Current Federal Tax Developments

Week of January 21, 2019

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Section: State Tax
New York State Publishes Position on Requirements for Out of State Sellers to Collect Sales Tax

Citation: New York Notice N-19-1, 1/15/19

New York has published guidance on how it will handle out of state sellers following the *Wayfair* decision in Notice N-19-1. The Notice provides:

> *A business that had no physical presence in New York State but has both made more than $300,000 in sales of tangible personal property delivered in the state and conducted more than 100 sales of tangible personal property delivered in the state in the immediately preceding four sales tax quarters is required to register as a sales tax vendor, and collect and timely remit the applicable state and local sales tax. 1 The sales tax quarters are: March 1 through May 31, June 1 through August 31, September 1 through November 30, and December 1 through February 28/29.*

Note that, unlike South Dakota's requirement to collect the tax if a taxpayer has over $200,000 in sales *or* 100 transactions, in this case, the seller has to have *both* $300,000 in sales *and* more than 100 sales in a year. However, while New York's standard is more forgiving here than South Dakota's, the announcement is not all good news for out of state sellers.

New York State takes the position that since laws on the books at the time of the *Wayfair* required such collections, the law immediately became effective. As the Notice provides:

> *On June 21, 2018, the United States Supreme Court ruling in South Dakota v. Wayfair (138 S.Ct. 2080 [2018]) eliminated the prohibition on a state imposing sales tax collection responsibilities on businesses that have no physical presence in that state. Due to this ruling, certain existing provisions in the New York State Tax Law that define a sales tax vendor immediately became effective. Businesses that fall within this definition and make taxable sales in New York State are required to collect and remit New York State and local sales tax, as discussed below.*

Section: State Tax
Supreme Court to Review Case Regarding When a State May Impose Its Income Tax on a Trust

Citation: Grant of Certiorari, US Supreme Court, North Carolina Dept. of Revenue v. Kaestner Family Trust, Case No. 18-457, 1/11/19

The US Supreme Court has agreed to look at under what circumstances a state can impose its income tax on a trust by granting certiorari in the case of *North Carolina Dept. of Revenue v. Kaestner Family Trust*, Case No. 18-457.

Last July the North Carolina Supreme Court decided that the state had no right to impose its income tax on a trust that, while it had a North Carolina beneficiary, was established in New York, did not have a North Carolina trustee and had no property in North Carolina. (See the prior article on Current Federal Tax Developments that discussed the original case along with another case on state taxation of trusts at *Two States Find Their State's Statutes for Taxing Trusts Violate Due Process Clause*.)

As noted at the time, the North Carolina Supreme Court found that there were not sufficient contacts in this case to the state, with the imposition of the tax violating the due process clause:

> *For taxation of a foreign trust to satisfy the due process guarantee of the Fourteenth Amendment and the similar pledge in Article I, Section 19 of our state constitution, the trust must have some minimum contacts with the State of North Carolina such that the trust enjoys the benefits and protections of the State. When, as here, the income of a foreign trust is subject to taxation solely based on its beneficiaries' availing themselves of the benefits of our economy and the protections afforded by our laws, those guarantees are violated. Therefore, we hold that N.C.G.S. § 105-160.2 is unconstitutional as applied to collect income taxes from plaintiff for tax years 2005 through 2008. Accordingly, we affirm the decision of the Court of Appeals that affirmed the Business Court's order granting summary judgment for plaintiff and directed that defendant refund to plaintiff any taxes paid by plaintiff pursuant to section 105-160.2 for tax years 2005 through 2008.*

The July 2018 article cited above also discussed the Minnesota Supreme Court's ruling in the case of *Fielding v. Commissioner of Revenue*. That case similarly decided that the state could not tax a true due to lack of minimum contact. In the Minnesota case, the state claimed the right to tax the trust because the original grantor was a Minnesota resident when the trust became irrevocable, even though in the year in question no trustee resided in Minnesota, there were no Minnesota beneficiaries, and there was no property in Minnesota.

The Minnesota Department of Revenue is also asking the Supreme Court to review this decision. In that petition the Department notes that state high courts have issued conflicting rulings in this area:

> *Some state appellate courts have held that a state may impose an income tax on a trust even when the trustee resides out-of-state, so long as the grantor resided in-state when the trust became irrevocable. Other courts have required, on top of grantor residence, that the trust have some additional contacts with the state during the tax year. One other state high court has held that a state may tax a trust as a resident if a beneficiary of the trust resided in the state during the tax year. Under any of those rules, Minnesota could have taxed the trusts at issue here. Other state appellate courts, however, have focused on the residence of the trustee and held that the Due Process Clause bars states from taxing resident trusts administered out-of-state despite significant in-state contacts. The Minnesota Supreme Court's decision here deepens that conflict.*

The Supreme Court has not yet announced if it will take up this case as well.

In an article covering the Supreme Court's grant of cert, Andrea Muse of *Tax Analysts* cited attorney Michael Lurie's view that the Court took this case to deal with differing holdings among the states in this area that Minnesota cites. The article notes Mr. Lurie's view of the potential consequences of this case:

> *Lurie said a decision by the Court in favor of the trust could open states that have ruled that such taxation of trusts is constitutional (including California, Missouri, and Connecticut) to refund claims.*[1]

The North Carolina Department of Revenue argues in its November 30 brief, likely looking to bring in some of the considerations the Supreme Court raised in the *Wayfair* sales tax case, that

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[1] Andrea Muse, "Supreme Court Agrees to Hear Trust Taxation Case," *Tax Notes Today*, 2019 STT 9-1, January 14, 2019

allowing the North Carolina Supreme Court ruling to stand would allow taxpayers to create trust-based devices to avoid state income taxes completely:

> *The Trust's brief also reveals this case as an example of how trusts are exploiting a judicially created tax shelter. The Trust engaged a trustee in Connecticut, conducted its business in New York, and existed solely for the benefit of a resident of North Carolina. Yet if the Trust succeeds in this case, none of those states (or any other) will have taxed the full extent of the Trust's income during the tax years at issue.*

That analysis does capture one important feature of state trust income taxation, namely that the states have varied rules for when the state will impose its income tax on a trust. It certainly is possible in many cases to achieve a structure where tax is avoided, especially if the location of the grantor when the trust becomes irrevocable is found not to be a basis upon which the state may impose its tax (which was the holding of the Minnesota Supreme Court).

Of course, the Supreme Court could decide this case on a basis that isn't as broad as the above analyses might suggest. However, advisers who work with trusts should keep a close watch on this case and the eventual opinion issued by the Court.

Section: 53
IRS Confirms Sequestration Reduction Will Not Apply to §53(e) Corporate Minimum Tax Credit Refunds

Citation: Effect of Sequestration on the Alternative Minimum Tax Credit for Corporations (fiscal year 2019), IRS Website, 1/17/19

The IRS confirmed that AMT credit refunds under the Tax Cuts and Jobs Act will not be subject to reduction under sequestration in an announcement on the IRS website (Effect of Sequestration on the Alternative Minimum Tax Credit for Corporations (fiscal year 2019)). However, claims for years beginning before January 1, 2018 by taxpayers making an election under IRC §168(k)(4) will be subject to a 6.2% sequestration reduction for claims processed on or after October 1, 2018 and on or before September 30, 2019.

The Office of Management and Budget had informed the IRS in December of 2018 that the agency was reversing the IRS's position that TCJA minimum tax refunds for corporations were subject to the sequestration rules.[2]

The IRS statement takes that change into account. The change impacts refunds under IRC §53(e), a provision added to the law by the Tax Cuts and Jobs Act. Under that provision, a corporation that has a remaining minimum tax carryover in excess of its regular tax obligation will be granted a refundable credit equal to 50% of that excess for tax years beginning in 2018, 2019 or 2020, and 100% of that excess for a tax year beginning in 2021.

The IRS describes the amounts that will be subject to the 6.2% offset as follows:

> *For taxable years beginning before Jan. 1, 2018, a corporation that can claim an additional first-year depreciation deduction under section 168(k) can choose instead to accelerate the use of its prior year*

[2] Emily Foster, "*OMB Reverses IRS's Stance on Sequestering AMT Credits,*" Tax Notes Today, January 9, 2019, 2019 TNT 5-4

> *minimum tax credits, treating the accelerated credits as refundable credits. Corporations making this section 168(k)(4) election and claiming a refund of prior year minimum tax credits should complete Form 8827.*
>
> *Corporations claiming refundable credits under section 168(k) will be notified that a portion of their requested refund was sequestered.*

But the agency then notes the different treatment for refundable amounts under IRC §53(e):

> *For taxable years beginning after December 31, 2017, refund payments and credit elect and refund offset transactions due to refundable minimum tax credits under section 53(e) will not be subject to sequestration.*

Section: 199A
IRS Provides Proposed Safe Harbor for Treating Rental as Trade or Business for §199A Purposes

Citation: Notice 2019-07, 1/18/19

At the same time as final regulations were issued under §199A, the IRS issued a proposed revenue procedure that would provide for a safe harbor rule for treating a rental as a trade or business for §199A purposes in Notice 2019-07.

Although issued as a proposed revenue procedure, the IRS provided that taxpayer may rely on this safe harbor:

> *The proposed revenue procedure is proposed to apply generally to taxpayers with taxable years ending after December 31, 2017.*
>
> *Until such time that the proposed revenue procedure is published in final form, taxpayers may use the safe harbor described in the proposed revenue procedure for purposes of determining when a rental real estate enterprise may be treated as a trade or business solely for purposes of section 199A.*

Even if a taxpayer's rental does not meet the safe harbor tests, the taxpayer may still be able to treat the rental as a trade or business if it meets the definition of Reg. §1.199A-1(b)(14). As well, the safe harbor *only* applies for purposes of §199A.

The proposed revenue procedure offers the following justification for its issuance:

> *The Treasury Department and the IRS are aware that whether a rental real estate enterprise is a trade or business for purposes of section 199A is the subject of uncertainty for some taxpayers. To help mitigate this uncertainty, this proposed revenue procedure provides a safe harbor for treating a rental real estate enterprise as a trade or business solely for purposes of the section 199A deduction.*

Relevant passthrough entities (partnerships, S corporations, trusts and estates, referred to as RPEs) can use this test as well as individuals.

The proposed revenue procedure defines a *real estate enterprise* which is used for testing purposes under this proposed procedure. That definition provides:

> *Solely for purposes of this safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in multiple properties. The individual or RPE relying on this revenue procedure must hold the interest directly or through an entity*

> *disregarded as an entity separate from its owner under § 301.7701-3. Taxpayers must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents (with the exception of those described in paragraph .05 of this section) as a single enterprise. Commercial and residential real estate may not be part of the same enterprise. Taxpayers may not vary this treatment from year-to-year unless there has been a significant change in facts and circumstances.*

Three requirements must be satisfied during a taxable year for a real estate enterprise to meet the safe harbor test to be treated as a trade or business. These requirements are:

- Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
- For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental enterprise. For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise; and
- The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. Such records are to be made available for inspection at the request of the IRS. The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2019.

Rental services for purposes of the 250-hour test are defined as follows:

> *Rental services for purpose of this revenue procedure include: (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property; (vi) management of the real estate; (vii) purchase of materials; and (viii) supervision of employees and independent contractors.*

These activities do not have to be performed by the taxpayer—rather they can be performed either by the taxpayer or his/her agents and independent contractors (such as handymen, landscapers, plumbers and the like).

> *Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners.*

While this expansion is helpful, it also means that beginning in 2019 taxpayers will have to inquire about the number of hours of work performed by those agents and contractors if the taxpayer him/herself cannot meet the 250 hour test simply using his/her own hours.

Certain activities, whether performed by the taxpayer or agents/contractors, do not count towards meeting the 250 hour test.

> *The term rental services does not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on*

> *operations; planning, managing, or constructing long-term capital improvements; or hours spent traveling to and from the real estate.*

Certain types of rentals will not qualify to use this safe harbor.

> *Real estate used by the taxpayer (including an owner or beneficiary of an RPE relying on this safe harbor) as a residence for any part of the year under section 280A is not eligible for this safe harbor. Real estate rented or leased under a triple net lease is also not eligible for this safe harbor. For purposes of this revenue procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities. This includes a lease agreement that requires the tenant or lessee to pay a portion of the taxes, fees, and insurance, and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant.*

The taxpayer must sign and include a statement attached to the tax return in order to make use of this safe harbor:

> *A taxpayer or RPE must include a statement attached to the return on which it claims the section 199A deduction or passes through section 199A information that the requirements in Section 3.03 of this revenue procedure have been satisfied. The statement must be signed by the taxpayer, or an authorized representative of an eligible taxpayer or RPE, which states: "Under penalties of perjury, I (we) declare that I (we) have examined the statement, and, to the best of my (our) knowledge and belief, the statement contains all the relevant facts relating to the revenue procedure, and such facts are true, correct, and complete." The individual or individuals who sign must have personal knowledge of the facts and circumstances related to the statement.*

Section: 965
Final §965 Transition Tax Regulations Published by the IRS

Citation: TD XXXX, 1/15/19

The IRS has released the final regulations on the IRC §965 transition tax enacted as part of the Tax Cuts and Jobs Act. Those regulations can be downloaded via the link below:

> Final Regulations Under IRC §965

The regulations document was initially issued without a Treasury document number—the PDF shows the citation as TD XXXX.

For the most part the final regulations are the same as the proposed regulations issued in August. The regulations incorporate guidance found in four notices (Notices 2018-7, 2018-13, 2018-26 and 2018-78) that were issued after the enactment of the Tax Cuts and Jobs Act.

There were some liberalizing changes made in the determination of aggregate foreign cash position and cash position for computing the portion of the amount subject to a higher rate of tax.

Section: 6654
Limited Waiver of Underpayment of Estimated Tax Penalties Offered to Individuals on 2018 Taxes

Citation: Notice 2019-11, 1/16/19

The IRS has announced a somewhat modest waiver of underpayments of 2018 estimated taxes in Notice 2019-11.

Due to changes in the tax law under the Tax Cuts and Jobs Act, the IRS modified the withholding tables and calculations. However, many employees simply used the withholding allowances they had used in the past rather than going through the IRS withholding calculator. As well, the calculator does not necessary properly take all situations into account.

For this reason, there has been concern expressed that certain taxpayers may end up being underwithheld on their 2018 taxes primarily due to the combination of the change in taxes under TCJA and the revised withholding tables. In response to concerns about this issue voiced by various parties, the IRS has now responded with its relief—but that relief only works if the taxpayer is mildly underwithheld.

As the notice points out, generally under §6654(d)(1)(B) a taxpayer must have paid in an amount equal to the lesser of 90 percent of the tax ultimately determined to be due or either 100% or 110% (based on income) of the prior year's taxes. If that is not paid in, generally if the taxpayer owes $1,000 or more in tax, an underpayment of estimated tax penalty will apply.

In this notice, the IRS provides relief—but only for those that still end up with payments equal to or in excess of 85% of the total tax shown on the return.

Those who qualify for this waiver must take the following steps to take advantage of it:

> *To request this waiver, an individual must file Form 2210, Underpayment of Estimated Tax by Individuals, Estates, and Trusts, with his or her 2018 income tax return. The form can be filed with a return filed electronically or on paper. Taxpayers should complete Part I of Form 2210 and the worksheet included in the form instructions to determine if the waiver in this notice applies. If the waiver applies, check the waiver box (Part II, Box A) and include the statement "85% Waiver" with the return. Forms, instructions, and other tax assistance are available on IRS.gov. The IRS toll-free number for general tax questions is 1-800-829-1040. This waiver is in addition to any other exception that section 6654 provides to the underpayment of estimated income tax.*

The notice provides that if a taxpayer falls short of the 85% number, they will still owe the same underpayment that normally would have been computed:

> *If neither the waiver provided by this notice nor any other exception applies to an individual taxpayer, the amount of the addition to tax is determined by applying the underpayment interest rate established under section 6621 of the Code to each required installment of estimated tax that was underpaid for the period that the installment is underpaid. The period of the underpayment runs from the due date for the installment to the earlier of April 15, 2019, or the date on which the underpayment is paid. This notice has no effect on determining the amount of each required installment for an individual whose total withholding and estimated tax payments do not equal or exceed eighty-five percent of the tax shown on that individual's return for the 2018 taxable year.*

This paragraph means that if the individual's required payment is based on 90% of the tax due without regard to this notice, if that individual pays in an amount equal to 84.9% of the tax due, the penalty will be computed on the shortfall from the 90% level, not the 85% level.