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What's Ahead for State and Local Tax in Our New Work World

HOSTED BY

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Agenda

- State Nexus Trends
- Sales Tax Update and Considerations
- State Pass-Through Entity Tax (PTET) Elections

State Nexus Trends

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Telecommuting Employees

Administrative Considerations

- Employee Filing Obligations
- Human Resources
- Legal Counsel
- Payroll Taxes/Benefits
- Tax Department
- IT Department

Business Tax Considerations

- Nexus
- Income Tax
- Property Tax
- Sales/Use Tax
- Sourcing
- Credits & Incentives
- Financial Statements

History of Sales Tax Nexus

- Nexus is the minimum contact an entity must have for a state to impose a tax
  - Due Process Clause – Purposeful Availment
  - Commerce Clause – Substantial Nexus
- *Quill (1992)*
  - Supreme Court held that physical presence is required to meet the substantial nexus test under the Commerce Clause
- *Erosion of Quill*
  - Permanent physical presence was never the standard
  - Temporary presence through property, employees or independent contractors was sufficient to create physical presence
- *Wayfair (2018)*
  - On June 21, 2018, the U.S. Supreme Court overturned *Quill* – physical presence is no longer required to meet substantial nexus test
  - States responded quickly to this decision enacting economic nexus thresholds for remote sellers
    - "Remote seller" is not limited to online sellers
- ***Wayfair* does not replace the physical presence; rather, it simply says physical presence is not required to meet the substantial nexus test**

History of Income Tax Nexus

- Nexus is the minimum contact an entity must have for a state to impose a tax
  - Due Process Clause – Purposeful Availment
  - Commerce Clause – Substantial Nexus
- *Interstate Income Tax Act, P.L. 86-272 (1959)*
  - P.L. 86-272 protects a business from being subject to income taxes in the state if the only business activities by or on behalf of the business:
    1. Are solicitation
    2. Are sale of tangible personal property (TPP)
    3. Order approval or rejection occurs outside state
    4. Inventory is filled for shipment outside the state
- *Wrigley (1992)*
  - Wisconsin Court addressed limitations of solicitation and created a *de minimis* exception
- *Wayfair (2018)*
  - On June 21, 2018, the U.S. Supreme Court overturned *Quill* – physical presence is no longer required to meet substantial nexus test
  - States responded quickly to this decision enacting economic nexus thresholds for remote sellers
    - "Remote seller" is not limited to online sellers
- *MTC Revised Statement on P.L. 86-272 (2021)*
  - MTC updated income nexus guidance in response to *Wayfair* economic presence decision

P.L. 86-272 Traditional Considerations

Protected Activities

- Soliciting orders by advertising
- Passing on orders to the home office
- Carrying promotional materials for display or distribution
- Exhibiting at trade shows, so long as orders are not accepted or facilitated
- Recruiting or training sales personnel
- Salespeople using personal property, such as auto, cell phones, computers, computer software or a home office to carry out protected solicitation

Unprotected Activities

- Approving or accepting orders
- Maintaining a warehouse or inventory in state
- Maintaining a sales or technical office
- Providing warranty services or repairs
- Installation services
- Providing onsite technical assistance or service
- Conducting seminars or training courses on the technical use of a product
- Collecting on delinquent accounts
- Repossessing products
- Shipping or delivering goods by means of company owned trucks by most states

Income Tax Nexus Trend

Current Gross Receipts Thresholds

Alabama	$500,000
Alaska	$50,000
California	$637,252
Colorado	$500,000
Connecticut	$500,000
Hawaii	$100,000
Maine	$500,000
Massachusetts	$500,000
Michigan	$350,000

Nevada	$4,000,000
New York	$1,000,000
Ohio	$500,000
Oregon	$750,000
Pennsylvania	$500,000
Tennessee	$500,000
Texas	$500,000
Virginia	$1
Washington	$100,000

Revised MTC Statement on P.L. 86-272

- MTC adopted a revised Nexus Whitepaper on August 5, 2021
  - https://www.mtc.gov/Nexus-Program
- California adopted similar language on February 14, 2022
  - Technical Advice Memorandum 2022-01
- Updated guidance around when internet activities create nexus
  - Telecommuting employees' activities will be unprotected unless only soliciting sales of TPP or are entirely ancillary to soliciting sales of TPP
  - Independent contractors create nexus when they perform unprotected activities, such as warranty work or accepting returns

Revised MTC Statement on P.L. 86-272

Protected Activities

- Posting static FAQ to assist customers
- Internet cookies that are used ancillary to the solicitation of orders, such as to remember items in a shopping cart
- Offering tangible personal property for sale on a searchable website

Unprotected Activities

- Providing post-sales assistance through an electronic chat or email that customers access through the company's website
- Soliciting or receiving online credit card applications
- Inviting or accepting applications for employment through a web-based platform
- Internet cookies used to gather market or product research
- Transmitting code or electronic instructions via the internet to fix or upgrade products
- Offering or selling extended warranty services over the internet
- Contracting with a marketplace facilitator to house products or inventory or to fulfill orders
- Contracting with in-state customers to stream videos and music to electronic devices

Income Tax Considerations

- Nexus
  - New filing requirements
    - Don't miss city filing requirements
  - PL 86-272 impact
  - Audit Risk
    - Other tax filings
    - 1099s
    - Websites / LinkedIn
- Apportionment factor
  - Throwback sales impacted?
- Commercial domicile
  - If fully remote model adopted, how will business determine commercial domicile

Other SALT Considerations

- Property tax
  - New personal property tax registrations and filings may be required
    - What is company policy for expensing/capitalizing purchases
  - Elimination or reduction of real and/or personal property tax from eliminating office footprint
- Credits and incentives
  - Impacts on previously negotiated credits/incentives (e.g., job creation credits)
  - Claw-back provisions

Polling Question

Has your business received an audit or nexus questionnaire in the past year?

a. Yes, in process
b. Yes, but threw those letters away
c. No, we don't talk about nexus

Sales and Use Tax Update and Considerations

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Sales and Use Tax Considerations

- Nexus – P.L. 86-272 does not apply to sales taxes; employees or agents in the state generally create sales tax nexus unless a COVID-19 waiver
  - *Wayfair* threshold irrelevant if physical presence exists
- Sourcing of services
  - Work performed location – how to track
- Software, services and equipment may be "used" in new jurisdictions
  - May create use tax accruals and remittances in new states
- Administrative costs of compliance in new states
  - Do you need to automate
  - How will you determine taxability and rates
  - Obtaining and maintaining exemption certificates

Sales and Use Tax Trends

- Digital economy
  - Software as a Service
    - Service vs. tangible personal property
  - Digital goods/products
    - Delivery method (download vs. streaming) impacts the classification
    - Non-Fungible Tokens (NFTs)
  - Digital advertising
- Expansions to the tax base
- Exemption certificate scrutiny during diligence process
- Impacts of Inflation – The auditors are coming

Sales and Use Tax Audits

- Inflation has impacted consumer spending habits
  - Revenue dips will likely lead to increased audit activity
- States employ various methods to find taxpayers for audit
  - Information sharing between government agencies
  - Data mining
  - Customer audits
  - Online shopping carts
  - News stories
  - Inventory reviews
  - “Late” *Wayfair* registration
- It’s time to prepare

Sales and Use Tax Process Review

- Identify process owners for both order-to-cash and purchase-to-pay
- Classification of products and services
- Exemption certificate management
- Timeline for new registrations
- Compliance – Will you keep compliance in house or outsource?
- Evaluate if automation is right for you

Polling Question

Does your business have a procedure to collect exemption certificates from customers?

a. Yes, we dot all i’s and cross all t’s
b. No, I don’t need more busy work
c. Unsure, I didn’t realize that was a thing

State Pass-Through Entity Tax (PTET) Elections

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State PTET – Background

- 2018-2025
  - TCJA's individual $10,000 state and local tax deduction cap
- 2018-2020
  - 7 states react with a PTE
    - CT (mandatory), LA, MD, NJ, OK, RI, WI
- 2020
  - IRS Notice 2020-75 provides guidance on state PTET
- Present
  - 22 states offer PTE option
    - AL, AR, AZ, CA, CO, GA, ID, IL, KS, MA, MI, MN, MO, MS, NM, NY, NC, OH, OR, SC, UT, VA
  - Legislative increase to $10,000 cap would impact many state elections

State PTET – General Formula

- Tax burden placed on entity vs. the owner
  - Creates federal deduction for the entity vs. distribution to owners (itemized deduction limitation)
  - Credit received by owner to offset owner’s partial state obligation
  - May eliminate owner state filing obligation
- Primarily a federal tax savings opportunity
  - Net benefit received dependent on entity’s state filings and owner’s residency
  - Reduced by state compliance obligations
    - Can lead to additional state filings, state income, state tax payments
    - Entity restructuring to consider

State PTET – Considerations Before Electing

- Federal considerations
  - Reliance on IRS Notice and legislative action regarding the $10,000 cap
  - Is the PTET an entity election or owner-by-owner election?
  - Will PTET create an ordinary income deduction = ordinary income credit by the state?
  - What entity is making the election? Is planning or restructuring required?
- State considerations
  - Entity and owner state filing requirements likely to change
  - All or nothing owner selection?
  - Tax imposed on resident owner's total or apportioned income?
  - Credit to cover full or partial state liability for owner?

State PTET – Financial Statement Implications

- FASB ASC 740 and tax reporting may treat differently
  - Requires determination about whether the taxes paid by the entity are attributable to the owners or the entity
    - ASC 740 provides three examples to use for guidance in making the determination if the tax is actually an income tax on the entity or is a transaction with the owners
    - If the tax is a transaction with the owners, it is treated as a distribution of equity for financial statement purposes
    - If the tax is on the entity (and not attributable to the owners), it is treated similarly to other income taxes
- Items to consider
  - Does state PTET offer owners a state credit
  - Are owners required to report state sourced income previously included in a state PTET
  - Does state impose a hybrid PTE tax on both taxpayer and its owners
  - Timing recognition

State PTET – Financial Statement Implications

- Wisconsin PTE elected by checking a box on timely filed return for the taxable year, including extension
- Once elected, the PTE is taxed as a corporation and pays tax on its income in the state at a rate of 7.9%
- Income subject to tax includes 100% of PTE income for resident owners and apportioned and allocated income for nonresident owners
- The PTE is not allowed to take any credits, other than the credit for taxes paid to other states, and the PTE is not allowed to claim a net operating loss (NOL) deduction
- The owners, under this election, will exclude income subject to the Wisconsin PTET from their Wisconsin income
  - Pursuant to the examples in ASC 740, PTE owners making a Wisconsin PTET election will not receive a credit for taxes paid by the PTE
  - **However, if the PTE fails to make the payment under the election, the owners remain liable to pay the tax**
    - *It appears the PTET is attributable to the owners and will not be considered an income tax for ASC 740*
  - This tax will be considered a transaction with the owners for GAAP purposes, which will be treated as distributions on the financial statements
  - When the taxpayer files its federal income tax return, a book-to-tax difference will be required to report the ordinary deduction

State PTET – Tax Deduction Timing

- Michco is a calendar year-end S Corporation owned 100% by Bob
- Michco timely elects to file the 2021 Michigan pass-through entity tax
  - The election also binds Michco to the PTET for tax years 2022 and 2023
- 12/31/2021 – Michco "elects" into the 2021 PTE tax by making a $100 payment
- 03/15/2022 – Michco makes a $40,000 payment with PTET election for tax year 2021
- 03/31/2022 – Michco is granted a 2021 return extension
- 06/15/2022 – Michco timely files the Michigan PTE reporting $1 million of taxable income and makes a payment of $2,400 for the additional tax due

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- Assume Michco is an **accrual basis** taxpayer

2021

- Michco may deduct $40,100, *If payments meet IRC Sec 461 deductibility*
- Bob may take credit of $40,100

2022

- Michco may deduct $2,400
- Bob may take credit of $2,400

State PTET – Tax Deduction Timing

- 12/31/2021 – Michco “elects” into the 2021 PTE tax by making a $100 payment
- 03/15/2022 – Michco makes a $40,000 payment with PTET election for tax year 2021
- 03/31/2022 – Michco is granted a 2021 return extension
- 06/15/2022 – Michco timely files the Michigan PTE reporting $1 million of taxable income and makes a payment of $2,400 for the additional tax due
- Assume Michco is a **cash basis** taxpayer

2021

- Michco may deduct $100
- Bob may take credit of $40,100

2022

- Michco may deduct $42,400
- Bob may take credit of $2,400

Polling Question

Has your business made or contemplated a PTET election in 2021 or 2022?

a. Yes, mailed and delivered
b. No, been waiting for my state to pass PTET legislation
c. Unsure if this is worth my time

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State PTET – 2022 Ohio

- Election and due date
  - April 15 following the taxable year (with originally filed return) for calendar year taxpayers
- Rates
  - 2022 – 5%; following years 3%
  - Highest individual rate for 2021 totals 3.99% (3% for business income)
- Tax base is computed as:
  - Business income apportioned to Ohio
  - Nonbusiness income allocated to Ohio
- Estimated payments are required
  - Able to transfer previously paid estimates from Ohio composite or withholding to Ohio PTET

State PTET – 2022 Ohio

- Owner participation is likely all or nothing
- Nonresident withholding waived with a valid Ohio PTET election in place
- Provides refundable credit to owners
- Resident owner considerations
  - Required to report state addback for Ohio PTET paid on their behalf
  - BID deduction unavailable on Ohio PTET form
- Nonresident owner considerations
  - Optional individual filing requirement
  - Required to report state addback for Ohio PTET paid on their behalf
  - BID deduction unavailable on Ohio PTET Form
  - Resident state treatment of PTET and the ability to take a credit for taxes paid to other states

State PTET – 2021 New York

- Election and due date
  - Election - March 15 of the taxable year (same time Q1 estimated payment is due) for calendar year taxpayers, but was extended to September 15th for tax year 2022 only
  - 2022 and future NY election due dates – March 15 following the close of the taxable year
- Election is made by an authorized person through New York's Online Business Services account
- Includes all Article 22 owners (i.e., individuals, estates and trusts)
- The calculation **is different** for partnerships and S Corporations
  - Partnerships include New York source income for nonresident owners and entire portion of partnership income for resident owners
  - New York S Corporations include only New York source income for nonresident and resident shareholders
- Provides refundable credit to owners
- Return must be filed through New York's Online Business Services account, so PTEs will need to file this return themselves, and the return cannot be amended once filed!

State PTET – 2021 Michigan

- Election and due date
  - Election – March 15 of the taxable year for calendar year taxpayers
  - Due Date – March 31 of the following tax year for calendar year taxpayers
- Election is binding for three years and is made by making a payment through Michigan Treasury Online (MTO)
- Includes positive income for owners who are individuals, pass-through entities, estates and trusts
- Rate is equal to the individual income tax rate – currently 4.25%

- Tax base
  - Sourcing and apportionment is the same as the individual income tax rules in Part I of the Income Tax Act
  - Calculation of income is similar to the calculation of income tax for individuals
- Provides refundable credit to owners, including ultimate corporate owners in a tiered partnership structure
  - Timing of when the entity makes the payments dictates when the owner can claim the credit

Polling Question

Our business is contemplating an M&A transaction soon?

a. Yes, can't wait to stop working weekends pulling data requests
b. Soon, in next 6 months
c. Unsure, I am the last to know

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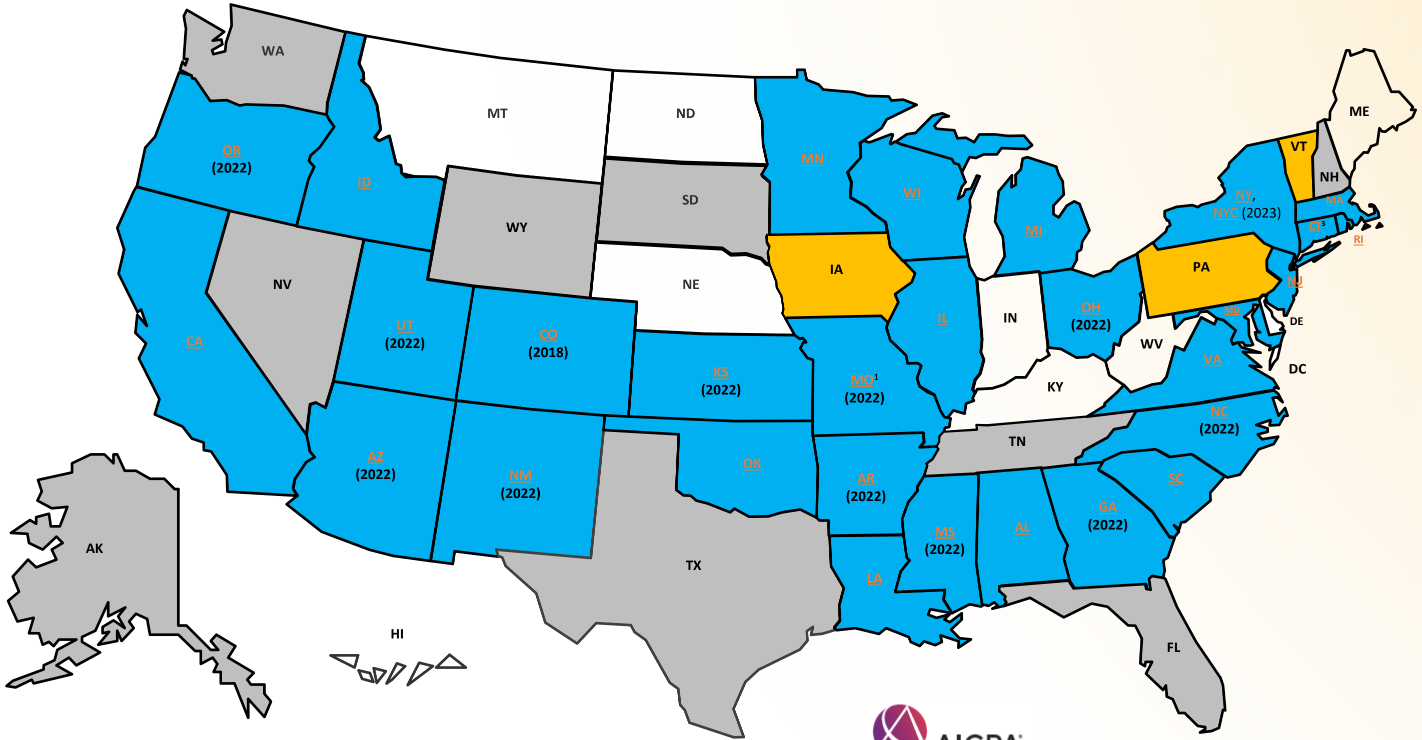
State PTET – Recent Developments

- New state elections for 2022
  - Arkansas, Arizona, Colorado, Georgia, Kansas, Mississippi, Missouri, North Carolina, New Mexico, Ohio, Oregon, Utah, New York City
- Alabama extends 2021 PTET election due date for certain taxpayers who missed online registration
- California modifies rules to broaden taxpayers qualifying for PTET elections and credit treatment
- Colorado amends PTET election to allow retroactive treatment back to tax year 2018
  - Previously owners excluded PTET income from Colorado personal return
  - Now the owners include PTET income but receive a credit for their portion of Colorado PTET paid
- Louisiana experiences extended delays in 2021 form release (similar to past years by MD and MI)
- New York extends 2022 PTET election due date to 9/15/2022
- New Jersey updates partnership tax base for resident owners included under a 2022 PTET election

States with Enacted or Proposed Pass-Through Entity Level Tax



As of July 19, 2022

- 29 states (& 1 locality) that enacted a PTE tax since TCJA SALT deduction limitation, effective for 2021 (or earlier) unless noted:

  AL, AR[1], AZ[1], CA, CO[2], CT[3], GA[1], ID, IL, KS[1], LA, MA, MI, MD, MN, MO[1], MS[1], NC[1], NJ, NM[1], NY, OH[1], OK, OR[1], RI, SC, UT[1], VA, WI, and NYC[1]

  [1] Effective in 2022 or later – on map (2022) or (2023)
  [2] Retroactive to 2018
  [3] Mandatory

- 3 states with proposed PTE tax bills:
  IA - HF 2087, session over, not enacted
  PA – HB 1709, in committee
  VT - H 0527 , session over, not enacted

- 9 states with no owner-level personal income tax on PTE income:

  AK, FL, NH, NV, SD, TN, TX, WA, WY

- 10 states with an owner-level personal income tax on PTE income that have not yet proposed or enacted PTE taxes:

  DE, HI, IN, KY, ME, MT, NE, ND, VT, WV

Thank you!

Please join us for the upcoming sessions:

August 10 – ASC 842: Is Your Software Up to the Challenge?
August 17 – STOP Tax Law Changes. Are you Ready?

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