxes) shall not apply in respect of the assessment or collection of any penalty imposed by this section.

Rev. Proc. 2008-35 – provides further guidance with respect to §301.7216-3.

The IRS provided an overview to the changes and an FAQ – see http://www.irs.gov/efile/article/0,,id=188390,00.html.

Selected items from the final regulations (TD 9375; 1/7/08; modified by TD 9409; 7/2/08) –

- Seeking comments on proposed rule that return preparer may not obtain consent to disclose or use tax return information for purposes of helping taxpayer get a refund anticipation loan (RAL).
- Expression of rationale for the provision: “information revealing the identity of, or how to contact, a person is information central to one’s privacy and deserving of treatment as tax return information when submitted for, or in connection with, the preparation of a tax return.” (TD 9375 preamble, p. 1059)

- Special rules for disclosures to contractors – see §.301.7216-2(d)(2).
- If disclosure is not allowed without taxpayer's consent, preparer may not disclose or use taxpayer return information without first getting written consent from the taxpayer. Consent must be obtained prior to any disclosure rather than retroactively.
- Generally, may not obtain consent to disclose a social security number to a preparer outside of the US unless some type of "adequate data protection safeguard" is used. See §301.7216-3T(b).

M-3 Disclosure Proposal - S. 3659, the Corporate Transparency Act, proposes to "provide for the disclosure of schedule M-3 to the Securities and Exchange Commission, to provide for the public disclosure of certain information on such schedule, to provide penalties for failure to file such schedule or inaccurately reporting information on such schedule, and for other purposes." The SEC disclosure would occur if the SEC requested the information from the IRS. The other public disclosure could be on an IRS website. Penalties would be imposed for failure to file the M-3.

International Developments

Cost Sharing under §482 / Buy-in Arrangements and IRS Examinations – In March 2008, LMSB issued a directive making cost sharing and buy-in arrangements a Tier I issues. [http://www.irs.gov/businesses/article/0,,id=180564,00.html]

Foreign Tax Credit Regulations – Final, temporary and proposed regulations were issued on the foreign tax credit of IRC §901 (TD 9416, REG-156779-06; 7/15/08). The regulations primarily address the FTC in structured passive investment arrangements.

CFCs and Obligations – In Notice 2008-91, the IRS states: "Section 956(c) defines United States property generally to include an obligation of a United States person. On September 16, 1988, the Internal Revenue Service and the Treasury Department published Notice 88-108, 1988-2 C.B. 445, which announced that final regulations issued under section 956 will exclude from the definition of the term "obligation" an obligation that would constitute an investment in United States property if held at the end of the controlled foreign corporation's taxable year, so long as the obligation is collected within 30 days from the time it is incurred. This exclusion shall not apply, however, if the controlled foreign corporation holds for 60 or more calendar days during such taxable year obligations which, without regard to the 30 day rule described in the preceding sentence, would constitute an investment in United States property if held at the end of the controlled foreign corporation's taxable year."

Notice 2008-91 applies just for the first 2 tax years of a foreign corporation that end after 10/3/08.

Form 5471 Penalties – In September 2008, Ernst & Young (and others) reported they had learned that the IRS will start automatically asserting the $10,000 penalty under §6038 for Forms 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations,* attached to a late filed Form 1120. So even if no penalties are owed for the late 1120, they will be asserted for each Form 5471 that is attached. This is not a new penalty, but a more aggressive assertion. [EY Tax Alert, "IRS To Begin Automatic Assertion of Penalties for Each Form 5471 Attached to a Late Filed Form 1120," 9/5/08]

Form TD F 90-22.1 – The IRS has revised the form and procedures for 2008 (10/08). The form (Report of Foreing Bank and Financial Accounts) can be found at **http://www.irs.gov/pub/irs-pdf/f90221.pdf**. The IRS has also provided information to preparers at **http://www.irs.gov/pub/irs-utl/fbar_document.doc**.

IRM and NRA Withholding – Internal Revenue Manual (IRM) Section 4.10.21 "U.S. Withholding Agent Examinations - Form 1042" was added 7/29/08. This section explains US source income and the reporting and withholding requirements for payments made to foreign persons and how revenue agents should approach audits of this matter. [http://www.irs.gov/irm/part4/ch09s24.html and IRC §§1441-1443 and 1461.]

Attention from Congress – In 2007 and 2008, various aspects of international taxation were the subject of congressional hearings and proposals within two themes: (1) addressing rules that lead to evasion or loss of jobs, and (2) modernizing U.S. tax rules.

Under the first theme, in July 2008, the Senate Finance Committee (SFC) held a hearing on the Cayman Islands and offshore tax issues. Senator Grassley and the Joint Committee on Taxation (JCT) (JCX-65-08) described some of the issues as "offshore tax evasion." A September 2007 SFC hearing looked more specifically at offshore tax issues related to insurance companies and hedge funds. In September 2008, Congressman Neal introduced H.R. 6969 to address offshore reinsurance tax concerns. A May 2007 SFC hearing looked at issues of cash moving offshore.

S. 96, the Export Products Not Jobs Act, illustrates a concern that the tax law affects the location of jobs. S. 96 proposed to make Subpart F rules more transparent. Deferral would end except for "active home country income." To address concerns of corporations incorporating abroad to avoid taxation of worldwide income, the definition of a domestic corporation would be modified to include a publicly-traded corporation with management and control primarily in the U.S.

Senator Kerry notes that S. 96 is not intended to reduce global competitiveness of U.S. companies. A U.S. company earning income in a foreign country in serving that country could still defer income. A car factory in India selling cars there would be able to defer income, but not if the cars are sold back to the U.S. Thus, the foreign entity selling back to the U.S. would be taxed the same as the company producing and selling in the U.S. (Cong. Rec. S99, 1/4/07).

Under the second theme, in June 2008, the SFC held a hearing to review current tax rules and to compare worldwide and territorial approaches to international taxation. Senator Grassley stated: "Our tax policy should enable U.S. companies to operate in the global marketplace without the artificial boundaries set in place by the tax code." He noted that any revised system should (1) support economic development, (2) raise sufficient revenue, and (3) support U.S. job growth.

An August 2008 report from the General Accountability Office (GAO), *U.S. Multinational Corporations – Effective Tax Rates Are Correlated with Where Income is Reported*, noted increased business activity of foreign affiliates of U.S. companies. In response to the report, Senator Baucus noted the need to consider international tax rules in the committee's work in 2009 on overall tax reform (9/8/08 SFC press release).

Commentary: Given concerns over outdated international tax provisions, the need to improve global competitiveness of U.S. firms, and offshore tax evasion, reform of international tax rules seems quite likely in the 111th Congress. Much work has been done to get ready for reform. In 2007, the Treasury Department held a conference on international tax reform and issued a report on possible reforms. The SFC has held a series of hearings and various reports have been produced by the GAO, JCT, and others.

Global Internet Development – In June 2008, OECD countries created the "Seoul Declaration for the Future of the Internet Economy" – a resolution with aspirations countries should pursue to ensure effective development of the potential of the Internet.

"WE STATE our common desire to promote the Internet Economy and stimulate sustainable economic growth and prosperity by means of policy and regulatory environments that support innovation, investment, and competition in the information and communications technology (ICT) sector. We will work with the private sector, civil society and the Internet community to secure the ICT networks that underpin the Internet Economy as well as to take measures to protect the users of the Internet Economy, including the necessary cross-border co-operation."

The resolution mentions privacy, security, wide applications, protection of intellectual property rights, a level playing field for competition, and more. [http://www.oecd.org/dataoecd/49/28/40839436.pdf]

OECD Model Tax Treaty – In July 2008, the draft revision (discussion draft) of Article 7 on business profits was released for comment.
[http://www.oecd.org/document/48/0,3343,en_2649_33747_40970288_1_1_1_37427,00.html]

California Developments

Schedule M-3 – The FTB had announced that it would have a Schedule M-3 for 2008. [http://www.ftb.ca.gov/professionals/taxnews/2008/0808/0808.PDF] However, due to concerns raised by taxpayers and practitioners, in August 2008, the FTB announced that it would defer M-3s until 2009. [http://www.ftb.ca.gov/forms/Schedule_M3/Announcements.shtml] California's M-3 website is at http://www.ftb.ca.gov/forms/Schedule_M3/index.shtml.

Tax Changes to Settle Budget Passage Standoff – Once again, the California legislators missed the June deadline for passing a budget. Addressing a $15 billion shortfall was the key hold up. Both legislative Democrats and the governor suggested tax increases, but they were opposed by most Republicans. Tax changes included in the budget bills (AB 1452 and SB X1 28) include the following, per a Franchise Tax Board summary. [http://www.ftb.ca.gov/law/2008_Legislative_Update.shtml]

"AB 1452 Enacted (Chapter 08-763)

1. Limits business tax credits to 50% of net tax (before credits) for tax years 2008 and 2009. [exempts taxpayers with net business income of under $500,000]
2. Suspends NOL deductions for 2008 and 2009 [except for taxpayers with less than $500,000 of net business income in either year], then conforms to federal NOL carryback rules with modifications with a phase-in of the carryback rule.
3. Requires the LLC fee to be estimated and paid 10 months before the current due date of the return; imposes a 10% underpayment penalty.
4. Amnesty 2009 - repealed by SB X1 28.
5. Allows existing corporate tax law credit carryovers, under corporation tax law, to be assigned to unitary affiliates for taxable years beginning on or after July 1, 2008. [See text in Appendix D]
6. Requires the Franchise Tax Board to issue a report on the use of tax credits in the 2010 and 2011 taxable years. [by 6/30/13]

SB X1 28 Enacted (Chapter number unavailable)

1. Changes estimate payment percentages to 30% of the annual tax liability for the 1st and 2nd estimate payment installments and 20% of the annual tax liability for the 3rd and 4th installments under PIT and CORP law for tax years on or after January 1, 2009.
2. Requires corporate taxpayers not required to make a 1st installment to pay 40%, 30%, and 30% for installments due.
3. Eliminates option of using a percentage of prior year's tax to compute the required annual payment for taxpayers with AGI of $1 million or more ($500,000 in the case of a married individual filing a separate return).
4. Repeals Tax amnesty provisions and penalty in AB 1452.
5. Enacts new corporation tax penalty for understatements of tax greater than $1 million equal to 20% of understatement for taxable years beginning on or after January 1, 2003.
6. Clarifies operative date for the requirement to estimate and pay the LLC fee for taxable years beginning on or after January 1, 2009.

7. Clarifies the business tax credit assignment language in AB 1452 with regard to application of limitations on credits when initially earned."

FTB Analysis of AB 1452 - http://www.ftb.ca.gov/law/legis/07_08bills/AB1452_091508.pdf.

More from Assembly Revenue & Taxation Committee on LLC fee change: "Require payment of the estimated payment of the Limited Liability Corporation (LLC) fee payment by June 15 of the current taxable year, instead of April 15 of the following year. This would result in a one-time double payment in the first half of calendar 2009 - the 2008 payment by April 15 and the estimated 2009 payment by June 15. This change would in a one-time General Fund revenue acceleration of $360 million in 2008-09, and an ongoing General Fund benefit of about $35 million. This bill would conform the treatment of LLCs to local business license taxes and personal income taxes, which require estimated payment in the tax year, instead of the following year. LLC fees range from $900 for gross incomes under $500,000 to $11,790 for gross incomes at or over $5,000,000. This bill includes a 10-percent penalty for late or underpayment, but includes a safe-harbor if the estimated payment is equal to or greater than the fee that was due in the previous year." [9/17/08 analysis]

More from FTB on assignment of credits: "Provides that an "eligible credit" may be assigned by a taxpayer to an "eligible assignee."

> "Eligible credit" means any credit earned by a taxpayer in a taxable year beginning on or after July 1, 2008, or any credit earned in any taxable year beginning before July 1, 2008, that is eligible to be carried forward to the taxpayer's first taxable year beginning on or after July 1, 2008.
>
> "Eligible assignee" means any "affiliated corporation" that is properly treated as a member of the same combined reporting group4 at specified times.
>
> "Affiliated corporation" means a corporation that is a member of a commonly controlled group. [R&TC §25105]

- The election to assign any credit is irrevocable once made and is required to be made on the taxpayer's original return for the taxable year in which the assignment is made.
- Gives the Franchise Tax Board (FTB) authority to issue rules, procedures, guidelines and regulations necessary to implement this provision."

[http://www.ftb.ca.gov/law/legis/07_08bills/AB1452_091508.pdf]

Software and Property Tax – *Cardinal Health 301, Inc. v. County of Orange*, Super. ___ Cal.Rptr.3d ___, WL 4405337 (9/08) – this case involved whether software was subject to property tax in California. CH produces software to help in tracking patient medicine. The software could not be purchased without the equipment. The software is part of the Med-Station and represents about 90% of the value of the equipment. The Board found that the software was taxable because it was bundled. The court reversed and remanded the case so that the value of the non-BIOS software could be determined.

Generally, software is subject to property tax if it is bundled with the computer. R&T §995 doesn't refer to bundling though, but provides that basic operational programs are subject to tax. Basic operational software is something other than application software, that is "fundamental and necessary to the functioning of a computer" (§995). The court next reviewed Rule 152 for guidance. The court noted that the basic purpose of this rule is to value application software that comes bundled with the computer so it won't be taxed. The court interpreted Rule 152(d) as meaning that ""basic operational software" *must* be bundled in order to be "basic operational software" under section 995, and if not, it's not taxable."

The court reviewed the history of the rules under §995, Rule 152 and the *Hahn* case (73 Cal.App.4th 985 (1995)) so the case provides a comprehensive review of the rules on the application of property tax to software in California.

California Proposal for Broader Nexus - CA AB 1840 would broaden the definition of "substantial nexus" in California and modify Regulation 1684. See full text at Appendix E.

Proposal to Tax Services – Board of Equalization Chair Judy Chu has proposed expanding sales tax to include some services. [http://www.boe.ca.gov/members/jchu/sales_tax_article.html]

California Tax Commission – On 10/30/08, with the support of Assembly Speaker Karen Bass, Governor Schwarzenegger announced the formation of California Commission on the 21st Century Economy (Executive Order S-12-08). The 12-member commission will have six appointees by the governor and six by the legislature. The commission is to issue a report on 4/15/09. Per the Executive Order, the following goals should guide the commission's work:

" a. Establish 21st century tax structure that fits with state's 21st century economy;

b. Stabilize state revenues and reduce volatility;

c. Promote the long-term economic prosperity of the state and its citizens;

d. Improve California's ability to successfully compete with other states and nations for jobs and investments;

e. Reflect principles of sound tax policy including simplicity, competitiveness, efficiency, predictability, stability and ease of compliance and administration;

f. Ensure that tax structure is fair and equitable."

Multistate Tax Developments

Sales Tax Base

- **Missouri and Software Used Online –** Letter Ruling 4724 (5/08): An out-of-state business provides customized training software to customers. The software is stored on servers located outside of Missouri. Customers are charged a registration fee, monthly license fee, user license fee, module development fee and a variety of other fees. The state tax agency ruled that none of the fees were subject to sales and use tax. Missouri law primarily subjects tangible personal property sole at retail to sales and use tax. The services did not meet the definition of taxable telecommunications services. [http://dor.mo.gov/tax/rulings/LR4725.htm]
- **Missouri and Software –** Letter Ruling 4832 (6/08) – a company headquartered outside of Missouri began selling software and maintenance contracts to its financial advisory clients in Missouri. Its employees installed the software on customer computers. Clients are charged a lump sum amount for the software, maintenance contract and various service fees. The tax agency ruled that the software, maintenance fees and services were subject to sales and use tax. [http://dor.mo.gov/tax/rulings/LR4832.htm]
- **Missouri and Downloaded Photos –** Letter Ruling 5058 (8/08): The Missouri Director of Revenue held that copyrighted photos downloadable over the Internet were not subject to sales or use tax because they were intangible and did not constitute a taxable telecommunications service.
- **New York –** downloading and watching video online is not subject to sales and use tax in New York per TSB-A-08(22)S (5/2/08). [http://www.tax.state.ny.us/pdf/advisory_opinions/sales/a08_22s.pdf] The ruling was requested by Google.
- **Washington and Multiple Points of Use Software** - Det. No. 07-0120, 27 WTD 109 (2008): Taxpayer is a clothing retailer headquartered in Washington with stores throughout the US. T purchased software under an arrangement with the seller that provided T with a copy and the right to make copies for use at multiple locations including several outside of Washington. The

software programs would be loaded on computers in T's Washington location and then transferred electronically to some of T's other locations, with the licensing controlled by T's headquarters.

Washington treats software as tangible personal property subject to sales tax and the seller collected sales tax from T on the full purchase price. T later requested a refund of sales tax for a portion of the amount software that was used outside of the state. T argued that the transaction consisted of two parts: (1) the purchase of the software used in Washington and (2) the licenses for use of the software at other locations.

The court denied T's claim because "Washington sale and use tax laws simply do not differentiate between software acquired under a single use license arrangement and software acquired under a multiple use license arrangement." The fact that the item purchased can be copied multiple times and used does not change the "selling price" on which sales tax is owed. T noted that Colorado allows for what T had proposed, but the court viewed that as support that Washington doesn't have a similar rule allowing the treatment sought by T. The court also noted that the SSUTA had considered a multiple points of use for software provision but then rejected it due to complexities of determining where the software would be used after its initial purchase. Thus, the court concluded that until Washington enacts a multiple points of use rule, T was subject to sales tax on the entire price of the software delivered to Washington.

In referencing the SSUTA, the opinion also makes a footnote reference to *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 US 175 (1995) involving sales tax on a bus ticket where the trip involved more than one state. The court noted that in *Jefferson Lines*, the Court stated: "We have therefore consistently approved taxation of sales without any division of the tax base among different States, and have instead held such taxes properly measurable by the gross charge for the purchase, regardless of any activity outside the taxing jurisdiction that might have preceded the sale or might occur in the future. *See e.g.McGoldrick v. Berwind-White Coal Mining Co.*, [309 U.S. 33, 60 S.Ct. 388 (1940). [http://dor.wa.gov/Docs/Rules/wtd/2008/27WTD109.pdf]

- **What is Custom Software in Wisconsin? –** In *Wisconsin Dept. of Revenue v. Menasha Corporation* (Wisc S Ct 7/08)**,** the state supreme court affirmed the appellate decision to find that the software purchased from SAP that was greatly modified to be usable by the taxpayer was really custom software and thus not subject to sales tax.

Menasha is a Wisconsin corporation with over 5,700 employees and 63 business locations in 20 states and 8 countries. Starting in 1993, M sought a software system to meet its special accounting and business needs. M acquired a system from SAP that consisted of over 70 software modules for clients to select for their needs. The accounting and business system has to be customized to meet any client's operational needs. "It is only after this customization process is completed that the client has a usable software system that will serve its business and accounting needs."

"Menasha understood that the requisite customization process could take years to complete and would cost tens of millions of dollars." M also knew that if the system was not customized to its needs, it would be worthless. M's board of directors approved a SAP license while acknowledging that the estimated implementation cost was about $46.5 million. The initial package cost was $5.2 million, which was purchased in September 1995. Over 3,000 modifications were made to the initial software package.

Upon audit of SAP in 1998, the Wisconsin Dept. of Revenue concluded that the software was not custom and thus was subject to sales tax. As a result, SAP paid over $1.9 million in tax and interest for sales to its Wisconsin customers and promised to collect the tax thereafter. This amount did not include the software sold to M because M promised to pay the tax directly to the WDOR.

M paid the tax, but then filed a refund claim of $342,614. This claim was denied in April 1999.

Wisconsin law requires all facts and circumstances to be considered in determining if software is custom and provides seven factors to weigh in the consideration:

1. Presale consultation – this occurred
2. Loading and testing of software by the vendor – it was loaded by an ex-SAP employee and testing took about 4 months
3. Substantial training and written documentation – was required
4. If enhancement and maintenance support by the vendor is needed – met
5. Rebuttable presumption that program is not custom is cost is $10,000 or less – met
6. Not a pre-written or basic operational program – met. Per the Wisc. Admin. Doce §11.71(1)(k): “"Prewritten programs", often referred to as "canned programs", <u>means programs prepared, held or existing for general use</u> normally for more than one customer, including programs developed for in-house use or custom program use which are subsequently held or offered for sale or lease.(Emphasis added).” – the Wisconsin Tax Appeals Commission ruled that this factor was met. Per the Commission: "The distinction between custom and prewritten programs hinges on the amount of effort necessary to get the software operational for the particular customer's needs."
7. Significant modification to an existing program – n/a per the Commission because the system “was a custom program rather than an existing program.”

The Commission also considered the cost, noting that $5.2 million “favored a conclusion that the [software] was custom.”

The WDOR appealed the decision of the Commission to the circuit court which gave more weight in interpreting the tax law to the WDOR and found that the software was not custom. M appealed to the Court of Appeals which held for M.

WDOR’s argument focuses on factors 6 and 7 which it argued were of prime importance. Since the software was prewritten and available to many customers, these factors indicate the software cannot be considered custom. However, the courts found that due to the number of modifications and the reality that the software was not usable without modification, it was custom.

“We too are persuaded by the initial cost, the costs for modifications, the presale consultations over the span of a few years, the testing required once installed, the requisite training, the requisite enhancement and maintenance, and that the R/3 System cannot be used until modified——in this case some 3,000 modifications. As a result, we conclude that the Commission's conclusion that the R/3 System was custom is reasonable.”

A lengthy dissenting opinion noted that the court’s decision would result in a revenue loss to Wisconsin of will “exceed $277.6 million prior to the end of the 2007-09 biennium and $28.3 million annually thereafter.” The dissent pointed out that the software package was not written solely for M, but was available for anyone.

[http://www.wicourts.gov/sc/opinion/DisplayDocument.html?content=html&seqNo=33384]

Subsequent state action: The WDOR has released information on how companies can determine if they are entitled to a refund and if yes, how to obtain it. [http://www.revenue.wi.gov/faqs/ise/menasha.html]

Sales Tax Nexus

- *Barnesandnoblecom v. BOE*, CGC-06-456465 (Ca Sup Ct SF, 10/11/07) – the court reversed the earlier decision to find that BN did not have nexus for sales and use tax purposes in California. 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).

  BN operated as a Delaware LLC. BN is owned 40% by Barnes & Noble, Inc. (B&N), 40% by Bertelsmann AG, and 20% by barnesandnoble.com, inc., a publicly-traded corporation. BN operates as a separate legal entity and has offices at a different location than B&N and its affiliates and subsidiaries. BN has separate and independent management from B&N. Booksellers (B), a wholly-owned subsidiary of B&N, operates retail stores in the US. The only connection between BN and B was including BN's coupons in shopping bags used by B. B and BN did not share employees, inventory, facilities, management or any information. B's stores did not take returns of BN merchandise and provided no "unique or preferential services to [BN's] customers" and did not refer customers to BN.

  From mid-November 1999 through mid-December 1999, B's shopping bags included coupons for a $5 discount for online purchases from BN of $25 or more. The bags had B's logo on one side and BN's logo on the other side. BN paid to have the coupons printed and the extra cost of having its logo on the shopping bags.

  In September 2001, the BOE issued a memorandum decision in Borders Online where it indicated that it interpreted that "selling" as used in R&T §6203(c) to mean "inclusive of all activities that are an integral part of making sales." The BOE used this same interpretation for B and BN to find that use of the coupons was an integral part of making sales thus making BN a "retailer engaged in business" in California with "substantial nexus" as required by the commerce clause of the US Constitution due to B being its representative or agent in California.

  The court did not find any difference between the terms "agent" and "representative" (both used in §6203). It also did not find similarities between BN's situation and the two cases the BOE cited as support of the existence of an agency relationship between B and BN. In *Borders Online LLC v. State Bd. of Equalization,* 129 Cal.App.4th (2005), the two corporations involved were wholly-owned subsidiaries of the same parent corporation. They also had overlapping boards of directors and corporate officers. Borders stores provided "unique and preferential services" to Online's customers such as returns of merchandise on favorable terms. Borders employees also solicited sales for Online.

  The court distinguished the BN situation in that while B&N and BN had two directors in common as well as the same chairman, the court found that B and BN shared no officers or directors. The court also did not find that B&N had "actual control" over BN and B. "Thus, the fact that [BN] and [B} are sister corporations does not support a finding that [B] was [BN's] agent."

  The BOE also relied on *Scholastic Book Clubs, Inc. v. State Bd. of Equalization*, 7 Cal.App.3d 734 (1989). In this case school employees provided various services to enable Scholastic, which had no physical presence in California, to sell books in California. Per the court: "This is a far cry from the passive distribution of coupons."

"The concept of agency requires something significantly more than simply passing out information at somebody else's request. An essential element is that the agent (or representative) must have the authority to bind the principal, authority held neither by [B&N] retail stores nor the hypothetical person on the street corner handbag out promotional material. [B] had no input in creating the coupon program. [B] had no authority to adjust the terms of the coupons or to redeem them. [B] could not accept returns of books purchased from [BN] with the coupons. [B] did not solicit sales and could not accept orders for [BN]. [B] had no authority to accept anything from customers that would be passed on to [BN]. With regards to [BN], [B] could do nothing but pass out the coupons created and distributed by [BN]. [B] could not speak for or bind [BN] on any subject whatsoever. Thus, the Court finds that [B] was not [BN's] agent for the purposes of RTC §6203."

The court also noted that the fact that B and BN had similar names does not make B the agent of BN because there was no evidence that B could bind BN. "Finally, the Board argued that [B] gave [BN] preferential treatment because [B] did not pass out coupons from any company other than [BN]. The evidence only shows that [B] did not pass out coupons from other companies during the tax period. There is no evidence that [B] did not pass out coupons from other companies during another time period or that [B] would not offer this service to any other company. In any event, even if this were only a one-time operation, that would not alter the agency analysis."

While recognizing that the term "selling" as used in R&T §6203 had been modified by the BOE's ruling in Borders, it was not relevant since B was found not be an agent of BN. Per the court: "Because the Boards's statutory interpretation of "selling" has been conclusively adopted as law in Borders Online, the Court of Appeal's definition of that term now controls the outcome of this case. Accordingly, the interpretation of that term, as first applied by the Board in its memorandum opinion, is now a matter of settled decisional law. But "selling" activity in California would subject [BN] to the Board's jurisdiction only if carried out by [BN's] "agent," which, as explained above, it was not."

Thus, BN was not subject to sales and use tax collection in California as it had no physical presence in the state.

Subsequent Activity: The 10-Q (pp. 26-27) for the quarter ending 8/2/08 for Barnes & Noble, Inc. indicates that in May 2008, the BOE and B&N entered a settlement agreement to resolve all disputes between BN and California. Apparently, the BOE had filed an appeal. The $17.7 million assessment was canceled and the BOE waived any claims for tax, interest and penalties through 11/1/05 which is the date when BN started to voluntarily collect sales tax in California. As part of the settlement, BN agreed to pay $9 million.

- **Mixed Transactions** – In *Dell, Inc. v. The Superior Court of the City and County of San Francisco*, 71 Cal Rptr 3d 905 (2008), the court held that service contracts sold with computers were not subject to sales and use tax because there were for intangible property and services which are not taxable in California. Although the cost of the service contracts was not separately stated on the retailer's invoice, the court found that they were still not subject to sales tax. Dell sells the service contracts as an agent of BancTec which is the entity that provides the services. Dell was not a registered seller in California, but BancTec was and Dell collected sales tax on BancTec's behalf.

The court viewed the sale as a "mixed transaction" rather than a "bundled transaction." In a mixed transaction, the items sold are separately identifiable items. In a bundled transaction, goods and services are "inextricably intertwined in a single sale." "Unlike bundled transactions, the goods and services in a mixed transaction are distinct (not intertwined) and each is a significant object of the transaction (not one incidental to the other)."

Also relevant was that the warranties were not mandatory in which case they would be incidental to the sale of the tangible personal property and taxed. Optional warranties are not subject to sales tax. The court also noted that the computer and service contract are significant parts of the transaction with neither being incidental to the other.

"We conclude that the proper approach under California law is to tax the computer (tangible personal property) and not the service contract (service or intangible property). As other courts have recognized, "when there is a fixed and an ascertainable relationship between the value of the article and the value of the services rendered, and each is a consequential element capable of a separate and distinct transaction, then the elements must be analyzed as separate transactions for tax purposes." (Clark, supra, 624 A.2d at p. 301.)" The court held that the service contracts were not part of the sale of the computers and even without separate invoicing, the service contracts are not subject to sales and use tax.

Query: Both the BOE and Dell argued that the service contracts were subject to tax. Why?

- **New York Law Change to Broaden Nexus** – New York's governor proposed and the legislature adopted a change in its sales tax nexus determination (A09807 enacted in April 2008). As described in the Governor's budget proposal: ""E-Commerce Retailer - Registered Vendor. Creates an evidentiary presumption that certain sellers using New York residents to solicit sales in the State are vendors required to collect sales and use taxes. This will correct a competitive disadvantage experienced by New York-based businesses by subjecting out-of-State vendors to the same sales tax requirements. This will raise $47 million in 2008-09, and $73 million in 2009-10."
[http://publications.budget.state.ny.us/eBudget0809/fy0809littlebook/BudgetInitiatives.html]

The language of the new provision states (NY Tax Law §1101(b)(8)): "a person making sales of tangible personal property or services taxable under this article ("seller") shall be presumed to be soliciting business through an independent contractor or other representative if the seller enters into an agreement with a resident of this state under which the resident, for a commission or other consideration, directly or indirectly refers potential customers, whether by a link on an internet website or otherwise, to the seller, if the cumulative gross receipts from sales by the seller to customers in the state who are referred to the seller by all residents with this type of an agreement with the seller is in excess of ten thousand dollars during the preceding four quarterly periods ending on the last day of February, May, August, and November. This presumption may be rebutted by proof that the resident with whom the seller has an agreement did not engage in any solicitation in the state on behalf of the seller that would satisfy the nexus requirement of the United States Constitution during the quarterly periods in question. …"

This new law has been called the Amazon bill because one of the few retailers who will be subject to it is Amazon that has many affiliates in New York with a link on their website and who make commissions when customers link to Amazon to make a purchase. Another company subject to the new law is Overstock.com.

On April 25, 2008, Amazon filed a compliant in New York challenging the new law as unconstitutional. Amazon argues that it has no physical presence in New York as required for sales tax collection. It posits that its associates perform advertising rather than solicitation of sales. Per *Tyler Pipe*, 483 US 232 (1987), such activity is not sufficient to find nexus. Amazon also notes that the associates are not its agents. Amazon also notes that its Associates Program does not depend on the residence of any associate and it does not know how many are legal residents of New York.

Overstock.com also filed a suit against the state.

On May 8, 2008, the NY State Department of Taxation and Finance issued guidance on the new rule (TSB-M-08(3)S). [http://www.tax.state.ny.us/pdf/memos/sales/m08_3s.pdf]

Amazon is now collecting sales tax from its New York customers while Overstock.com terminated its relationships with its approximate 3,400 New York affiliate advertisers.

In a California Board of Equalization memo (6/19/08) on the New York law change, staff conclude that a link on an affiliate's website does not by itself make the affiliate an authorized salesperson for the remote vendor. [http://www.boe.ca.gov/meetings/pdf/070808nexus.pdf]

- **Federal Legislative Response to NY Nexus Approach** – In October 2008, Senator Bunting introduced S. 3670 to mandate that a state only impose tax on vendors with a physical presence in the state. "No taxing authority of a State shall have power to require the collection and remittance of a State tax by any person resulting from the electronic commerce of such person unless such person has a physical presence in the State during the taxable period with respect to which the tax is imposed." Physical presence is defined as:

  > "(A) Being an individual physically in the State, or assigning one or more employees to be in the State.
  >
  > (B) Using the services of an agent (excluding an employee) to establish or maintain the electronic commerce in the State, if such agent does not perform the same services in the State for any other person during such taxable year.
  >
  > (C) The leasing or owning of tangible personal property or of real property in the State."

  Physical presence excludes de minimis presence defined as:

  > "(A) entering into an agreement to share revenue generated by an electronic commerce presence owned or maintained by a person who is physically present in a State;
  >
  > (B) presence in a State for less than 15 days in a taxable year (or a greater number of days if provided by State law); and
  >
  > (C) presence in a State to conduct limited or transient business activity."

  The provision does not apply to a person domiciled or incorporated in the state.

  Comment: This approach needs to be considered along with business activity tax nexus proposals (discussed later).

- **New York and Advertising** – In ruling TSB-A-08(36)S (8/08), G, a seller of jewelry via television and the Internet inquired as to whether its relationships with television and other advertisers and cable operators might create nexus in NY. G had no physical presence in NY. The Department of Taxation and Finance stated: "If an out-of-state seller merely advertises on satellite and cable television stations in New York State, this activity would not by itself create nexus with New York State. Contractual relationships for the purchase of airtime or advertising of the kind described by Petitioner with STP, Procurer, and the cable operators also do not appear by themselves to give an out-of-state seller the physical presence in New York that would require it to register for sales tax purposes or collect sales tax on its sales. This presumes that STP, Procurer, and the cable operators have no economic interests or stake in Petitioner's sales and their relationships with Petitioner are strictly related to the sale of advertising and airtime in arm's length transactions." However, the Department would not conclusively rule that G had no sales and use tax nexus. "A determination as to whether an out-of-state seller has nexus with New York, however, depends on all the facts and circumstances of a case. It is beyond the scope of this Opinion to conclusively determine whether Petitioner has nexus with New York." The Department did not that NY buyers of the jewelry owed use tax. [http://www.tax.state.ny.us/pdf/advisory_opinions/sales/a08_36s.pdf]

- **Nexus Background** – An Arizona Department of Revenue Advisory Ruling on nexus and the Arizona privilege tax provides a good overview of the legal guidance on nexus. [http://www.revenue.state.az.us/ResearchStats/rulings/TPR08-1.pdf]

- **Need to use Available Information to Collect Sales Tax** – In *Town Fair Tire Centers, Inc. v Commissioner of Revenue*, Dkt No. C280607 (Mass. 6/9/08), the court held that TFT was required to collect Massachusetts sales tax when it installed tires on cars of Massachusetts residents in its New Hampshire store. TFT, a Connecticut corporation, operates 60 stores in Connecticut, Rhode Island, Massachusetts and New Hampshire. The court found that such tires were purchased for use in the state. The court noted that TFT had the license plate information and sometimes also the driver's license of the owner – all of which would indicate that the tires would be used in Massachusetts.

  The court did not agree with TFT's equal protection argument either. TFT argued that it was being held responsible for use tax collection whereas other businesses that chose not to collect customer information would not be subject to use tax collection. The court noted that there wasn't much to collect given that the car's license plate showed where the car was registered.

  "Even assuming, *arguendo,* that appellant's contention was correct, appellant offered no evidence that the discrimination existed or was of the magnitude necessary to constitute a violation of its equal protection rights. "The equal protection clause imposes no 'iron rule of equality.'" Kenneth Keniston & others v. Board of Assessors of Boston & Others, 380 Mass. 888, 894 (1980) (quoting Allied Stores of Ohio, Inc. v. Bowers, 358 U.S. 522, 526 (1959)). *See also* Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356, 364 (1973) (holding that the discrimination must be shown to be hostile and oppressive). Furthermore, "'[W]here taxation is concerned and no specific federal right, apart from equal protection, is imperiled, the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation.'" Kenneth Keniston, 380 Mass. at 893 (quoting Lehnhausen, 410 U.S. at 359)." [http://www.mass.gov/atb/2008/08p707.doc]

- **Taxable Use in California Required for Use Tax –** In an unpublished California appellate decision – *Modern Mold Int'l v. State Board of Equalization*, 2008 WL 4816629 (Cal.App. 2 Dist.), the court found that M did not owe use tax because it never made any taxable use of the property in California. M arranged with a company in Mexico to imprint pens and to package and mail them to M's customers. The pens were intended to be free samples. The court held that the facts indicated that M "intended to effect a present transfer of ownership to the intended recipients upon shipment of the merchandise from" the Mexico plant. [http://www.courtinfo.ca.gov/opinions/nonpub/B200874.PDF]

- **Efforts to Simplify Sales & Use Tax Nexus**
  - Streamlined Sales & Use Tax Agreement (SSUTA)
    - www.streamlinedsalestax.org
    - Started in 2000
    - "It is the purpose of this Agreement to simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance."
    - Goals:
      - Draft uniform SUT law for states to adopt

        - Get states to adopt it
        - Create governing board once at least 10 states representing 20% of population of states imposing a sales tax have enacted appropriate legislation – accomplished in October 2005
        - Get Congress to reverse *Quill* for adopting states
    - Includes technological compliance and third party collection options
    - Remote vendors can get limited amnesty if register with an adopting state (which also means they register for all adopting states)
    - Issues:
        - Destination sourcing made some local retailers unhappy
            - EX – florist who used to be able to charge sales tax for store location, had to change to customer location
            - Solution – SSUTA modified to allow state to elect origin sourcing for in-state sales of tangible or digital goods (not services)
            - Problem – uniformity missing; constitutionality
                - EX – San Jose resident purchases book online from Ventura seller – 7.25% sales tax. SJ resident purchase book online from registered Michigan seller – 8.25% sales tax
        - Simple?
        - Will Congress overturn Quill for adopting states?
            - Proposals at least back to 108th Congress.
        - Many changes - 12 amendments to 11/02 version, such as
            - Option for origin sourcing rather than destination
            - Definition of digital goods
            - Separate definition for "fur clothing" (so is no longer part of clothing definition)
        - California – would get one vote on governing board
- S. 34. and H.R. 3396 (110th Congress)
    - To the extent SSUTA meets specified simplification standards, adopting states may collect sales tax from remote sellers.
    - Exemption for small sellers with less than $5 million of remote taxable sales in the prior year.
    - Commentary:
        - Small seller exemption challenges the touted simplification.
        - Unless states exempt purchases from small businesses from use tax, buyers still need to self-assess use tax.
        - Another solution to explore is better use of technology, such as at the time of sale having buyer's credit card charged sales tax by state tax

agency. This approach results in no filing obligations for vendors or buyers.

- 12/6/07 Hearing in House Judiciary Subcommittee on Commercial and Administrative Law on H.R. 3396:
  - Opposed by Direct Marketing Association
    - States should have used NCCUSL approach.
    - SSUTA did not create uniformity and created some new complexities.
    - "It has not produced a one stop/one form tax return and remittance system." Ex – states still allowed sales tax holidays – no uniformity.
    - One rate per state was an original premise for the project.
    - Uncollected use tax overstated.
  - In favor:
    - National Conference of State Legislatures
      - Uniformity of definitions is more important than one rate/state.
      - Lowers collection costs.
      - No consumer privacy issues.
    - JC Penney
      - JC Penney, National Retail Federation and many multi-channel retailers support HR 3396
  - http://judiciary.house.gov/hearings/hear_120607_2.html

Income Tax Nexus

- **Oregon's New Income Tax Nexus Guidance -** In May 2008, the Oregon Department of Revenue (DOR) adopted Rule 151-317.010 to clarify that a corporation can have substantial nexus in the state for corporate excise and income tax purposes without physical presence. "Substantial nexus exists where a taxpayer regularly takes advantage of Oregon's economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in the state."

  To determine if substantial nexus exists the DOR may look at the regularity of contacts in the state, deliberateness of marketing to Oregon customers, and significant gross receipts from Oregon customers or from the use of intangible property in Oregon. Also relevant is whether the business is protected by Oregon laws, has court access, uses state roads, benefits from Oregon's educated workforce, or receives "police and fire protection for property in Oregon that displays taxpayer's intellectual or intangible property." [http://arcweb.sos.state.or.us/rules/OARS_100/OAR_150/150_317.html]

- **Florida Economic Nexus Ruling –** In Florida Technical Assistance Advisement 07C1-007 (10/17/07), the Florida Dept of Revenue held that a financial services firm providing various services to retailers in Florida had nexus for income tax purposes even though it had no physical presence in the state. T is licensed with the Florida Dept. of Financial Services under Florida law.

The license indicates that T has a number of authorized retailers in the state and T paid a fee for each one. The retailers bind T because if a retailer does not pay for any transaction, T is liable to the service provider.

P.L. 86-272 does not apply to T because it is not selling tangible personal property. In analyzing due process, the DOR stated: "the U.S. Supreme Court has said that the "simple but controlling question is whether the state has given anything for which it can ask return." See *Wisconsin v. J. C. Penney Co.*, 311 US 435, 444 (1940). In this case, Florida has provided the Taxpayer with a license, and with an orderly and regulated marketplace. Florida is also providing the Taxpayer with access to its courts. Therefore, Florida meets the requirements of the Due Process Clause."

In analyzing commerce clause concerns using *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)., the DOR also found no problem with imposing tax. "Florida has provided the Taxpayer with a license, and with an orderly and regulated marketplace. Florida is also providing the Taxpayer with access to its courts and police and fire protection for its authorized agents/representatives. Therefore, Florida's corporate income tax has a fair relation to the services Florida provides."

In analyzing any physical presence requirement, the DOR noted that cases in other states have found that the *Quill* physical presence standard does not apply for income tax purposes. The DOR also noted that the US Supreme Court had declined to hear a state case on this issue. It found these cases to be "persuasive, especially given the fact that the U.S. Supreme Court declined to hear the cases."

While not mentioning the cases, the DOR was likely referring to *MBNA*, 640 SE2d 226 (2006) and *Lanco*, 188 NJ 380 (2006), cert denied 127 S. Ct. 2997 (06/18/2007). In these cases, the courts held that for commerce clause purposes, a "significant economic presence test" was appropriate to determine if a business had a substantial nexus in a state for income tax purposes (*MBNA*).

The DOR found that T had substantial nexus in the state.

- **Indiana and Economic Presence** – In *MBNA America Bank v. Indiana Dept. of Revenue* (Cause No. 49T10-0506-TA-53, 10/08), the Indiana Tax Court held that MBNA was liable for Indiana's financial institutions tax because while it did not have a physical presence in the state, it had an economic presence. MBNA had no employees or facilities in Indiana and only contacted credit card customers and potential customers there by phone or mail. At issue was whether economic presence is sufficient to meet the substantial nexus requirement under the commerce clause of the US Constitution. The court concluded: "The Commerce Clause does not require MBNA to have a physical presence in Indiana to be subject to the FIT – its economic presence is enough." [http://www.in.gov/judiciary/opinions/pdf/10200801tgf.pdf]

- **Virginia and Third Party Warranty Services** – In Ruling 08-184 (10/17/08), the Virginia Department of Taxation ruled that a taxpayer (T) did not have income tax nexus under PL 86-272. T sold products to contractors who installed them for commercial customers. Another product was sold to distributors who then sell the product to retailers and contractors for sale to residential customers. T has no property in Virginia and sales activities were only those permitted under PL 86-272. T requested a ruling to determine if its arrangements for warranty work created income tax nexus. All warranty work was performed by third parties to whom T would ship any needed parts.

The DOT noted first: "Although P.L. 86-272 applies to tangible property, the Department's policy has been to extend the "solicitation test" of P.L. 86-272 to situations involving the sales of services. The Department has a long established policy of narrowly interpreting the provisions of

P.L. 86-272." The DOT notes that generally, warranty services are a type not protected by PL 86-272. However, T did not provide the services but instead reimbursed independent third parties for providing them. Public Document 99-278 (10/14/99) provides that warranty services carried on in Virginia are not an activity protected by P.L. 86-272. That ruling further states that the provision of services in Virginia by an independent contractor on behalf of a taxpayer was the purchase by the taxpayer of services from a vendor that were then resold to the taxpayer's customers. Accordingly, such activity would not create nexus for the taxpayer purchasing the services."

The DOT found that T's activities were "substantially similar" to those of a sign manufacturer covered in Public Document 01-136 (9/18/01). In that ruling, T also hired unrelated third parties to provide installation and warranted services. The DOT found that performance of such services was the purchase of services by T that did not exceed the protections of PL 86-272. Thus, the DOT ruled similarly for T.

Virginia DOT rulings can be found at http://www.policylibrary.tax.virginia.gov/OTP/Policy.nsf.

- **Michigan and MBT Nexus** – The Michigan Department of Treasury issued Revenue Administration Bulletin 2008-4 explaining when a business has nexus for purposes of owing the Michigan Business Tax which includes both the Michigan business income tax, gross receipts tax, gross direct premiums tax and the franchise tax. The bulletin states: "two alternative nexus standards under the MBT. First, a person has nexus with the state if that person has *physical presence* in the state for more than one day during the tax year. Alternatively, a person has nexus with the state if the person *actively solicits sales in this state and has Michigan gross receipts of $350,000 or more*." The bulletin also notes that if a business falls under the protections of PL 86-272, it will not be subject to the business income tax although it could be subject to other Michigan taxes not covered by PL 86-272. This lengthy bulletin includes details for how PL 86-272 operates in Michigan and when a business is subject to MBT. It can be found at http://www.michigan.gov/documents/treasury/RAB2008-4_253768_7.pdf.

- **Colorado Factor Presence Nexus Proposed Regulation** – In August 2008, the Colorado Department of Revenue proposed a factor presence nexus standard for companies that are not domiciled in Colorado, but doing business in the state (Regulation (39-) 22-301.1. Doing business in Colorado). Such entities would be considered as having substantial nexus and have income tax filing obligations in any period in which any of the following thresholds are exceeded (unless prohibited from imposing income tax per US Constitution or PL 86-272):

  (a) a dollar amount of $50,000 of property; or

  (b) a dollar amount of $50,000 of payroll; or

  (c) a dollar amount of $500,000 of sales; or

  (d) twenty-five percent of total property, total payroll or total sales.

  The thresholds would be adjusted for inflation. A hearing is scheduled for 11/3/08. [http://www.revenue.state.co.us/taxstatutesregs/REG3922301.1.html]

- **Income Tax Nexus Solutions**

  Business Activity Tax Simplification Act proposals, S 1726 and HR 5267 (110th Congress), would expand PL 86-272 to also apply to services and intangibles. They require a physical presence for a business to be subject to income tax. The bills generally define physical presence

as including employees, an exclusive agent or tangible property. Presence of less than 15 days or to conduct limited or transient business activity is ignored.

Congressman Boucher, a co-sponsor, states (Cong. Rec. 2/7/08, E137):

> "The measure we are introducing today will bring certainty to the increasingly chaotic tax environment for businesses by clarifying that the states cannot attempt to tax the income of a company that has no physical presence within the taxing state's borders. Our legislation sets forth clear, specific standards to govern when businesses should be obliged to pay business activity taxes to a state. Generally, a business must use employees or services in a state for 15 days or more in a calendar year before it is liable to pay business activity taxes to that jurisdiction.
>
> The Business Activity Tax Simplification Act also modernizes a law which Congress enacted forty-nine years ago that set clear, uniform standards for when states could tax out of- state businesses based upon the solicitation of orders for specified kinds of sales. Reflecting the economy of its time, the scope of Public Law 86–272 was limited to income taxes on the sale of tangible personal property. Our nation's economy has changed dramatically over the past half-century, and the statute must be modernized to apply equally to the sale of intangible property and services, and to other business activity taxes.
>
> I want to emphasize that the Business Activity Tax Simplification Act does not diminish the ability of states and localities to collect tax revenue. Rather, it rationalizes and makes more predictable the process of doing so."

In February 2008, the House Small Business Committee held a hearing on tax and nexus issues small businesses face that "significantly inhibit their ability to engage in commerce." (http://www.house.gov/smbiz/PressReleases/2008/pr-02-14-08-business-tax.htm)

State governments are generally opposed to the BAT Simplification proposals of the 110th and earlier Congresses (such as HR 1956 and S 2721 in the 109th Congress). The National Governors' Association (NGA) state that the proposed nexus rule is "neither clear nor fair." They are also concerned that it will encourage companies to "shelter" income via increased planning opportunities and that it will hurt smaller and local businesses. They also believe that states will lose over $6 billion annually from the proposal. (9/05 statement on HR 1956)

For more information on cost estimates of BAT simplification legislation – HR 1956 (109th Congress):

- NGA - http://www.nga.org/Files/pdf/0509BAT.PDF
- COST - http://finance.senate.gov/hearings/testimony/2005test/072506dl2test.pdf

HR 1956 defines nexus differently than in S 1726 and HR 5267 (110th Congress).

Subsidiaries Holding Intangibles and Nexus – In *Nordstrom v. Comptroller of the Treasury* (MTC No. 07-IN-OO-0317; 2008), the Maryland Tax Court found that two subsidiaries formed outside of Maryland to own Nordstrom trademarks did not have economic substance. Thus, any activities of the subsidiaries should be treated as activities of the parent corporation, an entity that had income tax nexus in Maryland. Nordstrom paid about $200 million in royalties to one of the subs which then loaned back about two-thirds of that amount to the parent. Nordstrom paid interest, but not much principal. The sub had very little expenses. It did have a full-time paralegal overseeing management of the intangibles. Per the court: "Fundamentally, the subsidiaries did not act independently, although the financial structure creates an illusion of substance." [http://www.txcrt.state.md.us/pubs/PDF/NordstromOct2008.pdf]

New Jersey and "Throwout" and Other Reforms – AB 2722 (5/08) would repeal the "throw-out" treatment where the income apportionment factor excludes from the denominator sales in states where the taxpayer isn't subject to tax. That approach increased the amount of income subject to NJ tax. Governor Corzine also lists repeal of throwout as one of his reforms for the corporate income tax in addition to conforming the NOL carryforward period from 7 years to the federal 20 years. He also directed the State Treasurer to meet with major corporate taxpayers to find a strategy for moving to a single sales factor apportionment approach and unitary combined reporting.
[http://www.state.nj.us/governor/home/media_long.html]

In *Pfizer v. NJ Division of Taxation* (2008), the court found the throwout rule to be constitutional. Pfizer has appealed the decision.

UDITPA Rewrite – The National Conference of Commissioners on Uniform State Laws (NCCUSL) drafted the Uniform Division of Income for Tax Purposes Act (UDITPA) in 1957. It was last amended in 1966. UDITPA provides rules on apportionment and allocation of multistate business income among states. In 2007, NCCUSL decided to form a committee to look at changes to update UDITPA. Section 17 of UDITPA which deals with sourcing of sales that are not of tangible property was to be a focal point, but other areas could be looked at as well.

For more information see:

- UDITPA http://www.law.upenn.edu/bll/archives/ulc/fnact99/1920_69/udiftp57.htm
- Committee's work
http://www.nccusl.org/Update/CommitteeSearchResults.aspx?committee=302.

The Committee held its first meeting in late May 2008. There were protests by some businesses urging NCCUSL to terminate the project. A coalition of businesses issued a letter noting that state lawmakers were not interested in uniformity of apportionment rules and that uniformity would only be achieved by Congress
(http://www.nccusl.org/Update/Docs/UDITPA/UDITPA_Coalition%20in%20Opposition_052808.pdf).

Uniformity among states will not be guaranteed through a UDITPA revision because states are not required to adopt the act, although Congress could provide some incentive for doing so. Federal legislation would provide uniformity, but agreement among legislators, states and businesses on what that uniformity should be remains elusive as indicated by several years of efforts to adopt business activity tax (BAT) nexus rules at the federal level (see http://www.cob.sjsu.edu/nellen_a/TaxReform/PL86-272-50thAnniversary.htm).

A committee meeting is scheduled for December 5 – 7, 2008 in Chicago.

50th Anniversary of PL 86-272 – The BAT Simplification proposals stem from efforts to update PL 86-272 enacted on 9/14/1959. PL 86-272 provides that if the only in-state activity a business has is the solicitation of orders for tangible personal property approved and filled from outside the state, the state may not impose a net income tax on the business. States set the rules, within due process and commerce clause constraints of the US Constitution, for businesses that sell services or intangibles. Given changes in how businesses operate, PL 86-272 which only applies to sales of tangible personal property is out of date. PL 86-272 was originally intended to be stop-gap legislation, but was never amended or expanded in its coverage. For more information on PL 86-272, a short article about its history, and issues surrounding it today see:

http://www.cob.sjsu.edu/nellen_a/TaxReform/PL86-272-50thAnniversary.htm

Gross Receipts Tax Nexus – Once more, a nexus case involving Dell has been decided in state court. In *Dell Catalog Sales L.P. v. New Mexico Taxation and Revenue Dept*, N.M. Ct. App., Dkt. No. 26,843 (6/3/08), aff'g In the Matter of the Protest of Dell Catalogue Sales, L.P., New Mexico Taxation and Revenue Dept Decision and Order No. 06-11 (6/22/06), the court found that Dell had nexus in NM for gross receipts tax purposes. Dell Catalog (D) is a limited partnership owned by Dell, Inc. D sells computers to individual customers. D has its principal place of business in Texas and has no physical presence in NM and does not license or franchise its tradename in NM. Dell and its limited partnerships all referred to themselves as "Dell" in contracts and advertisements.

Customers purchase computers from D through mail order catalogs and Internet sales, contacting D at its location in Texas. D also ran ads in NM, but never entered NM. D purchased the computers from Dell and resold them. The computers were shipped to customers via common carrier. Title transferred to customers upon shipment (outside of NM), but D had risk of loss until delivery was make.

While the computers were covered by a manufacturer's limited warranty, it did not cover on-site repair. If customers wanted that service, D contracted with a third party provider – BancTec that would repair computers. D has no ownership interest in B, which is a Delaware corporation operating in Texas. B has no ownership interest in D.

Customers could purchase the B service contract when they purchased the Dell computer or later. D "often 'bundled' the cost of the service contract with other items in the sales package as a marketing tool."

If a customer contacted D to report a problem, D would try to help them over the phone. If that did not work, B was contacted to send a technician; customers did not contact B directly. B was obligated to accept all contracts that D sold; D used no other service provider. D also specified some guidelines on how B was to serve customers. If a customer was dissatisfied with B's service, it was to contact D to report it.

"The hearing officer found that "[t]he availability of in-home service was an important factor in establishing [Taxpayer's] market for sales." Approximately seventy-five percent of Taxpayer's customers in New Mexico purchased the additional service contract." During the years under audit, B made 1,273 service calls and installation visits to NM customers.

"BancTec was paid based on a formula that considered, among other factors, the number of on-site service repairs made during the previous ninety-day period and the level of BancTec's performance. The arrangement was profitable to both BancTec and Taxpayer. Dell, Inc. acted as agent for BancTec, registered BancTec in New Mexico, and paid all New Mexico gross receipts tax on Taxpayer's sale of BancTec's service agreements to New Mexico customers."

In July 1999, NM audited D and determined that it owed $1.8 million of GRT for sales of computers to NM customers from January 1993 to June 1999. D filed a protest. A hearing was held and the hearing officer determined that D was liable for the GR tax and that there was no commerce clause violation. D appealed arguing that its computer sales were not "sales" per the GRT Act or that imposition of the GRT violated the commerce clause.

Under NM GRT Act, "gross receipts" are defined as "the total amount of money or the value of other consideration received from selling property in New Mexico." D argued that since title transferred in Texas so that is where the sales took place, rather than NM. The court agreed with the hearing officer that the sales were in NM because the sales were "consummated" in NM and D had risk of loss until the delivery in NM. The court also supported its position using the policy behind the NM GRT tax.

"The Act is intended to "provide revenue for public purposes by levying a tax on the privilege of engaging in certain activities within New Mexico and to protect New Mexico businessmen from the unfair competition that would otherwise result from the importation into the state of property without payment of a similar tax." § 79-2 (emphasis added). Our understanding of this policy is aided by a discussion of gross receipts tax in the leading treatise on state and local taxation, which states:

"A good consumption tax should result in taxation in the jurisdiction in which consumption takes place. Taxing the sale or use of goods that cross state lines at their destination implements this principle because goods typically are consumed at their destination. Moreover, taxation by the state of destination promotes neutrality by treating all goods consumed in the state in the same way, regardless of the location from which they were shipped. Although the American retail sales tax is hardly a model of a good consumption tax, by and large it embraces the destination principle in its application to the sale of goods. "Imports" shipped from outside the state to purchasers within the state generally are subject to sales or use tax in the state of destination, and "exports" shipped from within the state to purchasers outside the state generally are exempt from sales or use tax in the state of origin.…

"The "destination principle" of taxation, as articulated by the Hellerstein treatise, aligns with the policy underlying our gross receipts tax. Our gross receipts tax seeks to achieve fairness between out-of-state sellers and New Mexico sellers who sell to New Mexico customers. The destination principle furthers that policy by "promot[ing] neutrality by treating all goods consumed in the state in the same way, regardless of the location from which they were shipped."

"Adoption of the destination principle does not require us to construe the gross receipts tax to include principles of transfer of title, transfer of possession, or risk of loss, which are concepts that were not included in the language employed by our legislature. Therefore, we hold that the destination principle applies to determine whether an interstate transaction is a taxable sale under our gross receipts tax laws. Applying this rule to the facts in this case, we conclude that Taxpayer's activities constituted taxable sales in New Mexico. The computers sold by Taxpayer had New Mexico as their destination and were, in effect, "consumed" in New Mexico."

Next, the court analyzed the imposition of tax under the commerce clause of the US Constitution using the four-part test of Compete Auto Transit v. Brady, 430 US 274 (1977). Under this test, a state may tax a out-of-state business engaged in interstate commerce if the tax "(1) is fairly apportioned, (2) does not discriminate against interstate commerce, (3) is fairly related to the services provided by the taxing state, and (4) is applied to an activity with a substantial nexus with the taxing state." D challenges only the 4th part of the test.

The court examined whether BancTec established substantial nexus for D. "[T]he crucial factor governing nexus is whether the activities performed in this state on behalf of a taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in [the taxing state] for the sales." Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue, 483 US 232, 250 (1987) (emphasis added)."

The hearing officer had held that B's activities helped D to establish and maintain a market in NM which is necessary for B's activities to create substantial nexus for D. D argued though that the third party, as in *Scripto*, had to be engaged in sales-related activities. D also noted that the Supreme Court "has never held that a third-party non-agent engaged in an activity other than solicitation creates nexus." The court disagreed noting that the Court had "not yet addressed the question of whether a third party's non-sales activities in the taxing state can constitute nexus. This absence of case law does not equate to a holding that such activities cannot provide nexus. We decline to reach such a conclusion because it would ignore the reality of the relationship between [B] and [D] and the critical nature of [B's] activities to [D's] business."

The court also noted that its holding was supported by the MTC's nexus Bulletin 95-1 dealing with third party warranty repair services.

Finally, the court also held that D was liable for compensating tax on its use of catalogs and other advertising items in NM.

State Conformity to Bonus Depreciation – Taxpayers and their tax advisers need to review state law where taxpayers are subject to income tax to determine if the state conforms to bonus depreciation and the acceleration of AMT and research tax credits in lieu of bonus depreciation. Florida announced that it does not conform to the federal bonus depreciation, but that asset basis for federal purposes is also asset basis

for state purposes. See TIP #08C01-02 (8/29/08) at http://dor.myflorida.com:80/dor/tips/tip08c01-02.html.

State Taxation and Mobile Employees – H.R. 3359, the Mobile Workforce State Income Tax Fairness and Simplification Act of 2007, provides that "No part of the wages or other remuneration paid to an employee who performs duties in more than one State or locality shall be subject to the income tax laws of any State or locality other than--

(1) the State or locality of the employee's residence; and

(2) the State or locality in which the employee is physically present performing duties for more than 60 days during the calendar year in which the income is taxed."

Internet-Focused Developments

Size of Internet Sales - The size of Internet sales has been a disputed area since the late 1990s. Estimates vary widely as to the amount of gross receipts – both B2B and B2C. Thus, states are not really sure how much sales tax they are losing due to Internet sales by remote vendors to customers located in their states. Some researchers and Internet businesses raised the issue in 2008 that sales of small Internet vendors who may not even have their own website, may be missing from the reported data.

- At its August 2008 meeting, the Streamlined Sales Tax Project heard from professors (Joe Bailey, et al) at the University of Maryland's School of Business. They estimate that prior studies may have underestimated the size of sales by $10 - $20 billion. They observe that sales by small retailers, such as those using eBay, are undercounted. [Bailey, et al, *The Long Tail is Longer than You Think: The Surprisingly Large Extent of Online Sales by Small Volume Sellers;* http://www.streamlinedsalestax.org/Small%20Seller%20Task%20Force%20Committee/Documents/UMDLongTailSlides.pdf and http://www.streamlinedsalestax.org/Small%20Seller%20Task%20Force%20Committee/Documents/UMDRemoteSalesPaper.pdf]
- In testimony before the House Small Business Committee on 4/24/08 on the role of small business in stimulating the economy [http://www.house.gov/smbiz/PressReleases/2008/pr-04-24-08-small-biz-econ.htm], Paul Misener of Amazon noted the "surprising" share of the online market held by small business. He noted that services provided by large companies, such as Amazon and eBay, help small businesses to have online sales. He noted thought that some of this data may be overlooked. For example, the trade publication – The Internet Retailer, publishes a list of the top 500 firms. Amazon was at the top of the list in 2007, but part of the revenue it reports is transaction fees earned by assisting small businesses. Also, eBay and Google are not included in the list despite their large revenues and the larger revenue generated by the sellers using eBay to sell items. [http://www.house.gov/smbiz/hearings/hearing-04-24-08-smallbiz-economy/testimony-04-24-08-misener.pdf]
- The Department of Commerce estimated that total e-commerce sales in 2007 were 19% higher than in 2006. [http://www.census.gov/eos/www/ebusiness614.htm]

Internet Tax Moratorium

- PL 110-108 (10/31/07)
  - Extended to 11/1/14.
  - Primarily applies to prevent state and local governments from taxing Internet access services.

- Some grandfathering still allowed
- Definitional issues

Transient Occupancy Tax Issue - Online company helping to arrange travel charges tax based on price customer is charged**.** Online company remits tax based on what on the price that the hotel is actually charging. Some cities have sued online companies to get the difference.

New Federal Reporting Requirement May Capture Overlooked Internet Sales - When a merchant allows a customer to pay with a credit or debit card, an entity, such as a bank, must process the transaction to enable the merchant to receive the funds. Per Treasury, the failure of some merchants to "accurately report their gross income, including income derived from payment card transactions, represents a significant part of the tax gap." [*General Explanations of the Administration's Fiscal Year 2007 Revenue Proposals,* p. 117; http://www.treas.gov/offices/tax-policy/library/bluebk06.pdf] President Bush's budget proposals starting with FY2007 have included calling for regulations on information reporting of reimbursements made to merchants on credit cards, plus backup withholding.

The Housing and Economic Recovery Act of 2008 (PL 110-289; 7/30/08) created IRC §6050W, *Returns Relating to Payments Made in Settlement of Payment Card and Third Party Network Transactions.* This rule requires payment settlement entities to file information returns with the IRS and the merchant. These returns are to include the merchant's name, address, taxpayer identification number (TIN), and the gross amount of the transactions the entity processed for the merchant. The provision covers credit and debit cards and third party payment networks, such as online payment systems.

A de minimis exception provides that third party settlement organizations are only required to file returns regarding third party network transactions if the aggregate value of a merchant's transactions exceed $20,000 and the aggregate number of transactions exceeds 200.

Penalties are imposed for failure to file (IRC §6724). Backup withholding is required if a merchant does not provide a TIN (IRC §3406); effective for amounts paid after 12/31/2011.

IRC §6050W is effective for calendar years beginning after 12/31/2010. For further details, see §6050W and the Joint Committee explanation JCX-63-08. [http://www.house.gov/jct/x-63-08.pdf]

Observations:

- Revenue reality: The Administration's FY2007 report (http://www.treas.gov/offices/tax-policy/library/bluebk06.pdf; p. 118) estimated that regulations calling for information reporting on payment cards would generate $225 million over 10 years. In the FY 2008 report (http://www.treas.gov/offices/tax-policy/library/bluebk07.pdf; p. 66), the estimate was up to $10.7 billion and for FY 2009 (http://www.treas.gov/offices/tax-policy/library/bluebk08.pdf; p. 66), $18.7 billion. The Joint Committee on Taxation (JCX-64-08; http://www.house.gov/jct/x-64-08.pdf) estimate for §6050W is $9.5 billion. This range of estimates likely reflects the challenges of measuring the tax gap, as well as the effect of a measure on compliance and enforcement.
- Additional benefits: In 4/18/07 testimony on the Administration's tax gap proposals, Treasury Assistant Secretary Eric Solomon made the following observations on additional benefits of credit card reporting: [http://www.treas.gov/press/releases/hp360.htm]
    - "[T]he proposed information reporting would assist the IRS by providing the merchant's overall volume of payment card sales in relation to expenses claimed and cash transactions reported. The reporting would also assist the IRS in analyzing the accuracy of reporting for payment card sales."
- Complexities: In his 2007 testimony, Mr. Solomon also noted complexities in the credit card system due to the number of parties that can be involved in the reimbursement cycle. Refunds and cash back arrangements also pose problems. These issues should be addressed in regulations.

- Small business concerns: On 6/12/08, the House Committee on Small Business held a hearing on electronic payment information reporting. Issues raised by those testifying included privacy, security, cost, the need for some entities to obtain new computer programming to comply, transaction complexity that will lead to inaccurate reporting or information that is not useful to verify gross receipts, and not addressing unreported cash receipts instead. [http://www.house.gov/smbiz/PressReleases/2008/pr-06-12-08.htm]

Miscellaneous

I) In response to the Emergency Economic Stabilization Act (P.L. 110-343; 10/3/08), the IRS has issued some guidance mostly relevant to financial institutions and TARP (Troubled Asset Relief Program) including:

- Notice 2008-94 – guidance on executive compensation deductions changes to §162(m)(5) and §280G(e) added by the 10/3/08 legislation.
- Notice 2008-83 - §382 modification for banks. Full text:

  Notice 2008-83, 2008-42 IRB 905

  1. Overview

  The Internal Revenue Service and Treasury Department are studying the proper treatment under section 382(h) of the Internal Revenue Code (Code) of certain items of deduction or loss allowed after an ownership change to a corporation that is a bank (as defined in section 581) both immediately before and after the change date (as defined in section 382(j)). As described below under the heading Reliance on Notice, such banks may rely upon this guidance unless and until there is additional guidance.

  2. Treatment Of Deductions Under Section 382(h)

  For purposes of section 382(h), any deduction properly allowed after an ownership change (as defined in section 382(g)) to a bank with respect to losses on loans or bad debts (including any deduction for a reasonable addition to a reserve for bad debts) shall not be treated as a built-in loss or a deduction that is attributable to periods before the change date.

  3. Reliance On Notice

  Corporations described in section 1 of this notice may rely on the treatment set forth in this notice, unless and until there is additional guidance.

  4. Scope

  This notice does not address the application of any provision of the Code other than section 382.

  - Senator Grassley and others have questioned whether the IRS had the authority to issue this notice that relaxes the §382 loss limitation for banks. An 11/11/08 story in the *LA Times* estimated that the change would cost the federal government another $140 billion as well as $2 billion to California.
  - See letter from Senator Grassley questioning Treasury's authority to issue the notice - http://finance.senate.gov/press/Gpress/2008/prg111408c.pdf.
  - For more information and links, see TaxProf Blog entry of 11/15/08 at http://taxprof.typepad.com/taxprof_blog/2008/11/grassley-seeks-investigation.html.
  - H.R. 7300 would rescind the effect of the Notice.

II) §382 Guidance – In 9/08, the IRS issued Notice 2008-78 providing guidance that they expect to publish in the future in regulations. Taxpayers may rely on the rule of this notice for ownership changes that occur in any tax year ending on or after 9/26/08. When Congress enacted §382 (1986), concern was expressed as to efforts to increase the value of the loss corporation in order to increase the amount of usable loss. Generally, the §382 limitation is equal to the FMV of the loss corporation's stock immediately prior to the ownership change multiplied by the applicable long-term tax-exempt rate. Section 382(l)(1)(A) provides that any capital contribution to the loss corporation that is part of a plan where the principal purpose is to avoid or increase the §382 loss limitation, is not taken into account in determining the loss limitation. Per §382(l)(1)(B), capital contributions made during the 2-year period ending on the change date (§382(j)) are treated as part of such a plan unless otherwise provided for in regulations.

Notice 2008-78 provides guidance as to what these long-awaited regulations may provide. Per the notice, these rules are as follows.

"**A. Section 382(l)(1)(B).**

A. Notwithstanding section 382(l)(1)(B), a capital contribution shall not be presumed to be part of a plan a principal purpose of which is to avoid or increase a section 382 limitation solely as a result of having been made during the two-year period ending on the change date.

B. Section 382(l)(1)(A).

(1) *In general.* A capital contribution received by an old loss corporation shall be taken into account (and will not reduce the value of the old loss corporation for purposes of section 382(e)(1)) unless the contribution is part of a plan a principal purpose of which is to avoid or increase a section 382 limitation (hereinafter, a plan). Whether a capital contribution is part of a plan is determined based on all the facts and circumstances, unless the contribution is described in one of the safe harbors in Section III.B.2 below or section 382(l)(1) does not apply to the contribution pursuant to § 1.382-9(k). The fact that a contribution is not described in a safe harbor does not constitute evidence that the contribution is part of a plan.

(2) *Safe harbors.* A capital contribution will not be considered part of a plan if—

(a) The contribution is made by a person who is neither a controlling shareholder (determined immediately before the contribution) nor a related party, no more than 20% of the total value of the loss corporation's outstanding stock is issued in connection with the contribution, there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change, and the ownership change occurs more than six months after the contribution.

(b) The contribution is made by a related party but no more than 10% of the total value of the loss corporation's stock is issued in connection with the contribution, or the contribution is made by a person other than a related party, and in either case there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change, and the ownership change occurs more than one year after the contribution.

(c) The contribution is made in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan, under the terms and conditions of § 1.355-7(d)(8) or (9), respectively.

(d) The contribution is received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built in loss) or it is received before the first year from which there is a carryforward of a net operating loss, capital loss, excess credit, or excess foreign taxes (or in which a net unrealized built-in loss arose).

C. Coordination of Sections 382(l)(1) and 382(l)(4).

C. If the value of the old loss corporation is subject to reduction under both sections 382(l)(1) and 382(l)(4), appropriate adjustments must be made to ensure that a reduction in value is not duplicated."

The IRS is seeking comments on Notice 2008-78.

III) Proposed §336(e) Regulations (REG–143544–04, 8/25/08) – In August 2008, IRS issued proposed regulations under §336(e). When finalized, these regulations "would permit taxpayers to make an election to treat certain sales, exchanges, and distributions of another corporation's stock as taxable sales of that corporation's assets." These regulations address the requirements and procedures to treat the sales, exchange or distribution of stock as a deemed asset sale under §338.

On the Horizon

1) In September 2008, IRS and Treasury issued their 2008-2009 Priority Guidance Plan. It contains the following items relevant to high tech businesses:
   - Proposed regulations under §41 regarding the exception from the internal use software exception under §41(d)(4)(E).
   - Guidance under §41 on whether the gross receipts component of the research credit computation for controlled groups under §41(f) includes gross receipts from transactions between members of the controlled group.
   - Finalization of the ASC regulations.
   - Regulations on the reduced §41 credit election under §280C(c)(3).
   - Guidance under §174 concerning inventory property.
   - Regulations under §162 and §263 on the capitalization of expenditures for tangible assets.
   - Proposed regulations under §263(a) on the treatment of capitalized transaction costs.
   - The list also includes many international guidance projects including regulations on contract manufacturing.

   [http://www.irs.gov/pub/irs-utl/2008-2009_gpl.pdf]
2) Energy and Green Legislation – it is likely that Congress and state legislatures will continue to consider renewal of energy incentives and perhaps create new ones (beyond those created or extended in 2008 and earlier). The focus is not only on the environment but also the possibility of helping the economy and creating jobs. A carbon tax has also been discussed as well as a cap and trade program that would have tax implications (such as treatment of the receipt of tradable certificates, trading or selling the certificates, etc.).
3) Small business benefits – On April 10, 2008, the House Small Business Committee held a hearing - "Modernizing the Tax Code: Updating the Internal Revenue Code to Help Small Businesses Stimulate the Economy." The Committee also issued its own report - "Seven Ways to Stimulate the Economy by Updating the Internal Revenue Code." In addition to having witness testimony online in written form, the Committee has videos on YouTube about the hearing. This can all be accessed at http://www.house.gov/smbiz/PressReleases/2008/pr-04-10-08-tax-code.htm. Ideas for reform included allowing an option of a standard deduction for home office expenses;

removing computers, PDAs and similar equipment from the listed property requirements in order to reduce recordkeeping; reduce depreciation lives, and create incentives for green technologies.

4) Tax reform in the 111th Congress – the Senate Finance Committee has been holding hearings since 4/15/08 to help get ready for future tax reform discussions. Congressman Rangel introduced the "mother of all tax reforms" HR 3970 in October 2007. This bill would repeal the individual AMT replacing it with a surtax on high income individuals. It would also reduce the corporate rate to 30.5% with some base broadening. For example, the amortization period for §197 intangibles would be extended to 20 years (form 15), the lower-of-cost-or-market method for inventory valuation would be repealed, expenses of CFCs would be deferred until income was repatriated, and the §199 manufacturing deduction would be repealed.

   The Treasury Department held a conference in July 2007 and issued a report in December 2007 on reasons why the tax law needed to be reformed to aid business competition and ideas for doing so. [http://www.treasury.gov/topics/taxes/]

   For a list of tax reform related hearing of the 110th Congress and links to the hearings and related reports, see http://www.cob.sjsu.edu//nellen_a/110th-hearings.htm.

5) UDITPA rewrite – continued activity on this project (see earlier explanation).

6) California –Assembly Speaker Bass and Governor Schwarzenegger will form a tax commission to study possible reforms. The governor announced this

7) Tax proposals of the next President and Congress – what might we expect relevant to high tech industries?
   - For additional information on the presidential candidates' tax plans, see:
     - Tax Policy Center information at http://www.taxpolicycenter.org/taxtopics/election_issues_matrix.cfm
   - Technology related items from the candidates' plans per their websites:
     - McCain [http://www.johnmccain.com/Issues/JobsforAmerica/taxes.htm]
       - Reduce the top corporate tax rate from 35% to 25%.
       - Create a permanent tax credit equal to 10% of research wages.
       - Allow expensing of assets and technology.
       - Ban Internet taxes and new cell phone taxes.
     - Obama [http://www.barackobama.com/pdf/taxes/Factsheet_Tax_Plan_FINAL.pdf]
       - Eliminate capital gain taxes for small businesses.
       - Reduce taxes for corporations that invest and create jobs in the US.
       - Make the research credit permanent.
       - Close loopholes, including by clarifying the economic substance doctrine.
       - "Crack down" on international tax havens.

Appendix A

Economic Stimulus Act of 2008

Public Law 110-185 (2/13/08)

TITLE I--RECOVERY REBATES AND INCENTIVES FOR BUSINESS INVESTMENT

Sec. 101. 2008 recovery rebates for individuals.
Sec. 102. Temporary increase in limitations on expensing of certain depreciable business assets.
Sec. 103. Special allowance for certain property acquired during 2008.

TITLE II--HOUSING GSE AND FHA LOAN LIMITS

Sec. 201. Temporary conforming loan limit increase for Fannie Mae and Freddie Mac.
Sec. 202. Temporary loan limit increase for FHA.

TITLE III--EMERGENCY DESIGNATION

Sec. 301. Emergency designation.

Appendix B

Public Law 110-289 (7/30/08)
Tax Provisions

(some of these provisions are described in the body of this outline)

DIVISION C—TAX-RELATED PROVISIONS
TITLE I—HOUSING TAX INCENTIVES
Subtitle A—Multi-Family Housing
PART I—LOW-INCOME HOUSING TAX CREDIT
Sec. 3001. Temporary increase in volume cap for low-income housing tax credit.
Sec. 3002. Determination of credit rate.
Sec. 3003. Modifications to definition of eligible basis.
Sec. 3004. Other simplification and reform of low-income housing tax incentives.
Sec. 3005. Treatment of military basic pay.
PART II—MODIFICATIONS TO TAX-EXEMPT HOUSING BOND RULES
Sec. 3007. Recycling of tax-exempt debt for financing residential rental projects.
Sec. 3008. Coordination of certain rules applicable to low-income housing credit and qualified residential rental project exempt facility bonds.
PART III—REFORMS RELATED TO THE LOW-INCOME HOUSING CREDIT AND TAXEXEMPT HOUSING BONDS
Sec. 3009. Hold harmless for reductions in area median gross income.
Sec. 3010. Exception to annual current income determination requirement where determination not relevant.
Subtitle B—Single Family Housing
Sec. 3011. First-time homebuyer credit.
Sec. 3012. Additional standard deduction for real property taxes for nonitemizers.
Subtitle C—General Provisions
Sec. 3021. Temporary liberalization of tax-exempt housing bond rules.
Sec. 3022. Repeal of alternative minimum tax limitations on tax-exempt housing bonds, low-income housing tax credit, and rehabilitation credit.

Sec. 3023. Bonds guaranteed by Federal home loan banks eligible for treatment as tax-exempt bonds.
Sec. 3024. Modification of rules pertaining to FIRPTA nonforeign affidavits.
Sec. 3025. Modification of definition of tax-exempt use property for purposes of the rehabilitation credit.
Sec. 3026. Extension of special rule for mortgage revenue bonds for residences located in disaster areas.
Sec. 3027. Transfer of funds appropriated to carry out 2008 recovery rebates for individuals.

TITLE II—REFORMS RELATED TO REAL ESTATE INVESTMENT TRUSTS
Subtitle A—Foreign Currency and Other Qualified Activities
Sec. 3031. Revisions to REIT income tests.
Sec. 3032. Revisions to REIT asset tests.
Sec. 3033. Conforming foreign currency revisions.
Subtitle B—Taxable REIT Subsidiaries
Sec. 3041. Conforming taxable REIT subsidiary asset test.
Subtitle C—Dealer Sales
Sec. 3051. Holding period under safe harbor.
Sec. 3052. Determining value of sales under safe harbor.
Subtitle D—Health Care REITs
Sec. 3061. Conformity for health care facilities.
Subtitle E—Effective Dates
Sec. 3071. Effective dates.

TITLE III—REVENUE PROVISIONS
Subtitle A—General Provisions
Sec. 3081. Election to accelerate the AMT and research credits in lieu of bonus depreciation.
Sec. 3082. Certain GO Zone incentives.
Sec. 3083. Increase in statutory limit on the public debt.
Subtitle B—Revenue Offsets
Sec. 3091. Returns relating to payments made in settlement of payment card and third party network transactions.
Sec. 3092. Gain from sale of principal residence allocated to nonqualified use not excluded from income.
Sec. 3093. Delay in application of worldwide allocation of interest.
Sec. 3094. Time for payment of corporate estimated taxes.

Appendix C

Public Law 110-343 (10/3/08)
Tax Provisions
(some of these provisions are described in the body of this outline)

For revenue effects, see JCS-78-08 (10/1/08) at http://www.house.gov/jct/x-78-08.pdf.

DIVISION A--EMERGENCY ECONOMIC STABILIZATION OF 2008

TAX PROVISIONS
Sec. 301. Gain or loss from sale or exchange of certain preferred stock.
Sec. 302. Special rules for tax treatment of executive compensation of employers participating in the troubled assets relief program.
Sec. 303. Extension of exclusion of income from discharge of qualified principal residence indebtedness.

DIVISION B--ENERGY IMPROVEMENT AND EXTENSION ACT OF 2008

TITLE I--ENERGY PRODUCTION INCENTIVES
Subtitle A--Renewable Energy Incentives
Sec. 101. Renewable energy credit.
Sec. 102. Production credit for electricity produced from marine renewables.

Sec. 103. Energy credit.
Sec. 104. Energy credit for small wind property.
Sec. 105. Energy credit for geothermal heat pump systems.
Sec. 106. Credit for residential energy efficient property.
Sec. 107. New clean renewable energy bonds.
Sec. 108. Credit for steel industry fuel.
Sec. 109. Special rule to implement FERC and State electric restructuring policy.
Subtitle B--Carbon Mitigation and Coal Provisions
Sec. 111. Expansion and modification of advanced coal project investment credit.
Sec. 112. Expansion and modification of coal gasification investment credit.
Sec. 113. Temporary increase in coal excise tax; funding of Black Lung Disability Trust Fund.
Sec. 114. Special rules for refund of the coal excise tax to certain coal producers and exporters.
Sec. 115. Tax credit for carbon dioxide sequestration.
Sec. 116. Certain income and gains relating to industrial source carbon dioxide treated as qualifying income for publicly traded partnerships.
Sec. 117. Carbon audit of the tax code.

TITLE II--TRANSPORTATION AND DOMESTIC FUEL SECURITY PROVISIONS
Sec. 201. Inclusion of cellulosic biofuel in bonus depreciation for biomass ethanol plant property.
Sec. 202. Credits for biodiesel and renewable diesel.
Sec. 203. Clarification that credits for fuel are designed to provide an incentive for United States production.
Sec. 204. Extension and modification of alternative fuel credit.
Sec. 205. Credit for new qualified plug-in electric drive motor vehicles.
Sec. 206. Exclusion from heavy truck tax for idling reduction units and advanced insulation.
Sec. 207. Alternative fuel vehicle refueling property credit.
Sec. 208. Certain income and gains relating to alcohol fuels and mixtures, biodiesel fuels and mixtures, and alternative fuels and mixtures treated as qualifying income for publicly traded partnerships.
Sec. 209. Extension and modification of election to expense certain refineries.
Sec. 210. Extension of suspension of taxable income limit on percentage depletion for oil and natural gas produced from marginal properties.
Sec. 211. Transportation fringe benefit to bicycle commuters.

TITLE III--ENERGY CONSERVATION AND EFFICIENCY PROVISIONS
Sec. 301. Qualified energy conservation bonds.
Sec. 302. Credit for nonbusiness energy property.
Sec. 303. Energy efficient commercial buildings deduction.
Sec. 304. New energy efficient home credit.
Sec. 305. Modifications of energy efficient appliance credit for appliances produced after 2007.
Sec. 306. Accelerated recovery period for depreciation of smart meters and smart grid systems.
Sec. 307. Qualified green building and sustainable design projects.
Sec. 308. Special depreciation allowance for certain reuse and recycling property.

TITLE IV--REVENUE PROVISIONS
Sec. 401. Limitation of deduction for income attributable to domestic production of oil, gas, or primary products thereof.
Sec. 402. Elimination of the different treatment of foreign oil and gas extraction income and foreign oil related income for purposes of the foreign tax credit.
Sec. 403. Broker reporting of customer's basis in securities transactions.
Sec. 404. 0.2 percent FUTA surtax.
Sec. 405. Increase and extension of Oil Spill Liability Trust Fund tax.

DIVISION C--TAX EXTENDERS AND ALTERNATIVE MINIMUM TAX RELIEF OF 2008

TITLE I--ALTERNATIVE MINIMUM TAX RELIEF
Sec. 101. Extension of alternative minimum tax relief for nonrefundable personal credits.
Sec. 102. Extension of increased alternative minimum tax exemption amount.
Sec. 103. Increase of AMT refundable credit amount for individuals with long-term unused credits for prior year minimum tax liability, etc.

TITLE II--EXTENSION OF INDIVIDUAL TAX PROVISIONS
Sec. 201. Deduction for State and local sales taxes.
Sec. 202. Deduction of qualified tuition and related expenses.
Sec. 203. Deduction for certain expenses of elementary and secondary school teachers.
Sec. 204. Additional standard deduction for real property taxes for nonitemizers.
Sec. 205. Tax-free distributions from individual retirement plans for charitable purposes.
Sec. 206. Treatment of certain dividends of regulated investment companies.
Sec. 207. Stock in RIC for purposes of determining estates of nonresidents not citizens.
Sec. 208. Qualified investment entities.

TITLE III--EXTENSION OF BUSINESS TAX PROVISIONS
Sec. 301. Extension and modification of research credit.
Sec. 302. New markets tax credit.
Sec. 303. Subpart F exception for active financing income.
Sec. 304. Extension of look-thru rule for related controlled foreign corporations.
Sec. 305. Extension of 15-year straight-line cost recovery for qualified leasehold improvements and qualified restaurant improvements; 15-year straight-line cost recovery for certain improvements to retail space.
Sec. 306. Modification of tax treatment of certain payments to controlling exempt organizations.
Sec. 307. Basis adjustment to stock of S corporations making charitable contributions of property.
Sec. 308. Increase in limit on cover over of rum excise tax to Puerto Rico and the Virgin Islands.
Sec. 309. Extension of economic development credit for American Samoa.
Sec. 310. Extension of mine rescue team training credit.
Sec. 311. Extension of election to expense advanced mine safety equipment.
Sec. 312. Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico.
Sec. 313. Qualified zone academy bonds.
Sec. 314. Indian employment credit.
Sec. 315. Accelerated depreciation for business property on Indian reservations.
Sec. 316. Railroad track maintenance.
Sec. 317. Seven-year cost recovery period for motorsports racing track facility.
Sec. 318. Expensing of environmental remediation costs.
Sec. 319. Extension of work opportunity tax credit for Hurricane Katrina employees.
Sec. 320. Extension of increased rehabilitation credit for structures in the Gulf Opportunity Zone.
Sec. 321. Enhanced deduction for qualified computer contributions.
Sec. 322. Tax incentives for investment in the District of Columbia.
Sec. 323. Enhanced charitable deductions for contributions of food inventory.
Sec. 324. Extension of enhanced charitable deduction for contributions of book inventory.
Sec. 325. Extension and modification of duty suspension on wool products; wool research fund; wool duty refunds.

TITLE IV--EXTENSION OF TAX ADMINISTRATION PROVISIONS
Sec. 401. Permanent authority for undercover operations.
Sec. 402. Permanent authority for disclosure of information relating to terrorist activities.

TITLE V--ADDITIONAL TAX RELIEF AND OTHER TAX PROVISIONS
Subtitle A--General Provisions
Sec. 501. $8,500 income threshold used to calculate refundable portion of child tax credit.
Sec. 502. Provisions related to film and television productions.
Sec. 503. Exemption from excise tax for certain wooden arrows designed for use by children.
Sec. 504. Income averaging for amounts received in connection with the Exxon Valdez litigation.
Sec. 505. Certain farming business machinery and equipment treated as 5-year property.
Sec. 506. Modification of penalty on understatement of taxpayer's liability by tax return preparer.

TITLE VII--DISASTER RELIEF
Subtitle A--Heartland and Hurricane Ike Disaster Relief
Sec. 701. Short title.
Sec. 702. Temporary tax relief for areas damaged by 2008 Midwestern severe storms, tornados, and flooding.
Sec. 703. Reporting requirements relating to disaster relief contributions.
Sec. 704. Temporary tax-exempt bond financing and low-income housing tax relief for areas damaged by Hurricane Ike.
Subtitle B--National Disaster Relief

Sec. 706. Losses attributable to federally declared disasters.
Sec. 707. Expensing of Qualified Disaster Expenses.
Sec. 708. Net operating losses attributable to federally declared disasters.
Sec. 709. Waiver of certain mortgage revenue bond requirements following federally declared disasters.
Sec. 710. Special depreciation allowance for qualified disaster property.
Sec. 711. Increased expensing for qualified disaster assistance property.
Sec. 712. Coordination with Heartland disaster relief.

TITLE VIII--SPENDING REDUCTIONS AND APPROPRIATE REVENUE RAISERS FOR NEW TAX RELIEF POLICY
Sec. 801. Nonqualified deferred compensation from certain tax indifferent parties.

Appendix D

California AB 1452 (Chapter 763; 9/30/08)

Excerpt on Assigning Tax Credits

R&T §23663. (a)(1) Notwithstanding any other law to the contrary, for each taxable year beginning on or after July 1, 2008, any credit allowed to a taxpayer under this chapter that is an "eligible credit (within the meaning of paragraph (2) of subdivision (b)) may be assigned by that taxpayer to any "eligible assignee" (within the meaning of paragraph (3) of subdivision (b)).

(2) A credit assigned under paragraph (1) may only be applied by the eligible assignee against the "tax" of the eligible assignee in a taxable year beginning on or after January 1, 2010.

(3) Except as specifically provided in this section, following an assignment of any eligible credit under this section, the eligible assignee shall be treated as if it originally earned the assigned credit.

(b) For purposes of this section, the following definitions shall apply:

(1) "Affiliated corporation" means a corporation that is a member of a commonly controlled group as defined in Section 25105.

(2) "Eligible credit" shall mean:

(A) Any credit earned by the taxpayer in a taxable year beginning on or after July 1, 2008, or

(B) Any credit earned in any taxable year beginning before July 1, 2008, that is eligible to be carried forward to the taxpayer's first taxable year beginning on or after July 1, 2008, under the provisions of this part.

(3) "Eligible assignee" shall mean any affiliated corporation that is properly treated as a member of the same combined reporting group pursuant to Section 25101 or 25110 as the taxpayer assigning the eligible credit as of:

(A) In the case of credits earned in taxable years beginning before July 1, 2008:

(i) June 30, 2008, and

(ii) The last day of the taxable year of the assigning taxpayer in which the eligible credit is assigned.

(B) In the case of credits earned in taxable years beginning on or after July 1, 2008.

(i) The last day of the first taxable year in which the credit was allowed to the taxpayer, and

(ii) The last day of the taxable year of the assigning taxpayer in which the eligible credit is assigned.

(c) (1) The election to assign any credit under subdivision (a) shall be irrevocable once made, and shall be made by the taxpayer allowed that credit on its original return for the taxable year in which the assignment is made.

(2) The taxpayer assigning any credit under this section shall reduce the amount of its unused credit by the face amount of any credit assigned under this section, and the amount of the assigned credit shall not be available for application against the assigning taxpayer's "tax" in any taxable year, nor shall it thereafter be included in the amount of any credit carryover of the assigning taxpayer.

(3) The eligible assignee of any credit under this section may apply all or any portion of the assigned credits against the "tax" (as defined in Section 23036) of the eligible assignee for the taxable year in which the assignment occurs, or any subsequent taxable year, subject to any carryover period limitations that apply to the assigned credit and also subject to the limitation in paragraph (2) of subdivision (a).

(4) In no case may the eligible assignee sell, otherwise transfer, or thereafter assign the assigned credit to any other taxpayer.

(d) (1) No consideration shall be required to be paid by the eligible assignee to the assigning taxpayer for assignment of any credit under this section.

(2) In the event that any consideration is paid by the eligible assignee to the assigning taxpayer for the transfer of an eligible credit under this section, then:

(A) No deduction shall be allowed to the eligible assignee under this part with respect to any amounts so paid, and

(B) No amounts so received by the assigning taxpayer shall be includable in gross income under this part.

(e) (1) The Franchise Tax Board shall specify the form and manner in which the election required under this section shall be made, as well as any necessary information that shall be required to be provided by the taxpayer assigning the credit to the eligible assignee.

(2) Any taxpayer who assigns any credit under this section shall report any information, in the form and manner specified by the Franchise Tax Board, necessary to substantiate any credit assigned under this section and verify the assignment and subsequent application of any assigned credit.

(3) Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code shall not apply to any standard, criterion, procedure, determination, rule, notice, or guideline established or issued by the Franchise Tax Board pursuant to paragraphs (1) and (2).

(4) The Franchise Tax Board may issue any regulations necessary to implement the purposes of this section, including any regulations necessary to specify the treatment of any assignment that does not comply with the requirements of this section (including, for example, where the taxpayer and eligible assignee are not properly treated as members of the same combined reporting group on any of the dates specified in paragraph (3) of subdivision (b).

(f) (1) The taxpayer and the eligible assignee shall be jointly and severally liable for any tax, addition to tax, or penalty that results from the disallowance, in whole or in part, of any eligible credit assigned under this section.

(2) Nothing in this section shall limit the authority of the Franchise Tax Board to audit either the assigning taxpayer or the eligible assignee with respect to any eligible credit assigned under this section.

(g) On or before June 30, 2013, the Franchise Tax Board shall report to the Joint Legislative Budget Committee, the Legislative Analyst, and the relevant policy committees of both houses on the effects of this section. The report shall include, but need not be limited to, the following:

(1) An estimate of use of credits in the 2010 and 2011 taxable years by eligible taxpayers.

(2) An analysis of effect of this section on expanding business activity in the state related to these credits.

(3) An estimate of the resulting tax revenue loss to the state.

(4) The report shall cover all credits covered in this section, but focus on the credits related to research and development, economic incentive areas, and low income housing.

Appendix E

California Nexus Proposal – AB 1840

INTRODUCED BY Assembly Member Charles Calderon

JANUARY 24, 2008

An act to amend Section 6203 of the Revenue and Taxation Code, relating to taxation.

LEGISLATIVE COUNSEL'S DIGEST

AB 1840, as introduced, Charles Calderon. Sales and use taxes: retailers.
The Sales and Use Tax Law imposes a tax on the gross receipts from the sale in this state of, or the storage, use, or other consumption in this state of, tangible personal property. That law imposes the sales tax upon "retailers," and defines a "retailer engaged in business in this state" to include specified entities. Existing law provides that every retailer engaged in business in this state and making sales of tangible personal property for storage, use, or other consumption in this state, that engages in specified activity in this state shall, at the time of sale or at the time the storage, use, or other consumption becomes taxable, collect the tax from the purchaser.

This bill would revise those provisions relating to the definition of a "retailer engaged in business in this state" and would clarify existing law by providing that a retailer is deemed to be engaged in business in this state if a retailer has substantial nexus with this state, as provided by applicable federal and state law.
Vote: majority. Appropriation: no. Fiscal committee: yes.
State-mandated local program: no.

THE PEOPLE OF THE STATE OF CALIFORNIA DO ENACT AS FOLLOWS:

SECTION 1. Section 6203 of the Revenue and Taxation Code is amended to read:
6203. (a) Except as provided by Sections 6292 and 6293, every retailer engaged in business in this state and making sales of tangible personal property for storage, use, or other consumption in this state, not exempted under Chapter 3.5 (commencing with Section 6271) or Chapter 4 (commencing with Section 6351), shall, at the time of making the sales or, if the storage, use, or other consumption of the tangible personal property is not then taxable hereunder, at the time the storage, use, or other consumption becomes taxable, collect the tax from the purchaser and give to the purchaser a receipt therefor in the manner and form prescribed by the board.
(b) As respects leases constituting sales of tangible personal property, the tax shall be collected from the lessee at the time amounts are paid by the lessee under the lease.
(c) "Retailer engaged in business in this state" as used in this section and Section 6202 means ~~and includes~~ any *retailer that has substantial nexus with this state for purposes of the commerce clause of the United States Constitution and any retailer upon whom federal law permits this state to impose a use tax collection duty. "Retailer engaged in business in this state" specifically includes any* of the following:
(1) Any retailer maintaining, occupying, or using, permanently or temporarily, directly or indirectly, or through a subsidiary, or agent, by whatever name called, an office, place of distribution, sales or sample room or place, warehouse or storage place, or other place of business.
(2) Any retailer having any representative, agent, salesperson, canvasser, independent contractor, or solicitor operating in this state under the authority of the retailer or its subsidiary for the purpose of selling, delivering, installing, assembling, or the taking of orders for any tangible personal property.
(3) As respects a lease, any retailer deriving rentals from a lease of tangible personal property situated in this state.
~~(4) (A) Any retailer soliciting orders for tangible personal property by mail if the solicitations are substantial and recurring and if the retailer benefits from any banking, financing, debt collection, telecommunication, or marketing activities occurring in this state or benefits from the location in this state of authorized installation, servicing, or repair facilities.~~
~~(B) This paragraph shall become operative upon the enactment of any congressional act that authorizes states to compel the collection of state sales and use taxes by out-of-state retailers.~~

~~(5) Notwithstanding Section 7262, a retailer specified in paragraph (4) above, and not specified in paragraph (1), (2), or (3) above, is a "retailer engaged in business in this state" for the purposes of this part and Part 1.5 (commencing with Section 7200) only.~~

~~(d) (1) For purposes of this section, "engaged in business in this state" does not include the taking of orders from customers in this state through a computer telecommunications network located in this state which is not directly or indirectly owned by the retailer when the orders result from the electronic display of products on that same network. The exclusion provided by this subdivision shall apply only to a computer telecommunications network that consists substantially of online communications services other than the displaying and taking of orders for products.~~

~~(2) This subdivision shall become inoperative upon the operative date of provisions of a congressional act that authorize states to compel the collection of state sales and use taxes by out-of-state retailers.~~

~~(e)~~

(d) Except as provided in this subdivision, a retailer is not a "retailer engaged in business in this state" under paragraph (2) of subdivision (c) if ~~that retailer's sole physical presence in this state~~ *the only basis for such finding* is ~~to engage~~ *that the retailer engages* in convention and trade show activities as described in Section 513(d)(3)(A) of the Internal Revenue Code, ~~and if~~ *provided that* the retailer, including any of his or her representatives, agents, salespersons, canvassers, independent contractors, or solicitors, does not engage in those convention and trade show activities for more than 15 days, in whole or in part, in this state during any 12-month period and did not derive more than one hundred thousand dollars ($100,000) of net income from those activities in this state during the prior calendar year. Notwithstanding the preceding sentence, a retailer engaging in convention and trade show activities, as described in Section 513(d)(3)(A) of the Internal Revenue Code, is a "retailer engaged in business in this state," and is liable for collection of the applicable use tax, with respect to any sale of tangible personal property occurring at the convention and trade show activities and with respect to any sale of tangible personal property made pursuant
to an order taken at or during those convention and trade show activities.

~~(f)~~

(e) Any limitations created by this section upon the definition of "retailer engaged in business in this state" shall only apply for purposes of tax liability under this code. Nothing in this section is intended to affect or limit, in any way, civil liability or jurisdiction under Section 410.10 of the Code of Civil Procedure.