Current Federal Tax Developments

Week of August 20, 2018

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Section: State Tax
Physical Presence Not Necessary for Corporation to Be Liable for Oregon Corporate Income Tax

Citation: Capital One Auto Finance, Inc. v. Department of Revenue, Supreme Court of the State of Oregon, Docket No. SC S064803, 8/9/18

While the *Wayfair* decision involved sales tax issues, the fact that the Supreme Court found that there was no need for physical presence for a business to be required to collect sales taxes suggested it was unlikely that such a test would apply for other types of taxes. Shortly after the *Wayfair* decision was announced, Wells Fargo announced it was picking up an additional $481 million in state income taxes on its financial statements.[1]

Now the Oregon Supreme Court has ruled that the state's corporate income tax does not require the physical presence of the corporation in the case of *Capital One Auto Finance, Inc. v. Department of Revenue*, Docket No. SC S064803.

The Court noted that the entities in this case did not have an office in Oregon, nor did it have any employees in the state:

> *The banks did not have any property, offices, or employees in Oregon, and they did not apply to the Secretary of State under ORS 60.707 for authority to do business here. The parties have stipulated that the banks' "activities in [offering credit card products, consumer loans, accepting deposit products, and engaging in consumer and small-business lending] were all from [their] offices outside of Oregon."*

However, they did have revenue that had its source in the state of Oregon:

> *The banks did, however, make substantial amounts of money from customers in Oregon. The banks provided "consumer finance products" — credit cards, consumer loans, and similar products — to Oregonians; communicated with Oregonians; and collected fees from Oregonians. In 2007 and 2008, the banks sent 24 million solicitations to Oregonians. The banks had 536,000 Oregon customers in 2007, and 495,000 customers in 2008. During those same years, the banks charged Oregonians nearly $150 million in fees each year, including finance charges, late fees, and over-limit fees.*

The taxpayer concluded that there was no Oregon tax liability since they had no physical presence in the state:

> *Because the banks had no physical presence in Oregon, taxpayer concluded that the banks were not subject to Oregon tax. Accordingly, taxpayer did not use income earned by the banks from Oregonians in the formula to calculate the fraction of its income that could be taxed by Oregon.*

The Oregon Department of Revenue did not agree with that position, taking the position that the corporations owed Oregon income tax.[2]

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[1] "Wells Fargo's $481 Million Tax Surprise", *Wall Street Journal*, Online Edition, July 13, 2018, https://www.wsj.com/articles/wells-fargos-481-million-tax-surprise-1531499680

[2] Note the case will refer both to the Oregon income tax and the Oregon excise tax. The opinion gives the history and relationship between these two taxes (which arrive at the same

The opinion notes that at the trial court the:

> *… taxpayer contended that both the corporate income tax and the corporate excise tax applied only to taxpayers that had a physical presence in the State of Oregon. The corporate excise tax applies only when a taxpayer is "doing business * * * within this state," ORS 317.070, and taxpayer asserted that that phrase required a taxpayer to be physically conducting business activities in Oregon. As to the corporate income tax, taxpayer contended that the banks did not have any "income derived from sources within this state." ORS 318.020(1). That argument, too, was based on the banks not having any property or physically conducting any activities within this state.*

The Supreme Court looked at Oregon's statute, found at ORS 318.020(1), for income that is subject to Oregon's income tax:

> *(1) There hereby is imposed upon every corporation for each taxable year a tax at the rate provided in ORS 317.061 upon its Oregon taxable income derived from sources within this state, other than income for which the corporation is subject to the tax imposed by ORS chapter 317 according to or measured by its Oregon taxable income.*

The taxpayer did not argue that it had no items of income, nor that such income was not from Oregon residents. But the taxpayer argues the examples provided by the legislature in ORS 318.020(2) all involve taxpayers with a physical presence in the state, thus indicating that such a presence is required:

> *The legislature provided a list of three examples of what constitutes "income from sources within this state" in ORS 318.020(2):7 income from property located here, income from property with a situs here, and income from activities here. Taxpayer correctly recognizes that the examples in ORS 318.020(2) are not exclusive, because of the connotation of the term "includes," and asserts that our understanding of "income derived from sources within this state" should be informed by what it considers the "common characteristic" of all the examples. Specifically, taxpayer contends that "each [example] involves income derived from the taxpayer's physical presence in the state." (Emphasis in original.) Thus, taxpayer asserts, we should conclude that "income derived from sources within this state" requires a taxpayer to have a physical presence in Oregon.*

The Court agrees with the idea that the examples presented are context for understanding what was meant by the phrase "income derived from sources within the state." But the agreement stops there:

> *However, we do not find in the examples set out in ORS 318.020(2) the common characteristic that taxpayer asserts. What is common to all the examples — "income from tangible or intangible property located or having a situs in this state and income from any activities carried on in this state" — is that the source of the income — the property or the activities — are in this state. The examples imply only the taxpayer's existence as recipient of the income, and they say nothing about where the taxpayer must be located. The common characteristic that we find thus accords with the ordinary meaning of the text: there must be income from "sources within this state," and the taxpayer must receive that income. Nothing about the statutory text or context suggests that the taxpayer must also have some physical presence here.*

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tax), but the opinion notes that the two taxes should be construed together. For this reason, the article will simply refer to the Oregon corporate income tax.

> *…Accordingly, the Tax Court correctly concluded that taxpayer is subject to assessment for income earned by the banks from its Oregon customers.*

States had been asserting that there was no need for physical presence to impose an income tax with increasing frequency even before the *Wayfair* decision, as federal courts indicated that *Quill* was a sales tax only case. But, as Wells Fargo's actions note, many now expect more states to start looking for tax from out of state businesses on their income even when the businesses have no physical presence in the state.

While PL 86-272 does provide some protection for out of state businesses from an income tax imposed by a state, that protection is very limited. In this case it wasn't relevant because the issue was not the sale of a product, but rather the services provided by the banks.

Section: State Tax
Idaho Reminds Retailers of Affiliate Based Sales Tax Collection Requirement with a $10,000 Annual Sales Trigger

Citation: News Release, Idaho State Tax Commission, 8/15/18

While a lot of attention has been focused on the *Wayfair* decision and how it can require an out of state seller to collect sales taxes on behalf of a state under certain conditions, it is important to remember that prior laws that were written to work with the *Quill* decision are still on the books. As the Supreme Court noted in the *Wayfair* decision, *Quill* seemed to stand for the proposition that any physical presence in a state enabled a state to impose a sales tax collection requirement. Thus, such statutes were sometimes drafted with a very low *de minimis* exception for out of state sellers, well below the $100,000 level found in South Dakota's statute.

The state of Idaho has announced plans to continue to move forward with enforcing the state's affiliate agreement nexus law and that the Idaho State Tax Commission has contacted 500 out of state sellers to "remind" them of the requirement to begin collecting the tax ("Some out-of-state retailers required to collect Idaho sales tax", Idaho State Tax Commission News Release).

The Idaho tax is triggered at a much lower level of activity than that imposed by the state of South Dakota's pure economic nexus statute that the Supreme Court commented favorably on. But it does require a "physical presence" of a sort via an affiliate agreement.

Specifically, the Idaho Tax Commission release notes that the law requires collection when two conditions are met:

- *The out-of-state seller has an agreement with an Idaho retailer to refer potential buyers to the out-of-state seller for a commission that's paid on each resulting sale, and*

- *Total sales to Idaho buyers through these agreements exceed $10,000 in the preceding 12 months.*

The release notes that a business that needs to begin remitting the tax can register at http://tax.idaho.gov/ibr.

The Commission also notes that the state continues to study the *Wayfair* decision and its implications. As the release continues:

> *Meanwhile, the Tax Commission is carefully analyzing how the U.S. Supreme Court's recent "Wayfair" ruling affects out-of-state retailers making sales to Idaho citizens. The agency also continues to follow developing legal issues related to the court's decision. The Wayfair ruling upholds a South Dakota statute requiring out-of-state retailers to collect and forward the tax to South Dakota if the retailer has an economic connection as opposed to a physical presence in that state.*

Section: Circular 230
IRS Has the Right to Operate Credential Program for Unenrolled Preparers

Citation: American Institute of Certified Public Accountants v. IRS, Case No. 16-5256, DC CA, 8/14/18

The AICPA won and then lost in the case of American Institute of Certified Public Accountants v. IRS, Case No. 16-5256, DC CA.

The AICPA had instituted a challenge to the IRS's Annual Filing Season Program, established in Revenue Procedure 2014-42. The opinion describes the program as follows:

> *The Program grants an annual "Record of Completion" to any participant who has obtained a preparer tax identification number, taken the annual "federal tax filing season refresher course," passed a comprehension test, completed a minimum of eighteen hours of continuing education, and "consent[ed] to be subject to the duties and restrictions relating to practice before the IRS in subpart B and section 10.51 of Circular 230 for the entire period covered by the Record of Completion." Id. § 4.05(1)-(4).*
>
> *The IRS offers two incentives to participate in the Program. First, the IRS lists unenrolled agents with a Record of Completion in its online directory of tax preparers alongside attorneys, CPAs, and enrolled agents. Second, the IRS gives them the "limited practice right" to represent a taxpayer in the initial stages of the audit of a return he or she prepared; for this the unenrolled agent must have a Record of Completion for both the year of the return and the year the IRS initiated the audit. Id. § 6. Before the Program was established, all unenrolled agents had this limited practice right.*

The IRS appealed District Court opinion that ruled the AICPA had no standing to bring this suit on behalf of its members. The AICPA appealed that ruling to the DC Circuit Court of Appeals which reversed the District Court and held that the AICPA had standing to bring the suit.

But the DC Circuit went beyond that ruling—the panel moved on to consider the merits of the AICPA position. While normally a Court of Appeals would return the case to the trial court when reversing on a question of standing, the appellate panel noted:

> *Although our "general practice" is to remand the case when we reverse the district court's denial of standing, it may be appropriate to address the merits when the parties have "fully briefed the issue before this court," the merits "involve purely legal questions," which we would review de novo in a subsequent appeal, "[t]he district court has no comparative advantage in reviewing the agency action" for compliance with applicable law, and therefore "[a] remand to the district court would be a waste of judicial resources." Mendoza v. Perez, 754 F.3d 1002, 1020 (D.C. Cir. 2014). Because each of these conditions obtains here, we proceed to the merits of the dispute.*

The panel's decision on the merits of the AICPA's position did not go so well for the organization.

The panel first found that the program did not exceed the IRS's statutory authority in the area. The opinion holds:

> *The AICPA argues the Program is beyond the statutory authority delegated by the Congress to the Secretary of the Treasury, and hence to the IRS. The IRS responds that the Program is authorized by two statutes, 31 U.S.C. § 330(a) and 26 U.S.C. § 7803(a)(2)(A). As we have seen, § 330(a) authorizes the IRS to "[r]egulate the practice of representatives of persons before the [agency]" and to admit to practice only individuals of good character and good reputation, who have the necessary qualifications and competence. Section 7803(a)(2)(A) grants the Commissioner of the IRS "the power to administer, manage, conduct, direct, and supervise the execution and application of the internal revenue laws or related statutes," which obviously includes § 330(a).*
>
> *Consistent with its authority under § 330(a), and contrary to the AICPA's argument, the IRS uses the education, testing, and certification portions of the Program to ensure the unenrolled preparers who participate demonstrate the qualifications and competence necessary to practice before the agency. The Program specifies the education and testing requirements in detail, including the subject matter, number of instructional hours per year, form of testing, and minimum passing grade. REV. PROC. 2014-42 § 4.05. These requirements implement the IRS's stated purpose of encouraging unenrolled preparers "to complete continuing education courses for the purpose of increasing their knowledge of the law relevant to federal tax returns," id. § 1, consistent with its reasonable view that an "unenrolled tax return preparer who successfully completes continuing education courses related to federal tax law will generally have a better understanding of the tax law necessary to represent a taxpayer before the IRS during an examination" than one who has not. Id. § 2.*

The panel also disagreed with the AICPA's argument that the IRS had acted arbitrarily and capriciously in adopting the program. The AICPA first argues under this theory that the IRS failed to consider an important aspect of the problem it was addressing:

> *Specifically, the AICPA argues the IRS did not respond to its concern, before implementing the Program, that a public database of provider credentials may confuse taxpayers. The AICPA expressed these concerns in a July 6, 2011 letter to the IRS and again in its July 28, 2011 congressional testimony. The AICPA argued then that "any public database developed by IRS that is designed to serve as a 'look-up' function where taxpayers may search for their preparer should be structured to mitigate any taxpayer confusion regarding the relative qualifications of the different classes of tax return preparers." The Implementation of the IRS Paid Tax Return Preparer Program: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways and Means, 112th Cong. 52 (2011) (statement of Patricia Thompson).*

But the panel found the IRS had responded to that concern. The ruling holds:

> *The IRS responds that the directory does what the AICPA requested, and indeed it does: It allows users to filter the directory to show each category of service provider separately, including those identified in the directory as "Annual Filing Season Program Participant[s]." See IRS, Directory of Federal Tax Return Preparers with Credentials and Select Qualifications, https://irs.treasury.gov/rpo/rpo.jsf (last accessed May 6, 2018). The directory is also linked to a primer describing the various qualifications in greater detail. See IRS, Understanding Tax Return Preparer Credentials and Qualifications, https://www.irs.gov/tax-professionals/understanding-tax-return-preparer-credentials-*

> *and-qualifications (last accessed May 6, 2018). These features indicate the IRS considered and addressed the AICPA's comment.*

The AICPA also argued that the IRS had failed to consider all alternatives available to it. The Court did not accept this argument, noting:

> *In particular, the AICPA points to a June 24, 2014 letter it submitted to the IRS in the wake of the Loving litigation, suggesting the agency had ample authority to punish "unethical or fraudulent tax return preparers" without adopting the Program. Nowhere in those comments, however, did the AICPA propose an alternative way to deal with the problem of incompetent tax preparers and taxpayers who cannot tell whether an uncredentialed tax preparer is or is not competent. We cannot fault the IRS for failing to consider an alternative that was not addressed to the problem with which it was concerned.*

The panel concluded that the case should be decided in favor of the IRS, and thus the agency has the right to continue to operate the program.

Section: 461
AICPA Writes IRS Asking for Guidance on S Corporation and Excess Business Loss Issues

Citation: AICPA Letter to IRS, 8/13/18

The AICPA has sent a letter dated August 13, 2018 asking for immediate guidance on issues arising from the Tax Cuts and Jobs Act related to S corporations and excess business losses under IRC §461(l). This request was developed by the AICPA S Corporation Taxation and Trust, Estate, and Gift Taxation Technical Resource Panels and approved by the AICPA Tax Executive Committee.

The AICPA letter notes:

> *Taxpayers and practitioners need clarity on S corporation issues in order to comply with their 2018 tax obligations and to make informed decisions regarding cash-flow, entity structure, and tax planning issues.*

Accompanying the letter is a 16-page memorandum setting out in detail the various items the AICPA is seeking guidance on. The letter summarizes the major items for which information is begin requested as follows:

> *1.Guidance on the application of the new laws on loss carryforwards.*
>
> > *a. Clarify how to coordinate various loss and deduction limitations with section 199A qualified business income (QBI) carryover losses by applying the order as follows: section 163(j), 1366(d), section 465, section 469, section 461(l), and section 199A.*
> >
> > *b. Clarify that the carryforward rule under section 163(j)(2) applies to S corporations despite section 1371(b)(2).*
> >
> > *c. Clarify the definition of real property trades or businesses beyond section 469(c)(7)(C) for purposes of the disallowed business interest deduction under section 163(j).*
> >
> > *d. Clarify the application of the section 461(l) limitation on net operating losses (NOLs).*

2. Guidance on certain provisions relating to the post-termination transition period (PTTP) and the eligible terminated S corporation period ("ETSC Period") under section 1371(f).

a. Clarify how a corporation computes its accumulated adjustments account (AAA) upon re-electing S corporation status if the corporation was an ETSC and if the corporation was not an ETSC.

b. Clarify how the ETSC Period rules of section 1371(f) apply when a corporation has more than one PTTP.

c. Identify the shareholders eligible to receive distributions from a corporation's AAA during the ETSC Period.

d. Clarify how distributions are allocated between the AAA and accumulated earnings and profits (AE&P) under section 1371(f).

e. Clarify how AAA is adjusted during the PTTP and the ETSC Period.

3. Guidance on the treatment of deferred foreign income upon transition to participation exemption system of taxation (section 965) for S corporation trust shareholders3 and what trust transactions are section 965 triggering events and how a transferee of S corporation stock held in trust might assume the liability for the section 965 transition tax.

a. Clarify that transition tax on deferred foreign income is not triggered by transfer to an irrevocable grantor trust or a revocable grantor trust.

b. Provide clarity regarding the assumption of the section 965 transition tax liability on the death of the grantor of a grantor type irrevocable trust that holds S corporation stock, as well as on the death of the grantor of a revocable trust making the section 645 election.

c. Provide clarity regarding a qualified subchapter S trust (QSST) and whether the trust or the beneficiary assumes the liability for the section 965 transition tax.

d. Provide clarity on whether a QSST conversion to an electing small business trust (ESBT) conversion, or an ESBT to QSST conversion, is a triggering event for purposes of the section 965 transition tax.

e. Provide clarity on whether the severance or division of a trust into separate shares is a triggering event for purposes of the section 965 transition tax.

f. Provide clarity on the material modifications in trusts or trust beneficiaries that Treasury and the IRS would treat as a triggering event for purposes of section 965(i)(2)(A)(iii).

One of the comments is of special interest as it has application beyond the S corporation context and deals with broader TCJA issues. The question raised in the memorandum is whether a §461(l) loss carried into the following year would be once again subjected to the §IRC 461(l) excess business loss limitation.

As the memorandum notes:

Under the TCJA, new section 461(l) provides that an "excess business loss" of a taxpayer other than a corporation is not allowed for the tax year. Any disallowed excess business loss of the taxpayer is treated as the taxpayer's NOL and carried forward for utilization in a subsequent tax year (subject to certain taxable income limitations).

Those limits are $250,000 for individual taxpayers other than married taxpayers filing a joint return, for whom the limit doubles to $500,000. A net business loss in excess of those limits is denied in the year incurred and converted into a net operating loss carryover that begins to be taken into effect in the following year.

The AICPA memorandum describes the potential issue and how the organization suggests it be resolved as follows:

> *For taxable years beginning after December 31, 2017 and before January 1, 2026, excess business losses of a taxpayer other than a corporation are not allowed for the taxable year. These losses are carried forward and treated as an NOL carryforward.*
>
> *An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation of the provision), over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount.7 The threshold amount for a taxable year is $250,000 (or $500,000 in the case of a joint return). The threshold amount is indexed for inflation.*
>
> *Once the NOL has been established, there is a question as to whether an "aggregate deduction" of the taxpayer's trade or business in a subsequent tax year should include the NOL. Treating the NOL in this manner would potentially subject the original NOL to an additional loss limitation deferral under section 461(l). We believe that subjecting the NOL to a loss limitation in a subsequent year is a misinterpretation of the statute.*
>
> *The new statute explicitly states that the disallowed loss becomes an NOL and there is no mention that this amount is retested under section 461(l) in a subsequent tax year. Furthermore, the new provision does not parallel pre-2018 section 461(j), which involved subsidized farming losses. The pre-2018 section 461(j) explicitly provided that disallowed subsidized farm losses retained their character in a subsequent tax year. New section 461(l) does not contain a similar character-retention rule. Accordingly, it would appear that the NOL generated under section 461(l) is no longer subject to other loss limitation provisions (but nevertheless remains subject to taxable income limitations).*
>
> *Treasury and IRS should provide guidance that an NOL that is created upon the occurrence of the loss limitation provisions of section 461(l) is not included in the definition of aggregate deductions of the taxpayer, and therefore is not subject to the loss limitation provisions of section 461(l) in a subsequent year.*

Will the IRS heed the AICPA's call to issue timely guidance on this issue and the others raised in the letter? Unfortunately, the track record on the letters issued to date in getting an IRS response hasn't been encouraging.

While the AICPA wrote the IRS asking for immediate guidance on various §199A matters in late February 2018, the first guidance did not appear until early August. Similarly, the AICPA wrote indicating the need for immediate guidance on meals and entertainment issues in early April and that guidance has yet to emerge from the IRS.

This isn't surprising—the IRS is receiving a lot of correspondence from various interested parties regarding the need for guidance on various provisions of the TCJA and most are asking for an immediate answer.

That doesn't mean these letters don't matter—they are part of the input Treasury will take into account in developing the rules. As well, they remind us of the areas of uncertainty that still exist in dealing with TCJA issues many months after the bill was signed into law.