AICPA

October 4, 2022

Mr. Scott Vance
Associate Chief Counsel
Income Tax & Accounting
Internal Revenue Service
1111 Constitution Ave., NW
Washington, DC 20224

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

**RE: 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**

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.

The below comments and recommendations identify and provide additional information to Treasury and the IRS regarding needed additional guidance on certain issues arising for taxpayers with respect to the Notice and various states' enacted legislation (or proposed enactment) imposing PTE taxes on the passthrough entity. This letter addresses PTE tax rules pertaining to accrual basis taxpayers. Our below comments highlight the confusion of the "taxable year in which the payment is made" language and recommend Treasury and IRS issue guidance that provides that the Notice does not change, and Treasury and IRS did not intend to change, any section 461, or section 461 regulation, principles.[1]

We plan to submit additional comments on other issues and suggestions regarding the Notice in the near future.

The below comments are in addition to AICPA comments submitted on October 26, 2021, 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 our prior October 26, 2021 comments, AICPA recommended:

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

1455 Pennsylvania Ave. NW, Washington, DC 20004-1081
T: +1 202.737.6600 F: +1 202.638.4512
aicpaglobal.com | cimaglobal.com | aicpa.org | cgma.org

- 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").

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

Our below comments focus on and recommend needed guidance on the Notice and section 461 accounting method issues and address Section 3.02(2) of the Notice, which discusses the allowance of a deduction for a SITP in the year of payment.

We recommend:

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)).

**Specific Comments**

**<u>Background</u>**

On November 9, 2020, the IRS released the Notice, announcing that Treasury and the IRS intend to issue proposed regulations with respect to state taxes imposed at a partnership or S corporation entity level. In the Notice, Treasury and the IRS state that SITPs are deductible by partnerships and S corporations in computing their non-separately stated income or loss.

Section 3.02(2) of the Notice provides that a partnership or S corporation that makes a SITP during a taxable year is allowed a deduction for such payment for the taxable year in which the payment is made.

The language the Notice explicitly specifying a deduction when paid is causing taxpayers and practitioners to question whether the Notice and forthcoming proposed regulations intend to restrict the timing of the SITP deduction to only when paid versus a deduction allowed to accrual basis taxpayers in the subsequent year under the recurring item exception of Treas. Reg. § 1.461-5.

As of the date of this letter, 29 states have enacted a mandatory or elective PTE taxes. How each state implements and maintains its PTE tax varies, which leads to additional taxpayer confusion regarding the timing of the deduction for a PTE tax for Federal income tax purposes. Recommendations for each state that has implemented a PTE tax are outside the scope of these comments, but the general recommendations contain principles that can be applied to each state's specific operative rules.

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

**Overview**

The language in Section 3.02(3) of the Notice causes confusion amongst taxpayers and tax practitioners as the Notice indicates a SITP is deductible for the taxable year in which the payment is made. In response to a previously issued Treasury Regulation[2] intended to address state and local government programs intended as workarounds to the Federal $10,000 state and local deduction cap, taxpayers and advisors are closely hewing to following the four corners of the Notice.

The Notice does not make mention of an entity's method of accounting controlling the timing of the deduction and only references payment, leading many to question whether the deduction is to be taken on a cash basis method of accounting. However, to be a SITP the tax must be an income tax and must be directly imposed by the state (or other domestic jurisdiction) on the partnership or S corporation.

**Recommendation**

The AICPA recommends that Treasury and the IRS issue guidance that the deduction for a SITP is deductible in accordance with the passthrough entity's established method of accounting.

**Analysis**

Section 446 provides the general rule for methods of accounting and allows a taxpayer to compute taxable income under any of the following methods of accounting:

a. The cash receipts and disbursements method;
b. An accrual method;
c. Any other method provided by Chapter 1 of Subtitle A of U.S. Code Title 26; or
d. Any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

[2] Treas. Reg. §1.170A-1, 84 Fed. Reg. 27513 (June 13, 2019).

In general, but subject to various restrictions, a taxpayer is allowed to elect its own methods of accounting for each trade or business it operates. Many of the restrictions around methods of accounting relate to the ability to use the cash receipts and disbursements method so many passthrough entities that would make PTE tax payments are on an accrual basis method of accounting.

Under an accrual basis method of accounting, a liability is deductible when the all-events test is met. This test is met when a liability is fixed, determinable, and economic performance has occurred with respect to that liability. This recommendation focuses on the timing of economic performance as we discuss the fixing of the PTE tax liability below.

Treasury Reg. § 1.461-4(g)(6) provides that, in general, economic performance for a liability to pay a tax occurs as the tax is paid to the governmental authority that imposed the tax. While there are exceptions for real property taxes and certain foreign taxes, economic performance for taxes generally occurs upon payment.

An exception for this general rule is the recurring item exception under Treas. Reg. § 1.461-5. To utilize this exception, first, all the events that fix the fact of the liability must occur as of the end of the taxable year and the amount of the liability can be determined with reasonable accuracy. In addition, economic performance for the liability must occur on or before the earlier of (1) the tax the taxpayer files a timely (including extensions) return for that taxable year, or the 15$^{th}$ day of the 9$^{th}$ calendar month after the close of that taxable year. Finally, the liability must be recurring in nature and either the amount of the liability is not material or the accrual of the liability results in better matching of the liability to the income to which it relates.

While many of the PTE tax regimes are elective and the election can be made individually for each taxable year, the requirement for a liability to be recurring in nature does not require the liability to recur each year and a new liability may be treated as recurring if it is expected that the liability will be incurred on a recurring basis in the future. Finally, for a taxes liability described in Treas. Reg. § 1.461-4(g)(6), the matching requirement is deemed to be satisfied.

All told, the basis for the deduction to be claimed in accordance with the taxpayer’s method of accounting and that the PTET liability is an eligible recurring item exception item is sound. Taxpayers though, in an abundance of caution, would appreciate guidance from the IRS affirmatively stating so.

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

**<u>Overview</u>**

The recurring item exception must be consistently applied to a type of item, or for all items, from one taxable year to the next to clearly reflect income. In other words, the recurring item exception is a method of accounting and as such, if a taxpayer is not on a recurring item exception method for a type of item, it must request consent of the IRS to change its method of accounting.

A passthrough entity may have an established method of accounting for other taxes, such as state income, franchise, or real property taxes. However, as 29 states now have entity level tax regimes, the state income tax liability may take on more significance. In the interest of administrative benefit for both taxpayers and the IRS, the IRS should state that a SITP liability is a separate item for purposes of the ability to adopt the recurring item exception method of accounting.

**<u>Recommendation</u>**

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

Alternatively, if the IRS disagrees that the SITP is a separate item from state income taxes, the IRS should plainly state this determination and provide an eligibility restriction waiver for a prior five-year change for the timing of incurring liabilities for state income taxes to allow taxpayers to adjust any methods of accounting for these liabilities.

**<u>Analysis</u>**

Treasury Reg. § 1.461-5(d)(1) provides that a taxpayer is permitted to adopt the recurring item exception as part of its method of accounting for any type of item for the first taxable year in which that type of item is incurred. In addition, the recurring item exception must be consistently applied with respect to a type of item, or for all items, from one taxable year to the next in order to clearly reflect income.

As the Treasury and IRS are aware, the SITP is for a tax directly imposed upon an entity without regard to whether the imposition of and liability for the income tax is the result of an election by the entity. While the item is a state income tax, the separate definition of a SITP by the IRS recognizes this tax as a separate item from a general state income tax.

**3. A taxpayer 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.**

**Overview**

As noted, section 3.02(2) of the Notice states SITPs are deductible when paid. However, section 3.02(1) of the Notice defines SITPs as amounts paid to satisfy a liability for income taxes. There is confusion among practitioners about whether a taxpayer would have a liability for income taxes in the current taxable year for an elective PTE tax where the election is made after the end of the current taxable year, especially in states where the statute does not permit an election to be made any earlier than the following taxable year. Some practitioners have been advising taxpayers to enter into a binding agreement directing the passthrough entity to make an election to pay PTE tax in order to claim a deduction in the current taxable year. In the interest of administrative benefit, the IRS should allow taxpayers to make a binding election on its timely filed tax return to claim a current year deduction for SITP arising from any PTE tax imposed on current year taxable income.

**Recommendation**

The AICPA recommends that with respect to elective SITP regimes, the IRS allow taxpayers to treat the SITP as a liability for the year in which the tax is imposed (meaning a fixed liability in the case of an accrual method taxpayer and an otherwise deductible liability in the case of a cash basis taxpayer) in situations where the state does not provide a mechanism or procedure for taxpayers to elect into the PTET prior to the end of the tax year for which the tax is imposed.

**Analysis**

This treatment would be similar to the operation of section 404(a)(6) which permits a taxpayer to treat a contribution to certain employer plans as having been made by the end of the taxable year, if the payment is made on account of such taxable year and the payment is made by the time the return is due (including extensions).

For accrual method taxpayers, the rule will have the effect of treating the liability as fixed and determinable as of the end of the current taxable year. For cash method taxpayers, the rule will have the effect of treating any prepayment as a payment of an actual assessed tax liability rather than a deposit of an estimated tax.

For accrual method taxpayers, section 461(h)(4) provides that a liability is taken into account when "all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy, and economic performance has occurred." This test must be met by the end of the taxable year for a taxpayer to accrue a liability and claim a deduction for that taxable year. Similarly, in the case of a cash basis taxpayer, a prepayment of tax that is not an established liability is not a deductible item until the tax year in which the tax represents a legal liability.

In situations where a state revenue authority lacks a formal procedure for a taxpayer to make an election to pay PTE tax on current year taxable income until the following year, there is uncertainty whether the all events test is met during the current taxable year. Generally, practitioners have interpreted the all events tests as denying a SITP deduction of an elective PTE tax where an affirmative election to pay PTE tax is not made on or before the end of the taxable year. However, other practitioners have suggested the fact of the liability is fixed as of the end of the year since by statute income tax is assessed on any taxable income earned by a passthrough entity as of the end of the taxable year. A PTE tax election only acts to shift the liability from the individual owners or partners to the entity itself rather than establish that a liability exists.

As a work around when an election to pay PTE tax is unavailable on or before the end of the taxable year, some practitioners have been advising taxpayers to put in place binding agreements before the end of the taxable year mandating the passthrough entity make the election in the following taxable year. However, even with such an agreement in place, there is still uncertainty for taxpayers whether the IRS will respect the substance of such an agreement or what specific information would have to be included in such an agreement to avoid a challenge by the IRS. This process also places an administrative burden on taxpayers to draft such agreements, especially for smaller taxpayers who may be lacking counsel, and on the IRS to review such agreements upon examination for completeness.

PTE taxes are put in place by states to change the state tax treatment of individual owners and partners in certain passthrough entities. By issuing the Notice and treating PTE taxes as a deductible expense for Federal income tax purposes, Treasury has signaled its apparent agreement that changes to state tax laws that shift the state tax liability from the individual to the passthrough entity removes such tax from the limitation on individual SALT deductions. From a policy perspective, there seems little reason to deny similar treatment to individuals who are owners or partners in passthrough entities which conduct business in states where the taxpayer is certain of paying PTET but is only prevented from making an affirmative election to pay PTE tax during the taxable year by state statute.

Therefore, for the sake of eliminating uncertainty and reducing administrative burden on both taxpayers and the IRS, the IRS should allow a passthrough entity to make a binding election on its timely filed tax return to treat any PTE tax imposed on current year taxable income as fixing a liability to pay PTE tax as of the end of the that taxable year regardless of when an actual election is allowed by the state revenue authority, and any payment of such PTE tax to be treated as a deductible SITP in the year paid.

*****

The AICPA is the world's largest member association representing the accounting profession, with more than 421,000 members in the United States and worldwide, and a history of serving the public interest since 1887. Our members advise clients on federal, state, and international tax matters and prepare income and other tax returns for millions of Americans. 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@grassicpas.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,

Jan Lewis, CPA
Chair, AICPA Tax Executive Committee

cc: Ms. Wendy Friese, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Timothy Powell, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Charles Magee, Office of Chief Counsel, Internal Revenue Service
Peter Blessing, Associate Chief Counsel International, Internal Revenue Service
Ms. Julie Hanlon-Bolton, Income Tax & Accounting, Internal Revenue Service
Ms. Karla Meola, Income Tax & Accounting, Internal Revenue Service