Current Federal Tax Developments

Week of November 4, 2019

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SECTION: STATE TAX
WISCONSIN APPEALS COURT RULES MICROSOFT'S PAYMENTS FROM OEMS FOR MACHINES EVENTUALLY SOLD FOR USE IN WISCONSIN IS NOT WISCONSIN INCOME

Citation: Wisconsin Department of Revenue v. Microsoft Corporation, Court of Appeals, District IV, Appeal No. 2018AP2024, 10/31/19

The state of Wisconsin lost in an attempt to look further down the line to find an ultimate consumer to source sales in the case of *Wisconsin Department of Revenue v. Microsoft Corporation,* Court of Appeals, District IV, Appeal No. 2018AP2024.[1]

The case involves the state of Wisconsin looking to include in the sales factor fees paid to Microsoft for licensing *Windows* that are included in machines eventually purchased for use in Wisconsin. The purchasers of the computers enter into a sublicense with the manufacturer to use *Windows*. The Wisconsin Department of Revenue argues that the licensing fee paid by the manufacturer when they installed *Windows* on the machine should be sourced to Wisconsin when sold to a Wisconsin resident.[2]

The decision describes the licensing agreements as follows:

> Relevant to the tax years in dispute, Microsoft entered into software copyright license agreements with OEMs. Some OEMs with which Microsoft entered into license agreements were based in Wisconsin, but the vast majority were not based in Wisconsin. Because this appeal does not concern OEMs based in Wisconsin, for clarity from this point forward all references to "OEMs" are to those OEMs that were not based in Wisconsin.
>
> Under the license agreements, the OEMs paid royalties to Microsoft, in exchange for which Microsoft granted the following non-exclusive rights to the OEMs: (1) to install Microsoft's software on computers; and (2) to distribute Microsoft's software that was installed on the computers and grant sublicenses for end-users to use the software.

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[1] *Wisconsin Department of Revenue v. Microsoft Corporation*, Court of Appeals, District IV, Appeal No. 2018AP2024, October 31, 2019, https://www.wicourts.gov/ca/opinion/DisplayDocument.pdf?content=pdf&seqNo=249452,

[2] *Wisconsin Department of Revenue v. Microsoft Corporation*, p. 2

> OEMs sold the computers with the installed Microsoft software to consumers directly or through retailers such as Best Buy. The Commission referred to the consumers as "end-users," and we do the same. All that is at issue here is end use of the Microsoft software that occurred in Wisconsin, not end use that occurred outside Wisconsin.
>
> Computers sold by the OEMs with Microsoft software installed came with End-User Licensing Agreements (which we will refer to as "end-user agreements"). By accessing and using the Microsoft software on the computers sold by the OEMs, end-users agreed to be bound by the terms of the end-user agreements. The terms of the end-user agreements were dictated by Microsoft. By their terms, the end-user agreements were contracts between the OEMs and the end-users which started with this sentence: "IMPORTANT — READ CAREFULLY: This [end-user agreement] is a legal agreement between you . . . and the manufacturer [OEM] of the computer system or computer system component ('HARDWARE') with which you acquired the Microsoft software product(s) identified above ('SOFTWARE')." The DOR does not contend that Microsoft was a party to the end-user agreements. [3]

Under Wisconsin law, generally income is sourced to Wisconsin if the income-producing activity occurs in the state—and, in this case, the OEM's royalty payments to Microsoft were triggered by their installation of the software on the machines when they were built. That activity would rarely occur in Wisconsin.[4]

But there is a special rule that provides that gross receipts for computer software includes receipts from the use of computer software where the licensee uses the software at a location in Wisconsin.[5] The Department of Revenue asserted that the ultimate customer, as sublicensee of the OEM that made the computer, is properly treated as having licensed the software from Microsoft and the fees paid by the OEM covers this use in Wisconsin.

Unfortunately for the Department of Revenue, the Tax Appeals Commission and the Appeals Court did not agree that a *sublicensee* of Microsoft's customer represented a *licensee* of Microsoft in this case.

[3] *Wisconsin Department of Revenue v. Microsoft Corporation*, p. 3-4

[4] *Wisconsin Department of Revenue v. Microsoft Corporation*, p. 8

[5] *Wisconsin Department of Revenue v. Microsoft Corporation*, pp. 8-9

First, the Appeals Court did not accept the Department's argument that, as a matter of , the sublicensee in this case was a licensee of Microsoft, finding they cited no precedential support for that proposition. The Department argued:

> Next, the DOR argues that the Commission's determination that the end-users were not licensees of Microsoft was "myopic" and "disregard[ed] the economic reality" of these transactions. The DOR contends that, although the OEMs were licensees of Microsoft, the end-users were also licensees of Microsoft when viewing the "transactions . . . as a whole."[6]

The appellate court, however, emphasizes that the statute only refers to licensees, noting:

> Initially, we note that the question of whether end-users had licenses with Microsoft as the DOR proposes, or instead the end-users did not have a contractual relationship with Microsoft and had only a sublicense with the OEMs as the Commission concluded, must be viewed in the light of the applicable statutory language. To repeat, the exception in the statutory subpart the DOR relies on, WISCONSIN STAT. § 71.25(9)(df), is limited to a "licensee" who uses Microsoft's software in Wisconsin. See § 71.25(9)(df). The text of the statutory provision makes no reference to use of the computer software in Wisconsin by a sublicensee. As already discussed, the terms "license," "licensor," "licensee," "sublicense," and "sublicensee" have commonly understood meanings in the law.7 In construing the subpart in this fact situation, we must be mindful of those meanings and the distinction between a license and a sublicense. See WIS. STAT. §990.01(1) ("All words and phrases shall be construed according to common and approved usage; but technical words and phrases and others that have a peculiar meaning in the law shall be construed according to such meaning.") (emphasis added); see also *State v. Hemp*, 2014 WI 129, ¶31, 359 Wis. 2d 320, 856 N.W.2d 811 (appellate courts "should not read into [a] statute language that the legislature did not put in" (quoted source omitted)). We presume that the legislature chose the term "licensee" carefully to express the statute's intended meaning. See *id.*[7]

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[6] *Wisconsin Department of Revenue v. Microsoft Corporation*, p. 11

[7] *Wisconsin Department of Revenue v. Microsoft Corporation*, pp. 11-12

The appellate opinion agrees with the lower tribunal that Microsoft only had a licensing contract with their OEM customers, not with those that bought the computers that the OEMs loaded the software onto:

> Upon our independent review of the end-user agreements, we agree with the Commission's interpretation that those were contracts only between OEMs and end-users. See *Tufail v. Midwest Hosp*., LLC, 2013 WI 62, ¶22, 348 Wis. 2d 631, 833 N.W.2d 586 (contract interpretation presents a question of law an appellate court reviews de novo). As noted in the Background section, the end-user agreements explicitly stated that the contracts were between the end-users and the OEMs, and the DOR does not contend that Microsoft was a party to the end-user agreements. It then follows that there could not have been mutual expression of assent to the end-user agreements, a requirement for a valid contract such as a license, by both Microsoft and an end-user because Microsoft was not a party to the end-user agreement. See *Gustafson v. Physicians Ins. Co. of Wis., Inc.,* 223 Wis. 2d 164, 173, 588 N.W.2d 363 (Ct. App. 1998) (setting forth the requirements for a contract). Without that basic requirement for a contract, there were no licenses between Microsoft and the end-users, and the end-users were not licensees of Microsoft.[8]

Fundamentally, Microsoft was only paid by OEMs when they put *Windows* on the computers the OEM had built.

> The Commission rejected this argument and found that "Microsoft's gross receipts were not a function of use by actual end-users." We affirm the Commission's finding because substantial evidence in the record demonstrates that the amounts paid to Microsoft by the OEMs for the software licenses were not paid as a result of end-user payments to OEMs for the sublicenses as the DOR asserts. The Commission found, and the DOR does not dispute, that the obligations of the OEMs to pay royalties to Microsoft for licenses did not depend on the OEMs' sales of the computers because OEMs were required to pay royalties to Microsoft even when the OEMs did not sell the computers on which the Microsoft software was installed. Microsoft, in briefing in this court, relies on evidence in the record that Microsoft was paid by the OEMs for the licenses months (if not years) before the OEMs sold the computers, with licensed Microsoft software included, to end-users. In reply, the DOR does not dispute those facts. The Commission further found, and the DOR does not dispute, that the royalties that the OEMs paid to Microsoft were not tied in any way to the prices for which the OEMs sold the computers, and that the

[8] *Wisconsin Department of Revenue v. Microsoft Corporation*, pp. 13-14

OEMs, not Microsoft, were entitled to the sale proceeds and profits from the sales of all of the OEMs' computers, including any amounts attributable to the software. Thus, the licensing royalties that the OEMS paid Microsoft were not paid indirectly by the end-users.[9]

SECTION: 121
TAXPAYER ALLOWED TO USE BOTH §121 AND §1031 IN DISPOSITIONS FOR PROPERTY FOLLOWING FIRE

Citation: PLR 201944006, 11/1/19

The IRS issued a private letter ruling to a taxpayer dealing with both the exclusion of gain on the sale of a residence under IRC §121 and the like-kind exchange provisions of IRC §1031 in PLR 201944006.[10]

The ruling involves a piece of property.

- One of the taxpayers had purchased the property to use as a principal residence, and when the taxpayers were married they continued to use it as their principal residence. Eventually the taxpayers moved into a new residence.
- The property was then offered to rent. While there was a period of time when the property was rented to full-time tenants, they also rented it for short-term rentals during other portions of this period of time. The rental use ended when the property was destroyed in a fire.
- Following the fire the taxpayers received funds for the destroyed residence, sold the land without rebuilding the residence and acquired new property in a transaction they hoped would qualify for deferral of gain under IRC §1031.[11]

The taxpayers asked the IRS to rule on three items:

- Did IRC §121 (exclusion of gain of the sale of a principal residence) apply to any of this transaction?
- Is it possible for both §121 and §1031 to apply to the same transfer of property?

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[9] *Wisconsin Department of Revenue v. Microsoft Corporation*, p. 15

[10] PLR 201944006, November 1, 2019, https://www.irs.gov/pub/irs-wd/201944006.pdf, retrieved November 2, 2019

[11] PLR 201944006, p.1-2

- Was the property they disposed of held for investment for purposes of §1031?

The taxpayers were concerned because there were two sales here—one for the disposition of the building due to the fire and then the later sale of raw land. The ruling notes that §121 can apply to a separate sale of raw land and the remainder of a residence. The ruling notes:

> Section 1.121-1(b)(3)(i) addresses when gain from a sale of land is excluded under § 121. Although Taxpayers sale of land is not a sale of vacant land as described in § 1. 121-1(b)(3) (§ 1.121-1(b)(3) addresses the sale of property adjacent to the dwelling unit whereas the land sold by Taxpayers is the actual property on which the dwelling unit was located), it is reasonable to apply those same requirements to a sale of vacant land on which the dwelling unit was actually located. Here, Taxpayers meet the requirements in § 1.121-1(b)(3)(i) on the sale of their land and gain from the sale is excluded as provided in § 121. The destruction of the dwelling unit and subsequent receipt of insurance proceeds in the taxable year before the land sale qualifies as a sale or exchange of the dwelling unit within 2 years of the land sale as described in § 1.121-1(b)(3). In addition, Taxpayers meet the other requirements of § 121 with respect to the land. Taxpayer 1 purchased Property 1 on Date 1 and owned the underlying land until Date 9. Thus, Taxpayer 1 met the ownership requirement under § 121(b)(2)(A)(i) for the land. Both Taxpayers resided on Property 1 as their principal residence from Year 1 until Date 3. Therefore both spouses met the use requirement of § 121(b)(2)(A)(ii) for the land. Finally, Taxpayers assert that neither spouse is ineligible for the benefits under § 121(a) because neither spouse applied § 121 to a sale within two years of the sale of Property 1. The sale or exchange of the dwelling unit and the land, although occurring in different taxable years, are treated as one sale or exchange for purposes of § 121(b)(3). See § 1.121-1(b)(3)(B).
>
> In addition, under § 1.121-1(b)(3)(ii)(A), in applying the maximum limitation amount under § 121 to sales or exchanges of a dwelling unit in one year and land that qualifies for the exclusion under § 121 in a subsequent taxable year, gain from the sale or exchange of the dwelling unit is excluded first. Gain on the sale of the land is then excluded only to the extent of the maximum limitation amount applicable to the taxpayer, minus the gain excluded on the sale of the dwelling unit.[12]

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[12] PLR 201944006, p. 4

Thus, the ruling concludes that the gain exclusion not yet used following the sale of the residence is available in this case to be used for the sale of the land:

> Here, Taxpayers sold the dwelling unit on Property 1 in Year 2 and sold the land on which the dwelling unit was located before its destruction on Date 9. Therefore, the gain excluded under § 121 on the sale of the land is the difference between the maximum limitation amount applicable to Taxpayers and the gain excluded under § 121 in the Year 2 sale of the dwelling unit.[13]

The ruling also points out that the IRS had previously ruled it is possible for both §121 and §1031 to apply to the same transaction:

> The issue of whether § 121 and § 1031 may apply to the same transfer of property was addressed in Rev. Proc. 2005-14, 2005-1 C.B. 528. The revenue procedure provides that a transfer of property qualifying for the § 121 exclusion may also qualify for nonrecognition under § 1031, provided that the requirements of § 1031(a) are met with respect to the transfer.[14]

Thus, the IRS also rules:

> Taxpayers represent that they held Property 1 as investment property from around Date 5 until Date 9. Therefore, Taxpayers held Property 1 for investment, as described in § 1031(a), prior to its transfer on Date 9. Under Rev. Proc. 2005-14, a transfer of property qualifying for the § 121 exclusion may also qualify for nonrecognition under § 1031, provided all the requirements of § 1031are met with respect to the transfer. The fact that Taxpayers exclude gain under § 121 on the sale or exchange of Property 1, does not preclude them from deferring all or a portion of the remainder of the gain, if any, under § 1031.[15]

While the ruling doesn't explain the exact method to be used for such reporting, Rev. Proc. 2005-14 itself provides the mechanics of recording such a combined §121/§1031 transaction. Section 4.02 of that procedure provides:

> **.02 Computation of gain**.
>
> **(1) Application of § 121 before § 1031.** Section 121 must be applied to gain realized before applying § 1031.

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[13] PLR 201944006, pp. 4-5

[14] PLR 201944006, p. 4

[15] PLR 201944006, p. 5

(2) Application of § 1031 to gain attributable to depreciation. Under § 121(d)(6), the § 121 exclusion does not apply to gain attributable to depreciation deductions for periods after May 6, 1997, claimed with respect to the business or investment portion of a residence. However, § 1031 may apply to such gain.

(3) Treatment of boot. In applying § 1031, cash or other non-like kind property (boot) received in exchange for property used in the taxpayer's trade or business or held for investment (the relinquished business property), is taken into account only to the extent the boot exceeds the gain excluded under § 121 with respect to the relinquished business property.

.03 Computation of basis. In determining the basis of the property received in the exchange to be used in the taxpayer's trade or business or held for investment (the replacement business property), any gain excluded under § 121 is treated as gain recognized by the taxpayer. Thus, under § 1031(d), the basis of the replacement business property is increased by any gain attributable to the relinquished business property that is excluded under § 121.[16]

SECTION: 199A
PARTNERSHIP DRAFT 2019 INSTRUCTIONS ADD SAME §199A STATEMENTS AS WERE ADDED FOR S CORPORATIONS

Citation: Draft Instructions for 2019 Form 1065 and K-1, 10/30/19

The IRS has released the drafts of instructions for Form 1065[17] and Schedule K-1 Form 1065.[18]

The Form 1065 draft instructions describe the following new items on the 2019 forms in the "What's New" section:

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[16] Rev. Proc. 2005-14, Section 4.02

[17] https://www.irs.gov/pub/irs-dft/i1065--dft.pdf, October 29, 2019, retrieved November 2, 2019

[18] https://www.irs.gov/pub/irs-dft/i1065--dft.pdf, October 30, 2019, retrieved November 2, 2019

Schedule B

- New Question 27 has been added to Schedule B to enter the number of foreign partners that transferred all or part of their interests or received a distribution subject to section 864(c)(8).

- New Question 28 regarding disclosures for disguised sales has been added to Schedule B.

Schedule K

- Schedule K and Schedule K-1, line 4, Guaranteed payments, now has three lines: a. Guaranteed payments for services, b. Guaranteed payments for capital, and c. Total.

- Schedule K, lines 16(d) and (k), are reserved for future use because section 951A categories are no longer reported on Schedules K and K-1.

Schedule K-1

- Item E—A parenthetical has been added to caution against using the TIN of a disregarded entity.

- Item H—Has been revised to request the name and TIN of a disregarded entity, if applicable.

- Item J—A new checkbox has been added to indicate the sale of a partnership interest.

- Item K—A new checkbox has been added to indicate whether the liabilities shown in Item K include liabilities from lower-tier partnerships.

- Item L—Partner's capital accounts are now reported only on the tax basis method, and checkboxes to indicate other methods have been removed.

- Item N—A new item has been added for partner's share of unrecognized section 704(c) gain or (loss) at the beginning and the end of the year.

- Box 11—Code F will no longer be used for section 951A income. Instead, it will now be used for any net positive income effect from section 743(b) adjustments.

- Box 13—New code V has been added for any negative income effect from section 743(b) adjustments.
- Box 20—Codes Z through AD that were previously used to report section 199A information have been changed. Only code Z will be used to report section 199A information.
- Box 20—Code AA is used for the net income/loss effect for all section 704(c) adjustments.
- Box 20—Code AB is used for section 751 gain or loss from the sale of a partnership interest.
- Box 20—Code AC is used for any deemed gain or loss from section 1(h)(5) collectibles from the sale of a partnership interest.
- Box 20—Code AD is used for any deemed gain under section 1250 from the sale of a partnership interest.
- Box 20—Code AH, Other, includes net section 743(b) adjustment for partners with basis adjustments.
- Lines 21 and 22—These new lines have checkboxes to indicate that there are attachments to the Schedule K-1 related to the partnership having more than one activity for section 465 at-risk purposes, or more than one activity for section 469 passive activity purposes, or both.

The draft Schedule K-1, Form 1065 instructions contain the following details regarding changes to that form in the What's New section of these instructions:

> Changes on page 1.
>
> > **Item E.** The partner's social security number (SSN) or taxpayer identification number (TIN) is entered here. If the partner is a disregarded entity (DE), the SSN or TIN of the beneficial owner is entered, not that of the DE.
> >
> > **Item F.** This field contains the name and address of the person whose SSN or TIN is entered in item E.
> >
> > **Item H2.** A new checkbox has been added to indicate if the partner is a DE. If so, the TIN and name of the DE is entered in the spaces provided.

Item J. A new checkbox has been added to indicate if a decrease in the partner's ownership percentages of profit, loss, or capital is due in part or in whole to a sale or exchange of a portion or all of the partnership interest.

Item K. A new checkbox has been added to indicate if the partner's share of liabilities includes liability amounts from lower-tier partnerships.

Item L. The partner's capital account is shown using only tax basis.

Item N. This new item shows the partner's beginning and ending share of net unrecognized section 704(c) gain or (loss).

Line 4, and page 2, line 4. Guaranteed payments is now three lines: 4a Guaranteed payments for services, 4b Guaranteed payments for capital, 4c Total guaranteed payments.

New line 21. This new line provides a checkbox for the partnership to indicate if it has more than one activity for at-risk purposes.

New line 22. This new line provides a checkbox for the partnership to indicate if it has more than one activity for passive activity purposes.

Changes on page 2.

Boxes 11 and 16. Codes in boxes 11 and 16, that in 2018 were used for information concerning global intangible low-taxed income (GILTI) under section 951A, are reserved or repurposed. Information concerning GILTI will be provided to affected partners in statements attached to Schedules K-1 by the partnership.

Boxes 11 and 13. Code F in box 11 is used to indicate section 743(b) positive adjustments. Code V in box 13 is used to indicate section 743(b) negative adjustments.

Box 20. Codes Z, AA, AB, AC, AD. Code Z is section 199A information; code AA is section 704(c) information; code AB is section 751 gain (loss); code AC is section 1(h)(5) gain (loss); and code AD is section 1250 unrecaptured gain.

The instructions for Form 1065 contain the same three statements related to §199A that are to be provided with K-1s that are found in the draft Form 1120-S instructions for 2019. The statements begin with statement A that provides information on the trades or businesses of the partnership being reported to partners:

Statement A—QBI Pass-Through Entity Reporting

Partnership's name:		**Partnership's EIN:**	
Partner's name:	**Partner's identifying number:**		
	Trade or Business 1	**Trade or Business 2**	**Trade or Business 3**
	EIN:	EIN:	EIN:
Partner's share of:	☐ PTP ☐ Aggregated ☐ SSTB	☐ PTP ☐ Aggregated ☐ SSTB	☐ PTP ☐ Aggregated ☐ SSTB
QBI or qualified PTP items subject to partner-specific determinations:			
Ordinary business income (loss)			
Rental income (loss)			
Royalty income (loss)			
Section 1231 gain (loss)			
Other income (loss)			
Section 179 deduction			
Charitable contributions			
Other deductions			
W-2 wages			
UBIA of qualified property			
Section 199A dividends			

Statement B is provided when any aggregation elections are in effect at the partnership level:

Statement B—QBI Pass-Through Entity Aggregation Election(s)

Partnership's name: **Partnership's EIN:**

Trade or business aggregation 1*

Provide a description of the aggregated trades or businesses and an explanation of the factors met that allow the aggregation in accordance with Regulations section 1.199A-4. In addition, if the partnership holds a direct or indirect interest in a relevant pass-through entity (RPE) that aggregates multiple trades or businesses, attach a copy of the RPE's aggregations.

Has this trade or business aggregation changed from the prior year? This includes changes in the aggregation due to a trade or business being formed, acquired, or disposed of, or having ceased operations. If yes, explain.

* If the partnership has more than one aggregated group, attach additional Statements B. Name the additional aggregations 2, 3, 4, etc.

Statement C is provided when the partnership is a patron of an agricultural cooperative to report §199A(g) information.

Statement C—QBI Pass-Through Entity Reporting—Patrons of Specified Agricultural and Horticultural Cooperatives

Partnership's name:		**Partnership's EIN:**	
Partner's name:	**Partner's identifying number:**		
	Cooperative 1	**Cooperative 2**	**Cooperative 3**
	EIN:	EIN:	EIN:
Beneficiary's share of:	☐ PTP ☐ Aggregated ☐ SSTB	☐ PTP ☐ Aggregated ☐ SSTB	☐ PTP ☐ Aggregated ☐ SSTB
QBI items allocable to qualified payments subject to partner-specific determinations:			
Ordinary business income (loss)			
Rental income (loss)			
Royalty income (loss)			
Section 1231 gain (loss)			
Other income (loss)			
Section 179 deduction			
Charitable contributions			
Other deductions			
W-2 wages allocable to qualified payments			
Section 199A(g) deduction			

The instructions also contain the same flowchart to identify §199A qualified business income items:

Flowchart To Help Determine if Items Are Qualified Business Income

Questions	Yes	No
1. Is the item effectively connected with the conduct of a trade or business within the United States?	Continue to next question.	**Stop.** This item is not QBI.
2. Is the item attributable to a trade or business (this may include section 1231 gain/(loss), charitable contributions, section 179 deductions, interest from debt-financed distributions, etc.)? Examples of an item not considered attributable to the trade or business at the entity level include gambling income/(loss) where the entity is not engaged in the trade or business of gambling, income/(loss) from vacation properties when the entity is not in that trade or business, activities not engaged in for profit, etc.	Continue to next question.	**Stop.** This item is not QBI.
3. Is the item treated as a capital gain or loss under any provision of the Internal Revenue Code or is it a dividend or dividend equivalent?	**Stop.** This item is not QBI.	Continue to next question.
4. Is the item interest income other than interest income properly allocable to a trade or business? (Note that interest income attributable to an investment of working capital, reserves, or similar accounts is not properly allocable to a trade or business.)	**Stop.** This item is not QBI.	Continue to next question.
5. Is the item an annuity, other than an annuity received in connection with the trade or business?	**Stop.** This item is not QBI.	Continue to next question.
6. Is the item gain or loss from a commodities transaction or foreign currency gain or loss described in section 954(c)(1)(C) or (D)?	**Stop.** This item is not QBI.	Continue to next question.
7. Is the item gain or loss from a notional principal contract under section 954(c)(1)(F)?	**Stop.** This item is not QBI.	Continue to next question.
8. Is the item of income or loss from a qualified publicly traded partnership?	This item is a qualified PTP item. **Report this item as qualified PTP income or loss, subject to partner-specific determinations, and check the PTP box.**	This item is QBI. **Report this item as QBI subject to partner-specific determinations.**