SALT in a changing world: Election 2020 impact

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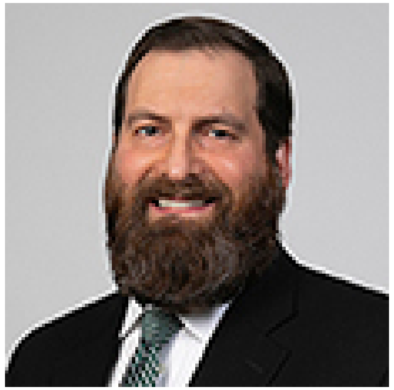
Your presenters



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Agenda

- Worker Mobility
- Public Law 86-272 and Nexus
- Section 118 and Government Incentives
- SALT Deduction and “Workarounds”
- Wrap-up with Prognostication

Worker Mobility

Worker Mobility

- Prior to the pandemic, the issue of worker mobility and employer withholding was being discussed by all stakeholders:
  - Nonresident employees.
  - Employers.
  - States.
  - Practitioners.
- Employers with multi-state employees must comply with various rules and thresholds for withholding.
  - Employee business travel.
  - Similar to retailers and sales tax compliance.
- Reciprocity agreements between states.
- Time and expense systems to track employees.
- Employers, risk and practical business decisions.

Worker Mobility

- Generally, wages reported to the state in which the employee primarily performs services and usually to one state per calendar year.
  - Easy case: employer has business operations in the state from which the employee works and the employee is a resident of the state.
  - Hard cases:
    1. Employer has business operations in multiple states and has nonresident employees working in those other states.
    2. “COVID-19 case” – employee wants to temporarily live in another state.
- Wage sourcing rules:
  - Localization of services
  - Base of operations
  - Direction and control
  - Residence

Worker Mobility

- In some states, such as Illinois, the tests for determining whether compensation is paid in the state under state income tax laws are substantially the same as those used to define employment under the state unemployment insurance laws.
- In Illinois, the primary test is localization.
  - If compensation is paid in Illinois because the service or work is localized in the state under the localization tests, then the place of the base of operations, the place from which the service is directed or controlled, and the number of working days spent in any state are irrelevant.
  - Illinois has adopted a 30 working day rule.

Worker Mobility

- Four approaches to nonresident employee withholding:

  1. No de minimis threshold for employer withholding.
  2. Number of day thresholds (e.g., 14 days).
  3. Long-term thresholds (e.g., 30 days or more).
  4. Wage based thresholds.

Remote Working and COVID-19

- On October 19, 2020, New York State issued guidance on its website for nonresident telecommuters:

  My primary office is inside New York State, but I am telecommuting from outside of the state due to the COVID-19 pandemic. Do I owe New York taxes on the income I earn while telecommuting?

  If you are a nonresident whose primary office is in New York State, your days telecommuting during the pandemic are considered days worked in the state unless your employer has established a bona fide employer office at your telecommuting location.

  There are a number of factors that determine whether your employer has established a bona fide employer office at your telecommuting location. In general, unless your employer specifically acted to establish a bona fide employer office at your telecommuting location, you will continue to owe New York State income tax on income earned while telecommuting.

- “Frequently Asked Questions about Filing Requirements, Residency, and Telecommuting for New York State Personal Income Tax.”

Remote Working and COVID-19

- Other states have issued guidance, for example:
  - Illinois
  - New Jersey
  - Pennsylvania
  - Massachusetts

Worker Mobility – Possible Federal Solution

- H.R.5674 - Mobile Workforce State Income Tax Simplification Act of 2020, introduced in Congress on 1/24/2020.

  "(a) IN GENERAL.—No part of the wages or other remuneration earned by an employee who performs employment duties in more than one State shall be subject to income tax in any State other than—

  (1) the State of the employee's residence; and

  (2) the State within which the employee is present and performing employment duties for more than 30 days during the calendar year in which the wages or other remuneration is earned."

  - Three categories of highly paid, highly mobile workers are not included under this legislation: professional athletes, professional entertainers, and certain prominent public figures.
  - Bi-partisan support.

Remote Working, Corporate Income Tax and COVID-19

- Some states have issued guidance that COVID-19 telework will not create nexus for corporate income tax. Examples:
  - California
  - Indiana
  - Massachusetts
  - New Jersey
  - Pennsylvania
- Caution: Some states have not waived nexus for sales tax. For example, on the list above, California has not issued guidance but Massachusetts has (no nexus for temporary telework during the pandemic).

Public Law 86-272 and Nexus

Public Law 86-272 and Nexus

- The Interstate Income Act of 1959, better known as Public Law 86-272 (codified at 15 U.S.C. § 381-384).
- No net income tax can be imposed by a state if the only business activities are solicitation of orders for sales of tangible personal property.
- Enacted in response to Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959).
- Commerce Clause: "The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes; . . . ." Article I, Section 8, Clause 3.

Public Law 86-272 and Nexus

- Impact of the U.S. Supreme Court decision in South Dakota v. Wayfair, 138 S. Ct. 2080 (2018).
  - Calls for Congressional regulation of state sales and use tax.
  - No action taken and internet sellers appear to be complying.
- Some practitioners and academics have recently said that P.L. 86-272 is unconstitutional.
  - Are they right?
  - Is there any chance the Supreme Court would rule P.L. 86-272 unconstitutional?

Public Law 86-272 and Nexus

- Should Congress step-in and repeal P.L. 86-272 and replace it with economic nexus?
- What would this look like?

Section 118 and Government Incentives

Section 118 and Government Incentives

Federal tax treatment of incentives before 2017 Tax Cuts and Jobs Act ("TCJA"):

- IRC Section 61(a): Gross income includes all income from whatever source derived, unless excluded by law.
- IRC Section 118(a): "In the case of a corporation, gross income does not include any contribution to the capital of the taxpayer."
- Treas. Reg. Sec. 1.118-1:

  "For example, the exclusion applies to the value of land or other property contributed to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities."

Section 118 and Government Incentives

Rules for the application of Section 118: U.S. v. Chicago, Burlington & Quincy R.R. Co.

1. The contribution must be a permanent part of the corporation’s working capital structure.
2. The payment cannot be in exchange for a direct benefit to the transferor.
3. The contribution must be bargained for.
4. The asset transferred must result in a benefit to the corporation in an amount commensurate with its value
5. The contributed property ordinarily will be used in a manner that ultimately generates income for the corporation.

- If the contribution of land, building, or money made by a governmental entity satisfies these rules, then it is excluded from gross income.
- BrokerTec Holdings Inc. v. Commissioner, U.S. Court of Appeals for the Third Circuit, involving a $56m New Jersey cash grant to attract the taxpayer to relocate from New York. The Court held that the grant was taxable income, not a contribution to capital, because there were no restrictions on the use of the cash by the state.

Section 118 and Government Incentives

Federal tax treatment of incentives <u>after</u> TCJA:

SEC. 13312. CERTAIN CONTRIBUTIONS BY GOVERNMENTAL ENTITIES NOT TREATED AS CONTRIBUTIONS TO CAPITAL.

(b) EXCEPTIONS.—For purposes of subsection (a), the term ‘contribution to the capital of the taxpayer’ does not include—

(1) any contribution in aid of construction or any other contribution as a customer or potential customer, and

(2) any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).

Effective 12/22/2017.

Section 118 and Government Incentives

Grants, Abatements, Rebates and Government Donations after 12/22/2017:

- In general, government monetary grants should be included as gross income for federal income tax purposes. Examples:
  - Cash grants.
  - Employee training allowance or grants.
  - Tax increment financing.
  - Government donations of land, buildings and other property (e.g., machinery and equipment) should be included as gross income for federal income tax purposes with tax basis equal to fair market value.

Section 118 and Government Incentives

- Policy issues behind the change to Section 118:
  - Economic development
  - Tax
- Thus far, little guidance from IRS.
- What are the chances that Congress will change taxation of incentives under Section 118?

SALT Deduction and “Workarounds”

SALT Deduction and "Workarounds"

- TCJA placed a $10k cap on the amount of state and local taxes ("SALT") that can be deducted under IRC Sec. 164(a).
  - Effective for tax years beginning after 12/31/2017 and before 1/1/2026.
  - Real and personal property taxes, income taxes, sales and use taxes.
- Proposed workarounds designed to provide federal deductions and state credits for contributions to:
  - State funds
  - Private charities
  - Private schools
- IRS promulgated regulations prohibiting those workarounds.
- Entity level pass-through deductions for partnerships and S corporations.

SALT Deduction and "Workarounds"

- IRS Notice 2020-75, "Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," issued on 11/09/2020.
- Per the IRS press release, "the proposed regulations will clarify that State and local income taxes imposed on and paid by a partnership or S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment, and therefore are not subject to the State and local tax deduction limitation for partners and shareholders who itemize deductions."
- Applicable to payments made on or after 11/09/2020 as well as payments made in a partnership or S corporation tax year ending after 12/31/2017 and before 11/09/2020.

SALT Deduction and "Workarounds"

- Authority cited by the Notice (see Section 2.02(2) on page 4):

> In enacting section 164(b)(6), Congress provided that "taxes imposed at the entity level, such as a business tax imposed on pass-through entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law." H.R. Rep. No. 115-466, at 260 n. 172 (2017).

- The IRS acknowledged that some jurisdictions that already enacted, and more are considering, the imposition of either mandatory or elective entity-level income taxes on partnerships and S corporations that do business in the jurisdiction or have income derived from or connected with sources within the jurisdiction.
- Usually the jurisdiction provides for a corresponding or offsetting, owner-level tax benefit, such as a full or partial credit, deduction, or exclusion.

SALT Deduction and "Workarounds"

- Seven states have adopted entity-level taxes:

Connecticut	New Jersey	Wisconsin
Louisiana	Oklahoma	
Maryland	Rhode Island	

- Key features:
  - Federal deduction at the entity level.
  - State credit at the partner level or exclude that portion of the income that was subject to the entity tax.
- Connecticut is the only state on the list above that is mandatory.

SALT Deduction and “Workarounds”

- Sounds great, but …
  - Which taxpayers would benefit from entity level tax paid?
    - Classic multi-state issue.
  - The credit mechanism should match – state should allow the entity level payment to apply to an individual income tax liability.
  - Multi-state businesses may have partners in a state with an entity level tax, but some of the partners might have little or no tax liability in that state.
  - What are the chances that more states will pass new tax laws?

SALT Deduction and "Workarounds"

- Complaints about disparate treatment because individuals and employees will be stuck with the $10k cap.
- Is there any chance that the IRS could change its position on the SALT workarounds that were developed previously?
  - E.g., donations to state funds, private schools, private charities.
  - But do those only help high income taxpayers at the expense of the working class families?

SALT Deduction and "Workarounds"

- New York's Optional Employer Compensation Expense Tax
  - Payroll tax workaround.
  - Employers can elect to pay an entity-level compensation expense tax and the employees receive a corresponding credit to offset their income tax liability.
- Is there any chance that the IRS will issue guidance on this type of workaround?

Wrap-Up and Prognostication

Wrap-up and Prognostication

- Will Congress repeal the $10k cap or otherwise make changes?
- Along with changes to the TCJA, such as the SALT deduction, Congress could introduce a comprehensive, bi-partisan package of reforms addressing worker mobility, state tax nexus, and government incentives, along with other tax and non-tax policy initiatives.
  - Which issues would each party need to “give” on?
    - Tax rates?
    - Minimum wage?
    - Child tax credits?
    - Many, many others…

Any questions?

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