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State Tax Issues Impacting Manufacturers

Presented by:

Alex J. Nitka, CPA, Tax Partner

Mickel Pompeii, CPA, CDA, Tax Partner

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Tax Implications of Operating in Multiple States - Nexus

... The History

Commerce Clause - Supreme Court Cases

- National Bellas Hess (1967) - Requirement for some physical contact with the state and that state violated U.S. Constitution's Commerce Clause.
- Complete Auto Transit (1974) - Created a four-part test to determine if state taxes discriminate or unfairly burden interstate commerce.
- Quill Corporation (1992) - Supreme Court ruled that attempts to impose use tax on goods purchased from an out-of-state mail order seller without outlets or sales representatives violated the Commerce Clause.

... Quill Corporation vs. North Dakota (1992)

- Quill Corp. was an office supplies retailer incorporated in Delaware with offices and warehouses in multiple states, but none in North Dakota.
 - No employees worked or lived in North Dakota.
 - Little to no tangible personal property within the state.
 - \$200,000,000 Global revenue.
 - North Dakota sales:
 - Approximately \$1,000,000 worth of sales to approximately 3,000 customers.
 - Sixth largest vendor of office supplies in the state.
 - Delivers all merchandise by mail or common carrier.

... The History (cont.)

- The tax must:
 - Be related to an activity with substantial nexus;
 - Be fairly apportioned;
 - Not discriminate against interstate commerce; and
 - Be fairly related to the services provided by the state.

... Wayfair, Inc.

- Wayfair, Inc. is a merchant with no employees or real estate in South Dakota.
- Wayfair, Inc. is a leading online retailer of home goods and furniture and had net revenues of over \$14.1 billion last year.
- Wayfair, Inc. does not have nexus in South Dakota, but ships its goods directly to purchasers there.

... South Dakota vs. Wayfair, Inc. (2018)

- In 2016, South Dakota passed an economic presence statute that required out-of-state sellers to collect and remit sales tax if the seller had a specified level of activity in the state. This new standard applied if the business delivered more than \$100,000 of goods or services in South Dakota or engaged in 200 or more separate transactions in South Dakota in the current calendar year.
- On June 21, 2018, the Supreme Court of the U.S. handed down a historic decision in the sales and use tax nexus case South Dakota vs. Wayfair, Inc. The 5-4 ruling overturns physical presence standards upheld in previous cases, such as Quill vs. North Dakota (1992) and National Bellas Hess Inc. vs. Department of Revenue of Illinois (1967), where a business had to have a physical presence in the state for the state to impose sales and use tax collection obligations on the business.

... South Dakota vs. Wayfair, Inc. (2018) (cont.)

- The court overturns Quill.
 - “Quill is flawed on its own terms.”
 - “The physical presence rule is not a necessary interpretation of the requirement that a state tax must be “applied to an activity with a substantial nexus” with the taxing state.”
 - “Quill creates rather than resolves market distortions.

... South Dakota vs. Wayfair, Inc. (2018) (cont.)

- “It treats economically identical companies differently for arbitrary reasons. For example, a business that maintains a few items of inventory in a small warehouse in a state is required to collect and remit a tax on all of its sales in the state, while a seller with a pervasive internet presence is not subject to the same tax for the sales of the same items.”
- “Rejecting the physical presence rule is necessary to ensure that artificial competitive advantages are not created by this Court’s precedents.”

Poll Question

Does your company have substantial sales to other states?

A. Yes

B. No

... Impact of Wayfair

- Pre-Wayfair – businesses used physical presence (i.e., a satellite location or employees working) in a state to determine if substantial nexus was created to require filing sales taxes in a state.
- Post-Wayfair – All states with the exception of Missouri have imposed a bright-line sales or receipts nexus test for sales tax. These bright-line tests range from \$100,000 in annual sales to \$500,000 in annual sales depending on the specific state. Missouri will be adopting a bright-line test for tax years beginning on or after January 1, 2023.

... Impact of Wayfair – Sales Tax

- Establishing the nexus (connection) between a remote vendor and a taxing state allow the state to increase sales tax revenue by increasing collections by requiring sellers to do one or more of the following:
 - Collect sales tax from customers within the taxing state and pay it to the state.
 - Register with the taxing state.
 - Provide customer/sales data to the taxing state.

... Impact of Wayfair - Income and Franchise Tax

- As a result of Wayfair, some states have also established bright-line tests for gross receipts, payroll and property for the imposition of income and minimum franchise taxes. Currently 11 states use some type of bright-line tests to determine income and franchise tax nexus. For example, Connecticut applies a \$500,000 annual gross receipts requirement for out-of-state businesses to be required to file an income tax return (unless Public Law 86-272 applies). Several states apply a \$100,000 annual gross receipts requirement, while New York currently has the highest bright-line test for gross receipts at \$1,000,000.
- Each state's rules and regulations contain many caveats, and each situation should be fully analyzed on a company-by-company basis and a state-by-state basis.

•• P.L. 86-272 Out-of-State Income Tax vs. Franchise Tax

- P.L. 86-272 prevents states from taxing out-of-state companies on income when the company's activities in the state are limited to "mere solicitation of orders" for the sale of tangible personal property (i.e., manufactured goods). However, receipts from the sales of services or other intangible property are not protected by P.L. 86-272.
- P.L. 86-272 does not apply to franchise taxes, which are taxes imposed by certain states that are not based on income. Typically, they are determined on a different tax base such as assets, net worth, or sales.
- It is important to assess whether a business meets the requirements to file a franchise tax return, even if it is protected under P.L. 86-272.

Poll Question

Has your company considered the tax implications of doing business in other states?

A. Yes

B. No

... Internal Strategies to Promote Compliance

In the everchanging environment of state income, franchise and sales tax, being **proactive** is the best way to stay in compliance and avoid penalties.

1. Review state income, franchise and sales tax nexus obligations on **at-least** an annual basis. Many states are adopting bright-line tests for economic nexus and you may find your company having nexus based on newly adopted rules.
 - Change in tax legislation is constant – just because you didn't have nexus in a prior year, doesn't mean you don't have it currently.
 - Identify and prioritize based on risk and exposure.
 - Make sure to register – often it's not enough to just file returns.

•• Internal Strategies to Promote Compliance – (cont.)

2. Communication with your CPA or tax preparer. We need to know when you are doing business in new states, including increased sales, payroll or property in states. We know the rules and can help you navigate this complex environment.
 - We receive correspondence and email blasts directly from many states throughout the country to ensure we are at the forefront of tax law changes.
3. Automation, especially in the sales and use tax arena.
 - There are a number of software providers who have products to automate sales and use tax for both large and small manufacturers. This leads to increased accuracy, reduced risk and frees up employee time to work on other projects.

... What if I am not in Compliance?

Voluntary Disclosure and Compliance Programs

- Many states offer taxpayers the option to voluntarily participate in programs to make good on back taxes, as opposed to being caught in the future for failure to comply.
- The main benefit of these programs:
 - Taxpayers can sometimes pay in installments.
 - Penalties are generally forgiven (these can often be steep if caught).
 - May protect the business from tax liens.
 - Lookback periods may be limited.

... State Nexus Questionnaires

Nexus questionnaires are forms produced by states that are sent to businesses not currently filing income tax, franchise tax, and/or sales tax returns to obtain information concerning the out-of-state company's business activities and to determine whether those activities subject the company to nexus.

- Sent directly to the manufacturers, not to their tax preparers.
- These questionnaires often appear harmless but can have major tax consequences.
- Make sure the appropriate people are filling out the questionnaires and **always** have your CPA review the completed product before submitting with the state.
 - This is likely your first communication with the state and your opportunity to describe your business activities in the state.

Poll Question

Has your company been subject to a state income, franchise or sales/use tax audit in the last 24 months?

A. Yes

B. No

... New York State Pass Through Entity Tax Overview (PTET)

- On August 25, 2021, the New York State Department of Taxation and Finance released guidance (Technical Memorandum, TSB-M-21(1)C, (1)I) addressing a recently enacted optional pass-through entity tax (PTET) that partnerships and New York S corporations may elect to pay for tax years beginning on or after January 1, 2021.
- Entities that elect to be subject to the PTET will pay a graduated tax of up to 10.9% on their NYS taxable income at the entity level, while their individual partners, members, and shareholders will receive a refundable tax credit equal to the pro rata share of taxes paid by the electing entity.

New York State Pass Through Entity Tax (PTET) – (cont.)

Tax Rate Schedule:

Tax Rate Schedule	
If the PTE taxable income is:	then the PTET due is:
\$2 million or less	6.85% of PTE taxable income.
greater than \$2 million but less than or equal to \$5 million	\$137,000 plus 9.65% of the excess of PTE taxable income greater than \$2 million.
greater than \$5 million but less than or equal to \$25 million	\$426,500 plus 10.30% of the excess of PTE taxable income greater than \$5 million.
greater than \$25 million	\$2,486,500 plus 10.90% of the excess of PTE taxable income greater than \$25 million.

• New York State Pass Through Entity Tax (PTET) – (cont.)

Why would Taxpayers want to elect to pay a pass-through entity tax?

- The PTET is intended to provide a workaround to the Federal SALT cap that was enacted with the Tax Cuts and Jobs Act (TCJA) of 2017. The TCJA limited deductions for state and local income taxes to \$10,000, thus eliminating the deduction for state income taxes for the vast majority of manufacturers.
- The PTET will now effectively allow pass-through manufacturers to take a Federal income tax deduction for their state income taxes, which they were previously disallowed from taking.

... New York State PTET – Who Qualifies?

Eligible partnership: Any partnership [including a limited liability company (LLC) treated as a partnership for Federal income tax purposes] that has a filing requirement under Tax Law §658(c)(1) and is not a publicly traded partnership. A partnership is eligible to make the election even if it has partners that are not eligible for the PTET credit, including, but not limited to, corporate partners.

Eligible S corporation: Any New York S corporation (including an LLC treated as an S corporation for New York and federal income tax purposes) as defined by Tax Law §208.1-A that is subject to the fixed dollar minimum tax under Tax Law §209

... New York State PTET – Who Does Not Qualify?

C Corporations: Not eligible. Not a pass-through entity and are already allowed to deduct state income taxes at the Federal level.

Important Caveat: While Partnerships and New York S Corporations qualify to make the election, they cannot pass-through the PTET credit to certain partners/members/shareholders. These include:

- S Corporation partners of a partnership;

- C Corporation partners of a partnership; and

- Certain non-grantor style trusts.

... New York State PTET – Making the Election

- An eligible entity must elect to opt into the PTET online on an annual basis, and such election is irrevocable for the tax year it is made. The election must be made by an authorized person of the organization, which includes any member, partner, owner, or other individual with authority to bind the entity and sign tax returns. CPA's, are not considered an authorized person and therefore cannot make the election on the client's behalf.

2021 Election: Must be made by October 15, 2021.

2022 Election and Future Years: Must be made on or after January 1 but no later than March 15th.

Poll Question

Did your company make the New York State PTET election for the tax year ended December 31, 2021 (had to be made by October 15, 2021)?

- A. Yes
- B. No
- C. Not eligible – not a pass-through entity
- D. I've never heard of it before today

... New York State PTET – Estimated Tax Payments and Annual Returns

2021 Estimated Tax Payments: Estimated PTET payments are optional in 2021 and may be made prior to December 31, 2021.

Tax Planning Opportunity: Cash-basis manufacturers should compute their estimated PTET in December of 2021 and make an estimated tax payment by December 31, 2021, in order to receive an accelerated 2021 Federal income tax deduction.

Accrual-basis manufacturers can compute and accrue the PTET, and still receive the deduction in 2021 even though the tax will not be paid until 2022.

... New York State PTET – Estimated Tax Payments and Annual Returns

2022 and Future Estimated Tax Payments: Estimated tax payments must be made on a quarterly basis (due March 15, June 15, September 15 and December 15). Each payment should be equal to 25% of the required annual payment for the taxable year, which is the lesser of : 1) 90% of the current year tax; or 2) 100% of the prior year tax.

Annual PTET Returns: Electing entities **must** file an annual PTET return on or before March 15th of the following year. New York State has issued guidance on how the tax is computed, but we have not seen any tax returns as of yet.

- What if my PTET computes to a loss? The electing entity is still required to file a “no balance due” PTET return.

... New York State PTET – Claiming the Credit

Eligible taxpayers must claim their PTET credit on Form IT-653, *Pass-Through Entity Tax Credit*, and attach the form to their individual New York State income tax return. The PTET credit may not be claimed on group returns filed for nonresident partners (i.e., Form IT-203-GR) or nonresident shareholders of S corporations (i.e., Form IT-203-S). **Taxpayers with PTET credits exceeding the tax due for the year may get the excess credit refunded.**

NYS PTET – Example – S-Corporations

ABC Corporation has 3 owners		
Federal Taxable income is 1.2 million		
NYS sales apportionment is 87%		
Ownership % are as follows:		
A	40%	
B	35%	
C	25%	
Total	100%	

	Step 1.	Net PTET Income		1,200,000	
	Step 2.	Net PTET Income		1,200,000	
		Apportionment %		87%	
		PTET Income		1,044,000	
	Step 3.	PTET Income		1,044,000	
		Tax		6.85%	
				71,514	
	Step 4.		Ownership	Total Credit	Allocated Credit
		A	40%	71,514	28,606
		B	35%	71,514	25,030
		C	25%	71,514	17,879

•Note: The shareholders receive a combined Federal income tax deduction of \$71,514. Assuming they are in the 32% tax bracket, they would recognize Federal income tax savings of approximately \$23,000.

NYS PTET – Example – S-Corporations - Potential Pitfall

What if the majority of my products are being shipped to other states and do not constitute New York State sales? Let's look at the previous example but change the New York State sales apportionment percentage to 5% instead of 87%.

NYS PTET – Example – S-Corporations Potential Pitfall

ABC Corporation has 3 owners		
Federal Taxable income is 1.2 million		
NYS apportionment % is 5%		
Ownership % are as follows:		
A	40%	
B	35%	
C	25%	
Total	100%	

Step 1.	Net PTET Income		1,200,000	
Step 2.	Net PTET Income		1,200,000	
	Apportionment %		5%	
	PTET Income		60,000	
Step 3.	PTET Income		60,000	
	Tax		6.85%	
			4,110	
Step 4.		Ownership	Total Credit	Allocated Credit
	A	40%	4,110	1,644
	B	35%	4,110	1,439
	C	25%	4,110	1,028

•Note: The shareholders receive a combined Federal income tax deduction of only \$4,110 based on the decrease in apportionment. Assuming they are still in the 32% tax bracket, they would recognize Federal income tax savings of only approximately \$1,300.

... Pass-Through Entity Tax – Other State Considerations

New York State is not the only state implementing a pass-through entity level tax to circumvent the SALT cap. The following two slides show the other states that are implementing similar taxes in 2021 and 2022.

If you are doing business in a multi-state environment, you may want to consider elections in the following states, as well as New York State:

... Other States Currently with PTE Taxes

- Alabama – Elective PTE Tax effective 1/1/2021.
- Connecticut – Mandatory PTE Tax effective 1/1/2018.
- California – Elective PTE Tax effective 1/1/2021.
- Idaho – Elective PTE Tax effective 1/1/2021.
- Illinois – Elective PTE Tax effective 1/1/2021.
- Louisiana – Elective PTE Tax effective 1/1/2019.
- Maryland – Elective PTE Tax effective 1/1/2020.
- Massachusetts – Elective PTE Tax effective 1/1/2021.

... Other States Currently with PTE Taxes

- Minnesota – Elective PTE Tax effective 1/1/2021.
- New Jersey – Elective PTE Tax effective 1/1/2020.
- Oklahoma – Elective PTE Tax effective 1/1/2019.
- Oregon – Elective PTE Tax effective 1/1/2021.
- Rhode Island – Elective PTE Tax effective 1/1/2019.
- South Carolina – Elective PTE Tax effective 1/1/2020.
- Wisconsin – Elective PTE Tax effective 1/1/2019.

Other States with PTE Taxes Becoming Effective 1/1/2022

STATES WITH PTE TAX IN EFFECT AFTER TY2021

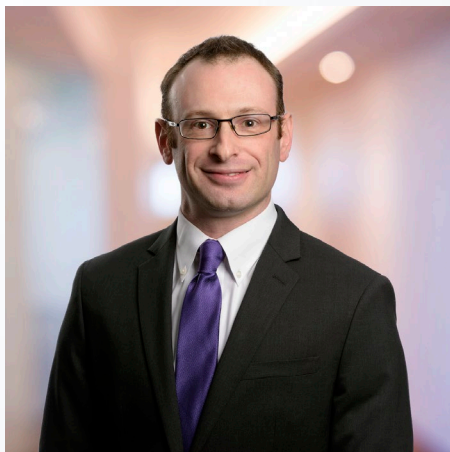
State	Effective Date	Election Due Date	Estimate Due Date	Return Due
Arizona	1/1/2022	On or before the due date or extended due date of return	4/15, 6/15, 9/15, 12/15 (pending)	3/15
Arkansas	1/1/2022	On or before the original or extended due date of the return	4/15, 6/15, 9/15, 1/15	4/15
Colorado	1/1/2022	4/15 (pending)	Pending	4/15 (pending)
Georgia	1/1/2022	On or before the original or extended due date of the return	Pending	3/15

•• What Happens to PTET if the SALT Cap is Eliminated?

New York State has not formally addressed this question, but other states such as California have it written into their PTE law. California's law automatically repeals itself if the Federal SALT cap is removed. I would imagine other states would follow suit, but we cannot be sure.

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- With our leading tax advisory services, we can identify and navigate nexus and other state and local sales tax compliance requirements and take advantage of the opportunities to save money.



Alex J. Nitka, CPA

Tax Partner

anitka@dmcpas.com



Mickel Pompeii, CPA, CDA

Tax Partner

mpompeii@dmcpas.com

DM Financial Plaza, 221 S. Warren St.
Syracuse, New York 13202

315-472-9127 | www.dmcpas.com

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