Tax Impact

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Tax Tips

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Supreme Court's Wayfair *decision*

What it means for Internet and mail-order sales

In its much-anticipated decision in *South Dakota v. Wayfair*, the U.S. Supreme Court ruled, by a 5 to 4 margin, that a state may require out-of-state sellers to collect sales and use tax even if they lack a physical presence in the state. In reaching this result, the court overturned its landmark 1992 decision in *Quill Corp. v. North Dakota*.

Ruling's effect on businesses

What does this mean for businesses that sell their products or services across state lines? The answer, as with so many questions about tax laws and regulations, is "it depends." One thing it doesn't mean is that you should start collecting sales tax from customers in every state in which you do business. That obligation depends on 1) whether a state has passed a statute requiring businesses without a physical presence to collect tax from customers in the state, and 2) if so, what level of activity is required within the state to trigger those tax collection obligations.

A state's constitutional power to impose tax collection obligations on your business depends on your connection, or "nexus," with the state.

In the wake of *Wayfair*, legislation in this area is in a state of flux. So it's important to monitor developments in the states in which you do business to determine your tax collection responsibilities.

Question of nexus

It's important to understand that Internet and mail-order purchases from out-of-state sellers have always been taxable to the *consumer*. But collecting tax from individuals — who rarely report their purchases — is impracticable. That's why states require sellers to collect the tax, if possible.

A state's constitutional power to impose tax collection obligations on your business depends on your connection, or "nexus," with the state. Nexus is established when a business "avails itself of the substantial privilege of carrying on business" in a state.

In *Quill*, the Supreme Court ruled that nexus requires a substantial *physical presence* in a state, such as brick-and-mortar stores, offices, manufacturing or distribution facilities, or employees. But in *Wayfair*, the Court acknowledged that in today's digital age nexus can be established through economic and "virtual" contacts with a state.

The Court emphasized that South Dakota's statute applied to sellers that, on an annual basis, deliver more than $100,000 in goods or services

Will other states follow South Dakota's lead?

In *South Dakota v. Wayfair*, the Supreme Court found that the South Dakota statute's annual sales thresholds ($100,000 in sales or 200 separate transactions) were sufficient to satisfy constitutional requirements. Those thresholds established the substantial nexus required before a state can regulate interstate commerce.

The court didn't rule on whether any of the statute's provisions unconstitutionally discriminated against or placed an undue burden on interstate commerce. But it did comment that three features of the statute appeared to be designed to avoid such a result:

1. The annual sales thresholds essentially created a "safe harbor" for businesses that had limited contact with the state.

2. The statute couldn't be applied retroactively — that is, the state couldn't hold out-of-state sellers liable for failure to collect taxes on past sales.

3. South Dakota was one of more than 20 states that had adopted the Streamlined Sales and Use Tax Agreement, which reduces out-of-state sellers' administrative and compliance costs.

This doesn't necessarily mean that states establishing lower thresholds or applying their statutes retroactively won't pass constitutional muster. But doing so opens them up to potential legal challenges. To avoid litigation, it's expected that most states will follow the South Dakota formula closely.

into the state or engage in 200 or more separate transactions for the delivery of goods and services into the state. This level of business, the Court explained, "could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota."

What's next?

Now that the physical presence requirement has been eliminated, you can expect many, if not most, states to pass or begin enforcing "economic nexus" statutes — that is, statutes that impose sales and use tax obligations based on a business's level of economic activity within the state. Some states already have such statutes on the books, with enforcement tied to *Quill* being overturned. Others are in the process of modifying existing laws or passing new ones to impose tax collection obligations on remote sellers that meet economic nexus requirements.

To avoid legal challenges, it's likely that states will adopt statutes similar to South Dakota's. (See "Will other states follow South Dakota's lead?" above.) States that have already passed or announced changes to their tax laws after the *Wayfair* decision have signaled that they'll adopt sales thresholds consistent with those applied under South Dakota law.

Do your homework

Right now it's critical to determine your sales and use tax compliance obligations in states where you sell products and services but don't have a physical presence. And keep an eye on legislative developments, because the requirements may change in coming months. ■

GST tax exemption has increased, but not permanently

One change affecting estate plans under the Tax Cuts and Jobs Act is that, for the estates of persons dying after December 31, 2017, and before January 1, 2026, the generation-skipping transfer (GST) tax exemption amount increases to an inflation-adjusted $10 million, or $20 million for married couples with proper planning ($11.18 million and $22.36 million, respectively, for 2018). However, without further congressional action, the exemptions will revert to an inflation-adjusted $5 million and $10 million, respectively, beginning January 1, 2026.

What is GST tax?

The GST tax is one of the harshest in the Internal Revenue Code. It's a flat 40% tax on asset transfers to "skip persons" — that is, your grandchildren, other family members who are more than one generation below you or nonfamily members who are more than 37½ years younger than you. The GST tax is calculated independently from and is *in addition to* gift and estate taxes, so it can take a significant bite out of your hard-earned wealth.

Fortunately, the estate tax law provides a generous GST tax exemption. Careful planning is required, however, to make the most of the exemption. In some cases, for an exemption to apply, you must allocate it to particular assets via an affirmative election on a timely filed gift tax return. In other cases, the exemption is allocated automatically (unless you opt out), which can lead to unwanted results if you prefer to allocate your exemption elsewhere.

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To avoid costly mistakes, it's a good idea to review each transfer for potential GST tax liability. Also, take steps to ensure that your exemption is allocated in the most advantageous manner.

What transfers are taxable?

The GST tax applies to direct gifts to a skip person, as well as to two types of transfers involving trusts:

1. **Taxable terminations.** Trust assets pass to your grandchildren when your child dies and the trust terminates.

2. **Taxable distributions.** Trust income or principal is distributed to a skip person.

GST tax doesn't apply to direct gifts that are covered by the annual gift

tax exclusion (currently, $15,000 per recipient; $30,000 for "split" gifts by married couples).

What protection do automatic allocation rules provide?

The automatic allocation rules are intended to protect you against inadvertent loss of GST tax exemptions. For example, if you make a direct gift in excess of the annual gift tax exclusion to a grandchild or other skip person, your unused GST tax exemption is automatically applied to the gift without the need to make an allocation on a gift tax return. The exemption is also allocated automatically to "GST trusts." The rules are complex, but in general a trust is considered a GST trust if there's a possibility it will benefit your grandchildren or other skip persons in the future.

In many cases, the automatic allocation rules work well, ensuring that the GST tax exemption is used where it's needed most. But in some cases the rules lead to unintended — and potentially costly — results. Here's an example:

You set up a trust primarily for the benefit of your children, although your grandchildren are named as contingent beneficiaries. This may be enough to trigger the automatic allocation rules even if the possibility that your grandchildren will receive any trust assets is remote. Depending on the size of your estate, you may be better off opting out of automatic allocation and directing your exemption to gifts that are more likely to trigger GST taxes.

GST exemption not permanent

Fewer families will be affected by the GST tax going forward, thanks to a significantly higher exemption amount. But there are still reasons to plan for this tax. Contact your estate planning advisor for more information. ■

Got bitcoin?

Understand your tax obligations

The tax treatment of bitcoin and other "virtual currencies" — also known as "cryptocurrencies" — is widely misunderstood. But if you invest in virtual currency, use it to pay for goods or services, or receive it as payment for goods or services, failure to understand your tax obligations can have serious consequences.

On the IRS's radar

According to the IRS, there are more than 1,500 known virtual currencies, generally defined as "a digital representation of value that functions in the same manner as a country's traditional currency." In 2014, the IRS published a notice explaining how existing general tax principles apply to virtual currency transactions. And in a release earlier this year, it reminded taxpayers that income from these transactions is reportable on their tax returns.

Taxpayers who fail to properly report the income tax consequences of virtual currency transactions, the IRS warned, can be audited and, when appropriate, charged with penalties and interest. In extreme cases, taxpayers can be subject to criminal prosecution for tax evasion or filing a false tax return.

The IRS release observes that, "because transactions in virtual currencies can be difficult to trace and have an inherently pseudo-anonymous aspect, some taxpayers may be tempted to hide taxable income

from the IRS." Be aware, however, that the IRS has several effective enforcement tools at its disposal. For example, it recently used a "John Doe summons" to obtain information from Coinbase, one of the largest virtual currency exchanges. The IRS requested data about customers who bought, sold, sent or received more than $20,000 of bitcoin in any one year during a period from 2013 to 2015.

Treated as property

The IRS treats virtual currency as property — rather than currency — for federal tax purposes. This has a number of consequences:

- Taxpayers who receive virtual currency as payment for goods or services must include the currency's fair market value (FMV) at the time of receipt in their gross income. Generally, FMV is based on the price quoted on a virtual currency exchange.
- Virtual currency payments that constitute wages are taxable to the employee, reportable by the employer on Form W-2 and subject to federal withholding and payroll taxes.
- Virtual currency payments to independent contractors are reportable by the employer on Form 1099 (provided the $600-per-year threshold is met) and subject to income and self-employment taxes. Backup withholding may be required if, for example, the payer doesn't obtain a taxpayer identification number from the payee.

Many people are surprised to learn that, if you use virtual currency to pay for goods or services, you may have to report a taxable gain or loss. Suppose, for example, that you bought 10 bitcoins several years ago for $500 each. Later, when the FMV has reached $5,000, you use them to buy a $50,000 ski boat. Your tax basis in the bitcoins is $5,000, so your taxable gain is $45,000. The nature of the gain depends on whether the bitcoins are considered capital assets and, if so, whether you've met the holding period requirement for favorable long-term capital gains treatment.

The IRS treats virtual currency as property — rather than currency — for federal tax purposes.

Get help

If you've invested in virtual currency or used it in transactions for goods or services, consult your tax advisor. This professional can help ensure that you meet your tax reporting and payment obligations. ■

Why your college-age child needs an estate plan

Most college packing lists don't include an estate plan, but a few basic documents can give you peace of mind as your son or daughter heads off to college. Without them, once your child turns 18, you'll lose the right to access financial or medical information or make decisions on his or her behalf. Recommended documents include:

- A HIPAA authorization and health care power of attorney, giving you access to medical information and the ability to make medical decisions if your child is unable to do so, and
- A financial power of attorney, authorizing you to access your child's financial records and handle financial matters while he or she is away from home.

Generally, a will isn't necessary unless your child owns a significant amount of property. ■

Should you donate your car to charity?

Donating an old car to a qualified charity may seem like a hassle-free way to dispose of an unneeded vehicle, satisfy your philanthropic desires and enjoy a tax deduction (provided you itemize). But in most cases, it's not the most tax-efficient strategy. Generally, your deduction is limited to the actual price the charity receives when it sells the car.

You can deduct the vehicle's fair market value (FMV) only if the charity 1) uses the vehicle for a significant charitable purpose, such as delivering meals to homebound seniors, 2) makes material improvements to the vehicle that go beyond cleaning and painting, or 3) disposes of the vehicle for less than FMV for a charitable purpose, such as selling it at a below-market price to a needy person.

If you decide to donate a car, be sure to comply with IRS substantiation and acknowledgment requirements. And watch out for disreputable car donation organizations that distribute only a fraction of what they take in to charity and, in some cases, aren't even eligible to receive charitable gifts. ■

IRS launches compliance campaigns

In recent months, the IRS's Large Business and International Division announced 18 compliance campaigns that target specific business-related tax issues. Examples include:

Section 48C energy credits. Only taxpayers whose advanced energy projects were approved by the Department of Energy and who have been allocated a credit by the IRS may claim the credit.

Microcaptive insurance. The IRS focus here is on taxpayers' attempts to reduce aggregate taxable income using contracts treated as insurance contracts and a related company that the parties treat as a captive insurance company.

Related-party transactions. The target here is transfers of funds from a corporation to related pass-through entities or shareholders.

S corporations. The IRS focus here is on losses claimed in excess of basis. ■

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