

Current California Tax Issues: New Sales Tax Nexus Thresholds, Market-Based Sourcing Rules, Pass-Through Entities, and Local Taxes

THURSDAY, OCTOBER 24, 2019, 1:00-2:50 pm Eastern

IMPORTANT INFORMATION FOR THE LIVE PROGRAM

This program is approved for 2 CPE credit hours. To earn credit you must:

- **Participate in the program on your own computer connection (no sharing)** - if you need to register additional people, please call customer service at 1-800-926-7926 ext. 1 (or 404-881-1141 ext. 1). Strafford accepts American Express, Visa, MasterCard, Discover.
- Listen on-line via your computer speakers.
- Respond to five prompts during the program plus a single verification code.
- To earn full credit, you must remain connected for the entire program.

WHO TO CONTACT DURING THE LIVE PROGRAM

For Additional Registrations:

-Call Strafford Customer Service 1-800-926-7926 x1 (or 404-881-1141 x1)

For Assistance During the Live Program:

-On the web, use the chat box at the bottom left of the screen

If you get disconnected during the program, you can simply log in using your original instructions and PIN.

Tips for Optimal Quality

FOR LIVE PROGRAM ONLY

Sound Quality

When listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, please e-mail sound@straffordpub.com immediately so we can address the problem.

Current California Tax Issues: New Sales Tax Nexus Thresholds, Market-Based Sourcing Rules, Pass-Through Entities, and Local Taxes

October 24, 2019

Michael J. Cataldo, Shareholder
Cataldo Tax Law
michael@cataldotaxlaw.com

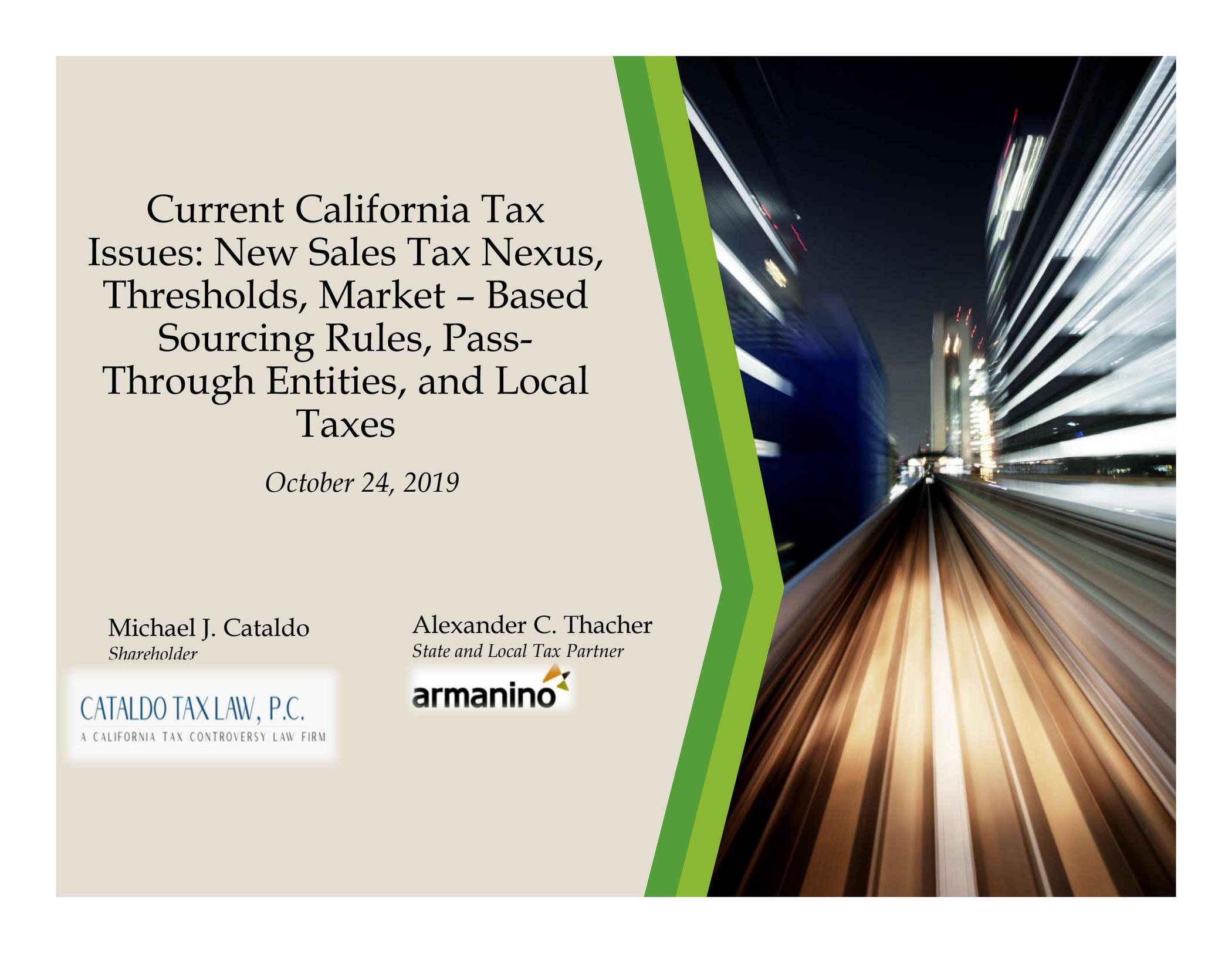
Alex Thacher, Partner
Armanino
alex.thacher@armaninollp.com

Notice

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

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

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



Current California Tax Issues: New Sales Tax Nexus, Thresholds, Market – Based Sourcing Rules, Pass- Through Entities, and Local Taxes

October 24, 2019

Michael J. Cataldo
Shareholder

CATALDO TAX LAW, P.C.
A CALIFORNIA TAX CONTROVERSY LAW FIRM

Alexander C. Thacher
State and Local Tax Partner

armanino

Outline

Key California tax developments

- *Wayfair* implementation
- Market-based sourcing rules
- Taxation of pass through entities
- California partial conformity to TCJA
- San Francisco and Los Angeles business taxes

Wayfair Implementation

Wayfair Implementation

Wayfair Background

- *National Bellas Hess*
- *Quill*
- Amazon laws
- Kennedy concurrence in *Direct Marketing Association*
- South Dakota economic nexus legislation and litigation

Wayfair Background

National Bellas Hess v. Department of Revenue of Illinois, 386 U.S. 753 (1967)

- In-state physical presence necessary to require use tax collection

Quill Corp. v. North Dakota, 504 U.S. 298 (1992)

- Retains *Bellas Hess* physical presence rule
 - *Stare decisis*

Wayfair Background

Quill

- Due Process and Commerce Clause are separate and distinct restrictions on a state's power to tax interstate commerce.
- Due Process does not require a physical presence to impose use tax collection obligation.
- Commerce Clause does require a physical presence to impose use tax collection obligation under *National Bellas Hess*.

Wayfair Background

Quill reasoning:

- *Stare decisis* – do not upset settled expectations from *National Bellas Hess*.
- Burdensome compliance.
- Congress has authority to reverse decision under its Commerce Clause power.

Wayfair Background

State responses to *Quill* physical presence requirement:

- Agency nexus (e.g., affiliate nexus, click-thru nexus, long-arm statutes).
- Purchaser information reporting (Colorado).
- Seek federal legislation imposing use tax collection requirement on vendors without physical presence.
 - Marketplace Fairness Act; Remote Transactions Parity Act
 - Collection obligation triggered if certain in-state sales thresholds met.

Wayfair Background

Direct Marketing Association v. Brohl, No. 13-1032, 575 U.S. ____ (March 3, 2015)

- Colorado use tax information reporting requirement for out-of-state vendors.
- Challenged in federal court as violating *Quill*.
- Court addressed whether action could be maintained in federal court under the Tax Injunction Act.
 - Tax Injunction Act provides that federal district courts “shall not enjoin, suspend or restrain the assessment, levy or collection of any tax under State law. where a plain, speedy and efficient remedy may be had in the courts of such State.” 28 U.S.C. § 1341
- Concurring opinion of Justice Kennedy calling for a case to overturn *Quill*.

Wayfair Background

South Dakota passes remote use tax collection (“economic nexus”) legislation in response to Justice Kennedy’s comments in *Direct Marketing Association*.

- Remote sellers must collect use tax if \$100,000 in sales or 200 separate transactions during the previous or current year.
- Legislation designed to get a case before the U.S. Supreme Court as quickly as possible.
- Prospective application.

Wayfair Background

- South Dakota filed suit in state court against Wayfair, Overstock.com and Newegg.
- South Dakota lost in the trial court, and on appeal to the South Dakota Supreme Court, because *Quill* was binding U.S. Supreme Court precedent.

Wayfair Background

South Dakota requested U.S. Supreme Court overturn *Quill* because:

- *Quill* decided incorrectly.
- Internet sales more significant part of economy (times have changed).
- Sales tax compliance software eases burden.
 - Most large internet sellers (e.g., Amazon) already complying.
- Discriminates against brick-and-mortar.

Wayfair Holding

On June 21, 2018, the Supreme Court issued its decision (Kennedy, J.), overturning the *Quill* physical presence standard. *South Dakota v. Wayfair, Inc.*, No. 17-494, 585 U.S. ____ (2018).

- 5-4 Decision
- Kennedy has since retired from Court, replaced by Kavanaugh.
- Dissent based on *stare decisis*

Wayfair Holding

- The Court rejected *stare decisis* because:
 - While Congress can act, it cannot change the constitutional default rule created by the Court
 - Internet changed the national economy since *Quill*
 - Ten-fold increase in e-commerce sales led to increased state revenue shortfall
- While other avenues remain to challenge tax collection systems under the Commerce Clause, South Dakota statute has certain safeguards:
 - Not retroactive
 - Small business safe harbor
 - Compliance with Streamlined Sales and Use Tax Agreement

California Implementation of *Wayfair*

California Department of Tax and Fee Administration (CDTFA):

- Stakeholders Meeting October 24, 2018, to address *Wayfair*.
<https://www.youtube.com/watch?v=e25ypcLiTKk&feature=youtu.be&t=1235>
- Special Notices L-565 and L-591 (December of 2018) requiring use tax registration and collection obligation under state's existing "long-arm statute" if \$100,000 in-state sales or 200+ in-state transactions exceeded.
- Effective April 1, 2019.
- California Legislature intervened with enactment of AB 147 on April 25, 2019.

California Implementation of *Wayfair*

AB 147:

- Use tax registration and collection obligation imposed beginning April 1, 2019, for out-of-state sellers with more than \$500,000 of California sales in the preceding or current calendar year.
 - Related party provisions apply under IRC section 267(b).
 - District portion of use tax collection obligations mirror the \$500,000 in state sales threshold.
- Marketplace facilitators with direct or facilitated California sales in excess of \$500,000 annually or an in-state physical presence must register with the CDTFA and collect and remit tax beginning October 1, 2019.

California Implementation of *Wayfair*

- Remote sellers with no in-state physical presence selling exclusively through marketplace facilitators are not required to register with the CDTFA and collect and remit the tax after October 1, 2019.
- Remote sellers with an in-state physical presence must be registered with the CDTFA, and report ALL taxable sales, including those made through a marketplace facilitator, but may claim a deduction for sales required to be reported by the marketplace facilitator.
- The \$500,000 annual sales threshold includes direct sales and sales made through a marketplace facilitator.

California Implementation of *Wayfair*

To be a marketplace facilitator, a person must do at least one of the following activities:

- Transmit or otherwise communicate the offer or acceptance between the buyer and seller.
- Own or operate the infrastructure, electronic or physical, or technology that brings the buyer and seller together.
- Provide a virtual currency (digital money) that buyers are allowed or required to use to purchase products from sellers.
- Software development or research and development activities related to any of the activities listed below if the activity is directly related to a marketplace operated by the person or related person.

California Implementation of *Wayfair*

To be a marketplace facilitator, a person must also engage in at least one of the following activities with respect to the marketplace seller's products:

- Payment processing services.
- Fulfillment or storage services.
- Listing products for sale.
- Setting prices.
- Branding sales as those of the marketplace facilitator.
- Order taking.
- Providing customer service or accepting or assisting with returns or exchanges.

California Implementation of *Wayfair*

- A newspaper, internet website, etc., that advertises tangible merchandise for sale, refers the purchaser to the seller by telephone, internet link, or other similar means to complete the sale and does not participate further in the sale is *not* a marketplace facilitator for purposes of the sale.
- Delivery network companies are not marketplace facilitators but may elect to be deemed a marketplace facilitator.

Market-Based Sourcing

Market-Based Sourcing Rules

Market-Based Sourcing

Background

- California implemented a mandatory single sales formula with market sourcing beginning in 2013 for sales other than tangible personal property.
 - Prior to 2013, the standard apportionment formula included property, payroll, and doubled-weighted sales factors.
 - For tax years 2011 and 2012, taxpayers were able to make an election to use the single sales formula instead of the standard four factor apportionment formula.
 - Sales of other than tangible personal property were sourced based on costs of performance.
- Sales of tangible personal property continue to be sourced to California if the property is delivered or shipped to a purchaser within California.

Market-Based Sourcing

Under California's market-based sourcing statute (Rev. & Tax. Code section 25136):

- Sales from services are sourced to where the purchaser receives the benefit of the services.
- Sales from intangible property are sourced to where the intangible property is used.
- Sales from marketable securities are sourced to where is the customer located.

Market-Based Sourcing

Regulation 25136-2

- Detailed set of rules
- Separate rules for services to individual and to business customers
- Separate rules for income from intangibles
 - marketing and non-marketing intangibles
 - complete transfer of all rights to intangibles
- Applies cascading approach for analyzing market
 - Contract with customer or taxpayer's books and records
 - Reasonable approximation
 - Population approach permitted
 - Customer/Licensee billing address
- Supposed to take into account the taxpayer's effort and expense for compliance

Market-Based Sourcing

Proposed amendments to Regulation 25136-2 under consideration:

- Exclude certain foreign jurisdictions or geographic areas from population ratio
- Asset management fees - look-through to beneficial owner
- Research and development
- Freight-forwarders
- Government contracts - U.S. population ratio
- Gain on sale of certain minority interests in business entities – commercial domicile of entity
- digital products such as music and eBook downloads, streaming services, and access to online digital products such as cloud-based programs and storage.

Market-Based Sourcing

Chief Counsel Ruling 2015-03

- Computing power provided to financial services industry classified a non-marketing service, thus no look-through to customer's customer for sourcing.
 - But, permitted taxpayer to use CPU usage data of customer's customer to reasonably approximate.

Chief Counsel Ruling 2017-01

- Company that provided information services to health care organizations required to look to its direct customer (the health care organizations) not the customer's customer (individuals) to determine where the benefit of the service was received.

Implications

- Classifies services as either marketing or non-marketing services to determine whether to look through to customer's customer or not.

California Taxation of Pass-Through Entities

Taxation of Pass-Through Entities

Swart Enterprises, Inc. v. Franchise Tax Board, 7 Cal.App.5th 497 (2017).

- Swart owned a 0.2 percent passive minority interest in LLC which was doing business in California.
- LLC was managed by a manager, not by the members.
- Court of Appeal held that passive interest in LLC that was doing business in California insufficient to find Swart was doing business in California.
 - Swart's interest in the LLC was comparable to a limited partnership interest
 - *Appeals of Amman & Schmid Finanz AG, 96-SBE-008*
- FTB Notice 2017-01 (2/28/17)

Appeal of Satview Broadband, Ltd., OTA Case No. 18010756, Sept. 25, 2018.

- Foreign corporation which held a 25 percent passive, non-managing member interest in an LLC which did business in California, was not itself doing business in California simply because it held that 25 percent interest.
- Nonprecedential decision.
- FTB Legal Ruling 2018-01, October 19, 2018: *Swart* holding narrow exception and limited to “same facts.”

Appeal of Jali, LLC, OTA Case No. 18073414, July 8, 2019.

- Membership interest in an in-state LLC was between 1.12 to 4.75 percent during years at issue.
- Non-managing membership interest for all years.
- No evidence the out-of-state member had any ability or authority, directly or indirectly, to influence or participate in the management or operation of the LLC.
- OTA rejected FTB's 0.2 percent ownership threshold as a new bright-line standard for determining whether an out-of-state LLC member is actively "doing business" in California.
- Pending precedential

Appeal of Wright Capital Holdings LLC, OTA Case No. 18010842, August 21, 2019 (nonprecedential).

- An out-of-state single-member LLC (SMLLC) held a 50% membership interest in an LLC doing business in California (CA LLC).
- The OTA held that SMLLC was doing business in California by virtue of its interests in CA LLC.
 - No evidence admitted concerning the SMLLC's management or control of the California LLC.
 - While SMLLC's 50 percent interest in CA LLC was not a controlling interest, "no other member had a larger interest, and appellant presumably could have used its 50 percent interest to block CC-LLC from taking action it disagreed with if it was so inclined."

Arizona v. California, No. 220150 (U.S.S.C. Mar. 4, 2019).

Arizona filed action against California with the United States Supreme Court alleging that FTB's application of its "doing business" standard to passive investors of LLCs doing business in California violates constitutional rights of Arizona investors.

Appeal of Larsen, 2018-OTA-073, July 25, 2018 (nonprecedential).

- Individual Idaho resident received 1099 from a business with a California.
- FTB asserted the individual was a sole proprietorship required to file a California tax return and pay tax on income sourced to California under the market-based sourcing rules for services (to where the customer received the benefit of the service).
- The OTA ruled that because the FTB could not prove that the taxpayer conducted a unitary business within and without California, it was not considered an apportioning business and therefore the market-based sourcing rules did not apply.
- The OTA ruled that simply showing a 1099 from a California business was not enough to show that the taxpayer conducted a unitary business within and without California.

Appeal of Bindley, 2019-OTA-179P, May 30, 2019.

- Screen writer (Bindley) based in Arizona agreed to write screen plays for California-based production companies.
- Bindley was issued 1099s reflecting payment for screen writing.
- OTA found Bindley was required to file a California tax return because he was conducting a unitary trade or business as a sole proprietorship within and without California, and, under market-based sourcing rules for services, the payments were sourced to California.
- Pending precedential.
- Compare *Appeal of Larsen*.

Paula Trust v. FTB, CGC-16-556126, Feb. 6, 2018).

- Substantially all of the income of the Paula Trust was from California sources. The trust had two trustees, one a California resident, the other a non-resident.
- The trial court found that the Paula Trust was only subject to tax on half of its income pursuant to Rev. & Tax. Code section 17743, which provides:

When the taxability of income under this chapter depends on the residence of the fiduciary and there are two or more fiduciaries for the trust, the income taxable, under Section 17742 shall be apportioned according to the number of fiduciaries resident in this state pursuant to rules and regulations prescribed by the Franchise Tax Board.

- Appeal pending.

California Partial Conformity to the Tax Cuts and Jobs Act

California partial conformity to TCJA

California Partial Conformity to the Tax Cuts and Jobs Act

Assembly Bill 91, enacted July 1, 2019, adopted limited conformity to some Tax Cuts and Jobs Act (TCJA) provisions.

- California continues general conformity to the Internal Revenue Code as of January 1, 2015.
- California did not adopt international tax provisions of the TCJA (e.g., transition tax, GILTI), or many of the most significant domestic business tax provisions (e.g., full expensing, interest expense deduction limitations, DRD, NOLs).

California Partial Conformity to the Tax Cuts and Jobs Act

California has conformed (with some modifications) to the following TCJA:

- IRC section 1031 exchanges
- Excessive employee remuneration deduction limitation under IRC section 162(m)
- Small business accounting methods
- Disallowance of excess business losses of noncorporate taxpayers
- Elimination of partnership technical terminations under IRC section 708(b)
- Limitation on deductibility of Federal Deposit Insurance Corporation premiums.

California Partial Conformity to the Tax Cuts and Jobs Act

The TCJA limits the amount of NOL carryforward deductions to 80 percent of taxable income, allows infinite carryforward, and prohibits NOL carrybacks except for certain farming and insurance businesses.

- California **does not** adopt the TCJA changes to the NOL rules, but AB 91 eliminated NOL carryback deductions beginning in 2019.

California Partial Conformity to the Tax Cuts and Jobs Act

- AB 91 prohibits separate state IRC section 338 elections.
- The prohibition against such split elections is inapplicable in the case of an acquisition that is subject to a binding contract entered into before June 27, 2019, and which remains binding at all times after that date.

Local Taxes

Local Taxes

San Francisco Gross Receipts Tax

The tax is imposed on a broad array of persons engaging in business in the City, including:

- Corporations
- Partnerships
- Sole proprietorships
- Limited liability companies
- Entities that are disregarded for federal income tax purposes (e.g., single-member LLCs) will not be treated as separate taxable entities for GRT purposes. (Tax Collector Regulation 2014-2).
- Small business exemption for persons with under \$1.12 million of annual SF gross receipts.

San Francisco Gross Receipts Tax

Tax is imposed on persons “engaging in business” in the City:

- Presence in the City for more than 7 days during the year soliciting sales, performing services, or using City roads for business purposes.
- Beginning January 1, 2019, having gross receipts attributable to the City in excess of \$500,000 annually.

San Francisco Gross Receipts Tax

“Gross receipts” subject to the tax are defined broadly as the total amount received from whatever source derived.

- There are several exclusions, including:
 - Certain types of investment income and distributions from business entities
 - Cost basis of sold real property
 - Sales of real property subject to the City’s Real Property Transfer Tax
 - Cost basis to acquire financial instruments
 - Receipts from a related entity
 - Taxes required to be collected and remitted to the government

San Francisco Gross Receipts Tax

Graduated tax rates vary by industry based on NAICS Code classification

- Retailers and Wholesalers 0.075% - 0.160%
- Manufacturing 0.125% - 0.475%
- Information Services 0.125% - 0.475%
- Financial, Professional, Technical, and Scientific Services 0.4 - 0.560%
- Real Estate - 0.285% - 0.300%
- Miscellaneous Business Activities 0.525% - 0.650%

San Francisco Gross Receipts Tax

For taxpayers conducting business within and outside of the City, the gross receipts attributable to the City are generally determined by:

- A payroll factor (payroll within the City to all payroll); or
- Gross receipts allocation rules, depending on type of receipt; or
 - Receipts from the performance of services are allocated to where the purchaser received the benefit of the service
 - Receipts from intangibles are allocated to where and to the extent the property is used
- A combination of the above (50/50 payroll factor and receipts allocation)

Methodology of sourcing receipts to SF depends on NAICS Code classification

San Francisco Gross Receipts Tax

NAICS Code classification allocation/ apportionment methodologies

- Retail, Wholesale, Manufacturing, Information Services
 - Combination Method
- Financial, Professional, Scientific, and Technical Services
 - Payroll Factor
- Real Estate
 - Receipts allocated based on location of property

Los Angeles Business Tax

Overview - Basics

- Gross receipts-based tax
 - Imposed on “gross receipts” from “persons” engaged in business in the City (L.A.M.C. §21.03(a))
 - Other bases for the tax are cost, flat rate, number of vehicles or equipment used, or the number of employees, depending on a taxpayer’s classification
- Location based tax
 - Each location within the City is required to register and pay tax separately (L.A.M.C. §21.06)
- Different classifications for various business activities
- Rates range from \$1.01 per \$1,000 to \$4.25 per \$1,000

Los Angeles Business Tax

Overview - Compliance

- Annual license and renewal required for each separate physical location within LA.
 - Due January 1st and considered delinquent after the last day in February – this year, delinquent after March 1st. (L.A.M.C. §21.04(a)), (L.A.M.C. §21.05(a)(1))
- Small business exemption for *registered businesses* with \$100,000 or less of total gross receipts (including taxable and non-taxable gross receipts) (L.A.M.C. §21.29(a))
- Taxpayers with multiple classifications can elect to report under one classification if 80% or more of gross receipts are attributable to that activity (L.A.M.C. §21.06.1(a))
- Intercompany transactions are eliminated for 80% or more commonly owned entities (L.A.M.C. §21.00(a)(5))

Los Angeles Business Tax

Overview - Nexus

- Nexus is broadly asserted
- Does not require fixed location in the City of Los Angeles
- Includes conducting, operating, managing or carrying on a business in the City limits
- Examples include:
 - Owning/leasing real property in the City for a business purpose
 - Maintaining inventory for sale in the City
 - Regular solicitation of business in the City
 - Performing work/services within the City for at least seven days in a year
 - Operating a motor vehicle on City streets for a business purpose

Los Angeles Business Tax

Overview - Apportionment

Wholesalers/Retailers (City Clerks Ruling "CCR" 13 & 14)

- In-city taxpayer (fixed location in Los Angeles)
 - Starting point is 100% of **CA destination sales** (L.A.M.C. § 21.168.1) with % reduction for activities taking place outside Los Angeles performed by the taxpayer:
 - Up to 30% for where sale is negotiated
 - Up to 20% for location of sales office
 - Up to 10% for location where orders/contracts are accepted/approved
 - Up to 20% for warehouse from which goods are shipped
 - Up to 5% each for location where shipments arranged, billing performed, collections performed, and location where merchandise is delivered by vehicles operated by the taxpayer
- Out-of-city taxpayers (no fixed location in Los Angeles)
 - Taxable gross receipts limited to **30%-35% of Los Angeles sales** depending on whether deliveries are made by vehicles operated by the taxpayer (City Clerks Ruling 13)

Los Angeles Business Tax

Overview – Apportionment

- **Service Providers (CCR 15)**
- Applies specifically to Professions & Occupations Fund Class
 - Office policy also applies to other service-related businesses; tax base is measured by activities performed in the City
- Tax base includes:
 - 100% of gross receipts attributable to services performed in City
 - If fixed location in City from which work is performed outside City
 - Up to 20% of gross receipts from work performed outside City
 - 5% each for admin., billing, collections, and accounting functions
 - If fixed location outside City, but work performed in City
 - Up to 80% of work performed in City
- Tax base can be reduced for travel and various activities performed by employees outside Los Angeles

Los Angeles Business Tax

- **Deviation from City Clerk Ruling 15**
- Per L.A.M.C. Section 21.49(c)(4), allocation shall be made on the basis of payroll, value and situs of tangible property, general expense, or by reference to any or other factors, or by another method of allocation that will fairly determine the amount of gross receipts derived from or attributable to engaging in business in the City

Questions?

Michael J. Cataldo
Cataldo Tax Law, P.C.
Phone: 925-395-4645

Email: michael@cataldotaxlaw.com

Alexander C. Thacher
Armanino, LLP
Phone: 408-200-4695

Email: Alex.Thacher@armaninoLLP.com