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January 20, 2021

The Honorable Andrew M. Cuomo
Governor of New York State
NYS State Capitol Building
Albany, NY 12224

Re: *Report No. 1446 – Report on New York State's Potential Response to Internal Revenue Service Notice 2020-75 and the State's Resident Tax Credit*

Dear Governor Cuomo:

I am submitting herewith for your consideration a report of the New York State Bar Association's Tax Section addressing possible adoption of an entity level tax on partnerships and S corporations in response to recent IRS guidance allowing deductions for such taxes without limitation by the $10,000 cap on state and local tax deductions.

Thank you for your attention to this matter.

Respectfully submitted,

Andrew H Braiterman

Andrew H. Braiterman
Chair

Enclosure

cc:

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Report No. 1446

New York State Bar Association

Tax Section

Report on New York State's Potential Response to Internal Revenue Service Notice 2020-75 and the State's Resident Tax Credit

January 20, 2021

New York State Bar Association
Tax Section

Report on New York State's Potential Response to Internal Revenue Service Notice 2020-75 and the State's Resident Tax Credit[1]

Introduction

On November 9, 2020 the Internal Revenue Service (the "IRS") issued Notice 2020-75 (the "Notice"), which announced that the Department of the Treasury (the "Treasury") and the IRS intend to issue proposed regulations to clarify that state and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated federal taxable income or loss in the year of payment. In states and localities that adopt such entity level taxes, the Notice operates to permit partners in partnerships and shareholders of S corporations to avoid the $10,000 limitation on the federal state and local tax deduction, which was enacted as part of the Tax Cuts and Jobs Act of 2017.

This report focuses on: (i) the issuance of the Notice, including its contents and requirements; (ii) areas of consideration should New York choose to adopt an entity-level tax in response to the Notice; and (iii) the related issue of the application of New York's residence tax credit to entity-level taxes imposed by other jurisdictions. [2] The Tax Section expresses no opinion on the merits of the Notice or whether New York State should adopt an entity-level tax in conformity with the Notice.

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[1] The principal drafters of this report are Jack Trachtenberg, Jennifer S. White, and Zachary T. Akins. Helpful comments were received from Kimberly Blanchard, Andy Braiterman, James Brown, Robert Cassanos, Carl Erdmann, Peter Faber, Richard Goldstein, Stephen Land, Glenn Newman, Elliot Pisem, Stuart Rosow, Michael Schler and Irwin Slomka. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its individual members, the NYSBA Executive Committee of House of Delegates, or any other party.

[2] On January 19, 2021, New York Governor Andrew Cuomo announced the FY2022 Executive Budget, which includes a new voluntary pass-through entity tax designed to mitigate the impact of the SALT Deduction Limitation. This report was prepared prior to that announcement and prior to the release of the Executive Budget draft legislation and memorandum in support. Therefore, this report does not comment on the Governor's proposal.

Discussion

I. Notice 2020-75

a. Background

Section 164(a) of the Internal Revenue Code (the "IRC"), as applied to individuals, generally allows a deduction from federal taxable income for certain state and local, and foreign, (i) real property, (ii) personal property, and (iii) income, war profits, and excess profits taxes. The deduction is allowable in the year the taxes are paid or accrued. A "State or local tax" includes only a tax imposed by a state, a U.S. territory, a political subdivision of a state or U.S. possession, or the District of Columbia.[3]

The taxable income of a partnership is generally computed in the same manner as that of individuals.[4] The deduction provided in section 164(a) of the IRC is, however, disallowed with respect to taxes paid or accrued to foreign countries and U.S. possessions.[5] Section 702(a) of the IRC provides that when determining a partner's income tax, a partner is required to take into account the partner's distributive share of certain partnership items of income, gain, loss, deduction or credit, as well as non-separately computed income and loss. A partner must then separately take into account his or her distributive share of taxes paid or accrued to foreign countries and U.S. territories.[6] Similar rules apply to S corporations and their shareholders.[7]

b. The State and Local Tax Deduction Limitation

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[3] IRC § 164(b)(2).
[4] IRC § 703(a).
[5] IRC § 703(a)(2)(B).
[6] IRC § 701(a)(6).
[7] IRC §§ 1363(b)(1), (2); 1366(a)(1).

For tax years beginning after December 31, 2017 and before January 1, 2026, an individual's deduction under section 164(a) of the IRC is limited to $10,000 for the aggregate amount of the following state and local taxes paid during the calendar year: (i) real property taxes; (ii) personal property taxes; (iii) income, war profits, and excess profits taxes; and (iv) general sales taxes (hereinafter referred to as the "SALT Deduction Limitation").[8]

c. State Response to the SALT Deduction Limitation

To date, seven states have responded to the enactment of the SALT Deduction Limitation by enacting entity-level income taxes on partnerships (including limited liability companies taxable as partnerships), S corporations, and/or sole proprietorships. These states are: (i) Louisiana; (ii) Oklahoma; (iii) Rhode Island; (iv) Wisconsin; (v) New Jersey; (vi) Maryland; and (vii) Connecticut.[9] With the exception of Connecticut, the entity level taxes adopted by these states are elective. In Connecticut (where the entity level tax is mandatory) and in the other states where a flow-through entity or sole proprietorship elects to pay the entity level tax, the provisions adopted provide a corresponding owner-level tax benefit in the form of a deduction from the tax base or, alternatively, a partial or full tax credit. For example, in Wisconsin, partners of partnerships and shareholders of S corporations that elect into the state's entity level tax, who are subject to Wisconsin's individual income tax, may exclude items of income, gain, loss, etc. reported on their K-1s for federal purposes from their federal adjusted gross income in computing their Wisconsin adjusted gross income.[10] These mechanisms operate to shift the tax burden from the individual owners—where the state and local tax deduction would be subject to the $10,000 limitation—to the business entity, where the deduction remains uncapped. In addition, because the tax is reflected in

[8] IRC § 164(b)(6).

[9] *See* La Rev. Stat. § 42:287.732.2; Okla. Stat. tit. 68, §2355.1P-1 et seq.; R.I Gen. Laws §44-11-2.3; Wis. Stat. §71.05(6)(a)(14); N.J. Rev. Stat. §54A:12-3; Md. Code Ann., Tax-Gen. § 10-102.1; CT Gen Stat § 12-726.

[10] Similar mechanisms exist under Louisiana and Oklahoma law.

the owners' share of entity income, which in turn is reflected in the owners/ adjusted gross income, owners benefit regardless of whether they itemize deductions or claim the standard deduction.

The following chart summarizes these aspects of each state's entity level tax regime:

	Entity-Level Tax		**Mechanism for Owner Benefit**		
	Mandatory	**Elective**	**Full Credit**	**Partial Credit**	**Deduction**
Louisiana		X			X
Oklahoma		X			X
Rhode Island		X	X		
Wisconsin		X			X
New Jersey		X	X		
Maryland		X	X		
Connecticut	X			X	

d. <u>Federal Response to the SALT Deduction Limitation</u>

Until the issuance of the Notice, there was some uncertainty, due to the SALT Deduction Limitation, as to the extent to which the IRS would follow its longstanding policy of allowing state and local income taxes imposed and paid by a partnership or an S corporation on its income as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss in cases where the entity-level tax was elective or possibly in cases involving a full (as opposed to a partial) credit. The Notice provides that "Specified Income Tax Payments" are deductible by partnerships and S corporations in computing their non-separately stated income, and therefore are not subject to the SALT

Deduction Limitation in the case of an individual owner even where the tax is elective at the entity level and where there is a full credit to the partners.

A "Specified Income Tax Payment" is defined as any amount paid by a partnership or an S corporation to a State, political subdivision of a State, or the District of Columbia (any such jurisdiction hereinafter referred to as a "Domestic Jurisdiction") to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation. The definition does not include income taxes imposed by U.S. possessions or their political subdivisions. The Notice explicitly states that Specific Income Tax Payments include any amount paid by a partnership or an S corporation "without regard to whether the imposition of and liability for the income tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit." Specified Income Tax Payments made by a partnership or an S corporation do not constitute items of deduction that owners take into account separately when determining their own federal taxable income. Instead, Specified Income Payments are reflected in the owner's distributive or pro-rata share of non-separately stated income or loss. Accordingly, Specified Income Payments are not subject to the SALT Deduction Limitation.

The forthcoming proposed regulations will apply to Specified Income Tax Payments made on or after November 9, 2020. The regulations will also permit taxpayers to apply the rules described in the Notice to Specified Tax payments made in a taxable year of the partnership or S corporation ending after December 31, 2017 and made on or before November 9, 2020, so long as the payments were made to satisfy an income tax liability pursuant to a law enacted prior to November 9, 2020. Prior to issuance of the proposed regulations, taxpayers may rely on the provisions of the Notice with respect to Specified Income Tax Payments.

II. Areas of Consideration if an Entity-Level Tax is Proposed

As a preliminary matter, the Tax Section observes that the entity-level taxing regimes sanctioned by the Notice arguably benefit principally higher income individuals. Such individuals are more likely to claim substantial deductions and, as discussed below, a regime that includes partnership investment income could disproportionately benefit the wealthy, as opposed to middle- and lower-income taxpayers with little or no investment income. We also note that entity-level taxing regimes arguably create arbitrary distinctions between taxpayers at similar income levels (e.g., a lawyer who is a partner in a law firm versus an in-house lawyer who is an employee). On the other hand, an entity-level taxing regime would also provide benefits to small business owners, who may not be high-income individuals, that conduct their businesses through partnerships, multi-member LLCs or S corporations, and may be particularly likely to benefit from the ability to deduct their share of entity-level taxes in calculating their adjusted gross income while still being able to claim the standard deduction. Such a regime could also encourage higher income individuals and businesses conducted in pass-through form to stay in New York, thereby preserving the state's tax base. We do not here analyze these issues as they are beyond the scope of our report.

The above considerations aside, the Notice's broad reach gives wide latitude for New York to enact an entity-level tax that will be deductible, and not subject to the SALT Deduction Limitation, by an individual who is a partner or shareholder in the passthrough entity. Should New York choose to pursue such legislation, it may be elective or mandatory, and may provide a full credit, partial credit, or deduction to individual owners; we note in this regard that a partial credit could raise revenue for the state at no net cost to taxpayers. The Notice provides no limitation as to whether a credit must be refundable or be permitted to be carried forward. We note that one limitation specifically enumerated in the Notice is that New York may not impose a retroactive entity-level tax in order to circumvent the SALT Deduction Limitation in years prior to the enactment of the tax.

Notwithstanding the expansive leeway provided by the Notice, if New York State chooses to adopt an entity-level tax, we urge consideration to be given to the following points:

- S Corporations. The Notice explicitly covers partnerships (including limited liability companies taxable as partnerships) and S corporations, but *not* sole proprietorships. If New York's desire is to maximize the benefits to taxpayers in adopting an entity-level tax to mitigate the application of the SALT Deduction Limitation, any entity-level tax adopted by New York should apply to both partnerships and S corporations. In addition, the Tax Section believes that any entity-level tax adopted by New York should apply to S corporations to minimize artificial differences between entities and lessen the need for taxpayers to exercise self-help in terms of entity choice. As the Notice does not apply to sole proprietorships, an owner of a sole proprietorship would—if a New York entity-level tax applied to S Corporations—potentially be able to avail himself or herself of the benefits of such a regime by either creating a partnership with another individual or forming an S corporation. Failure to apply a New York entity-level tax to S corporations would create an artificial inequity in treatment as between partnerships and S corporations and would likely incentivize individuals to form partnerships that may be questionable as a matter of substance.

- Mandatory v. Elective. The Notice paves the way for New York to propose a mandatory or elective entity-level tax. If the goal of an entity-level tax is to maximize the deduction available to New York residents, a mandatory tax would help achieve this goal because it would require every entity with New York owners to pay the tax at the entity level. A mandatory tax could, however, be detrimental to nonresident owners if they are subject to tax on their flow-through income in their home state and their home state does not provide a credit for the entity-level taxes paid in New York. This may not be desirable since the incremental tax on the income of the nonresident partners could cause partnerships and S corporations subject to the entity-level tax to seek to move their business operations outside of New York.

An elective tax has its own set of benefits and drawbacks. Electivity permits flow-through entities with owners who are resident in multiple states to decide for themselves whether—based on the tax regimes of those states—it is in the entity's and the owners' best interest to elect into the entity-level tax. Given that some nonresident owners could be negatively impacted by the entity-level tax, it should be anticipated that some entities would elect out of a non-mandatory tax, thereby eliminating the benefits of the tax to the New York resident owners. Making the regime elective could also benefit entities with tax-exempt owners by permitting such entities to elect out of a regime that would impose tax at the entity level without resulting in any benefit to the tax-exempt owners; issues relating to tax-exempt owners are further discussed below.

Another, more complex option would be to impose a tax at the entity level, but permit the entity to elect out of part of the tax. For example, a partnership could elect to be subject to tax only on the portion of its income allocable to New York resident partners. The corresponding benefit of the entity-level tax would then be allocated proportionately to the partners whose share of income had been taxed at the entity level. In this regard, we note that the regulations under section 704(b) of the IRC dealing with creditable foreign tax expenses incurred by partnerships may provide a template for making such allocations.

Since the Notice sanctions full electivity, there may be reason to conclude that a regime with partial electivity at the entity level should also be permitted. We strongly caution, however, that a partial entity-level tax election may go beyond the scope of the Notice, thereby raising serious questions as to its validity. Such a regime (effectively providing for a partner-by-partner election) may be determined by the IRS to be a partner-level tax, and not an entity-level tax. Indeed, a tax imposed at the entity level that is based on the character of the different partners looks, in many respects, like a withholding tax. We also note that a partial election at the entity level likely would not work for S corporations, as it would not appear to be consistent with the one class of stock requirement of section 1361(b)(1)(D) of the IRC or the requirement of pro rata allocations under section 1366(a)(1).[11]

- Treatment of Investment Income. The Notice draws no distinction between entity-level taxes paid on different types of income, including ordinary business income, capital gains and losses, and

[11] We acknowledge that this limitation with respect to S corporations would create an incentive toward organizing businesses as partnerships, which we recognize may be inconsistent with our recommendation that artificial differences between entities should be minimized.

gains and losses from sales of exchanges of property described in IRC section 1231. To the extent New York intends to provide the greatest benefits accorded under the Notice to its taxpayers, all such income should be subject to an entity-level tax. On the other hand, it may also be worth exploring conformity with the New York City unincorporated business tax insofar as it exempts from taxation partnerships that engage solely in investment activities for their own account. This approach would not maximize the benefits of mitigating the SALT Deduction Limitation through an entity-level tax, but would minimize the issues discussed in this report for tax exempt entities and REITs, without requiring entity-level electivity.

While the Tax Section expresses no opinion on what types of income should be subject to an entity-level tax, we note that some may question whether it is appropriate for the benefits of an entity-level tax to extend to investment income. If applied to nonbusiness income, sophisticated individual investors could, for example, put all their securities into a partnership with their spouses and get the benefit of the Notice, whereas less sophisticated taxpayers with a few securities probably would not. Subjecting investment income to an entity-level tax would also raise questions about the types of activities that would establish nexus in New York and, once established, how the investment income would be allocated to New York.

To the extent that an entity-level tax is imposed on only certain types of income, the allocation of such income should be used to allocate the credit/deduction at the owner level. For example, if only business income is subject to tax, an owner's ownership percentage should be computed solely by reference to business income. Consider the following example: Assume a 5% entity-level tax on business income. A partnership has $100 of capital gain allocated under the partnership agreement to individual A, and $100 of business income allocated to individual B. The partnership would owe tax of $5 (5% of $100), and the owner credit would be allocated entirely to individual B.

- Tax-Exempt Entities and REITs. The benefits of an entity-level tax dissipate when an owner is a tax-exempt entity or a real estate investment trust. This is because the granting of a credit or tax base reduction at the owner level, in exchange for a tax at the entity level, provides no benefit to the owner. As discussed above, this problem could be minimized if the entity-level tax is elective. A refundable credit would also address the problem. Another approach would be to impose the entity-level tax only on income that would flow through to individuals and be subject to New York tax on the individual. This is the approach Connecticut took in the adoption of its entity-level tax. An alternative base could also be designed to alleviate some of the problems discussed above regarding the tax being mandatory or elective. For example, an entity-level tax could include an alternative base calculation that excludes income allocable to nonresident partners who live in states that do not give a credit for the entity-level taxes paid to New York. If New York's goal in adopting an entity-level tax is to maximize the benefits to its residents, this would achieve that goal while assuring that the entity is not forced into a position of creating a tax detriment for its nonresident owners. Like the approach of the tax being partially elective at the entity level, however, an alternative tax base that excludes income allocable to nonresidents and tax-exempt entities may go beyond the scope of the Notice and may not be valid. The approach would also likely not work for S corporation since it would appear to run afoul of the one class of stock requirement of IRC § 1361(b)(1)(D) and requirement of pro rata apportionment.
- Combined Reporting. Any proposed legislation should address the issue of combined reporting. For example, Connecticut's entity-level tax permits pass-through entities with common ownership (i.e., where more than 80% of the voting control is directly or indirectly owned by common owners) to file combined returns. Connecticut requires a combined return election to be made annually, and that all entities included in the combined return compute the tax using the same tax base.
- Credit Mechanism. If an entity-level tax is adopted, the legislation would need to include a set of rules for how a partner's or S corporation shareholder's credit for the entity-level taxes is computed.

The existing rules allowing New York City resident individuals to claim a New York City unincorporated business tax ("UBT") credit, and the rules allowing a partner in a partnership subject to the UBT to claim a UBT credit against its own UBT or New York City corporate income tax liability, could be looked to for guidance.

- Existing Partnership Filing Requirements. New York currently requires partnerships having income derived from New York sources to file partnership information returns (Form IT-204). Additionally, the partnership may file a separate group return for its electing nonresident partners (Form IT-203-GR), in which case those nonresident partners do not have to file New York State nonresident returns. The partnership must then list in its IT-204 the names and social security numbers of the electing partners included in the IT-203-GR. Although beyond the scope of this report, we note that if a mandatory entity-level tax were to be enacted (or in the case of an entity that opts into an elective entity-level tax), the existing requirement to file a Form IT-204 Partnership Return or an S Corporation Return, both information returns authorized under Tax Law § 658(c) may no longer be necessary, thereby easing the tax return filing burden of such entities. Under Connecticut's mandatory entity-level tax, for example, the state does not require partnerships subject to its entity-level tax to file both an entity tax return and a partnership information return.

III. New York State's Resident Tax Credit

New York, like other states that impose a personal income tax, taxes the worldwide income of its residents, regardless of whether the income is derived from sources within or outside its borders. Virtually all states that impose personal income taxes allow their residents a credit for income taxes paid to other states and their political subdivisions. New York is no exception.[12]

As states have begun to implement entity-level income taxes as a means of addressing the SALT Deduction Limitation, the question arises whether partners, limited liability company ("LLC") members,

[12] Tax Law § 620.

and S corporation shareholders are allowed resident credits for entity-level income taxes paid to other states. The answer largely depends on each state's laws. The Tax Section believes the Tax Law clearly requires the credit to be granted and, for a variety of policy reasons, encourages the state to make it clear that the credit is available.

a. New York's Current Form Instructions on Resident Credits for Entity-Level Tax Payments.

The Department's instructions to the 2019 and 2020 Form IT-112-R-I ("New York State Resident Credit") state that New York residents are not entitled to a resident credit for entity-level income taxes on partnerships or S corporations paid to other state or local jurisdictions. The instructions state:

> A shareholder of a subchapter S corporation or a partner in a partnership is not allowed a resident credit for any income tax imposed upon or payable by the S corporation or partnership to another state, local government, or the District of Columbia. However, a shareholder or partner is allowed a resident credit if taxes are calculated on the income of the S corporation or partnership, but are imposed upon and payable by the shareholder or partner.[13]

Denying a resident credit for income taxes imposed upon or payable by *an S corporation* to another state is consistent with the Tax Law.[14] It is our view, however, that denying a resident credit in the case of income taxes imposed upon or payable by a partnership to another state is contrary to the Tax Law. Indeed, the Department's resident credit form instructions for tax years prior to 2019 were silent as to entity-level income taxes paid by partnerships.[15]

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[13] New York State Department of Taxation and Finance, Instructions for Form IT-112-R-I, New York State Resident Credit 1 (2020); New York State Department of Taxation and Finance, Instructions for Form IT-112-R-I, New York State Resident Credit 1 (2019) (emphasis added).

[14] Section 620(d) of the Tax Law expressly denies a resident credit to a shareholder of an S corporation that paid entity-level income taxes to another state.

[15] New York State Department of Taxation and Finance, Instructions for Form IT-112-R-I, New York State Resident Credit 1 (2018); New York State Department of Taxation and Finance, Instructions for Form IT-112-R-I, New York State Resident Credit 1 (2017).

b. <u>The Statutory Requirements for the Resident Credit</u>.

The statutes governing the resident credit reside in Part II, Article 22, of the Tax Law. Section 620(a) provides as follows:

> (a) General. A resident shall be allowed a credit against the tax otherwise due under this article for any <u>income tax</u> imposed for the taxable year by another state of the United States, a political subdivision of such state, the District of Columbia or a province of Canada, upon <u>income both derived therefrom</u> and <u>subject to tax</u> under this article.[16]

The New York courts have interpreted section 620(a) as allowing a credit for entity-level income taxes paid to other states when a resident is required to add such taxes back to his or her federal adjusted gross income ("AGI") when computing New York AGI. *Matter of Smith v. State Tax Commission* involved a New York resident who received a distribution from a trust in 1974.[17] Prior to making the distribution, the trust paid Massachusetts fiduciary income taxes on the income used to make the distribution. The resident taxpayer included the distribution in her New York AGI.

On audit, the Department contended that the taxpayer was required to include the distribution and the taxes paid by the trust in her New York AGI. The taxpayer conceded that the entire distribution, inclusive of the taxes paid by the trust, was properly included in her AGI but contended that she was entitled to a credit under section 620(a) for the taxes the trust paid to Massachusetts.

Observing that the resident credit protects New York residents from having their income subjected to double taxation, the court explained that because the taxpayer was required to include the taxes paid by the trust in her New York AGI she "ha[d] borne the burden of paying the Massachusetts taxes."[18] And because she bore the burden of the Massachusetts income taxes, the court said the taxpayer "constructively paid 'income tax imposed for the taxable year by another state'" and was entitled to a

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[16] Tax Law § 620(a) (emphasis added).
[17] 120 AD2d 907, 908 (3d Dept 1986).
[18] *Id.* at 909.

credit under section 620(a).[19] The court concluded that "[t]he same criteria should apply to both computation of adjusted gross income and to the payment of out-of-State taxes directly from the trust."[20]

Smith thus confirms that, in the absence of a statute to the contrary, the inclusion of income taxes paid to another state in a resident taxpayer's New York AGI satisfies the taxpayer's burden of showing that he or she has paid "income tax imposed for the taxable year by another state" and is entitled to a credit under section 620(a). We note that the decision of the Supreme Court, Appellate Division, Third Department is precedential and binding upon the Department.

Pursuant to the Tax Law and New York case law, including *Smith*, a resident is allowed a credit under section 620(a) for income taxes paid by a separate entity to another state when the following four requirements are satisfied:

(1) The tax imposed by the other state must be considered an "income tax" for purposes of section 620(a);

(2) The income upon which the other state-imposed tax must be "derived from sources within another state" for purposes of section 620(a);

(3) The income upon which the other state imposed tax must be "subject to tax" under Article 22 of the Tax Law for purposes of section 620(a); and

(4) The credit for such taxes is not expressly disallowed under the Tax Law.

We discuss each of these requirements in turn.

First, section 620(a) requires that the tax imposed by another state constitute an "income tax." In *Matter of Baker*, the Tax Appeals Tribunal held that a tax paid to another state constitutes an "income tax" under section 620(a) if it is imposed on an income base.[21] The Tribunal also noted that the label

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[19] *Id.* (quoting Tax Law § 620(a)).

[20] Id. In 2014, the Legislature amended section 621(a) of the Tax Law to expressly allow a resident beneficiary of a trust whose New York AGI includes all or part of an accumulation distribution by such trust a credit for income taxes imposed on the trust by other state and local jurisdictions upon income both derived therefrom and subject to tax under Article 22 of the Tax Law. L.2014, c. 59, pt. I, § 3.

[21] *Matter of Baker*, DTA No. 805550, 1990 WL 169491, at *5 (N.Y. Tax App. Trib. Oct. 11, 1990).

given to a tax, even by the state that imposes it, is not controlling. The nature and effect of the tax are determinative.[22]

Second, section 620(a) requires that the income upon which the tax is imposed by the other state be "derived from sources within another state." According to the Department's regulations, "income derived from sources within another state" should be construed consistently with the definition of "derived from or connected with New York State sources" under section 631 of the Tax Law.[23] The effect of the regulation is to require the resident taxpayer to assume, solely for purposes of determining whether a state tax is "derived from sources within another state," that he or she is a nonresident and the separate entity is a New York entity and determine if the income in question would be "New York source income" under section 631.

Section 631(b) generally provides that items of income derived from or connected with New York sources are those items attributable to, among other things: (1) the ownership of any interest in real or tangible personal property in New York; (2) a business, trade, profession or occupation carried on in New York; and (3) income from intangible personal property, including annuities, dividends, interest, and gains from the disposition of intangible personal property, to the extent such income is from property employed in a business, trade, profession, or occupation carried on in New York.[24] The regulation interpreting the term "income derived from sources within another state" under section 620(a) provides additional color:

> [T]he resident credit against ordinary tax is allowable for income tax imposed by another jurisdiction upon compensation for personal services performed in the other jurisdiction, income from a business, trade or profession carried on in the other jurisdiction, and income from real or tangible personal property situated in the other jurisdiction. Conversely, the resident credit is not allowed for tax imposed by another jurisdiction upon income from intangibles, except where such income is from property employed in a business, trade or profession carried on in the other jurisdiction.[25]

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[22] *Id*. at *5-7.
[23] 20 NYCRR 120.4(d).
[24] Tax Law § 631(b)(1)(A), (B), (b)(2).
[25] 20 NYCRR 120.4(d).

Third, section 620(a) of the Tax Law requires that the income upon which an income tax is imposed by another state be "subject to tax under [Article 22 of the Tax Law]." Under the principle established in *Smith*, when a New York resident includes in his or her New York AGI income upon which tax was paid to another state, the income has been subjected to tax under Article 22. More to the point, if the entity-level income tax paid to another state is included in the resident's New York AGI (i.e., if there is an addback to AGI of the taxes paid), the resident is entitled to a credit under section 620(a).

Finally, a New York resident who satisfies the three requirements discussed above is entitled to a credit under section 620(a) only insofar as the credit is not expressly disallowed under the Tax Law. New York residents who are shareholders of S corporations are a case in point. Section 620(d) provides in relevant part: "In the case of a shareholder of an S corporation, the term 'income tax' in [section 620(a)] shall not include any such tax imposed upon or payable by the corporation."[26] In the absence of an express statutory disallowance like that in section 620(d) for S corporations, a New York resident is entitled to a credit under section 620(a) for entity-level income taxes paid to other states if the first three requirements above are satisfied.

c. The Department Should Clarify That the Resident Tax Credit Applies to Partnership-Level Taxes Paid to Other Jurisdictions.

In our view, the language in the Department's resident tax credit form instruction, disallowing credits to resident partners for entity-level income taxes paid by a partnership to other states, conflicts with New York law. If the four requirements described in the preceding section are satisfied, the Tax Law dictates that the resident partner is entitled to a credit for entity-level income taxes paid to another state by a partnership. The same goes for resident members of limited liability companies that are treated as partnerships for federal income tax purposes.

New York residents generally are required to add back "[i]ncome taxes imposed by [New York] or any other taxing jurisdiction, to the extent deductible in determining federal adjusted gross income and

[26] Tax Law § 620(d). At the same time, taxes imposed upon or payable by the S corporation that are paid to other states are excluded from the resident S corporation shareholder's New York AGI. Id. § 612(b)(3)(B).

not credited against federal income tax," to their federal AGI.[27] It appears well-settled that a New York resident partner is required to add back his or her distributive share of entity-level income taxes paid by a partnership and deducted on the partnership's return.[28] Under *Smith*, a resident partner who adds his or her distributive share of entity-level income taxes paid by a partnership back to his or her federal AGI satisfies the third requirement for obtaining a resident credit under section 620(a) of the Tax Law because the resident partner has borne the burden of "income tax imposed for the taxable year by another state."[29]

If the resident tax credit form instructions correctly reflect the Department's position, then by simultaneously requiring that the resident partner's distributive share of the partnership income taxes be added back in determining New York AGI and disallowing the credit for said taxes to the resident partner, the Department is all but ensuring that the partner's income will be subjected to double taxation. Should New York pursue legislation to adopt an entity-level tax as a means to mitigate the impact of the SALT Deduction Limitation, this risk of double taxation is crucial to consider. Specifically, if the resident tax credit is not provided, at least on a reciprocal basis (i.e., for entity-level taxes paid to jurisdictions that permit a similar credit), the risk of double taxation to some partners will cause some, if not most, partnerships with partners resident in multiple states to opt out of the various states' elective entity-level tax regimes. This would thwart the reason behind the adoption of such entity-level taxes and minimize the benefits of mitigating the SALT Deduction Limitation to New York taxpayers through an entity-level tax.

A simple hypothetical illustrates the problem. Assume that a New York partnership ("P") has two fifty-fifty partners ("A" and "B," respectively), both of whom are New York residents. P has

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[27] Tax Law § 612(b)(3)(A).

[28] See, e.g., Matter of Berardino v. State Tax Commission, 78 AD2d 936, 937 (3d Dept 1980) (requiring resident partner to add back his distributive share of New York City Unincorporated Business Income Tax paid and deducted by a partnership); Matter of Gould, File No. 26648, 1983 WL 20671 (N.Y. State Tax Comm'n Oct. 21, 1983) (same); Matter of O'Neill, File No. 27461, 1982 WL 20003 (N.Y. State Tax Comm'n Dec. 14, 1982) (holding that resident partner who added back his distributive share of District of Columbia Unincorporated Business Franchise Tax paid and deducted by partnership was not entitled to a resident credit where tax was later declared invalid and refunded to partnership).

[29] *Smith*, 120 AD2d at 909.

business operations in New York and New Jersey. For tax year 2020, P has a total of $3 million of gross income, $1 million of which was derived from or connected with sources within New Jersey. Assume further that P is the sole source of A and B's income.

New Jersey has an elective entity-level income tax on partnerships and S corporations, referred to as the Pass-Through Business Alternative Income Tax, which it enacted in 2019.[30] If P elects to be liable for and pay the tax, its New Jersey tax liability would be $63,087.50.[31] For New Jersey purposes, A and B would receive a refundable gross income tax credit for their respective shares of the New Jersey tax paid by P,[32] preventing the income from being subjected to double taxation in New Jersey.

As New York residents, A and B would be required to include in their New York AGI their distributive shares of P's income, or $1.5 million each.[33] According to the position reflected in the resident tax credit form instructions, however, A and B would not be permitted a resident credit for their distributive shares of the $63,087.50 of tax P paid to New Jersey even if they satisfied the four requirements under section 620(a) of the Tax Law. The result is that A and B's distributive shares of P's income earned in New Jersey would be taxed twice—once by New Jersey and a second time by New York. This is the very problem the resident credit was intended to resolve.[34]

We also note that any legislative proposal to adopt an entity-level tax as a means to mitigate the impact of the SALT Deduction Limitation should take into consideration that an addback for a partner's distributive share of entity-level income taxes paid by a partnership and deducted on the partnership's return is already required by the Tax Law. In that case, and assuming the state wishes to adopt a revenue-neutral regime, the credit offered to the partners of the partnership subject to the entity-level tax should be

[30] N.J. Stat. Ann. § 54A:12-3. "A pass-through entity with at least one member who is liable pursuant to the 'New Jersey Gross Income Tax Act,' N.J.S.A. 54A:1-1 et seq., for tax on that member's share of distributive proceeds of the pass-through entity in a taxable year may elect to be liable for, and pay, a pass-through business alternative income tax in the taxable year." Id. § 54A:12-3(a).

[31] *Id.* § 54A:12-3(b)(2).

[32] *Id.* § 54A:12-5(a).

[33] *See generally* Tax Law § 612 (describing the computation of New York AGI for New York personal income tax purposes).

[34] *Smith*, 120 AD2d at 909.

100%. If the state were to adopt a proposal that overrides the addback, we believe the break-even point for the state would be achieved with a 93% credit to the partners.

d. Residents Should Receive Credits for Entity-Level Income Taxes as a Matter of Good Tax Policy.

Setting aside the legal issues with the Department's apparent current position as reflected in the resident tax credit form instructions, there are several strong policy justifications for allowing New York residents a credit for entity-level income taxes paid to another state. We describe some of these justifications below.

- *Avoid double taxation.* If New York does not permit a credit for residents for entity-level income taxes paid to other states, New York residents will be taxed on the same income twice. We acknowledge that states generally have broad powers to tax their residents, and double taxation is not necessarily prohibited by the United States Constitution.[35] The Legislature has recognized, however, that subjecting New York residents to double taxation is undesirable, which is why it enacted the resident credit in the first place. Providing a credit for entity-level income taxes paid to other states will allow New York residents to maximize the benefit of the deduction under section 164(a) of the IRC. Double taxation undercuts entity-level income taxes as an effective mitigation response to the SALT Deduction Limitation, as residents will receive the benefit of entity-level income taxes for *federal income tax purposes* but will be penalized for *New York personal income tax purposes*. The prospect of double taxation also may incentivize some New York resident partners or LLC members to establish residency elsewhere, especially in states that allow residents a credit for entity-level income taxes paid to other states. Reciprocal tax credit provisions would not only provide New York residents a credit for taxes imposed by other states, it would also incentivize other states to likewise provide credits to their residents for New York entity-level taxes.

[35] E.g., Matter of Tamagni v. Tax Appeals Tribunal, 91 NY2d 530, 533, 541-42 (1998); Chamberlain v. Dep't of Taxation & Fin., 166 AD3d 1112, 1113-14 (3d Dept 2018).

- *Promote uniformity.* Virtually all states that impose personal income taxes allow resident credits for taxes paid to other states. As entity-level income taxes grow more popular as a viable way of minimizing the adverse effects of the SALT Deduction Limitation, questions will arise as to whether existing states' laws will permit resident credits for entity-level income taxes paid to other states. In the Tax Section's view, section 620(a) of the Tax Law already permits the credit under these circumstances.[36] Permitting a resident credit for entity-level income taxes paid to other states may well encourage other states to do the same, which would promote uniformity. Uniformity (in permitting the resident tax credit) will also encourage partnerships and LLCs to avail themselves of the benefits to their partners and members, respectively, in electing into state entity-level taxing regimes, thereby furthering the goals of such legislation.
- *Give taxpayers certainty.* Tax laws and regulations should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction. A state taxing authority's guidance should be consistent with the tax laws and regulations they purport to interpret. Under New York law, residents are entitled to a credit for entity-level income taxes paid by to another state if the income in question is included in the resident's New York AGI. The Department's instructions to the resident tax credit form creates ambiguity and uncertainty. New York taxpayers should have certainty that the Department will administer the Tax Law in a manner that is consistent with the Tax Law as it is written.

[36] The resident credit under section 620 of the Tax Law does not require reciprocity; that is, the resident credit is not conditioned upon the state that imposed the tax also granting its residents a credit for income taxes paid to New York. If the Legislature desires to promote uniformity and a level playing field, it could consider limiting the resident credit for entity-level income taxes paid to other states to taxes imposed by states that provide reciprocal resident credits for New York entity-level income taxes.