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MEMORANDUM

From: Thomas J. Nichols, Esq.
Date: March 12, 2019
Re: 2017 Wisconsin Act 368 Authority

Executive Summary

State income taxes paid by S corporations and partnerships, limited liability companies and other entities treated as partnerships (collectively, "pass-through entities") under 2017 Wisconsin Act 368 ("Wisconsin Act 368") should not be subject to the new $10,000 state tax deduction limitation under section 164(b)(6) of the Internal Revenue Code of 1986, as amended (the "Code"). The Internal Revenue Service (the "Service") has consistently held that income and other taxes imposed upon and paid by pass-through entities are simply subtracted in calculating nonseparately computed income at the entity level, and are not separately passed through or incorporated into the various provisions and calculations applicable to itemized deductions at the individual level, such as the standard deduction, alternative minimum tax and the Pease reduction. In discussing the final provisions of the Tax Cuts and Jobs Act,[1] the Conference Committee Report explicitly reiterated and relied upon this principle in describing the scope of new section 164(b)(6) of the Code.

Authorities

Under Wisconsin Act 368, S corporations,[2] as well as partnerships, limited liability companies and other entities treated as partnerships[3] under the Code, may elect "to be taxed at the entity level," rather than having their income passed through and taxed to their individual shareholders or other owners for Wisconsin tax purposes. Wis. Stats. §§ 71.365(4m)(a); 71.26(6)(a); 71.05(10)(dm).[4] The purpose of this Memorandum is to analyze the authorities regarding whether such entity-level taxes are subject to the $10,000 limitation applicable to individuals under new section 164(b)(6) of the Code.

[1] Public Law 115-97, 131 Stat. 2054 (Dec. 22, 2017). Although this legislation is technically titled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," all references in this Memorandum will be to its popular name, namely, the "Tax Cuts and Jobs Act."
[2] The provisions of Wisconsin Act 368 with respect to S corporations are effective for taxable years beginning on January 1, 2018. 2017 Wisconsin Act 368, § 21(1).
[3] The provisions of Wisconsin Act 368 with respect to partnerships are effective for taxable years beginning on January 1, 2019. *Id.*
[4] Unless otherwise indicated, all references to the Wisconsin Statutes in this Memorandum are to the Wisconsin Statutes, as amended by Wisconsin Act 368.

By way of background, section 11042(a) of the Tax Cuts and Jobs Act added section 164(b)(6) of the Code, which provides as follows: "In the case of an individual and a taxable year beginning after December 31, 2017, and before January 1, 2026 . . . (B) the aggregate amount of taxes taken into account under paragraphs (1), (2), and (3) of subsection (a) . . . [5] for any taxable year shall not exceed $10,000 ($5,000 in the case of a married individual filing a separate return)." Since paragraphs (1), (2) and (3) of subsection (a) of section 164 of the Code cover state and local real property taxes, personal property taxes and income taxes, respectively, the net effect of this provision for high income individuals in states that impose an individual income tax is to render the bulk of their individual income taxes nondeductible for federal income tax purposes.

The legislative history to the Tax Cuts and Jobs Act clearly indicates that this provision does not apply to state and local taxes imposed on pass-through entities. In describing the conference agreement with respect to the final section 164(b)(6) provision contained in the Tax Cuts and Jobs Act, the Conference Committee Report states as follows: "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."[6] H.R. Rep. No. 115-466, at 260 n. 172 (2017).[7] Wisconsin Act 368 provides that pass-through entities subject to its provisions will "be taxed at the entity level at a rate of 7.9 percent of net income reportable to this state," which certainly appears to fall squarely within that description. Wis. Stats. §§ 71.365(4m)(a); 71.26(6)(a).

Such legislative history is quite compelling. As the Supreme Court noted in *United States v. Vogel Fertilizer*, "Of course, it is Congress' understanding of what it was enacting that ultimately controls." *Vogel*, 455 U.S. 16, 31 (1982). In that case, the Supreme Court held that "The legislative history of [one of the provisions contained in the controlled group provisions of the Code] resolves any ambiguity in the statutory language and makes it plain that [an

[5] This new provision also applies to state and local general sales taxes deducted in lieu of these other taxes at the election of the individual taxpayer. I.R.C. § 164(b)(6)(B). However, this election is of limited applicability in states that impose an individual income tax.

[6] This same statement was made in the General Explanation of the Tax Cuts and Jobs Act prepared by the Joint Committee on Taxation. General Explanation of Public Law 115-97 (JCS-1-18), December 20, 2018, at 68 n.296 ("Additionally, 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 prior law.").

[7] A Tax Technical and Clerical Corrections Act has been introduced, but the legislative history to the bill specifically confirms that "The treatment of business and investment taxes remains unchanged." Committee on Taxation, *Technical Explanation of the House Ways and Means Committee Chairman's Discussion Draft of the "Tax Technical and Clerical Corrections Act"* (JCX-1-19), January 2, 2019, at 5.

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inconsistent provision in the Treasury regulations] is not a reasonable statutory interpretation." *Id.* at 26. Lower Appellate Courts, including the Seventh Circuit to which any case involving the Wisconsin provision would likely be appealed, as well as the Tax Court, also look to legislative history when applying new tax legislation.[8]

The statement in the Conference Committee Report that business taxes imposed at the entity level on pass-through entities, such as those under Wisconsin Act 368, "will continue to reduce [a] partner's or shareholder's distributive or pro-rata share of income as under present law" is consistent with the long-standing position of the Service with respect to analogous state law income tax provisions. For example, in Revenue Ruling 58-25, the Service ruled that a City of Cincinnati tax on net profits "imposed upon and paid by a partnership" is "deductible in computing the taxable income of the partnership."[9] Similarly, in Revenue Ruling 71-278, the Service ruled that an Indiana tax imposed on gross income at the partnership level (thereby exempting such gross income from tax at the individual partner level) is deductible from partnership gross income "in computing the taxable income of a partnership and the distributable shares of the partners."[10] The Service has consistently followed these rulings in its publications. For example, publication 535, "Business Expenses," "For use in preparing 2018 returns," states that "A corporation or partnership can deduct state and local income taxes imposed on the corporation or partnership as business expenses."[11]

Significantly, both of the above rulings specifically noted that the deduction of these taxes at the entity level did not preclude the individual partners in these partnerships from claiming the standard deduction, which would have been the case if the tax imposed at the partnership level were separately stated and passed through to be treated as an itemized deduction at the individual level. Thus, income taxes imposed and paid at the entity level were

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[8] *RJR Nabisco, Inc. v. U.S.*, 955 F.2d 1457, 1462 (11th Cir. 1992) ("Indications of congressional intent contained in a conference committee report deserve great deference by courts because 'the conference report represents the final statement of terms agreed to by both houses, [and] next to the statute itself is the most persuasive evidence of congressional intent.'" (quoting *Demby v. Schweiker*, 671 F.2d 507, 510 (D.C. Cir. 1981))); *Emergency Servs. Billing Corp. v. Allstate Ins. Co.*, 668 F.3d 459, 465 (7th Cir. 2012) ("[W]hen the plain meaning of a statutory term is unclear, outside considerations can be used in an attempt to glean the legislative intent behind the use of the term. . . . These can include the legislative history." (citations omitted)); *Williams v. Comm'r*, 151 T.C. No. 1 (2018) ("The most enlightening source of legislative history is generally a committee report, particularly a conference committee report, which we have identified as among 'the most authoritative and reliable materials of legislative history.'").

[9] 1958-1 C.B. 95. *See also* Rev. Rul. 54-598, 1954-2 C.B. 121 (holding that a license tax based on 1% of "the net profits of all businesses, professions, or other activities" was "deductible from partnership gross income" and not deductible by individual partners). Revenue Ruling 54-598 was obsoleted, but apparently based upon another portion of the ruling dealing with disclosure and privacy law. Rev. Rul. 2003-67, 2003-1 C.B. 1119.

[10] 1971-2 C.B. 75. *Cf.* Rev. Rul. 81-288, 1981-2 C.B. 17 (holding that a New Hampshire tax on net profit shown on Schedule C and Schedule E and related net gains was deductible in determining adjusted gross income under section 62(1) of the Code and stating that "The intent of Congress was that state income taxes, imposed generally, would not be deductible under section 62 of the Code merely because the net income arose from a business, but that taxes of any kind that are imposed only on business activity, or business property, or business income, would be deductible.").

[11] I.R.S. Pub. No. 535, Business Expenses (2018), at 19.

deductible in computing nonseparately computed income[12] and did not trigger limitations on deductions at the individual level. It follows that the same should be true for Wisconsin Act 368 taxes, namely that such taxes should "continue to reduce [the] partner's or shareholder's distributive or pro-rata share of income as under present law" as stated in the Conference Committee Report. This is especially true here where Congress, and the public, were aware of (and relied on) the Service's long-standing interpretation of how entity-level taxes are treated.[13]

The Service followed these prior rulings to reach the same conclusion with respect to another Wisconsin tax based on income in a Field Service Advisory,[14] which dealt with the Temporary Recycling Surcharge imposed under section 77.92 of the Wisconsin Statutes.[15] At the time, the Surcharge was imposed at the rate of .4345% on the net business income of S corporations and partnerships allocated or apportioned to Wisconsin (subject to a cap of $9,800 and other exceptions).[16] Citing both Revenue Ruling 58-25 and Revenue Ruling 71-278 and analyzing the provisions in the Code and Regulations requiring the separate treatment of certain items passed through to partners, the Service concluded that "the Wisconsin temporary surcharge . . . imposed on and paid by a partnership based on its net business income . . . is not separately stated under section 702(a)(1) through (7) of the Code and . . . would be included under section 702(a)(8) in determining the partnership's [nonseparately computed] taxable income or loss," unless section 469 (relating to passive activity losses) applied.

Noting that "[t]he rules under section 1366 of the Code for S corporations are similar to the rules for partnerships under section 702" of the Code, the Service also concluded "that the Wisconsin temporary surcharge is not separately stated under section 1366(a)(1)(A) and that the Wisconsin temporary surcharge would be included under section 1366(a)(1)(B) in determining the S corporation's nonseparately computed income or loss," again unless section 469 applied. Clearly implicit in these conclusions is the fact that such taxes paid and deducted in determining nonseparately computed income at the entity level would not be treated as itemized deductions subject to limitations at the individual level. For example, just as specifically so held in the above-cited Revenue Rulings, individual partners and S corporation shareholders would still be

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[12] The opposite result occurs when the taxes are imposed and paid as part of the general state income tax at the individual level. *See, e.g.*, Rev. Rul. 65-19, 1965-1 C.B. 36; Temp. Treas. Reg. § 1.62-1T(d); *Tanner v. Comm'r*, 45 T.C. 145 (1965), *aff'd*, 363 F.2d 36 (4th Cir. 1966). However, there are no cases or rulings holding that a state income tax imposed at the pass-through entity level is to be passed through separately and subject to standard deduction or other limitations upon deductibility at the individual level.

[13] *United States v. Rutherford*, 442 U.S. 544, 554 n. 10 (1979) ("[O]nce an agency's statutory construction has been 'fully brought to the attention of the public and the Congress,' and the latter has not sought to alter that interpretation although it has amended the statute in other respects, then presumably the legislative intent has been correctly discerned." (quoting *Apex Hosiery Co. v. Leader*, 310 U.S. 469, 487–489 (1940)).

[14] 1991 WL 1283337 (1991).

[15] This Surcharge is still in effect, though the heading for it under Subchapter VII of Chapter 77 of the Wisconsin Statutes now lists it as an "Economic Development Surcharge."

[16] The Surcharge is now only imposed on corporations, and the rate for S corporations is .2%. Wis. Stat. § 77.94(1).

entitled to take the full standard deduction, notwithstanding deduction of the Surcharge based on income at the entity level. Moreover, the deduction for the Wisconsin Surcharge imposed at the entity level would also not be subject to disallowance for alternative minimum tax purposes[17] or the so-called Pease reduction at the individual level.[18] Significantly, both the standard deduction and the Pease reduction provisions, by their terms, only apply "[i]n the case of an individual," and the applicable alternative minimum tax provisions, by their terms, apply to any "taxpayer other than a corporation." I.R.C. §§ 63(b); 68(a); 55(a).

In the absence of the above-cited legislative history and rulings, an argument could be made that the section 164(b)(6)(B) $10,000 limitation should somehow be taken into account at the entity level, even though that limitation, by its terms, also only applies "[i]n the case of an individual." This is because both the S corporation and partnership provisions specify that the taxable income of the entity "shall be computed in the same manner as in the case of an individual," with certain enumerated exceptions.[19] I.R.C. §§ 1363(b), 703(a). Nonetheless, the above-cited rulings consistently and explicitly held that state and local taxes imposed and paid at the entity level should be taken into account in determining the nonseparately computed income or loss at the pass-through entity level and not subjected to the separate limitations on itemized deductions applicable at the individual owner level, a principle that was reiterated and relied upon in the above-quoted language of the Conference Committee Report describing the new section 164(b)(6)(B) provision.

The pass-through provisions of the Code have never been interpreted to incorporate all of the provisions relating to itemized deductions applicable at the individual level into the calculation of taxable income of pass-through entities. For example, the standard deduction, a provision which, as noted above, only applies "[i]n the case of an individual," is generally considered to be unavailable to S corporations.[20] This is notwithstanding the fact that the enumerated exceptions to "individual" treatment in the S corporation provisions specifically disallow "the deductions for personal exemptions provided in section 151" of the Code (which also only applies "[i]n the case of an individual") and "the additional itemized deductions for

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[17] For purposes of the individual alternative minimum tax, "[N]o deduction shall be allowed . . . for any taxes described in paragraph (1), (2), or (3) of section 164(a)," i.e., the same taxes covered by new section 164(b)(6) of the Code. I.R.C. § 56(b)(1)(A)(ii).

[18] I.R.C. § 68 (reduces up to 80% of certain itemized deductions by an amount equal to 3% of adjusted gross income above a certain level) (not applicable for tax years beginning after December 31, 2017, and before January 1, 2026). The Pease reduction was first effective for taxable years beginning after December 31, 1990. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11103(e).

[19] These enumerated exceptions specifically disallow "the deduction for taxes provided in section 164(a)" at the entity level, but only "with respect to taxes, described in section 901, paid or accrued to *foreign countries and to possessions of the United States*." I.R.C. §§ 1363(b)(2), 703(a)(2)(B) (emphasis added). The enumerated exceptions do not specify any disallowance or other separate treatment of any domestic taxes.

[20] The Code does provide that a partnership's standard deduction is zero. I.R.C. § 63(c)(6)(D); *see also* Treas. Reg. § 1.703-1(a)(2)(i). However, there is no similar authority with respect to S corporations. *Compare* Treas. Reg. § 1.1363-1(b), *and* Treas. Reg. § 1.1366-1(a)(2), *with* Treas. Reg. § 1.703-1(a)(2)(i).

individuals provided in part VII of subchapter B" of the Code (entitled "ADDITIONAL ITEMIZED DEDUCTIONS FOR INDIVIDUALS" and containing provisions that explicitly or implicitly apply only "[i]n the case of an individual"), but these enumerated exceptions say nothing regarding the standard deduction (which is contained in section 63(b) of the Code). I.R.C. §§ 1363(b)(2), 703(a)(2).

Conversely, in the rulings described above, the Service has consistently taken the position that entity-level taxes are simply subtracted in determining nonseparately computed income or loss, which means that the alternative minimum tax disallowance (which is contained in section 55 of the Code and applies to any "taxpayer other than a corporation") and the Pease reduction (which is contained in section 68 of the Code and also applies "[i]n the case of an individual") do not apply to income and other taxes paid or accrued at the entity level, whereas such disallowance and reduction provisions obviously do apply to taxes paid or accrued at the individual level on income passed through from an S corporation or partnership. Thus, it would be difficult to successfully argue that the "shall be computed in the same manner as in the case of an individual" language of the pass-through entity provisions of the Code somehow incorporates the section 164(b)(6)(B) $10,000 limitation, which only applies "[i]n the case of an individual," when that same "[i]n the case of an individual" or comparable language has been consistently held to preclude application of both taxpayer favorable and unfavorable individual-level itemized deduction provisions (such as the standard deduction, the alternative minimum tax disallowance and Pease reduction provisions) to taxes paid at the entity level, and the Conference Committee Report specifically reiterates that "taxes imposed at the entity level . . . will continue to reduce [a] partner's or shareholder's distributive or pro-rata share of income as under present law."

Accordingly, the Instructions for S corporation and partnership returns make no mention of the need to separately state or apply individual itemized deduction limitations to taxes paid at the entity level.[21] Based upon these authorities, the leading professional tax preparation software programs for S corporations and partnerships have treated entity level taxes as deductible in computing nonseparately computed income for these entities for years.

The fact that the entity level tax is triggered by an election under Wisconsin Act 368 is unlikely to preclude application of the above authorities. There are numerous elections under state and federal law, and the results of those elections have been consistently respected under the Code. Perhaps most fundamentally, revocation of an S corporation election itself and check-the-box elections for partnerships and limited liability companies to be treated as corporations (without making a corresponding S corporation election) trigger state-level corporate income and other taxes in nearly all circumstances. *See* I.R.C. § 1362(d)(1)(A); Treas. Reg. § 301.7701-3(a). *See, e.g.*, Wis. Stat. §§ 71.23(1), 71.195, 71.22(1k) (imposing Wisconsin corporate income tax

[21] 2018 Instructions Form 1120S, pp. 17, 32-33; 2018 Instructions Form 1065, pp. 21-22, 40-43.

upon such revocation). Nonetheless, consistent with the above authorities, we are not aware of any authority suggesting that the resulting entity-level taxes are somehow any less deductible as a consequence.

Similarly, the fact that elections under Wisconsin Act 368 can be retroactive because they are made "on or before the due date or extended due date" of the relevant S corporation or partnership income tax return should also not prevent them from being respected for federal income tax purposes. *See* Wis. Stats. §§ 71.365(4m)(a), 71.21(6)(a). Several provisions of the Code explicitly allow retroactive effect for elections triggering State and local income taxes. For example, revocations of S corporation elections during the first 2 ½ months of a taxable year are allowed, at the election of the taxpayer, to be effective at the beginning of the year, and elections by partnerships and limited liability companies to be taxed as C corporations can be retroactive for up to 75 days. I.R.C. § 1362(d)(1)(C)(i), (D); Treas. Reg. § 301.7701-3(c)(1)(iii). Moreover, S corporations are allowed to retroactively elect to distribute earnings and profits first, to make deemed dividend distributions and/or to forgo previously taxed income, all of which typically trigger additional taxable dividends and state income tax at the shareholder level. I.R.C. §§ 1368(e)(3), 1371(e)(2); Treas. Reg §1.1368-1(f). These elections are made "by attaching [the] statement[s] to a timely filed (including extensions) original or amended return." Treas. Reg § 1.1368-1(f)(5)(iii). Allowing such elections to be made on a timely filed *amended* return is even more generous than Wisconsin Act 368. Nonetheless, again, consistent with the above authorities, we are not aware of any authority for the proposition that any state taxes thereby triggered are somehow any less deductible as a consequence.

It is worth noting that, since 1987, Wisconsin has allowed federal S corporations to elect to be treated as C corporations for Wisconsin income tax purposes, thereby triggering state income tax at the entity level. Wis. Stat. § 71.365(4)(a). Just as with the new Wisconsin Act 368 elections under sections 71.365(4m)(a) and 71.21(6)(a) of the Wisconsin Statutes, this prior "opt out" election under section 71.365(4)(a) of the Wisconsin Statutes is allowed to be made "on or before the due date or extended due date" of the relevant S corporation income tax return. Consistent with the above authorities, the resulting entity-level Wisconsin corporate income taxes have been treated as deductible in computing nonseparately computed income of electing S corporations for federal income tax purposes. *See, e.g.*, Sobol and Starr, 732 T.M., *S Corporations: Shareholder Tax Issues*, at A-3 ("Taxes imposed directly against a corporation generally include income, franchise, or nonresident shareholder taxes. As a practical matter, such taxes are frequently incorporated into non-separately stated income."). Again, we are aware of no authority for the proposition that such taxes are not deductible in computing nonseparately computed income or loss at the entity level.

Wisconsin is not the only state to have such entity-level state income taxes imposed and treated as reducing nonseparately computed income in this way. For example, the District of

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Columbia has imposed an income tax on corporations, including S corporations, and an unincorporated business franchise tax on partnerships at the entity level since at least 1975. Just like under Wisconsin Act 368, the corresponding income is excluded from taxation at the individual shareholder or partner level. D.C. Code Ann. §§ 47-1807.02(a)(8), 47-1808.03(a)(8), 47-1803.02(a)(2)(D), (P). Also similar to Wisconsin, Pennsylvania allows S corporations to opt out of pass-through treatment for its state income tax. 72 Pa. Cons. Stat. § 7307. Conversely, Georgia, Mississippi, New Jersey and New York require some form of affirmative election or consent to qualify for S corporation pass-through treatment. Ga. Code Ann. § 48-7-27(d)(2); Miss. Code Ann. § 27-8-19(3)-(4); N.J. Stat. Ann. § 54:10A-5.22; N.Y. Tax Law § 660(a). Finally, Alabama, California, Illinois, Kentucky, New Hampshire, New York City and Tennessee have also had income taxes imposed at the entity level for some time. Ala. Code § 40-14A-22(a); Cal. Rev. & Tax. Code § 23802(b); 35 Ill. Comp. Stat. § 5/201; Ky. Rev. Stat. § 141.0401; N.H. Rev. Stat. § 77-E:2; N.H. Rev. Stat. § 77-A:2; NYC Admin. Code §§ 11-501-11-540; Tenn. Code Ann. §§ 67-4-2007, 67-2-102. All of these entity-level income taxes have been consistently deducted in calculating nonseparately computed income passed through to the owners for federal income tax purposes,and have not been treated as state income taxes paid at the individual level so as to trigger disallowance of the standard deduction, alternative minimum tax disallowance and/or the Pease reduction. *See, e.g.*, Sobol and Starr, 732 T.M., S Corporations: Shareholder Tax Issues, at A-3 732-1st T.M., *S Corporations: Shareholder Tax Issues*, at A-3 ("To the extent these entity level taxes are passed through to the shareholders on Schedule K-1, Line 1, Ordinary Business Income (Loss), there should be no additional limitation under §164(b)(6)."). It has not been suggested that the treatment of these taxes has somehow been changed by the Tax Cuts and Jobs Act.