AICPA Presses for More Guidance on Passthrough Entity Taxes

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RE: Additional Guidance Needed on Alignment of Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes with Internal Revenue Code Section 163 and Section 469 Regarding Nonpassive vs. Passive Income and Interest Expense Tracing

Dear Mr. Vance and 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.

These comments begin by referencing previously issued comments by AICPA on October 4, 2022 and October 26, 2021.[1] These comments then identify the consistency challenges arising from the treatment of "Specified Income Tax Payments" (SITP) in the year of payment. Specifically, this comment letter addresses PTE tax rules pertaining to nonpassive vs. passive income and interest expense tracing.

On October 4, 2022, AICPA submitted comments that focused on the PTE tax rules pertaining to accrual basis taxpayers and the comments identified confusion regarding the phrase "taxable year in which the payment is made." Those comments recommended Treasury and IRS issue guidance that provides that the Notice does not modify or amplify any section 461, or section 461 regulations, or tax accounting principles.[2] Specifically, our October 4, 2022 comments recommended issuing guidance on the Notice and section 461 accounting method issues. Additionally, in that letter, AICPA recommended:

1. The SITP liability is deductible in accordance with the partnership or S corporation's method of accounting.

2. The SITP liability is a specifically identified tax and accordingly, a taxpayer should be entitled to adopt the recurring item exception method of accounting with respect to the liability.

3. An entity that is unable to make an entity level election until a year subsequent to the taxable year of imposition should be allowed to make a Federal election to deduct the tax in the taxable year of imposition or the following

year (similar to the treatment of plan contributions made on account of a tax year but after the year they relate to under section 404(a)(6)).

On October 26, 2021, AICPA submitted comments that focused on an S corporation's inability to specially allocate items under section 1377(a)(1) and the single class of stock requirement under section 1361(b)(1)(D). In those comments, AICPA recommended:

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

2. Further clarification in proposed regulations of the definition of a qualified "Specified Income Tax Payment" and the character and classification of the associated deduction.

Our current comments recommend guidance on the alignment of the Notice with current regulations under sections 163 and 469 for treatment of SITPs for both the PTEs and their partners and owners for passive, portfolio or nonpassive treatment and application of interest expense. Specifically:

1. IRS and Treasury should issue guidance to supplement Notice 2020-75 as it pertains to the treatment of SITPs for both the passthrough entities and their partners so as to align the Notice with current regulations under sections 163 and 469.

2. IRS and Treasury should clarify that Treas. Reg. §1.163-9T(b)(2)(i)(C), Treas. Reg. § 1.469-2T(c)(7)(iii) and Treas. Reg. § 1.469-2T(d)(2)(vi) are only applicable to section 164 taxes that are not described in Section 62 (e.g., taxes that are itemized deductions).

Specific Comments

Alignment of the Notice with Current Regulations under Sections 163 and 469 for Treatment of SITPs for Both the PTEs and their Partners and Owners for Passive, Portfolio or Nonpassive Treatment and Application of Interest Expense

Overview

Passive, portfolio or nonpassive treatment

Notice 2020-75 is silent on the treatment of SITPs under the passive activity loss rules. Intuitively, if a passthrough entity pays PTE taxes on business income, the character of the SITP deduction should be the same character as the net income giving rise to the tax liability. Likewise, any refunds of SITPs would also be intuitively the same character as the deduction that gave rise to the refund. However, that might not be the case given Treas. Reg. § 1.469-2T(d)(2)(vi) (pertaining to deductions), and its companion provision in Treas. Reg. § 1.469-2T(c)(7)(iii) (pertaining to refunds). These two regulations provide that deductions, and associated refunds of, state, local, or foreign income taxes are specifically identified as nonpassive deductions or nonpassive income, whichever the case may be.

If these two regulations apply to SITPs, then all SITPs must be separately stated in situations where they are imposed on net income, where the passive or nonpassive character of such income is determined at the partner level.[3]

Section 702 provides that separate reporting is required for “other items of income, gain, loss, deduction, or credit, to the extent provided by Regulations prescribed by the Secretary.” The Senate Finance Committee Report accompanying the creation of Subchapter K in 1954 described it as a “catchall provision” which authorizes the Secretary to require each partner to take into account separately his distributive share of any other item of partnership income, gain, loss, deduction, or credit “the character of which would affect the computation of the partner's personal income tax.” Treasury Reg. § 1.702-1(a)(8)(ii) carries out that directive by stating, in relevant part, that “Each partner must also take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately." Treasury Reg. § 1.1366-1(a) contains similar rules for S corporations, but all references in this comment letter to Treas. Reg. § 1.702-1(a)(8)(ii) apply equally to Treas. Reg. § 1.1366-1.

Because the passive or nonpassive treatment of operating business income is determined at the owner level, this regulation requires items that are per se nonpassive income to be separately stated because erroneously including them as passive income could cause the income tax liability of that partner to be different than if it was taken into account separately. Thus, if Treas. Reg. § 1.469-2T(d)(2)(vi) is applicable to SITPs, then taxpayers are facing inconsistent authorities on the treatment of SITPs – Notice 2020-75 requiring these deductions to be non-separately stated or Treas. Reg. § 1.702-1(a)(8)(ii) requiring them to be separately stated. Accordingly, if passthrough entities non-separately state the SITP deduction, they are filing consistently with Notice 2020-75 but filing inconsistently with Treas. Reg. § 1.469-2T(d)(2)(vi) and Treas. Reg. § 1.702-1(a)(8)(ii), and thus likely have to consider whether filing a Form 8275-R, *Regulation Disclosure Statement*, is necessary to follow the direction in the Notice.

Tracing Interest Expense

Using the regulation authority under section 469(l), the IRS and Treasury issued Treas. Reg. §1.163-8T to address the tracing of interest expense. Treasury Reg. § 1.163-8T(a)(4) provides that interest expense must be allocated to one of the following items: (A) trade or business expenditures, (B) passive activity expenditures or a former passive activity expenditure; (C) investment expenditures; (D) personal expenditures; and (E) portfolio expenditures.

Treasury Reg. § 1.163-9T(b)(2)(i)(C) provides that personal interest includes interest paid by a trust, S corporation, or other pass-through entity on underpayments of State or local income taxes and on indebtedness used to pay such taxes. Thus, it appears that a SITP would be a personal expenditure under Treas. Reg. § 1.163-8T, and thus any interest traced to them would result in nondeductible interest.

Recommendations

The AICPA requests that the IRS and Treasury issue guidance to supplement Notice 2020-75 as it pertains to the treatment of SITPs for both passthrough entities and their partners so as to align the Notice with current regulations under sections 163 and 469.

The AICPA recommends that, as a matter of simplicity, and ease of tax administration for both taxpayers and the IRS, that the IRS and Treasury clarify that Treas. Reg. §1.163-9T(b)(2)(i)(C), Treas. Reg. § 1.469-2T(c)(7)(iii) and Treas. Reg. § 1.469-2T(d)(2)(vi) are only applicable to section 164 taxes that are not described in section 62 (e.g., taxes that are itemized deductions).

Analysis

States have imposed entity level taxes on gross or net income long before the enactment of section 164(b)(6) and Notice 2020-75. The three regulations discussed above, namely Treas. Reg. § 1.163-9T(b)(2)(i)(C), Treas. Reg. § 1.469-2T(c)(7)(iii), and Treas. Reg. § 1.469-2T(d)(2)(vi), have been widely applied to state income taxes that are not described in section 62 (e.g., taxes that are itemized deductions) and have not been applied to state income taxes described in section 62. We believe that the overriding intention of Notice 2020-75 was to treat SITPs in a manner consistent with other deductions incurred by the passthrough entities, as evidenced by the suggested non-separately stated treatment.

In addition, clarification that the three regulations discussed above (Treas. Reg. §1.163-9T(b)(2)(i)(C), Treas. Reg. § 1.469-2T(c)(7)(iii), and Treas. Reg. § 1.469-2T(d)(2)(vi)) are only applicable to section 164 taxes that are not described in section 62 (e.g., taxes that are itemized deductions) would ease the burden of administration for both taxpayers and the IRS.

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Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact David Kirk, Co-Chair, AICPA SALT Deduction PTE Tax Task Force, at (202) 327-7189 or David.Kirk@ey.com; Robert Tobey, Co-Chair, AICPA SALT Deduction PTE Tax Task Force, at (434) 882-2211 or RTobey@ReidLLP.com; Robert Amarante, AICPA Senior Manager – Tax Policy & Advocacy, at (919) 402-4582 or Robert.Amarante@aicpa-cima.com; or me at (601) 326-7119 or JanLewis@HaddoxReid.com.

Sincerely,

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cc:
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FOOTNOTES

[1]See AICPA comments, "Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 4, 2022, and AICPA comments "Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 26, 2021.

[2]All references to "section" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §," "Prop. Reg. §," and "regulations" are to U.S. Treasury regulations promulgated thereunder, unless otherwise specified.

[3]As a general rule, Treas. Reg. § 1.702-1(a)(8)(ii) provides that each partner must also take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately. Because state income taxes, whether they are expenses or refunds, would be treated as per se nonpassive, the calculation of a partner's taxable income would differ between those that materially participate (i.e., nonpassive) and those that do not (i.e., passive). Therefore, Treas. Reg. § 1.702-1(a)(8)(ii) would mandate separately stated treatment of these taxes. The same is true for S corporations by reason of Treas. Reg. § 1.1366-1(a)(2).

END FOOTNOTES