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Tax Policy Update

June 26, 2018

CASE OF THE WEEK: *South Dakota v. Wayfair, Inc.*

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On June 21, breaking with nearly half a century of legal precedent, the U.S. Supreme Court ruled 5-4 in *South Dakota v. Wayfair, Inc*. that online retailers may now be required to collect sales tax in states where they do not maintain a physical presence. The implications of the court's decision are monumental, as this opens the door for every state with a sales tax (45) to follow in South Dakota's footsteps and require online retailers to collect tax. According to a December 2017 Government Accountability Office report, this could amount to over $13 billion in revenue for states. Read more in the section below.

LEGISLATIVE LANDSCAPE

Way Fair or Nah? The road to repealing the Supreme Court's 1967 *Bellas Hess v. Illinois* and 1992 *Quill v. North Dakota* decisions has been long. In *Quill*, the Supreme Court limited a state's ability to collect sales tax to retailers with a physical presence (e.g., a warehouse or store) in the taxing jurisdiction. *Quill* followed the *Bellas Hess* decision in which the Supreme Court determined that states cannot tax mail order companies for in-state sales, unless they maintained a physical presence in the state.

In 2015, nearly 50 years after *Bellas Hess*, Justice Kennedy issued an invitation to revisit both these cases, signaling a potential shift in the court's opinion. In *Direct Marketing Association v. Brohl*, Justice Kennedy noted that in light of technological and social changes that have taken place in an increasingly interconnected economy, the Supreme Court should reconsider its previous decisions. Justice Kennedy also recognized the negative financial repercussions for states as a result of potentially outdated decisions in both these cases.

In *Wayfair*, the majority recognized that a physical presence requirement puts traditional brick-and- mortar companies at a disadvantage since they still have to collect sales tax, though online sellers do not. It also recognized that the physical presence requirement imposes an arbitrary standard on sales tax collection – while sellers with a pervasive Internet presence and a large customer base in-state were not required to collect sales tax, businesses with only a few items of inventory in the state were still subject to sales tax requirements.

Of course, the dissent took a different view, noting that this is more of a policy issue for Congress to take action. While the justices may have hoped that Congress might resolve the situation for states and online retailers, most sales tax collection bills have repeatedly failed. In 2013, the Senate passed the *Marketplace Fairness Act*, but the House did not act on the bill. More recently, earlier this year, Rep. Kristi Noem (R-SD) unsuccessfully pushed for the passage of the *Remote Transactions Parity Act* in the House.

Given the Supreme Court decision in *Wayfair* there is now additional pressure on Congress to act. Without congressional action, retailers may face a myriad of state sales tax collection statues, creating major administrative burdens, especially for small sellers. In the coming months, many online retailers will place increasing pressure on Congress to create a uniform set of rules in this space.

Given Congress's other priorities, however, the chances of passing a bill this year remain remote. That said, since the ruling, Sen. Heidi Heitkamp (D-ND) said that Congress should "facilitate the discussion on a national standard" and create a *de minimis* threshold to protect small sellers. The threshold would exempt small sellers from having to collect sales tax in states where they have minimal sales.

For more details on the ruling, check out McGuireWoods' legal analysis here.

Rettig Gets a Hearing. Charles Rettig, nominee to be the next IRS commissioner, will finally get a hearing before the Senate Finance Committee on Thursday, June 28. The confirmation hearing has taken a while to put together since Rettig's nomination became public back in February.

Given that he is not well known in Washington's policy circles, the confirmation hearing provides an opportunity for Rettig to introduce himself to the public. Committee members are expected to assess his understanding and views of the IRS — they will likely solicit his thoughts on the bipartisan package of IRS reforms passed by the House in April.

In case you missed it, here is our previous write-up on Rettig.

Sitting Pretty. House Democrats have been toying with the idea of releasing details on how they would respond to the GOP tax law if they gained control of the chamber next year. However, without a clear consensus on a comprehensive alternative to the law, they are reluctant to offer specific talking points.

Instead, Democrats have discussed a more general vision that includes job training investments, retirement and education incentives, and a balanced federal budget. In the meantime, Democrats continue to go on the offensive, arguing that the GOP's corporate tax cuts were paid for by the middle class and that the law has increased healthcare costs for middle class Americans.

It's Like a New Year's Resolution. On June 21, the House Budget Committee approved its FY 2019 budget resolution in a 21-13 vote. The budget blueprint, which calls for $8.1 trillion in deficit reduction, is widely viewed as nothing more than a messaging document for GOP members heading into the midterms. And that's a fair assessment, given that House and Senate appropriators are pretty far along into the FY 2019 appropriations process. Both chambers have approved the first "minibus" appropriations package for FY 2019 (H.R. 5895).

Even though the House budget blueprint isn't going anywhere, it's still helpful to know what messages the GOP is taking onto the campaign trail. The FY 2019 House budget calls for the following:

- Balanced Budget. The blueprint contains a myriad of provisions aimed at producing a balanced budget within the 10-year window. The balance would be achieved through a combination of spending cuts and economic growth.

- Spending Cuts. Provisions in the blueprint would generate about $6.5 trillion in savings. They include cuts to both mandatory and discretionary spending, targeting Medicaid, Medicare, Social Security, and other social programs. Under a dynamic score, the budget claims to reduce the deficit by $8.1 trillion.

- Deficit Reduction via Reconciliation. Of note, the budget includes reconciliation instructions for 11 House committees to produce $302 billion of savings. The Ways and Means Committee would have to offer up the biggest chunk of the pie: $150 billion. Typical to reconciliation instructions in the past, the blueprint does not say how the committee should go about achieving that target — a moot point since there is a near zero chance of Congress undertaking reconciliation legislation this year.

Here are some of the other noteworthy, aspirational policy objectives in the GOP budget:

- Reform entitlements — this includes establishing work requirements and modifying certain eligibility rules for food stamp recipients.

- Reform Medicaid and Medicare — this covers improvements to program integrity; tort reform; changes to Medicare's premium model; and work requirements for Medicaid.

- Repeal Dodd-Frank — this covers the provisions under the Financial CHOICE Act (H.R. 10).

- Privatize Fannie Mae and Freddie Mac.

- Streamline the federal student loan system.

Get to Know Your Gig Workers. Sen. Mark Warner (D-VA) wants the federal government to collect better data on workers in the gig economy, introducing a bill (S. 3097) on June 20 that would task the Treasury Department to conduct a study on workers earning "non-employer business income." The purpose of such a study is to help the government understand how it can improve tax compliance among "gig workers." Warner's bill also aims to collect information on how workers are using non-employer business income as a supplement to wages. Such data would help the government get a better picture of the contingent workforce.

“Between 2005 and 2018, the federal government collected basically no data about the size and scope of the contingent workforce … there’s frankly still a lot we don’t know about this population of the American workforce,” Warner said.

The gig economy has posed unique challenges for lawmakers and policymakers that wish to provide basic benefits and protections to nontraditional workers (e.g. healthcare, retirement benefits, etc.). Part of the challenge stems from the lack of reliable data on workers who make up the contingent workforce — for example, just how big is this workforce? The statistics vary, and that’s because most of the available data have been gathered through simple surveys and tax records.

The federal government has conducted some basic data collection over the years at the Bureau of Labor Statistics (BLS). According to a June 7 report, nontraditional workers — including independent contractors, on-call workers, temporary workers, workers on contract — make up 10.1 percent of the workforce in May 2017.

REGULATORY WORLD

Gaps in IRS Cybersecurity System. According to a June 21 Treasury Inspector General for Tax Administration (TIGTA) report, the IRS Cybersecurity Data Warehouse (CSDW), which stores personal taxpayer information, has several security weaknesses. This makes it particularly vulnerable to data breaches.

The CSDW was developed to collect security logs from certain devices and technology used to protect the IRS network. After a security breach to the Get Transcript program in May 2015, the IRS decided to transfer transactional audit logs containing taxpayer data from the Get Transcript application to the CSDW. TIGTA initiated an audit to determine whether the CSDW was adequately protected.

TIGTA found that the IRS had implemented adequate physical security controls over the CSDW; properly encrypted all transmitted data to the CSDW from source systems; and effectively implemented user access, identification, and authentication controls. However, taxpayer data from the Get Transcript program were improperly transferred to the CSDW.

TIGTA made four recommendations to the IRS:

- Hold employees accountable for not following established policies.
- Update all CSDW security documentation, including the risk assessment and system security plan.

- Automate processes to monitor the activities of all IRS personnel with access to taxpayer data in the CSDW.
- Complete an inventory of systems that transfer taxpayer data to the CSDW.

The IRS agreed to the last two recommendations and partially disagreed with the other two.

Holy Taxes, Batman! As part of the GOP tax law, tax-exempt organizations are required to begin paying a 21-percent tax on certain types of fringe benefits they provide to employees.

Specifically, the tax law requires all tax-exempt organizations to include any amount paid for qualified transportation fringe benefits, parking, or athletic facilities (e.g. gym memberships) as unrelated business taxable income (UBTI), which is taxed at 21 percent. To avoid the tax liability, a nonprofit would have to either provide the benefits as taxable items to employees or discontinue providing the benefits. Many nonprofits could face thousands of dollars of taxes.

The tax seems to be a surprise to many organizations that were previously unaware of the significant financial and administrative burden. For GOP lawmakers, the tax is a particularly sensitive issue given that churches will be subject to these provisions as well. Over 600 churches and other groups have already signed a petition demanding the tax be repealed. Larger nonprofits, such as the Boys & Girls Clubs of America, Goodwill Industries, the YMCA, and the National Council of Nonprofits are leading the fight, noting that the tax law is unclear on the mechanics of the tax.

CFPB Structure Called into Question. On June 21, U.S. District Judge Loretta Preska, a federal judge in New York, ruled that the Consumer Financial Protection Bureau's (CFPB) structure violates the U.S. Constitution.

Judge Preska said that the agency, which has a single director removable only for good cause, isn't sufficiently accountable to the president, which is in violation of the Constitution.

Her ruling goes against a decision by the full appeals court in Washington, DC earlier this year in an unrelated case validating the CFPB's structure. In a 7-3 decision the D.C. Circuit Court of Appeals ruled that the limits placed on the president's ability to remove the bureau's director does not violate the president's authority to appoint and remove executive branch officials. Judge Preska's ruling complicates the situation for the bureau.

If Judge Preska's ruling is upheld on appeal, it would create a split between federal appeals courts on the legitimacy of the CFPB, increasing the likelihood that a final determination would have to be made by the U.S. Supreme Court.

In the case at hand, Judge Preska dismissed an enforcement case against a company that provides advances to people who are due legal payouts. The CFPB has not yet released a comment on the case.

Sun's Out, Guidance Out. The IRS and Treasury issued Notice 2018-59, providing regulatory guidance on the commence construction requirement for the solar energy investment tax credit and other renewable energy resources like qualified fuel cells, qualified microturbines, and geothermal heat pumps. Regulatory guidance was needed in this area since the enactment of the *PATH Act*, which enacted a commence construction requirement for solar investment tax credit. The enactment of the *Bipartisan Budget Act of 2018* did the same for other renewable energy resources.

This long-awaited guidance provides two ways to determine when construction has begun. The taxpayer can satisfy the commence construction requirement either by starting physical work of a significant nature or by meeting the five percent safe harbor test. Both methods are similar to the way taxpayer can satisfy the commence requirement for the wind production tax credit.

Represent! The IRS and Treasury said that they are looking at the authority of partnership representatives to appoint their own successors. An IRS Chief Counsel attorney said that it is an issue that the IRS is "certainly looking into and thinking about as [they] try to finalize regulations." Many taxpayers submitted comments raising the question of whether that is fair. The IRS Chief Counsel attorney pointed to the statute wherein the sole authority to act on behalf of the partner is with the partnership representative. "Nothing in the statute talks about resignations or revocations or anything like that," IRS Chief Counsel attorney noted. As a refresher, the partnership audit regime underwent significant changes in 2015, and the tax community is still adjusting to those changes.

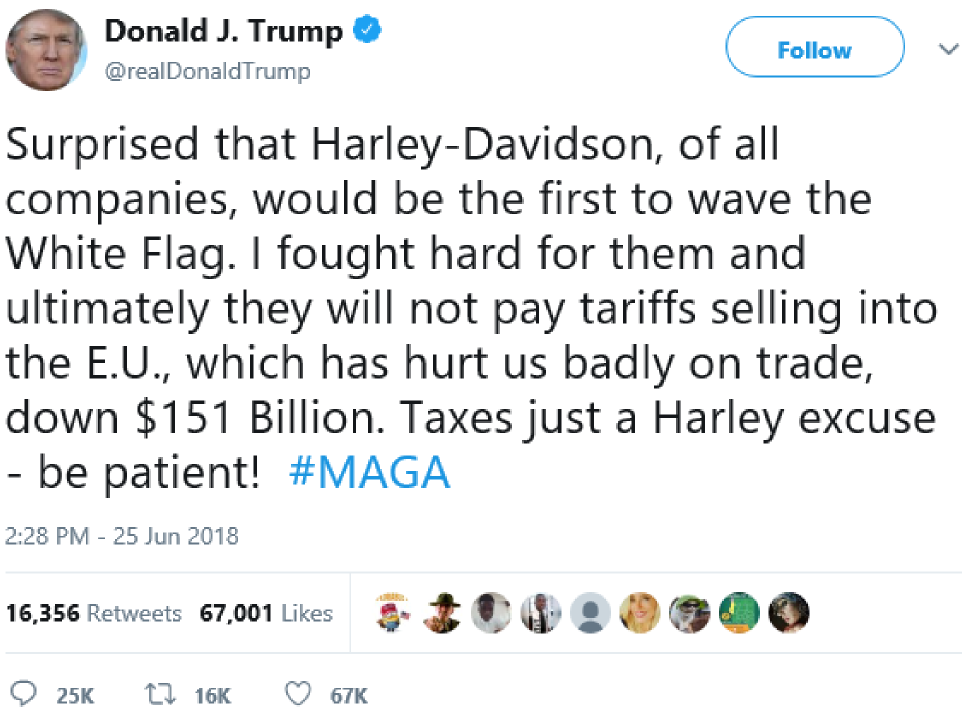
LINE ITEMS

1. The Treasury Department and the IRS will showcase the much anticipated "postcard" tax filing form this week. The postcard-sized Form 1040 was a key talking point of the GOP's 2017 tax reform efforts, which promised to simplify the tax code so that taxpayers filing simple returns can do so in the form of a postcard.

2. The Senate Appropriations Committee has unanimously approved its FY 2019 Financial Services spending bill, which includes about $11.3 billion in funding for the Internal Revenue Service. Like the House bill, the Senate measure would put $77 million towards the implementation of the GOP tax law.

3. In response to the Trump Administration's recent tariff actions, Harley-Davidson announced that the company will move some of its production operations outside of the United States. Read more here.

COMMANDER-IN-TWEET



Source: Twitter

IN THE QUEUE

Congressional Activity

Tuesday, 6/26

House Financial Services Committee
Subcommittee hearing on "International and Domestic Implications of De-Risking."

House Appropriations Committee
Committee markup of FY 2019 Labor-HHS-Education appropriations bill.

Senate Appropriations Committee
Markup of an original bill making appropriations for the Department of Labor, Department of Health and Human Services, Department of Education, and Related Agencies FY 2019.

Senate Finance Committee
Hearing on prescription drug affordability and innovation, focusing on addressing challenges in today's market.

Senate Banking Committee
Hearing to examine legislative proposals to increase access to capital.

Wednesday, 6/27

Senate HELP Committee
Hearing to examine how to reduce health care costs, focusing on understanding the cost of health care in America.

Senate Appropriations Committee
Subcommittee hearing to examine proposed budget estimates and justification for fiscal year 2019 for the Department of State.

House Financial Services Committee
Hearing on "Oversight of the Department of Housing and Urban Development." HUD Secretary Ben Carson to testify.

Thursday, 6/28

Senate Banking Committee
Hearing to examine legislative proposals to examine corporate governance.

Senate Appropriations Committee
Markup of the FY 2019 Defense spending bill and Labor-HHS-Education spending bill.

Agency Activity

Thursday, 6/28

SEC
Opening meeting to consider whether to propose a rule that would permit ETFs that satisfy certain conditions to operate without first obtaining an exemptive order from the commission. The commission will also consider potential amendments to smaller reporting company definition; rules to require the use of the XBRL format for the submission of operating company financial statement information and fund risk/return summary information; potential amendments to Form N-PORT and Form N-1A. More details here.

Other Activity

Tuesday, 6/26

Washington Post
Event on "Tax Reform in America: The Six-Month Report," featuring interviews with Council of Economic Advisers Director Kevin Hassett and House Ways and Means Chairman Kevin Brady, among others.

Wednesday, 6/27

AEI
Discussion on Federal Reserve reform with Rep. Andy Barr (R-KY).

Politico
Politico Playbook interview with Senate Majority Leader Mitch McConnell to discuss the GOP congressional agenda.

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