Current Federal Tax Developments

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SECTION: STATE TAX
WASHINGTON STATE ENACTS USE TAX TATTLETALE BILL WITH VERY LOW THRESHOLD

Citation: Washington HB 2163, 6/30/17

The state of Washington has upped the ante regarding the risk to businesses who don't pay attention to individual state laws requiring reporting on sales to residents of a state by a business with no connection with the state. Washington's governor signed into law Washington H.B. 2163, a "tattletale" use tax bill that is triggered whenever a remote seller in a year has more than $10,000 in gross sales to Washington state residents.

A "tattletale" bill does not attempt to require remote sellers to collect sales tax for the state on their remote sales. Rather the bill requires that such sellers take various steps to "turn in" such buyers to the state and "motivate" the buyers to comply with their use tax obligations. The law will often require some form of notice to potential buyers of their use tax obligations, along with later reports given at the end of the year to both the buyers (listing items they bought for which use tax would be due) and the state in question.

The state of Colorado enacted the first such bill and, not unexpectedly, it was immediately challenged in court. But the challenge did not turn out well for the remote sellers. In the case of *Direct Marketing Association v. Brohl*, 814 F.3d 1129 (CA10 2016) *cert denied* (2016), the Tenth Circuit Court of Appeals found that Colorado has the power to compel such reporting by out of state vendors. The panel found that since Colorado was not requiring the collection of tax, the physical presence test found in the US Supreme Court's *Quill Corp. v. North Dakota* case (504 US 298 (1992)) did not bar the state from imposing this obligation on remote sellers. The Supreme Court declined to hear the appeal of the result in this case, although previously they had heard the case on the question allowing the case to proceed.

The state of Washington's new law expands upon the Colorado requirements. An out of state entity with more than $10,000 of gross receipts from sales to Washington residents is required to follow these procedures unless the entity voluntarily agrees to collect the Washington sales tax on such sales. (Act Sections 202(1)(a)(i) and 202(2)(a)).

Section 205 of the Act imposes several requirements on those sellers who don't "get the hint" and simply collect tax for the state of Washington. First, pursuant to Section 205(2)(a) of the act the seller must comply with the following "pre-sale" notice requirements:

- Post a conspicuous notice on its marketplace, platform, website, catalog, or any other similar medium that informs Washington purchasers that:
    - Sales or use tax is due on certain purchases;
    - Washington requires the purchaser to file a use tax return; and
    - The notice is provided under the requirements of this section; and
- Provide a notice to each consumer at the time of each retail sale. This notice must include the following information:
    - A statement that neither sales nor use tax is being collected or remitted upon the sale;

  - o A statement that the consumer may be required to remit sales or use tax directly to the Washington State Department of Revenue; and
  - o Instructions for obtaining additional information from the Department regarding whether and how to remit the sales or use tax to the Department.

The notice to each customer above must be "prominently displayed on all invoices and order forms including, where applicable, electronic and catalog invoices and order forms, and upon each sales receipt or similar document provided to the purchaser, whether in paper or electronic form." (Act Section 205(2)(b))

As well, sellers are barred from stating that no sales or use tax is imposed on the sale unless the notice to sellers listed above immediately follows it or the sale is one which is exempted from *both* sales and use tax under Washington law. (Act Section 205(2)(b))

A "referrer" is subject to similar disclosure rules. A referrer would be an organization like eBay that lists items for sale but does not actually sell the item. In addition, the referrer must give notice that "if the seller to whom the purchaser is referred does not collect retail sales tax on a subsequent purchase by the purchaser, the seller may be required to provide information to the purchaser and the department about the purchaser's potential sales or use tax liability." (Act Section 205(3)(a)(vi)) This notice arguably is a bit "sneaky" since if the seller does not trip the $10,000 sales limit there won't be any required reporting—but the referrer's notice will likely be read by purchasers to mean that they will be turned in.

Referrers will be required to give a notice to each marketplace seller for which it referred a potential Washington seller. That notice, to be sent by February 28 of the following year, must give the seller information regarding their Washington reporting requirements. (Act Section 205(5)) A list of such notices issued must also be provided to the Washington Department of Revenue by the referrer. (Act Section 205(5)(c))

The Act imposes an annual reporting requirement on covered sellers for reports to be sent to their customers. A report must be sent to each Washington customer on or before February 28 of each year. That report must include:

- A list, by date, generally indicating the type of product purchased or leased during the immediately preceding calendar year by the consumer from the seller, sourced to Washington, and the price of each product;
- Instructions for obtaining additional information from the Washington State Department of Revenue regarding whether and how to remit the sales or use tax to the Department;
- A statement that the seller is required to submit a report to the Washington State Department of Revenue stating the total dollar amount of the consumer's purchases from the seller; and
- Any information as the Washington State Department of Revenue may reasonably require. (Act Section 205(4))

The notice must be sent to the customer:

- By first class mail at their billing address if known;
- If no billing address is available, then by first class mail to the shipping address if known;
- Otherwise by email to the customer's last known email address. (Act Section 205(4)(c))

The seller is also required to file a report with the State of Washington giving information about Washington customers. The report must be filed by February 28 of the following year and must include information about every customer that received an annual customer report from the seller. The report will list:

- The customer's name;
- The billing address and, if known, the last known mailing address;
- The shipping address of each product sold or leased to the customer for delivery in the state of Washington in the prior year; and
- The total amount of all such purchases by the customer. (Act Section 205(6))

Every seller subject to these rules must maintain suitable records for five years. (Act Section 205(8))

So, what happens if a seller decides to ignore the state of Washington—after all, if the seller is located in Vermont, what can Washington do? Well, assuming that the other Circuits agree with the Tenth Circuit's view that this law does not run into Constitutional issues, Washington's penalties should be enforceable against a business in any state. And those penalties are not insignificant.

The law provides a frankly draconian penalty of $20,000 in addition to any other penalties that may apply to any seller or referrer that fails to give the required pre-sale notice to consumers of their Washington state use tax obligations. (Act Section 206(1))

As well, if the annual notice is not given to consumers (or, for referrers, to sellers) another penalty applies. That penalty amounts to

- $5,000 for a seller with gross receipts sourced to Washington of less than $50,000;
- $10,000 for gross receipts of $50,000 or more but less than $150,000;
- $50,000 for gross receipts of $150,000 or more but less than $300,000; and
- For those with gross receipts of $300,000 or more
  - $100,000 plus
  - $25,000 for every $50,000 in gross receipts in excess of $300,000. (Act Section 206(2)(a))

Similar penalties will apply to referrers who fail to give the annual notice to sellers. (Act Section 206(2)(b))

Finally, the Act provides for penalties for failing to provide the required reports to the State of Washington. If a seller fails to provide the information to the State of Washington a penalty shall be imposed equal to the greater of:

- $20,000 or
- $25 times the number of consumers who should have been included in the report. (Act Section 206(3))

Having given the Department a potentially ruinous penalty with which to threaten out of state businesses, the seller is now offered a "one time only" chance to obtain a waiver.

First, the seller may obtain a conditional waiver of penalties and interest under this section if the seller:

- Enters into a written agreement with the department electing to collect retail sales or use tax or
- Fully comply with all applicable notice and reporting requirements of this chapter,

beginning by a date acceptable to the Department. (Act Section 206(9)(a)(i))

The Department is also granted the authority to grant a straight waiver of penalties and interest for failure to comply with the notice and reporting requirements for one or more violations. (Act Section 206(9)(a)(ii))

However, the Department is only allowed to grant a single request for a waiver of the penalties and interest. (Act Section 206(9)(a)(iii)).

If a conditional waiver is granted, the entire amount of penalties and interest will be reassessed if the Department finds that, after the effective date of an agreement to provide notice, the seller failed to:

- Provide notice under section 205(2)(a)(ii) of this act to at least ninety percent of the consumers entitled to such notice in any given calendar year or portion of the initial calendar year in which the agreement required under this subsection was in effect if the agreement was in effect for less than the entire calendar year;
- Timely provide the annual reports required to all consumers who received notice from the seller this act during any calendar year, unless the department finds that any such failure was due to circumstances beyond the seller's control;
- Timely provide the reports required to the Washington State Department of Revenue during any calendar year, unless the department finds that any such failure was due to circumstances beyond the seller's control; or
- With respect to referrers, timely provide the notice required under section 205(3) of this act and the notice and list required under section 205(5) of this act during any calendar year, unless the department finds that any such failure was due to circumstances beyond the referrer's control. (Act Section 206(9)(a)(iv))

If the conditional waiver was based on an agreement to collect and pay Washington sales tax, the entire amount of penalties and interest must be reassessed if:

- The seller failed to register with the department and
- Make a reasonable effort to comply with the requirements of RCW 82.08.050 and 82.12.040. (Act Section 206(9)(a)(v))

In all cases, the penalty must either be

- Originally assessed (Act Section 206(5)) within four years after the close of the calendar year in question *or*
- Reassessed for a conditional waiver (Act Section 206(9)(vi) with four years after the end of the calendar year in which the Department granted the conditional waiver.

The Act does provide some penalty relief options:

- Relief must be granted if the Department determines the failure to comply was due to circumstances beyond the seller's control (Act Section 206(9)(b)); or
- The Department may waiver penalties if the failure of the seller to fully comply with the notice or reporting requirements was due to reasonable cause and not willful neglect. The Department's determination must be granted great deference by a court or the board of tax appeals unless it is shown by clear and convincing evidence that the Department's decision lacked any reasonable basis. In making that determination, the Department will consider, among other factors, whether:
  - The failure was due to willful or reckless disregard of the seller's notice or reporting obligations;
  - The seller made subsequent efforts to avoid future noncompliance; and
  - The magnitude of the noncompliance was significant in terms of dollars and time when accounting for the seller's size and volume of transactions. (Act Section 206(9)(c)

These rules take effect for taxable years beginning on or after January 1, 2018 with an exception for certain digital goods and codes when the effective date is delayed until January 1, 2020. (Act Section 205(1)(a)(i) and (ii))

As a practical matter, except for a seller with a single sale to Washington in excess of $10,000 (or at least very few sales into Washington), it will likely be far more cost effective to simply agree to collect Washington sales tax rather than comply with the disclosure and reporting procedures cited above. And, frankly, that is likely the real reason Washington's (and, previously Colorado's) legislature enacted this provision.

This will likely not be the last "tattletale" provision to be enacted by a state to encourage remote sellers to collect the sales tax directly. No matter how small a business is, the business must be aware

that if product is sold to out of state buyers, those states may come calling and asking for payment of various taxes.

SECTION: 32
IRS WILL NOT FOLLOW CASE THAT ALLOWED TAXPAYER FILING MARRIED FILING SEPARATE TO CLAIM EARNED INCOME TAX CREDIT

Citation: Action on Decision 2017-05 (AOD 2017-05), 6/30/17

In the case of *Tsehay v. Commissioner*, TC Memo 2016-200, the Tax Court held that a taxpayer with a filing status of married filing separately nevertheless was eligible to claim an earned income tax credit under IRC §32. However, the IRS in Action on Decision 2017-05 (AOD 2017-05) announced that the agency will not acquiesce in this decision.

The original case involved an individual who filed a return with a married filing separate status. The IRS had challenged whether he was married in asking that he produce a Form 8332 signed by what the IRS viewed as his former spouse. However, the Court found Mr. Tsehay was married:

> Although the record in this case is meager, we found petitioner to be a credible witness. See *Diaz v. Commissioner,* 58 T.C. 560, 564 (1972) (stating that the process of distilling truth from the testimony of witnesses, whose demeanor we observe and whose credibility we evaluate, is the daily grist of judicial life). Petitioner testified that although he and his wife had previously been separated and he had at times been ordered to pay child support, for 2013 he was married and living in public housing with his wife and their children.

From the case, it appears the IRS was totally focused on the question of whether Mr. Tsehay could claim dependency exemptions for his children and did not argue for any alternative reason why Mr. Tsehay should not be allowed an earned income tax credit. Thus, the opinion held:

> Section 32(a)(1) provides an eligible individual with an earned income credit against the individual's income tax liability, subject to a phaseout explained in section 32(a)(2). The amount of the credit to which an eligible individual is entitled increases if the individual has a qualifying child. Sec. 32(b), (c)(3). Because he had "three or more" qualifying children for tax year 2013, petitioner is entitled to the earned income credit. Sec. 32(b).

However, the Court did not address a provision found at IRC §32(d) which provides:

> (d) Married individuals
>
> In the case of an individual who is married (within the meaning of section 7703), this section shall apply only if a joint return is filed for the taxable year under section 6013.

The IRS decided that they needed to address this holding even though they apparently hadn't raised an objection at trial (and, thus, were likely barred from raising that issue on appeal from the decision). The AOD simply provides that the IRS will not follow this decision—and, frankly, it is doubtful any other court will accept the holding if the IRS raises the obvious objection.

SECTION: 170
FAILURE TO REPORT BASIS OF PROPERTY DONATED FATAL TO CHARITABLE CONTRIBUTION

Citation: RERI Holdings I LLC v. Commissioner, 149 TC No. 1, 7/3/17

Details matter when claiming a charitable deduction under IRC §170—and failing to follow all of the requirements will most often trigger a complete disallowance of the deduction. That's true even of a claimed $33 million deduction in the case of *RERI Holdings I LLC v. Commissioner*, 149 TC No. 1.

In this case the LLC, being taxed as a partnership, purchased a remainder interest in property for $2.95 million in March 2002. In August 2003, the LLC assigned its interest to a university, a §501(c)(3) organization. The Form 1065 reported a noncash charitable contribution of $33,019,000 from this donation.

On the *Form 8283*, *Noncash Charitable Contributions*, the partnership reported the date it had acquired the property and how it had acquired that property. But the space on the form that asked for the "Donor's cost or other adjusted basis" was left blank.

Under Reg. §1.170A-13(c)(2)(i)(B) one of the requirements that must be fulfilled when claiming noncash contribution of most assets with a value in excess of $5,000 is the attachment to the return of a "fully completed appraisal summary" to the return on which the contribution is first claimed. Per Reg. §1.170A-13(c)(4)(ii)(E) one item to be included in that summary is "the cost or basis of the property" as adjusted by IRC §1016.

The taxpayer argued that, while it was true they hadn't provided that information as part of the return, they should not be denied the deduction since the partnership had substantially complied with the requirements. The taxpayer argued that they should be judged similar to the taxpayer in the case of *Bond v. Commissioner*. The Tax Court explained that holding as follows:

> In *Bond v. Commissioner*, 100 T.C. 32, 40-41 (1993), we determined that the reporting requirements of section 1.170A-13, Income Tax Regs., are "directory and not mandatory", so that a failure to comply strictly with those requirements can be excused if the donor demonstrates "substantial compliance". The taxpayers in that case attached to the return on which they claimed the deduction in issue an appraisal summary on Form 8283 that included all of the required information other than the appraiser's qualifications, which "were promptly furnished to respondent's agent at or near the commencement of his audit" of their return. Id. at 42. We reasoned: "The denial of a charitable contribution deduction under these circumstances would constitute a sanction which is not warranted or justified." Id. We thus concluded that the taxpayers had substantially complied with section 1.170-13A, Income Tax Regs., and were entitled to the claimed deduction.

But the Court went on to note that it had held in the 1997 *Hewitt* case that there are distinct limits to substantial compliance:

> By contrast, in *Hewitt v. Commissioner*, 109 T.C. 258 (1997), aff'd without published opinion, 166 F.3d 332 (4th Cir. 1998), the taxpayers neither obtained a qualified appraisal of

> the nonpublicly traded stock they donated nor attached an appraisal summary to their return. The Commissioner disallowed the taxpayers' claimed deduction even though she did not dispute that the deducted amount equaled the stock's value. We rejected the taxpayers' argument that they had substantially complied with the substantiation requirements. "Given the statutory language [requiring a qualified appraisal] and the thrust of the concerns about the need of respondent to be provided with appropriate information in order to alert respondent to potential overvaluations", we wrote, "petitioners simply do not fall within the permissible boundaries of Bond". *Id.* at 264; see also *Alli v. Commissioner,* T.C. Memo. 2014-15, at *52 ("In determining whether a taxpayer has substantially complied with the charitable reporting regulations, we return to the purpose of the regulations[.]").
>
> In *Smith v. Commissioner,* T.C. Memo. 2007-368, 2007 WL 4410771, at *19, aff'd, 364 F. App'x 317 (9th Cir. 2009), we derived from *Bond* and *Hewitt* a standard for determining substantial compliance under which we "consider whether * * * [the donor] provided sufficient information to permit * * * [the Commissioner] to evaluate the[ ] reported contributions, as intended by Congress."

In this case the Court found that failing to provide information about the original acquisition cost of the property kept information from the IRS that would have lead any reasonable person to wonder about whether a claimed value more than ten times higher than what had been paid for the asset just over a year earlier was reasonable. This was not just minor irrelevant information—rather it was information that was crucial to someone looking to evaluate how reasonable the claimed value was.