SALT – Wayfair Analysis

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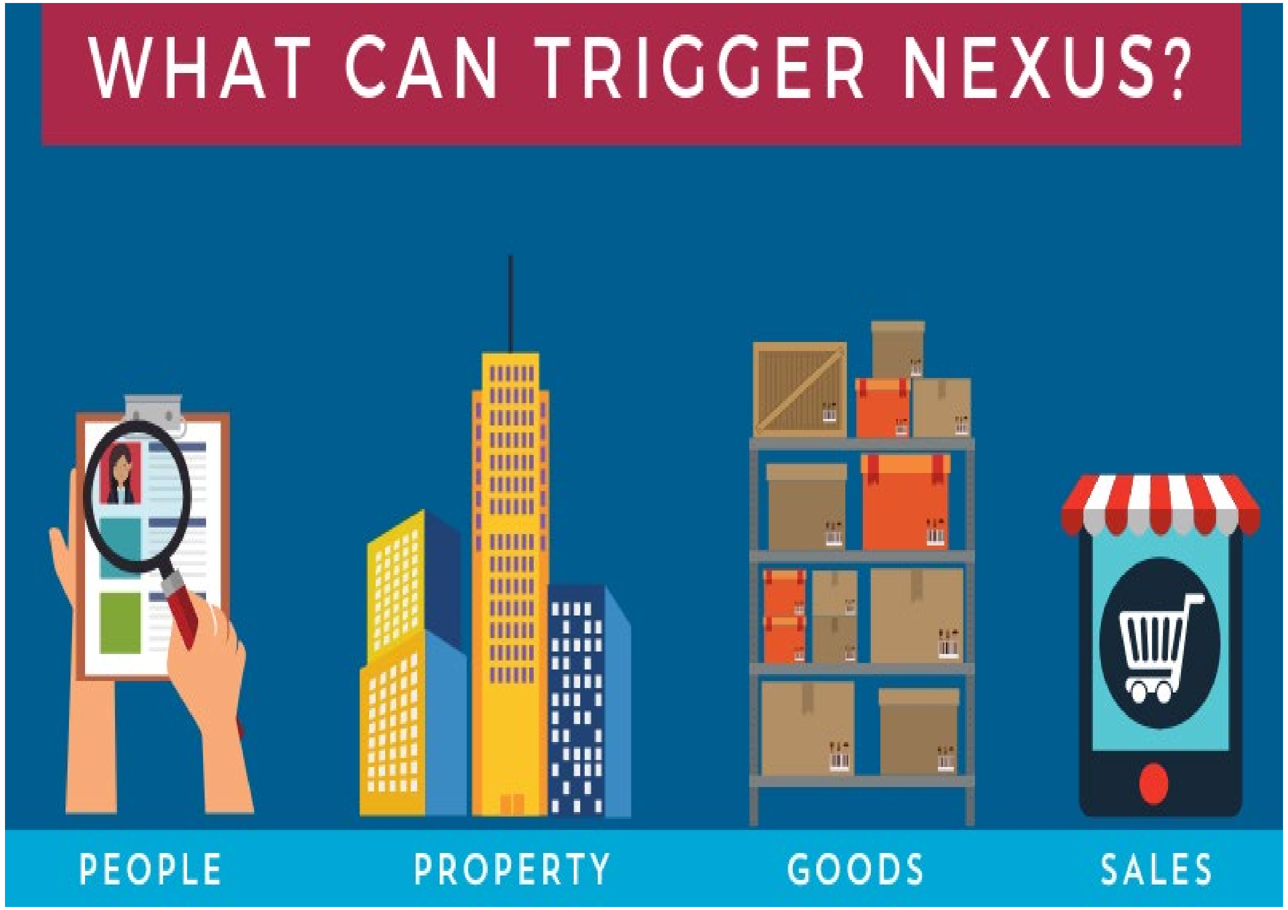
Nexus Defined

- “Nexus” describes the connection between a state and a business
- Having nexus allows a state to compel an out-of-state company to register and collect sales or use tax
- The out-of-state company must have “physical presence” – but that definition has changed in the Post-Wayfair world we live in today.



Pre-Wayfair and Physical Presence

- Quill v. North Dakota, 504 U.S. 298 (1992)
- Commerce Clause substantial nexus = physical presence
- National Bellas Hess v. Dept. of Revenue of Illinois, 386 U.S. 753 (1967)

Quill/National Bellas Cases (Physical Presence)

- The State of North Dakota filed an action in state court to force Quill Corp. (out-of-state mail order office equipment retailer) to pay tax to North Dakota when they were not physically located within the state.
- The Supreme Court ruled in favor of Quill Corporation that there was not substantial nexus.

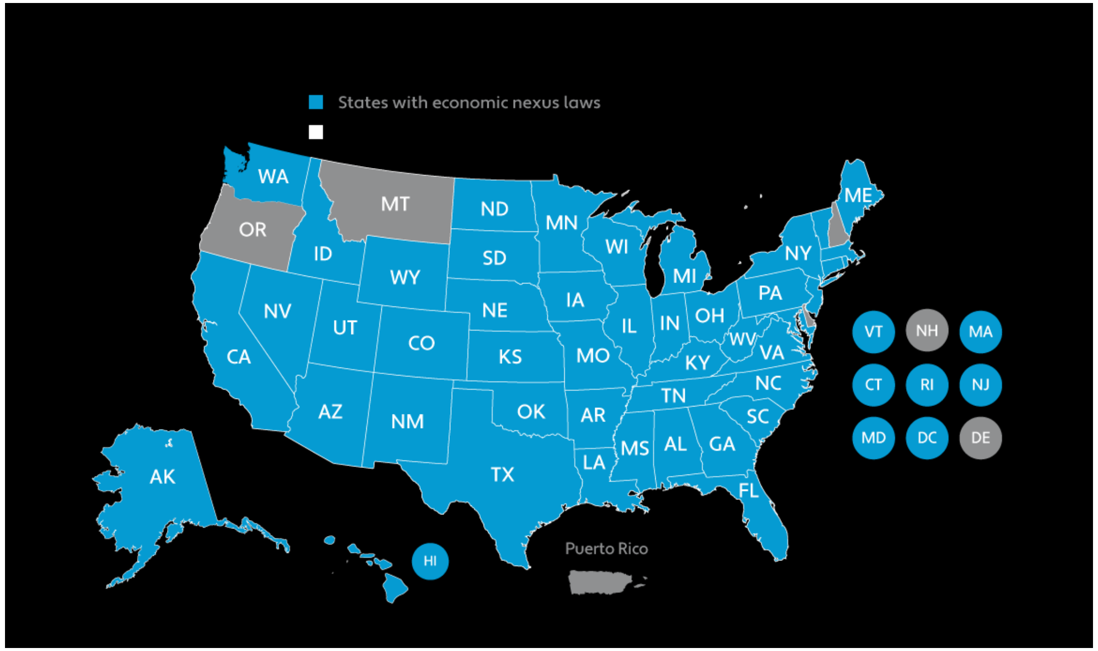
- The State of Illinois filed an action in Circuit Court to recover use tax/penalties from an out of state company who physically was never present within Illinois. The only solicitation was via mail and common carrier.
- The Supreme Court ruled in favor of the defendant on the grounds that there was no physical presence within the state of Illinois.

Wayfair Decision Background

- South Dakota asked the U.S. Supreme Court to overturn its long-standing physical presence rule (*Quill Corp. v. North Dakota*) for determining when a state can make remote sellers collect sales tax.
- **The Supreme Court ruled in favor of South Dakota on June 21, 2018.**
- South Dakota is granted authority to impose sales tax obligations on out-of-state transactions.

Wayfair Continued

- The ruling <u>adds</u> economic nexus to the existing list of nexus-creating activities.
- South Dakota's law applies to taxable sales made to consumers:
    - Does not change what is tax exempt
    - Will apply to service providers (not just tangible personal property) as South Dakota taxes many services
    - Will apply to manufacturers and wholesalers who sell direct to consumers



Wayfair Continued

- **Affected**: Remote sellers not currently registered with the state who meet threshold requirements. The thresholds vary from state to state. Many of the states adhere to a $100,000 threshold of sales or 200 separate transactions which would lead to economic nexus.
- **Impact**: States can now implement economic nexus laws – businesses don't need a physical presence to be required to collect & remit sales tax.
- *Most impactful is that the "physical presence" rule has been overturned.*

Post-Wayfair Decision 3 Years Later

- After the pandemic, many States are searching for additional tax revenues.
- Much of commerce takes place via the Internet (Amazon, Target, etc.)
- Many companies are still not in compliance with Wayfair.
- States are seeing non-compliance as an easy target.
- States are not lenient after 3 years Post-Wayfair.

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Marketplace Facilitators

- Definition: an entity that uses its own physical or electronic marketplace to facilitate sales between third-party buyers and sellers
- Limitations in System Capabilities
- Lack of Certainty in Marketplace Facilitator Laws
- Liability for Sales Taxes

- Determine how to calculate, bill, collect, and remit applicable taxes on behalf of marketplace sellers
- Maintain appropriate documentation
- Determine which actions to take and decision to make to limit exposure
- Create contracts and agreements with sellers to limit the impact of new legislation

Marketplace Facilitators Continued

- Nexus provisions vary from state to state
- Issues arise in regard to: does the marketplace have the legal liability to collect the tax?
- How are marketplace sales treated for purposes of determining whether the seller has exceeded a Wayfair threshold for direct sales outside of the marketplace?

Risk Mitigation

- Conduct Nexus Studies for Clients to determine exposure on a State-by-State basis.
- Register and back-file sales tax returns, with penalty waiver request
- Voluntary Disclosure
- Participate in tax amnesty
- Register and file prospectively only
- Create a centralized process to collect and store exemption certificates. Ensures a more simplified review process.
- Create a systematic approach to ensure awareness to legislation and cases within the court systems.

Example in Practice

- We have a client located in GA with Distributors located throughout the U.S.
- Conducted a thorough Nexus Study for the client
- Recognized that the initial agreement with client and customer needed revision because it presented an issue of joint and several liability.
- Advised that there should be a more centralized plan to manage the exemption certificates to customers.
- Sales Tax registration process is a comprehensive process.

State & Local Taxes Workaround

July 15, 2021

Nichols, Cauley & Associates

Background

- The Tax Cuts and Jobs Act of 2017 imposed a $10,000 limit on the deduction of state and local taxes (income taxes, general sales taxes, real property taxes, personal property taxes) at the individual level beginning December 31, 2017 through January 1, 2026.
- Otherwise known as the “SALT cap”
- Not for the deduction of foreign real property taxes
- For those individuals that itemize their deductions on Schedule A.

What is the SALT Workaround?

- Referred as the “PTE Workaround”
- Voluntarily elected (or mandatory depending on the state) to be taxed at the entity level to avoid the SALT cap at the individual level (Form 1040).
- A refundable credit based on taxes may be paid at the entity level can be claimed on the partner’s K-1 or the partner can decide to exclude their share of the taxes paid by the PTE on their state return **OR** the individual will not include the portion of income that the taxes are paid on. **(depends on the state)**
- Applicable to all pass-through entities (LLCs, Partnerships, and S-Corps).
- Election is irrevocable and made annually by the tax return filing due date, including extensions or by the first estimated payment due date **(will vary between states)**.

Before & After PTE Workaround

Before

- A $10,000 cap is imposed on state and local taxes at the individual business owner level.
- Those who reside in high tax states are unable to deduct most of their state and local taxes due to this limitation.

After

- The state and local taxes are paid at the PTE level.
- **Possibility #1:** Individual business owners are given a credit on their individual tax return (Form 1040) for the state and local taxes, which essentially gives the same effect as a regular tax deduction.
- **Possibility #2:** Individuals do not include the portion of income that the taxes are paid on.
- The individual business owner's state taxable income is reduced.
- States may have other state tax credit opportunities for the pass-through entities to take advantage in addition to the PTE Workaround.

States Involved

States that allowed PTE Workarounds:

- Idaho *(effective 1/1/2021)*
- Oklahoma *(effective 1/1/2022)*
- Arkansas *(effective 1/1/2022)*
- Louisiana *(effective 1/1/2022)*
- Alabama *(effective 1/1/2021)*
- Wisconsin *(effective 7/1/2020)*
- New York *(effective 1/1/2021)*
- Connecticut *(effective 1/1/2018)*
- Rhode Island *(effective 1/1/2019)*
- New Jersey *(effective 1/1/2020)*
- Georgia *(effective 1/1/2022)*
- South Carolina *(effective 1/1/2021)*
- Maryland *(effective 7/1/2020)*
- Colorado *(effective 1/1/2022)*
- Minnesota *(effective 1/1/2021)*
- Arizona *(effective 1/1/2022)*

States that have pending or no PTE Workarounds:

- California
- Delaware
- DC
- Hawaii
- Illinois
- Indiana
- Iowa
- Kansas
- Kentucky
- Maine
- North Carolina
- Massachusetts
- Michigan
- Mississippi
- Montana
- Nebraska
- New Mexico
- North Dakota
- Ohio
- Pennsylvania
- South Carolina
- Utah
- Vermont
- Virginia
- West Virginia

Case Study: Georgia

- Effective on or after January 1, 2022
- Elective each year by the filing date of the return, including any extensions granted
- Partnership/S-Corp will pay a 5.75% tax on its worldwide taxable income.
- Individuals do not recognize the portion of income that the taxes paid on and don't receive a tax credit for the taxes paid at the entity level.
- Can take advantage of at the PTE level:
  - Georgia Goal Scholarship Program tax credit as well (Georgia HB 149) - redirect up to 75% of the pass-through entity income
  - Georgia Rural Hospital Tax Credit (Reg. Sec. 560-7-8-.57(4)(d)) - state credit capped during January - June & no cap during July – December

Case Study: New York

- Effective on or after January 1, 2021
- Irrevocable annual election – needs to be made by the due date of the first estimated payment
- Partnership/S-Corp will pay a tiered tax rate based on its taxable income in a range of 6.85% - 10.9%.
- The business owner will receive a tax credit based on the state and local taxes paid by the business entity on a Schedule K-1.

Possible Issues of the PTE Workaround

- Multi state pass-through entities may have conflicting rules for members.
- Multi-state apportionment – financial information may not be accounted for on a state-by-state basis
- Tracking effective dates of elections – administrative burden for preparer & taxpayer
- State technical guidance may not be timely available for planning purposes.

Resources

- https://news.bloombergtax.com/daily-tax-report/salt-workarounds-spread-to-more-states-as-democrats-seek-repeal
- https://answerconnect.cch.com/topic/c327ee367d681000ba82005056881d2306/state-and-local-tax-deduction-limitation?searchId=724620651
- https://www.goalscholarship.org/about_goal/page/frequently-asked-questions
- https://answerconnect.cch.com/standalone_document/jga01a061815e7de11000a324000d3a8bba6b01/sec-48-7-23-georgia-taxation-of-partnerships-computation-of-net-income-disallowance-of-charitable-contributions-individual-liability-of-partners-individual-returns-of-distributive-shares-when-taxable-year-of-partner-differs-from-that-of-partnership
- https://answerconnect.cch.com/smartcharts?multistate=state
- https://answerconnect.cch.com/standalone_document/jny01c49504307ddf100090e7000d3a8abb4e01/sec-861-new-york-pass-through-entity-tax-election
- https://answerconnect.cch.com/topic/c327ee367d681000ba82005056881d2306/state-and-local-tax-deduction-limitation?searchId=734047085
- https://answerconnect.cch.com/standalone_document/jga016e5cc53c7dd31000afb1000d3a8daaf402/reg-sec-560-7-8-57-qualified-rural-hospital-organization-expense-tax-credit?searchId=734678504&disableHighlight=false

Circular 230

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