2021 State & Local Tax Updates

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Agenda

1. Income Tax
   a. SALT Deduction Cap Workarounds a/k/a Pass-Through Entity Taxes
   b. Nexus Updates: Telework and Economic Nexus
   c. Key State Legislative Updates: Colorado, Washington, Wisconsin
   d. Apportionment Updates
2. Sales Tax
   a. Economic Nexus
   b. Nexus

Income tax


SALT deduction
cap workarounds

What is a SALT deduction cap workaround?

- For tax years beginning after 12/31/17 and before 1/1/26, the 2017 TCJA limits an individual's itemized deduction for state and local taxes (SALT) to $10,000
  - Includes income tax (or sales tax, if elected); real property tax; and personal property tax
- In response, many states have adopted pass-through entity taxes (PTET) intended to bypass, or work around, this SALT deduction limitation
- A PTET is a state income tax imposed directly on a pass-through entity (PTE)
  - It is deducted against the PTE's non-separately stated income (IRS Notice 2020-75, 11/9/20)
- It is designed to be tax-neutral for the electing state, through:
  - A credit on the owner's return for his/her share of the electing PTE's tax, or
  - A deduction on the owner's return for his/her share of the electing PTE's net income

When is a PTET election beneficial?

- PTET elections are generally beneficial when both of the following criteria are met:
  - The PTE files a tax return in a state who has enacted a PTET regime (called the “electing state”).
    - In general, the larger the PTE’s apportionment in the electing state, the larger the PTET liability… and the larger the federal deduction.
  - The PTE has one or more owners who are individuals that:
    - Reside in the electing state; or
    - Reside in another state that does either of the following:
      - Imposes an individual income tax, but permits its’ residents to claim credits for other states’ PTETs
        - Watch for “substantially similar” credit requirements (e.g., IL, NY)
      - Doesn’t impose an individual income tax

What are other key state-level considerations?

- Impact on nonresident filings
  - In some states (e.g., MN, WI), nonresidents need not file
  - In other states (e.g., NJ, NY), they must still file but can claim a PTE Tax credit
- Tiered structures
  - PTE's with owners who are themselves PTEs are still eligible in some states (e.g., New York), but not in others (e.g., Minnesota)
- Apportionment for resident PTE owners
  - Generally, not required (a good thing)
  - There are exceptions (e.g., Minnesota for all PTEs; New York for S corps)
- Nonresident owners with a mix of creditability/non-creditability
  - Consider "state tax equalization" agreements – effective but complex

Which states have PTE Taxes for 2021?

- Enacted:
  - Alabama (2021), Arizona (2022), Arkansas (2022), California (2021), Colorado (2022), Connecticut (2018), Georgia (2022), Idaho (2021), Illinois (2021), Louisiana (2019), Maryland (2020), Massachusetts (2021), Minnesota (2021), New Jersey (2020), New York (2021), North Carolina (2022); Oklahoma (2019), Oregon (2022), Rhode Island (2019), South Carolina (2021), and Wisconsin (2018 for S Corps, 2019 for Partnerships).
- Still under consideration:
  - Michigan (H.B. 5376, would be effective for tax year 2021).
  - Ohio (S.B. 246, would be effective for tax year 2022).

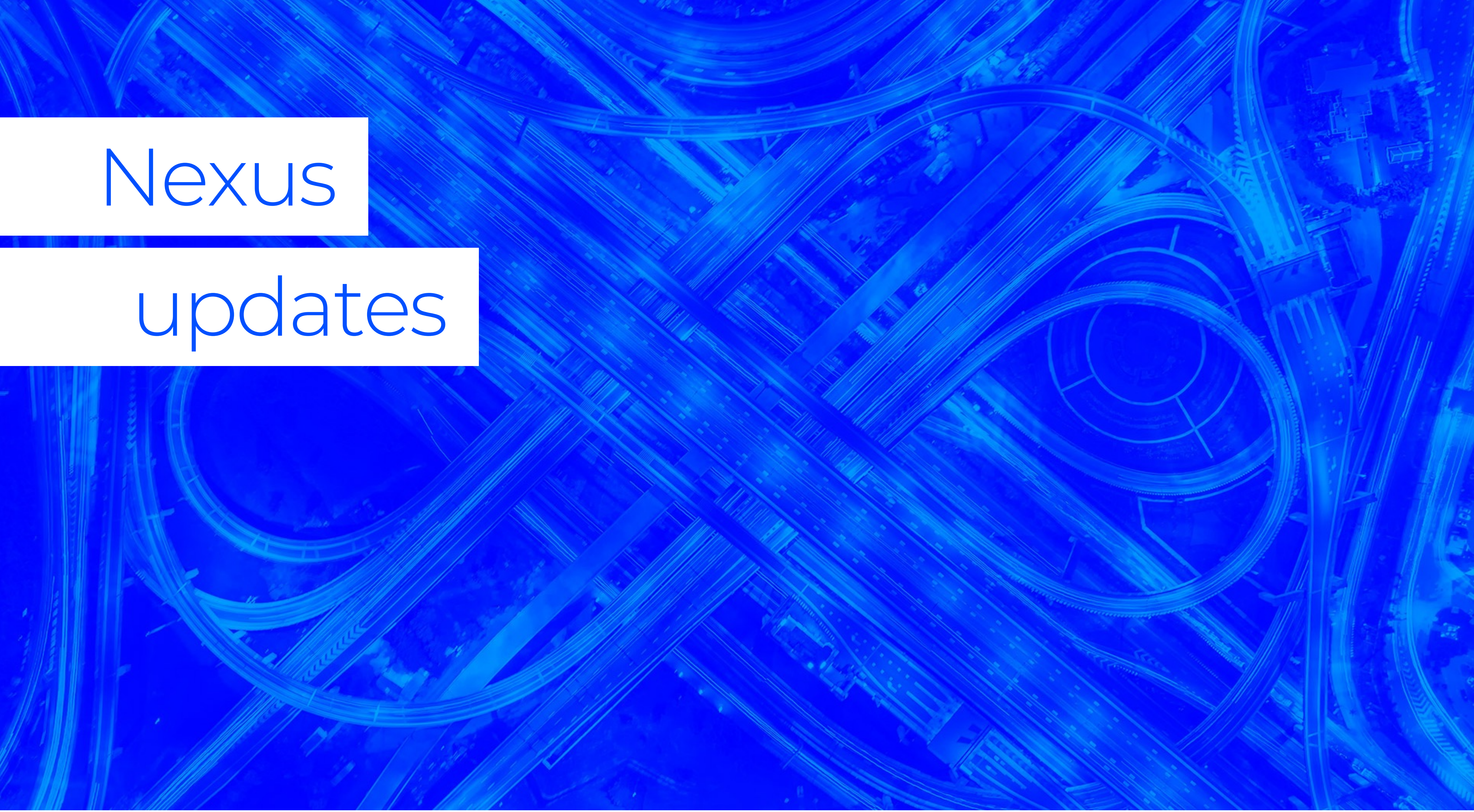
How might federal tax law changes affect state PTE Tax elections?

- In some states, the PTET election expires when the SALT deduction cap is repealed. In other states, the PTET election is not available if the PTE has no “capped” owners.
  - Such a limitation applies in some form in, e.g., CA, CO, IL, MA, MN, OR
- Under Nov. 11 House amendments made to the Build Back Better Act, the cap would be raised from $10,000 to $80,000 for tax years beginning after Dec. 31, 2020 (calendar 2021).
  - To illustrate: if enacted, this federal change could eliminate a PTE’s ability to make a 2021 MN PTET election if *none* of the PTE’s owners deducted <100% of their SALT on their 2021 Form 1040 Schedule A

Other Considerations / Next Steps

- Must a state's PTE Tax be paid during 2021 to get a 2021 fed deduction?
  - IRS Notice 2020-75 refers to PTEs getting a deduction for "the taxable year of payment" of a PTE tax
  - Hard to understand why PTE tax payments accrued in 2021 for an accrual basis PTE would not be deductible on the 2021 federal return, but until this issue is clarified it seems prudent to try to pay the proper PTE tax before the end of 2021
  - Creates urgency (by 12/31/21) to evaluate whether to make 2021 PTE tax elections
- Next steps
  - PTEs should evaluate whether the state(s) where they operate have enacted PTE taxes for the 2021 tax year, and likely decide by 12/31/21 whether to proceed (do modeling)
  - For states where a PTE Tax election is being sought, the PTE may have to make state PTE Tax payments *during 2021*
    - Potentially *in addition to* quarterly state estimated tax payments of its' owners

Nexus updates



Impact of telework

- Historically, few states addressed the nexus implications to employers of having an in-state, teleworking employee
- Due to the pandemic, some states announced temporary nexus safe harbors for such employees
  - See https://www.wipfli.com/insights/articles/tax-covid-state-tax-challenges-of-expanded-telework (last updated March 7, 2021)
- Most of these safe harbors have since been lifted (e.g., CA on 7/1/21), but some have been extended (e.g., SC to 12/31/21)
  - For the most up-to-date guidance, see the Hodgson Russ firm's matrix here: https://www.hodgsonruss.com/assets/htmldocuments/Telecommuting_5.22.20.pdf (last updated June 9, 2021)

Impact of telework (cont'd)

- Companies who dramatically increased their use of telework now face:
  - new payroll tax withholding obligations
  - new state unemployment insurance issues
  - new workers' compensation and related issues
- Employers need to adopt workable HR policies regarding which states employees are permitted to telework from
  - Otherwise, they risk unpleasant surprise state and local tax bills
- Consider the state and local tax impact of any "work from anywhere" policies

Economic nexus changes

- Wipfli's economic nexus matrix is always available here:
  - https://www.wipfli.com/insights/articles/tax-salt-economic-nexus-reporting-requirements
- Income/franchise/gross receipts tax changes :
  - California: 2021 sales threshold is $637,252 of California sales
  - Illinois (City of Chicago): $100,000 of total sales (effective July 1, 2021)
  - Maine: $500,000 of sales or 25% of total sales (effective 2022; only C corps)
    - Safe harbor for C corps with <$500K Maine sales (https://www.maine.gov/revenue/sites/maine.gov.revenue/files/inline-files/legischange21.pdf)
  - Pennsylvania (City of Allentown): $500,000 of sales (effective 2021)

Key state-specific tax law updates

Colorado: H.B. 21-1002 (Jan. 21, 2021)

- Colorado restored the state benefit of the CARES Act's retroactive provisions
  - For both individuals and corporations, this new law requires a "catch-up" subtraction on the return for tax years beginning on of after 1/1/21 but before 1/1/22 (generally, the 2021 calendar year).
  - See this article (published Jan. 27, 2021) for guidance: https://www.wipfli.com/insights/articles/tax-covid-19-colorado-restores-state-benefit-of-cares-act-provisions
- For QIP, Colorado conforms to the federal tax treatment for tax years ending on/after 3/27/20 (e.g., the 2021 calendar year).
  - See this CO-DOR publication (Aug. 2021) for guidance: https://tax.colorado.gov/sites/tax/files/documents/CARES_Act_Aug_2021.pdf

Colorado: H.B. 21-1311 (June 23, 2021)

- Individual income tax changes (all for tax year 2022)
  - Extends the Colorado limit on the Sec 199A deductions that are allowed for certain high-income taxpayers for an additional three years. Effective for tax years beginning on or after 1/1/21, but before 1/1/26.
  - Creates a limit on federal itemized deductions that are allowed for Colorado purposes for taxpayers with FAGI of $400,000 or more. Effective for tax years beginning on or after 1/1/22, the limit is set at $30,000 for taxpayers filing a single return and $60,000 for taxpayers filing a joint return.
  - Limits deductions for contributions to 529 Plans for tax years beginning on or after 1/1/22 to $20K per beneficiary for taxpayers filing a single return and $30K per beneficiary for taxpayers filing a joint return.
  - Provides that for tax years beginning on or after January 1, 2022, the qualified Colorado capital gain exclusion is limited to taxpayers with farming activity reported on federal Schedule F with qualified capital gains.

Washington: ESSB 5096 (5/4/21)

- Capital Gains Tax
  - Effective 1/1/22, Washington State enacted a tax on capital gains (Sec. 1221) at a flat 7% rate, on a WA resident's adjusted long-term capital gains allocated to WA.
    - This tax applies only to individuals, including owners of PTEs and DREs.
    - Deductions for (1) the first $250K of WA cap gains; (2) family-owned small biz.
  - There are several carve-outs, including gains from the sale or exchange of real estate, short-term capital gain assets, and depreciable/Sec 179 property.
  - Gain from IP: allocated to WA if seller was domiciled in WA at the time of the sale.
  - Gain from TPP: allocated to WA if (1) the TPP was in WA at any time during the current/prior tax year; (2) the seller was a WA resident at the time of the sale; and (3) the gain wasn't taxed in any other state.
  - Litigation has already started to challenge the validity of this tax.

Wisconsin

- PTE Tax Changes - 2021 Wis. Acts 1 and 2 (Feb. 18, 2021)
  - Tax-option (S) corporations that make the entity-level tax election under sec. 71.365(4m)(a), Wis. Stats., are entitled to or subject to the following:
    - The 30- or 60-percent LTCG exclusion under Wis. Stat. 71.05(6)(b)9. or 9m.
    - A capital loss deduction limitation of $500.
    - No underpayment interest for corps with no income or tax liability in the PY.
- Research Credit Changes - 2021 A.B. 68 (July 8, 2021)
  - For tax years beginning after December 31, 2020, up to 15% (increased from 10%) of the Wisconsin research expense credit is refundable.
- Individual income tax rate cut – 2021 A.B. 68 (July 8, 2021)

WI tax. inc. over	But not over	Old rate	New rate
$0	$15,960	3.54%	Same
$15,960	$31,910	4.65%	Same
$31,910	$351,310	6.27%	5.3%
$351,310	----	7.65%	Same

State apportionment changes

Recent changes – market-based sourcing

Tax Year First Effective	State(s)	Discussion
2019	Colorado, Indiana, New Jersey	
2020	Hawaii, Missouri, New Mexico, North Carolina, Vermont	
2021	New Hampshire	
2021 (retroactive to 2008)	Texas	• Market Sourcing regulations (34 TAC 3.591) adopted Jan. 2021 • In Sept. 2021, the Texas Supreme Court agreed to hear the appeal of the Texas Court of Appeals' May 2020 decision in *Sirius XM.* Oral arguments were scheduled for Nov. 30, 2021, and a final decision is expected in early 2022
2022	West Virginia	


C corporation
combined/consolidated
updates

C corporation filing method updates

- Tax Year 2019:
  - Kentucky and New Jersey (mandatory water's edge unitary combination)
- Tax Year 2020:
  - New Mexico (worldwide unitary combination as default; water's edge unitary combination or federal consolidated group as elections)
- Tax Year 2021:
  - Virginia required unitary questionnaires and pro forma calculations, threatening a $10,000 penalty for noncompliance… and then retroactively repealed the $10,000 penalty!
  - No new combined/consolidated filing requirements for tax year 2021

Sales and Use Tax

Economic nexus updates

Economic Nexus Updates

- It's been over three years since *Wayfair* (June 21, 2018)
- Florida
  - Enacted July 1, 2021
  - Exceeds $100,000 in taxable retail sales
- Kansas
  - Effective July 1, 2021
  - Adopts $100,000 threshold for remote sellers (previously, no threshold)
- Missouri
  - Enacted June 30, 2021; effective January 1, 2023
  - Exceeds $100,000 in taxable sales of tangible personal property
  - Requires MO-DOR to maintain a database of the boundaries for all of MO's 2,200+ local use tax jurisdictions, which is the main reason for the law's significantly-delayed effective date

Economic Nexus Updates

- Common Challenges
  - What are the sales thresholds (gross sales, taxable sales, retail sales)?
    - Thresholds varies by state and states that use the transaction test
    - Remember: https://www.wipfli.com/insights/articles/tax-salt-economic-nexus-reporting-requirements
  - Not charging and collecting the correct sales tax rate
  - Misconceptions on where sale takes place for sales tax purposes
    - Shipping terms (e.g., FOB) versus physical possession
  - How a transaction is taxed
    - Products and services separately stated on invoice
    - Combining labor and product as one line item on an invoice (i.e., bundled transaction)
    - Putting a system in place to track and retain sales tax exemption certificates

Prospective registrations post-*Wayfair*

Registrations After the Fact

- Many businesses still not in compliance despite *Wayfair* (6/21/18)
- Rush to register
  - Ignoring prior period risk
  - Statute of limitations for prior years doesn't toll where no returns have been filed
  - Consider impact on other tax types
  - "Date Began Business in the State" on SOS or tax registration forms
- States aggressively sending out nexus questionnaires shortly after registration is submitted
  - AZ, MN, UT, WI to name a few
- Applying interest and penalties
- Consider a voluntary disclosure agreement (VDA)

Thank you!

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