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Indirect Taxes in the Age of COVID-19

Over the past few months, COVID-19 has significantly altered many taxpayers' business operations and sales. In response to this pandemic, the federal government enacted the CARES Act, which contains a number of tax provisions aimed at ameliorating the economic fallout. Additionally, state governments are also adapting tax laws to help ease the strain on companies. This article will examine a few potential indirect tax considerations and liquidity planning. The topics discussed include a general discussion of state relief efforts along with possible indirect tax considerations for companies' sales and purchases.

What measures have state governments adopted in order to provide relief for taxpayers?

In an effort to relieve the burden on taxpayers, states have been extending filing and payment deadlines as well as waiving penalties and interest for a number of indirect taxes. For instance, the California Department of Tax and Fee Administration automatically extended the filing and payment due date for first quarter sales and use tax returns to

July 31, 2020 for small businesses, *i.e.*, those filing a return for less than $1 million in tax.[1] The New York State Department of Taxation and Finance is abating penalties and interest for quarterly and annual filers who pay sales and use tax within 60 days of March 20, 2020.[2]

In addition, some states are incentivizing businesses to donate to COVID-19 relief efforts. For example, the Indiana Department of Revenue announced that manufacturers making donations of medicine, medical supplies or other eligible items as part of COVID-19 relief efforts will not incur a use tax obligation for those donations.[3] Similarly, California is exempting healthcare supplies sold or purchased by the state from sales and use tax.[4]

Both the CARES Act and a number of states provide indirect tax relief for alcohol distillers when the alcohol is used to produce hand sanitizer.[5] To the extent taxpayers' portfolios include breweries, wineries, or distilleries that are producing hand sanitizer, reviews of alcohol purchased can result in potential tax recoveries.

What are some indirect tax considerations surrounding the post COVID-19 working environment?

Sales considerations: The Supreme Court's *South Dakota v. Wayfair* ruling expanded the ability of states to collect sales tax from remote retailers by removing the physical presence requirement and allowing states to adopt a nexus standard based on economic activity.[6] Since this decision, 42 states and the District of Columbia use an economic nexus standard[7] for sales and use taxes and most states have passed marketplace-facilitator laws, which impose a duty to collect and remit sales tax on large websites that broker transactions.[8]

COVID-19 has caused an increase in the volume of online sales. As a result, a vendor's sales or a number of transactions with in-state customers may now exceed the threshold requirements and create economic nexus in jurisdictions where it previously did not have filing and remittance obligations. A number of companies have also adapted their business operations to the current circumstances. These new operating models can create taxable sales for companies whose sales were previously nontaxable. For example, businesses which previously sold nontaxable gym memberships may now be renting out equipment and selling classes through apps or software, all of which may be taxable in certain jurisdictions. As companies shift their operations and pursue customers in new jurisdictions, the patchwork of state and local tax rules can create an increased compliance burden.

Additionally, as states have ordered companies to close their offices, companies have adapted to new circumstances by requiring employees to work remotely. This raises the possibility of creating sales tax nexus in the jurisdictions where the employees are currently working. Some states have issued guidance stating that the presence of employees

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[1] Governor Newsom Grants Additional Relief for Business Taxpayers – Small Businesses Now Have Until July 31, 2020 to File First Quarter Returns (Mar. 31, 2020), https://www.cdtfa.ca.gov/news/20-06.htm.
[2] NYS Dep't of Tax and Fin., Announcement Regarding the Abatement of Penalties and Interest for Sales and Use Tax due to the Novel Coronavirus, COVID-19 (Mar. 2020).
[3] Indiana Dep't of Rev., Indiana DOR Waiving Use Tax on Donated COVID-19 Supplies (April 6, 2020), https://content.govdelivery.com/accounts/INDOR/bulletins/285274c.
[4] California Executive Order No. N-46-20 (April 7, 2020), https://www.gov.ca.gov/wp-content/uploads/2020/04/4.7.20-EO-N-46-20.pdf.
[5] *See*, *e.g.*, Illinois Dep't of Rev., Department of Revenue Moves to Assist Distillers Making Hand Sanitizer (April 8, 2020), https://www2.illinois.gov/IISNews/21368-Department_of_Revenue_Moves_to_Assist_Distillers_Making_Hand_Sanitizer.pdf; Washington State Liquor and Cannabis Board, Guidance for Distillers Producing Hand Sanitizer (Mar. 24, 2020), https://lcb.wa.gov/sites/default/files/publications/temp_links/Coronavirus_Distillers_3-24-20.pdf.
[6] *See generally South Dakota v. Wayfair, Inc.*, 138 S. Ct. 2080 (2018).
[7] Most states define this nexus as a defined dollar amount of sales to in-state customers or a defined amount of transactions with in-state customers. *See*, *e.g.*, Ga. Code Ann. §48-8-2(8)(M.1-.2); Me. Rev. Stat. Ann. tit. 36, §1754-B(1-B)(B).
[8] *See generally* Bloomberg Tax, Sales and Use Tax Chart- Economic Presence Nexus Standard; Bloomberg Tax, Sales and Use Tax Chart- Marketplace Facilitators or Referrers.

that are only working in the state due to COVID-19 will not create sales tax nexus.[9] However, many states have not issued guidance yet so taxpayers should consider the possibility that states will assert nexus for sales tax.

Purchase considerations: Companies should evaluate their purchases and software allocations under the current circumstances. For example, a beneficial sales and use tax reallocation may exist for purchasers who paid sales and use tax on the purchase of information services and software licenses to use in one location where, due to office shutdowns, the software is now subsequently used in another state and/or locality with lower tax rates. For instance, companies that were based in New York City continue to pay for monthly information services and software as if the software were still being accessed and used in New York City (at a rate of 8.875%).[10] In an effort to stop the spread of the pandemic, Governor Andrew Cuomo issued the "New York State on PAUSE" executive order which mandates that any businesses not deemed "essential" must keep 100 percent of their workforce home.[11] As a result, most employees are no longer commuting to New York City, and may be working from jurisdictions which have lower state and local sales and use tax rates. Therefore, companies may be able to beneficially reallocate such service and software charges to better reflect where they are being used.

Additionally, in an effort to protect their employees during this time, companies may be purchasing deep cleaning services or personal protective equipment. Businesses should determine whether these purchases may be exempt from sales tax in their respective jurisdictions. Furthermore, companies should also examine suspended or terminated taxable services to determine the appropriate sales tax treatment of any such charges or termination payments.

Marketplace reactions: In response to the pandemic, companies are rapidly adjusting their business models and operations. Companies may need to prioritize mitigating supply chain disruptions as well as maintaining cash flow. In addition to addressing immediate needs, companies should contemplate long-term considerations around recovery and what changes in operating models should continue to remain in place.

Due to the rapidly shifting multistate compliance framework, many companies have been co-sourcing or outsourcing sales and use tax compliance as a cost-effective solution to free time for them to focus on immediate needs and value-add projects.

How can Deloitte help?

In a rapidly evolving business environment, taxing jurisdictions are challenged with applying antiquated tax laws to today's emerging technologies and evolving services. Deloitte's Multistate Tax group has a team of indirect tax professionals across its network of member firms specializing in indirect tax services. Drawing upon our in-depth knowledge of each jurisdiction's tax laws, coupled with data analytics and other technology-based services, we offer distinct insights regarding how these laws apply to companies in various industries. Our professionals represent a mix of accounting, legal, industry, and state government backgrounds. The displacement of personnel and tightened budgets will likely cause many companies to rethink how they structure their tax departments and Deloitte offers scalable assistance to tax departments.

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[9] *See e.g.*, New Jersey Division of Tax., Telecommuter COVID-19 Employer and Employee (May 6, 2020), https://www.state.nj.us/treasury/taxation/covid19-payroll.shtml; https://otr.cfo.dc.gov/release/otr-tax-notice-2020-05-covid-19-emergency-income-and-franchise-tax-nexus.
[10] NYC Dep't of Fin., New York State Sales and Use Tax (2020), https://www1.nyc.gov/site/finance/taxes/business-nys-sales-tax.page.
[11] New York Executive Order No. 202.6 (March 18, 2020), https://www.governor.ny.gov/news/no-2026-continuing-temporary-suspension-and-modification-laws-relating-disaster-emergency.

Settlement Payments Post Tax Cuts and Jobs Act – Don't Forget About IRC § 1341

One of the changes made by the Tax Cuts and Jobs Act ("TCJA") was a reduction of the US federal corporate tax rate from 35% to 21% for tax years beginning after 2017. The tax rate reduction increases the importance for taxpayers to consider an often-overlooked section of the Code, IRC § 1341, Computation of Tax Where Taxpayer Restores Substantial Amount Held Under a Claim of Right. IRC § 1341 is a fairness provision intended to mitigate inequities created by, among other things, a change in tax rates.

History & overview of a claim of right

IRC § 1341 has been part of the Internal Revenue Code since 1954. In recent years, this provision has been more commonly applied to individual taxpayers because the top corporate tax rate remained at 35% from 1993 to 2017. However, when the TCJA lowered the top corporate tax rate from 35% to 21% this made IRC § 1341 more relevant to corporate taxpayers.

IRC § 1341 applies to taxpayers who are required to repay a portion of an item of gross income earned in one (or more) prior taxable year(s). The fairness provision of IRC § 1341 creates a tax benefit when the taxpayer's tax situation has changed from the year in which it recognized the income and the year in which it is paying back the income. The mechanics (described below) of IRC § 1341 provide for an alternative computation of tax liability, which attempts to place the taxpayer in the same economic position it would have been in had it not included the item in gross income in the previous year(s).

Does relief under IRC § 1341 apply to you?

IRC § 1341 involves multiple years. The first year or years is when a taxpayer includes amounts in gross income because it appeared in such prior year(s) that the taxpayer had an unrestricted right to a particular item of gross income in such year.[12] Then in a later year it is established that the taxpayer did not, in fact, have an unrestricted right to such item of gross income in the prior year(s) and the taxpayer is entitled to a deduction on account of repaying the item.[13]

The following are the primary criteria to consider when determining whether IRC § 1341 applies:

1. The taxpayer made an involuntary payment related to an item included in gross income in a prior taxable year, and in that prior year the taxpayer appeared to have an unrestricted right to an item of gross income.[14]
2. In the year of repayment, it was established that the taxpayer did not have an unrestricted right to the income in the prior year(s).
3. The payment must be a deductible expenditure under a section of the Code (*e.g.*, IRC § 162) and the amount of the deduction must exceed $3,000.
4. Except for certain payments made by a regulated utility, deductions associated with repayment of an item included in gross income from the sale of inventory (or other property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business) are not eligible for IRC § 1341
5. IRC § 1341 is applied in the current year tax return for the year of repayment as opposed to the prior taxable years in which the gross income was included.

[12] IRC § 1341(a)(1)
[13] IRC § 1341(a)(2)
[14] IRC § 1341 does not apply if the item of income was earned as a result of intentional or illegal wrongdoing by the taxpayer.

The alternative computation ("With & Without") of tax

To the extent IRC § 1341 applies, the taxpayer's tax liability for the year of repayment is the lesser of the tax liability taking a deduction ("with")[15] or claiming a credit in lieu of a deduction ("without").[16]

If the deduction is taken, the taxpayer will deduct the amount restored in the year of repayment. If the tax payment/credit is applied, then the taxpayer will recompute its tax liability by following these steps:

1. Compute taxable income for the year of repayment without deducting the repaid amount;
2. Recompute the tax for the prior year(s) without including in gross income the amount repaid;
3. The reduction of tax in the prior year(s) is the tax payment/credit; and
4. Subtract the tax payment/credit from the tax for the year of repayment computed without the deduction. To the extent no tax is paid in the year of repayment, the credit is refundable to the taxpayer.

Can you give us an example?

Let us consider an example derived from Example 40 of IRS Publication 525 (2018) that illustrates the mechanics of IRC § 1341.

For 2017, Taxpayer filed a tax return and included $5,000 in income because it appeared that the taxpayer had an unrestricted right to such income. In 2019, taxpayer repaid the $5,000 because it was established that it did not, in fact, have an unrestricted right to the income in 2017. For purposes of this example, the tax rate in 2017 is 35%, and the tax rate in 2019 is 21%. Income and tax for both years are as follows:

	2017	
	With Income	**Without Income**
Taxable Income	$15,000	$10,000
Tax	$5,250	$3,500

	2019	
	Without Deduction	**With Deduction**
Taxable Income	$50,000	$45,000
Tax	$10,500	$9,450

The tax in 2019 *with the deduction* is $9,450.

The tax in 2019 *without the deduction* (but with the IRC § 1341 credit) is $8,750, computed as follows:

Tax previously determined for 2017:	$5,250
Less: Tax as refigured:	- $3,500
Decrease in 2017 tax:	**$1,750**
Regular tax liability for 2019:	$10,500
Less: Decrease in 2017 tax:	- $1,750
Refigured tax for 2019:	**$8,750**

Because the Taxpayer's 2019 tax liability without the deduction but with the IRC § 1341 credit is $700 lower ($9,450 less $8,750), the taxpayer is better off foregoing the deduction and applying IRC § 1341(a)(5).

When do I record the adjustment?

IRC § 1341(b) provides that if the decrease in tax ascertained by excluding the item from income in prior years exceeds the tax imposed for the taxable year without such deduction, such excess shall be considered a payment of tax for the taxable year. As such, the adjustment under IRC § 1341 is applied to the year of repayment. For any

[15] IRC § 1341(a)(4)
[16] IRC § 1341(a)(5)

taxable years where the taxpayer deducted a qualifying repayment, and which remain open under the statute of limitations, the taxpayer may amend the prior year's tax return and instead, compute such prior year's tax liability under IRC § 1341 with respect to the repayment amount. It is important to note that when a taxpayer is subject to the "without" computation they still reduce earnings and profits by the amount that would have been a deduction.[17] Special computational rules are also applicable if the deduction or exclusion result in a net operating loss in either the current or prior taxable year.[18]

Why does this matter to me?

The alternative computation ("With & Without") of tax under IRC § 1341 may result in permanent tax savings. The restoration in the year of repayment may be matched to the year in which the income was initially generated resulting in permanent tax savings (*e.g.*, matched to a 35% tax rate year).

Coronavirus Aid, Relief, and Economic Security Act ("CARES") implications

The CARES Act included several significant business tax provisions intended to improve cash flow and liquidity. These provisions, among other things, provide a temporary five-year carryback for certain net operating losses ("NOLs") arising in a taxable year beginning after December 31, 2017, and before January 1, 2021, and repeals the 80% limitation for taxable years beginning before January 1, 2021. The temporary repeal of the 80% limitation, when coupled with the new five-year carryback period, affords corporations the ability:

1. To utilize NOLs in taxable years beginning as early as 2013 (for an NOL experienced in a taxable year beginning in 2018), and
2. To offset taxable income in those prior years that had been subject to tax at a 35% tax rate.

As a result of the CARES Act taxpayers should analyze the ability of the 5 year carryback when computing their "with and without" tax liability computations.

In a situation where the taking of a deduction for the restoration creates or increases an NOL the CARES Act may allow the taxpayer to carryback five years any NOLs generated at 35%. Alternatively if all or a portion of the restoration deduction does not create an NOL that is able to be utilized in a higher tax rate year the alternative computation of tax under a claim of right may create a lesser tax liability to the taxpayer by allowing the taxpayer to match the full amount of the restoration to a higher tax rate year.

How can Deloitte help?

Deloitte's Strategic Tax Review ("STR") group is a national practice that focuses on understanding an organization's business, as well as its current tax positions to help identify potential opportunities to generate additional cash tax savings, tax refunds, and lowering the effective tax rate. STR is experienced in various industries and market areas, with a reputation for quality and experience providing advice on accounting methods planning from a domestic and global perspective.

The STR group can assist companies with implementing and analyzing Section 1341 applications and has developed tools and procedures to assist in developing an effective analysis of potential Claim of Right.

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[17] Treas. Reg. § 1.1341-1(b)(2)
[18] Id

COVID-19 tax policy updates

Congress has approved, and President Trump signed the Coronavirus Aid, Relief, and Economic Security (CARES) Act, a massive tax-and-spending package intended to provide additional economic relief to address the impact of the COVID-19 pandemic. COVID-19 stimulus: A taxpayer guide, a Deloitte Tax LLP publication, looks at the tax provisions in the new legislation and their potential implications for business and individual taxpayers.
URL: https://www2.deloitte.com/us/en/pages/tax/articles/covid-19-tax-policy-updates.html?id=us:2em:3na:usic:awa:tax:061520&sfid=7011O0000038lB4QAI

Additional Resources:

- **Combatting COVID-19 with resilience:** A collection of Global Deloitte Insights to help businesses manage and mitigate the risk associated with COVID-19
  URL: https://www2.deloitte.com/global/en/pages/about-deloitte/topics/combating-covid-19-with-resilience.html?id=us:2em:3na:usic:awa:tax:061520&sfid=7011O0000038lB4QAI
- **Deloitte COVID-19 Tax & Fiscal Measures:** Deloitte is offering two free digital resources which can help you keep track of tax and financial measures introduced around the world and review the measures by country.
  URL: https://www2.deloitte.com/global/en/pages/tax/solutions/tax-atlas-signal.html?id=us:2em:3na:usic:awa:tax:061520&sfid=7011O0000038lB4QAI

Calendars to watch

Each edition, be sure to mark your calendars for some of the more important events (recent and upcoming) as well as tax developments making in impact on businesses investing into the United States.

Upcoming activities

June 1 1:00 p.m. ET	**Dbriefs archive:** Special Edition | Cyber risk in the wake of COVID-19: Building greater resilience Watch **URL:** https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/june/2020/dbriefs-cyber-risk-in-wake-of-covid19-building-greater-resilience.html?id=us:2em:3na:usic:awa:tax:061520&sfid=7011O0000038lB4QAI
June 8 1:00 p.m. ET	**Dbriefs archive:** Special Edition | Supply chain and workforce recovery and transformation Watch **URL:** https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/june/2020/dbriefs-covid19-supply-chain-workforce-recovery-transformation.html?id=us:2em:3na:usic:awa:tax:061520&sfid=7011O0000038lB4QAI
June 9 2:00 p.m. ET	**Dbriefs archive:** COVID-19 business recovery: Financial and tax considerations Watch **URL:** https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/june/2020/dbriefs-covid-19-business-recovery-financial-tax-considerations.html?id=us:2em:3na:usic:awa:tax:061520&sfid=7011O0000038lB4QAI
June 19 11:00 a.m. ET	**Dbriefs:** Quarterly accounting roundup: Q2 2020 update on important developments and financial reporting impacts related to COVID-19 Register **URL:** https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/june/2020/dbriefs-quarterly-accounting-roundup-q2-2020-update-on-important-developments.html?id=us:2em:3na:usic:awa:tax:061520&sfid=7011O0000038lB4QAI
June 26 1:00 p.m. ET	**Dbriefs:** Financial accounting and reporting for income taxes: Midyear update Register **URL:** https://www2.deloitte.com/us/en/pages/dbriefs-webcasts/events/june/2020/dbriefs-financial-accounting-and-reporting-for-income-taxes-midyear-update.html?id=us:2em:3na:usic:awa:tax:061520&sfid=7011O0000038lB4QAI

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