October 26, 2021

Ms. Holly Porter
Associate Chief Counsel
Passthroughs & Special Industries
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

RE: Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes

Dear Ms. Porter:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) in providing initial guidance in Notice 2020-75 ("the Notice") clarifying that state and local income taxes ("PTE taxes") imposed on and paid by a partnership or S corporation (each a "passthrough entity") are deductions allowable in computing the non-separately stated income of such entities. The Notice further states an intent to develop and issue proposed regulations regarding PTE taxes.

The below comments and recommendations identify and provide additional information to Treasury and the IRS regarding certain issues arising for S corporation shareholders with respect to the Notice and various states' enacted legislation (or proposed enactment) imposing PTE taxes on the passthrough entity. These comments are limited in scope and focus on an S corporation's inability to specially allocate items[1] and the single class of stock requirement.[2]

Overview

Many states have enacted, or are proposing to enact, PTE tax legislation.[3] The owners of passthrough entities generally may either be allowed: (1) a credit for their share of the tax; or (2) to exclude their share of the passthrough entity's income from the taxing locality's imposition of income tax on the owners. The taxing localities have different approaches for PTE tax. Different mechanisms for shifting tax from owners to the passthrough entity include:

- The owners may elect to have the passthrough entity pay the tax versus a PTE tax mandate.

[1] Section 1377(a)(1). Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.
[2] Section 1361(b)(1)(D).
[3] AICPA PTE Tax Map: States Adopting, Proposing, or Considering a State Pass-through Entity (PTE) Level Tax (rev. October 8, 2021).

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- The PTE taxes apply to all income of the passthrough entity versus applying the PTE tax only to resident owners of the passthrough entity.
- All of the income allocable to the owner may be taxed versus only the income apportionable to the locality and allocated to the owner.

Where the law is applicable to all owners regardless of residency or type of owner (individual, trust, corporation, foreign, domestic, taxable, tax exempt organization, etc.), it is often easy to achieve parity in tax treatment for all owners as the tax is strictly based on the entity's income.

In other circumstances, the laws may create inequities among shareholders. For example, if the tax is only assessed against the income allocable to resident owners that receive a credit on their individual income tax return for any taxes paid at the passthrough entity level, *nonresident* owners will need to pay taxes in the locality at the *owner* level. Often, S corporations distribute amounts to owners to assist with tax payments associated on the income allocable to the owner. If the S corporation were to make a distribution to nonresident owners, a disproportionate distribution issue may arise notwithstanding that the effect of the company (or owners) electing PTE tax on income allocable to resident shareholders has the equivalent economic effect of a distribution to those resident owners.

Recommendation

The AICPA recommends that any actual distributions to compensate owners that are either ineligible or do not elect to participate in a PTE tax assessment[4] are treated similarly to tax payments under Reg. § 1.1361-1(l)(2)(ii) ("composite payments").

Analysis

Regulation § 1.1361-1(l)(2)(ii) makes clear that constructive (deemed) corporate distributions are treated in the same manner as actual distributions for purposes of the S corporation second class of stock requirements. An S corporation that makes state income tax payments on behalf of some or all of an S corporation's shareholders (e.g., composite payments) is deemed to make constructive distributions to those shareholders. Providing those shareholders who are not part of the composite payment program proportionate compensating distributions ensures they receive identical economic rights to those shareholders participating in the composite payment program. Therefore, a second class of stock is not created if, after the S corporation accounts for the constructive distributions and actual distributions, the outstanding shares confer identical rights to operating and liquidating distributions.

The AICPA acknowledges that while Specified Income Tax Payments[5] are deductible in computing non-separately stated income, the economic effect of those payments to shareholders is similar to composite payments. Treating Specified Income Tax Payments to the benefited S

[4] This distribution potentially creates a second class of stock thus invalidating the S election if it could be treated as a binding agreement among shareholders and therefore a governing provision.
[5] Notice 2020-75, §3.02(1).

corporation shareholders[6] as deemed distributions to those shareholders alleviates the potential creation of a second class of stock if actual proportionate distributions are made to non-benefited shareholders.

Treating Specified Income Tax Payments as deemed distributions can result in the unexpected consequence of a double reduction in stock basis and the accumulated adjustment account ("AAA"). This result occurs due to the deduction against non-separately stated income (which is the shareholder's allocated amount based on ownership regardless of participation), and again subsequently as a constructive distribution. Creating an amount of tax-exempt income equal to the deduction that would not be treated as tax-exempt income for AAA purposes resolves this double reduction issue.[7]

Recommendation

The AICPA recommends further clarification in proposed regulations of the definition of a qualified "Specified Income Tax Payment" and the character and classification of the associated deduction.

Analysis

Uncertainty exists under the Notice whether an election by the shareholder to participate in a PTE regime itself creates a Specified Income Tax Payment. The Notice defines a Specified Income Tax Payment as:

> "… any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or 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 that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability…" (emphasis added).

Further, the Notice does not differentiate between the character of the income (i.e., capital or ordinary income) giving rise to a Specified Income Tax Payment. Similarly, the Notice does not differentiate between trade or business and investment activities giving rise to a Specified Income Tax Payment. Clarification is requested as to whether a Specified Income Tax Payment is limited to the tax associated with ordinary trade or business income, or if such definition may also include state taxes associated with trade or business capital gain income (e.g., section 1231 gains) and other investment income (e.g., working capital interest income).

[6] This is regardless of whether the PTE tax regime in question is elective or mandatory.
[7] Similar to the treatment under Reg. § 1.965-3(f)(2). Section 965 also specifically provides for such treatment.

The Notice states the following with respect to the deductibility of a Specified Income Tax Payment:

> "Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year does not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately under section 702 or section 1366 in determining the partner's or S corporation shareholder's own Federal income tax liability for the taxable year. Instead, Specified Income Tax Payments will be reflected in a partner's or an S corporation shareholder's distributive or pro-rata share of non-separately stated income or loss reported on a Schedule K-1 (or similar form)."

Under section 1363(b), an S corporation's taxable income is generally calculated in the same manner as that of an individual. Section 1366(a)(2) provides that "non-separately computed income or loss" means gross income minus the deductions allowed to the S corporation, by excluding all separately stated items described in section 1366(a)(1)(A). The S corporation's shareholders, in computing their tax liabilities, take into account their distributive shares of the S corporation's non-separately stated income or loss, as well as their distributive shares of each separately stated item.

In considering items which are not required to be separately stated, the residual category of non-separately stated income or loss is generally considered trade or business income or loss for purposes of section 62 and section 63. However, the Notice does not appear to limit the application of Specified Income Tax Payment to state taxes associated only with ordinary trade or business income of the taxpayer. Clarification should be provided with respect to the application of Specified Income Tax Payments in the case of state taxes associated with capital gain income (e.g., section 1231 gains) and other investment income (e.g., working capital interest income).

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We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact Bryan Keith, Chair, AICPA S Corporation Taxation Technical Resource Panel, at (202) 419-1417, or bryan.keith@andersen.com; Alexander Scott, Senior Manager — AICPA Tax Policy & Advocacy, at (202) 434-9204, or alexander.scott@aicpa-cima.com; or me at (601) 326-7119 or JanLewis@HaddoxReid.com.

Sincerely,

Jan Lewis, CPA
Chair, AICPA Tax Executive Committee

cc: Mr. Samuel P. Starr, Special Counsel to the Associate Chief Counsel, Office of Associate Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service