

Multistate Tax Commission



**REPORT OF THE HEARING OFFICER ON THE AMERICAN
BAR ASSOCIATION MODEL S CORPORATION INCOME
TAX ACT ("MOSCITA") WITH SIX PROPOSED
MODIFICATIONS**

**(PLEASE NOTE THAT THE UNIFORMITY PROPOSAL BEING RECOMMENDED BY
THE HEARING OFFICER IS ATTACHED AS *EXHIBITS A AND Q* TO THIS REPORT.)**

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ASSOCIATION MODEL S CORPORATION INCOME TAX ACT
("MoSCITA") WITH SIX PROPOSED MODIFICATIONS**

Paul Mines, the hearing officer designated by the Executive Committee of the Multistate Tax Commission for conducting a hearing on the American Bar Association Model S Corporation Income Tax Act ("MoSCITA") with Six Proposed Modifications, respectfully submits the following report.

PROCEDURE.

The Uniformity Committee of the Multistate Tax Commission referred MoSCITA (*Exhibit A*) with Six Proposed Modifications (*Exhibit B*) to the Executive Committee of the Multistate Tax Commission for its consideration. By its resolution of August 29, 1991, the Executive Committee referred MoSCITA with Six Proposed Modifications to a Public Hearing (*Exhibit C*). The designated hearing officer prepared a Notice of Public Hearing, which provided for the holding of the Public Hearing on January 25, 1991. (*Exhibit D*). In compliance with the requirements of bylaw 7 of the Bylaws of the Multistate Tax Commission (as amended through July 28, 1989) appropriate notice was given to the affected party states, to those who had made written requests for notice and to those whose names are maintained on the mailing list maintained by the office of the Multistate Tax Commission. (*Exhibits E and F*).

The Public Hearing was conducted on January 25, 1991. The Hearing Officer submits this Report to the Executive Committee in compliance with the directive of the Committee's resolution above identified and bylaw 7 of the Bylaws of the Multistate Tax Commission (as amended through July 28, 1989).

SYNOPSIS OF HEARING PROCEEDINGS.

The Proposal: Preliminary Comments. The proposal is set forth in two exhibits to this Report. *Exhibit A* is MoSCITA itself and *Exhibit B* is the Six

Proposed Modifications to MoSCITA. *Exhibit B* sets forth the original provisions contained in MoSCITA that are proposed for modification and then sets forth the actual proposed modification. The statutory intent with regard to MoSCITA as originally drafted is well summarized in the *Commentary to the Model S Corporation Income Tax Act*, 42 TAX LAW. 1009 (1989). (*Exhibit M*). The statutory intent with regard to the Six Proposed Modifications is summarized in the sections labeled, "*MTC staff's statement*," to each of such Modifications in *Mines, MTC Considers Endorsing Modified MoSCITA*, 1991 MULTISTATE TAX COMMISSION REVIEW 30. (*Exhibit O*).

The Hearing Officer believes there may be some confusion about the purpose of the Six Proposed Modifications. The Hearing Officer does not understand that the Six Proposed Modifications have been suggested as permanent, substituting changes to MoSCITA. Thus, the Six Proposed Modifications are not proposed to replace the designated provisions of MoSCITA sought to be modified as the so-called MTC version of MoSCITA. In this sense then, the Six Proposed Modifications have not been developed as the Commission's expression of what state tax policy should be in the affected areas.

The Hearing Officer understands the Six Proposed Modifications are proposed to permit states to have at ready reference suggested statutory language that would allow implementation of *existing* state tax policy, if MoSCITA as originally drafted does not correspond to the adopting state's *existing* state tax policy in the areas covered by the modifications.

The modifications address limited peripheral areas of MoSCITA and do not affect the core provisions of MoSCITA. The modifications reflect the fact that MoSCITA as an integral statute has had to make some inherent policy choices that may well conflict with the *existing* tax policy of an adopting state. There may be no advantage to the promotion of state tax uniformity to propose MoSCITA in an "all or nothing" format. Any state desiring to consider the core of MoSCITA may wish to preserve the policy choices it has already made in certain peripheral areas.

Since MoSCITA is a tightly written statute, access to suggested amendatory language is probably essential if the integrity of MoSCITA is to be preserved. Any change in language in a tightly written statute can have unintended effects if the drafters of amendatory language are not extremely careful. It is in this spirit that the Hearing Officer understands that the Six Proposed Modifications have been proposed.

Consideration of MoSCITA represents a departure from the Commission's normal operation. MoSCITA is the work product of the Subcommittee on the State Taxation of S Corporations, Committee of S Corporations, Section of Taxation, American Bar Association (Garland Allen, Chair) and not the staff of the Commission. The Commission's endorsement of MoSCITA, however it may be modified by alternative provisions developed by the Uniformity Committee and the staff, thus would constitute a recommendation of a proposal whose core was developed by third parties with no relationship with the Commission.

The Hearing Officer does not believe that the origin of MoSCITA should cause pause among the Commission's membership, because, in the Hearing Officer's estimation, if a state tax uniformity product is worthy, authorship is irrelevant.¹ The challenge for state taxation to modernize and to become more uniform is boundless. Welcoming the laboring oar of any group that *fairly* addresses the development of uniform state tax rules in any substantive area of state tax law preserves the limited resources of state tax administrators and the Commission. The Hearing Officer believes it was in this spirit that MoSCITA was developed.

Witnesses and Record. The hearing was called to order in Conference Room 1906, LaSalle-Wacker Building, 221 N. LaSalle Street, Chicago, IL

¹Indeed, as a matter of history, the Commission relied on the Uniform Division of Income for Tax Purposes Act, a recommendation of both the National Conference of Commissioners on Uniform State Laws and the American Bar Association, for the development of the Compact and its subsequent regulations that govern the apportionment and allocation of income. See MTC Compact Art. IV and MTC Allocation and Apportionment Regulations, Regs. IV.1. through IV.18. (1973). This reliance on an outside product evidences that the Commission is not interested in solely promoting its own in-house work.

60601, by the Hearing Officer at 10:00 a.m., January 25, 1991. Seven people, including the Hearing Officer, attended the hearing in person. (*Exhibit G*). As an experiment in hearing procedure, the Hearing Officer also allowed four other representatives of state tax administrators to appear at the Public hearing by telephone. The individuals and their respective agencies appearing by telephone were (in their order of appearance)--

Name	Tax Agency
Michael Hodges Roland Young	North Carolina North Carolina
Phil Aldape	Idaho
Doug Bramhall	California Franchise Tax Board

Pursuant to the invitation of the Notice of Public Hearing three states and two interested parties submitted written statements. The states submitting statements in order of receipt were Iowa (*Exhibit H*), Colorado (*Exhibit I*)² and Oregon (*Exhibit J*). The two statements received in connection with the Public Hearing from interested parties other than states were those of Mr. Stephen T. Ryan (*Exhibit K*) and Mr. Michael H. Lippman. (*Exhibit L*).

Eight witnesses appeared before the Hearing Officer. The witnesses and their respective affiliations were (in their order of appearance)--

Witness	Affiliation
Garland Allen	Lawyer/pprincipal drafter of MoSCITA

²The statement of the State of Colorado was actually a statement of an *ad hoc* committee consisting of members of the Colorado Department of Revenue, the Colorado Bar Association Tax Section and the Colorado Society of Certified Public Accountants. Notwithstanding the mixed authorship of this statement, the Hearing Officer has categorized the statement as a statement of the State of Colorado.

William Schanlaber	Lawyer/principal drafter of MoSCITA
Stephen T. Ryan	Interested CPA
Michael Hodges	North Carolina Department of Revenue
Roland Young	North Carolina Department of Revenue
Phil Aldape	Idaho Department of Revenue and Taxation
Michael H. Lippman	Interested CPA
Doug Bramhall	California Franchise Tax Board

In addition, in the course of these proceedings, the Hearing Officer has consulted additional materials. These items are made a part of the record as follows: (i) *Commentary to the Model S Corporation Income Tax Act*, 42 TAX LAW. 1001 (1989), which is the commentary of the Subcommittee on the State Taxation of S Corporations, Committee of S Corporations, Section of Taxation, American Bar Association (Garland H. Allen, Chair) (*Exhibit M*); (ii) Memorandum of Martin A. Culhane, III, to Garland H. Allen, dated 05/01/89, regarding *Model S Corporation Income Tax Act--Constitutionality of Nonresident Zero-Basis Provision* (*Exhibit N*); and (iii) *Mines, MTC Considers Endorsing Modified MoSCITA*, 1991 MULTISTATE TAX COMM'N REV. 30 (*Exhibit O*).

During his deliberations on MoSCITA with Six Proposed Modifications, the Hearing Officer issued an interim report to the Executive Committee. The Interim Hearing Officer's Report is attached. (*Exhibit P*).

Description of Public Comments Received. The State of Iowa appears to support the endorsement of MoSCITA and all Six Proposed Modifications as a uniformity recommendation of the Multistate Tax Commission. The caveat to this interpretation of the statement of the State of Iowa is that state's reservation about the constitutionality of the initial zero basis rule for non-resident shareholders of S corporations. See §1003(c) of MoSCITA.

The State of Colorado supports the endorsement of MoSCITA as a uniformity recommendation of the Multistate Tax Commission. In the interest of uniformity, Colorado suggests that modifications be kept to an absolute minimum. Colorado is willing to concede that Modification #1 (IRC not *in futuro*) could be adopted. Colorado does not want to see any of the other modifications adopted as a part of the Commission's uniformity recommendation, although it states that if Modification #2 were *absolutely* necessary, it would prefer to see Optional Draft B.

The State of Oregon also supports the endorsement of MoSCITA as a uniformity recommendation of the Multistate Tax Commission. Oregon is only willing to accept Modifications ## 1 (IRC not *in futuro*) and 6 (informational returns). Oregon's objection to the other proposed modifications is based upon either the inconsistency of the modification with present Oregon law or the fact that Oregon law already addresses the problem sought to be solved by the modification.

Mr. Stephen T. Ryan supports the objectives of MoSCITA--to bring rational and uniform state income tax treatment for S corporations and their shareholders. Mr. Ryan acknowledges that many state laws have yet to focus on the unique tax characteristics of S corporations and their shareholders, especially when the S corporation is multistate in operation. MoSCITA therefore serves a useful function by stressing the need of states to address directly the state income tax treatment of S corporations and their shareholders. Mr. Ryan nonetheless believes that certain of the provisions of MoSCITA are flawed.

First, Mr. Ryan does not believe the initial zero basis rule of MoSCITA §1003(c) fairly treats non-resident shareholders who will face divergent

state tax consequences from the rule.³ Notwithstanding the problem sought to be solved by the initial zero basis rule, Mr. Ryan points to Example 1 of his three page handout, which is a part of *Exhibit K*, as an illustration of the point he seeks to make. In addition, Mr. Ryan interpreted (erroneously in the Hearing Officer's estimation) §1003(c) upon passage to require amendments of existing tax returns of non-resident shareholders. Finally, Mr. Ryan notes (i) the taxability of the non-resident in his/her home state as demonstrating that there is no avoidance of taxation by non-residents; (ii) credits afforded by resident states for taxes paid in non-resident states or credits employed through reciprocal credit agreements among the states as generally equalizing the tax burden of residents and non-residents; (iii) MoSCITA's failure to consider the growing trend among states to agree to credits afforded by non-resident states in favor of resident state taxation; and (iv) the Minnesota system for taxing gains resulting from the sale of stock in an S corporation.⁴

Second, Mr. Ryan specially criticizes the MoSCITA rule that limits corporate modifications to "Income Attributable to the State" and individual modifications to "Income Not Attributable to the State" on the grounds of unreasonable administrative burden. Mr. Ryan would opt for applying individual modifications across the board except in the limited circumstances where there was entity level taxation due to excess passive income and/or built-in gains.

Third, Mr. Ryan, while supportive of the general rule that the character of income as business income or non-business income should be determined at the entity level, desires to codify cases such as *Robert M. and Ann T.*

³The initial zero basis rule for non-resident shareholders was developed to account for the fact that typically non-resident shareholders are not subject to tax on gain realized from the sale of stock in an S corporation in states in which they are not resident. As a result, losses of an S corporation allowed to a non-resident shareholder potentially may never be recouped by the state when the stock of the corporation is subsequently sold.

⁴Minnesota's law attributed gain realized from the sale of stock in an S corporation to the non-resident state based upon in-state to everywhere ratios attributable to the business activities of the S corporation. The Hearing Officer now understands that Minnesota has subsequently repealed this provision in its law. See 1991 Minnesota Omnibus Tax Bill.

Bass, Cal. B.O.E. (01/29/89) (passive income passes directly to partners in their states of residence rather than as business income earned in a state of non-residence where pass-through entity (a partnership) is not "doing business" in the taxing state).

Fourth, Mr. Ryan believes MoSCITA should directly deal with the issue of whether S corporations should be combined in a unitary business with other entities. Mr. Ryan believes that tax avoidance should be the only reason an S corporation should be subjected to a combined report. MoSCITA has purposely avoided resolving the issue.

Fifth, Mr. Ryan urges that MoSCITA should contain rules for determining the application of the federal passive activity losses (PALs) restrictions across state lines. Mr. Ryan notes at least two approaches. Most states apply the PAL rules solely to losses attributable to their states. Illinois on the other hand applies the rules without regard to geographical limitations. Mr. Ryan expresses no preference for any rule but rather expresses the need for a uniform rule.

Mr. Ryan supports Modifications ## 1 (IRC not *in futuro*), 2 (entity level taxation) and 4 (no automatic deduction for state taxes). Mr. Ryan does not support Modifications ## 3 (no credit for entity level taxes), 5 (federal entity level taxes do not reduce state income passed through) and 6 (informational filing).

Mr. Michael H. Lippman enthusiastically supports the adoption of MoSCITA as a uniformity recommendation of the Commission. (*Exhibit L*). Mr. Lippman speaks from his experience as a practitioner and student of S Corporations. The theme emphasized by Mr. Lippman is that most state tax rules governing state taxation of S corporations are woefully inadequate to the potential detriment of both state tax administrators and S corporations and their shareholders alike. Mr. Lippman, who initially opposed MoSCITA, now believes after further consideration that MoSCITA is a fair (but not a perfect) solution to the present inadequacy.

Messrs. Garland Allen and William Schanlaber were the first witnesses to testify before the Hearing Officer.⁵ As two of the principal drafters of MoSCITA, Messrs. Allen and Schanlaber were able to put forward succinctly the case for adoption of MoSCITA forward:

☒ Almost every state's existing rules governing the taxation of S corporations in a multistate context (*i.e.*, with operations or shareholders in more than a single state) are inadequate. Generally, states adopt simplistic rules based on federal conformity without having considered how the federal rules should operate in a multijurisdictional context. Unanswered questions and ambiguities result that create for even the best intentioned taxpayers interpretative opportunities. Reporting positions taken in this environment naturally result in less tax revenues being received by the states.

☒ The importance of pass-through entities to the modern economy has escalated. The increased use of pass-through entities is reflected in the latest available statistics from the Internal Revenue Service. Before 1987 pass-through entities in the aggregate reported slightly negative income. In 1988, pass-through entities reported \$20+ billion in income in the aggregate. Income in 1980 for S corporations in the aggregate was approximately 8 billion. In 1987, that income figure had grown to approximately \$45 billion. Election rates for S corporations have likewise increased dramatically in the same

⁵Before recounting the useful observations of Messrs. Allen and Schanlaber, the Hearing Officer desires to make known the level of dedication exhibited by these two lawyers in pursuit of state uniformity in the taxation of S corporations. In addition to bearing much of the burden for actually developing MoSCITA over a three and one-half year period, these gentlemen have since become the primary spokespersons for the MoSCITA. This glamorous duty has resulted in both individuals expending substantial professional time and even incurring personal travel cost to meet with the Uniformity Committee of the Commission and the Commission's staff. Regardless of how the Executive Committee or the Commission ultimately views MoSCITA, the Hearing Officer unreservedly recommends that the Commission appropriately recognize the selfless, generous and tireless contributions these two professionals have made to the betterment of state taxation by placing state taxation of S corporations into public view and debate.

relative period. S corporations today are for many business ventures the entity of choice.

☒ MoSCITA offers a significant incentive for the non-resident shareholder of an S corporation to report his/her prorata share of the S corporation's Income Attributable to the State. Unless the non-resident shareholder has filed an agreement to file a return with, and to be subject to the personal jurisdiction of, the state in which the S corporation operates, the S corporation is required to make a tax payment on behalf of the non-resident shareholder.

☒ MoSCITA contains a logically consistent and comprehensive body of rules based upon federal principles governing S corporations that answers most questions likely to be raised and, for those questions not answered, analogies that through parallel reasoning will point to appropriate answers.

☒ MoSCITA respects a number of important state tax policy matters not vital to the proper taxation of S corporations and their shareholders. Thus, MoSCITA incorporates and/or does not interfere with state rules for determining the character of income as apportionable or allocable, the application of appropriate corporate and individual modifications to federal taxable income, the definition of residence, apportionment and allocation principles, the availability of credits for taxes paid by resident shareholders to non-resident states and the application of combined reporting rules to S corporations.

☒ MoSCITA is technically correct, because it has been drafted by experienced practitioners and scholars who are most familiar with the operation of S corporations and the effect of these operations on S corporation shareholders. The drafting perspective of the Subcommittee was to develop a fair statute, not a statute that favored either state tax administrators or taxpayers. The statute has eliminated traps for the unwary by developing a public law that will

be accessible to all requiring information as to how a state taxes S corporations instead of a regime that is known only to a select few.

▣ While MoSCITA is complex, any state recognizing S corporations inevitably is committed to administering a complex set of rules, especially when factoring in multijurisdictional operations of some S corporations. Nonetheless, the complexity is unlikely to overburden the local, less sophisticated S corporation, because the MoSCITA rules necessary to deal with multijurisdictional operations will not be applicable. In addition, the application of separate income modification rules to "Income Attributable to the State" and "Income Not Attributable to the State," one of the most criticized aspects of MoSCITA, is unlikely to result in any practical differences in the vast majority of cases.

Messrs. Allen and Schanlaber also reiterated their subcommittee's general opposition to the Six Proposed Modifications. Specifically, while Modifications ## 1 (IRC not *in futuro*) and 4 (no automatic deduction for state taxes) correctly focus on potential problems with existing state law that may occur upon state adoption of MoSCITA, Messrs. Allen and Schanlaber urged that there will always be problems of these sorts.⁶ Messrs. Allen and Schanlaber believe these problems should be addressed in the specific context of a state actively considering the adoption of MoSCITA rather than through a modification of the model act itself. Messrs. Allen and Schanlaber urged that the area of concern for Modifications ## 1 and 4 should be dealt with in commentary.

⁶Indeed, the State of Hawaii had a special problem occur upon its adoption of MoSCITA. MoSCITA's requirement of making any corporation recognized as an S corporation federally also an S corporation for state income tax purposes was the source of the problem, since the State of Hawaii prior to MoSCITA required separate elections. MoSCITA's rule had the effect of eliminating state loss carryovers held by a corporation that was an S corporation for federal tax law purposes and a C corporation for state tax law purposes. The State of Hawaii has apparently solved this problem successfully by allowing these losses to be used by the corporation that has been newly classified as an S corporation under state law.

Messrs. Allen and Schanlaber reiterated opposition to Modification # 2 (entity level tax) based upon their subcommittee's desire for true state tax uniformity. In restating their subcommittee's opposition, Messrs. Allen and Schanlaber noted that nothing in MoSCITA would prevent it from operating on a mechanical level with a state having an entity level tax.

Messrs. Allen and Schanlaber summarized their subcommittee's objection to Modification # 3 (no credit for entity level taxes) as being based upon the inconsistency such a rule has with a state allowing a credit to avoid duplicative taxation on individuals. According to Messrs. Schanlaber and Allen, if a state that recognizes S corporations grants a credit for taxes paid to another state, it should not distinguish between another state's entity level taxes imposed on S corporations and taxes paid by the individual shareholders. Denial of a credit on the ground that the payor (the S corporation) is separate from the shareholder is in effect double taxation on the individual S corporation shareholder.

Messrs. Allen and Schanlaber reserved their strongest opposition for Modification # 5 (federal entity level taxes do not reduce state income passed through). In the cry of Messrs. Allen and Schanlaber, Modification # 5 is conceptually flawed. Messrs. Schanlaber and Allen are of the view that when Congress enacted entity level taxes on S corporations, it intended shareholders of S corporations should receive treatment equivalent to that which they would receive if the S corporation were a C corporation. Thus, the *federal* tax rules allow *federal* entity level taxes to reduce *federal* income passed through, because once the tax is paid the money represented by the income is no longer within the corporation. Messrs. Allen and Schanlaber lobbied hard that the states should not depart from MoSCITA in this area to be conceptually consistent with the federal principles.

Messrs. Allen and Schanlaber repeated their subcommittee's resistance to Modification # 6 (informational filing). In addition to speculating about possible constitutional defects in Modification # 6, Messrs. Allen and Schanlaber stated categorically that there is no need for a state to receive the informational filing.

In closing their prepared comments Messrs. Allen and Schanlaber acknowledged that one could pick a single provision from MoSCITA and analyze the provision for purposes of determining whether the absolutely best choice had been made. Sometimes such an analysis might conclude that a different approach would be better. This conclusion would not, however, justify the adoption of a new rule. MoSCITA must be judged as a whole. From this perspective, Messrs. Allen and Schanlaber feel comfortable in representing MoSCITA as the best possible solution available to states today to eliminate inadequate attention to state taxation of S corporations and their shareholders.

Upon questioning by the Hearing Officer Messrs. Allen and Schanlaber were unwilling to abandon their subcommittee's opposition to the Six Proposed Modifications. The subcommittee's desire for true state tax uniformity was a driving force in this opposition. Messrs. Allen and Schanlaber did grudgingly concede that states desiring to adopt MoSCITA with some of the changes represented by the Six Proposed Modifications would benefit from having access to the specially drafted language. (MoSCITA is too tightly drawn to avoid that acknowledgement.) Messrs. Allen and Schanlaber also reluctantly admitted that the Six Proposed Modifications did not upset the operation of any other rules not within the intended coverage of the Modifications.⁷ Even in the face of these comments, Messrs. Allen and Schanlaber emphasized their distaste for Modification # 5 and further alleged that Modification # 5 did present special problems.

Finally, Messrs. Allen and Schanlaber conceded that they had thus far been unable to come up with any definitive legislative history that would support their view of Modification # 5 as being inconsistent with the C corporation regime that was intended at the federal level with respect to

⁷In the Hearing Officer's words, this admission is tantamount to saying that the Six Proposed Modifications do not affect the core provisions of MoSCITA.

federal entity level taxes. At best, the foundational support for the subcommittee's opposition to Modification # 5 is a theory.⁸

Mr. Stephen T. Ryan was the next witness to testify. Mr. Ryan's testimony has been adequately summarized in the context of his written statement. (*Exhibit K*). One point not noted previously was Mr. Ryan's observation that state tax policy should provide similar direction to partnerships, if MoSCITA is adopted for S corporations. In Mr. Ryan's view it is not appropriate to leave the partnership area undeveloped if S corporations have a clear set of rules available to them.

Messrs. Michael Hodges and Roland Young of the North Carolina Department of Revenue next testified by telephone.⁹ North Carolina's testimony was deemed important, because North Carolina was the first state to adopt MoSCITA in large part.¹⁰ Messrs. Hodges and Young indicated that no significant administrative issues arose in implementing MoSCITA in North Carolina. As far as North Carolina has thus far experienced it, practitioners appear to understand MoSCITA readily,

⁸As will be noted later, Doug Bramhall of the California Franchise Tax Board testified that he too was unable to discover any legislative history that would confirm the subcommittee's theory that Congress intended to establish the C corporation regime for federal entity level taxes.

⁹The Hearing Examiner experimented with soliciting testimony from interested states through the use of telecommunications. Given the restrictions that govern state travel, the Hearing Officer desired to learn whether receipt of testimony from state tax officials by telephone was feasible and desirable. The Hearing Officer is pleased to report that the experiment in this Public Hearing was a resounding success.

As a result of using this procedure the Hearing Officer was able to secure important comments from affected states that might not otherwise be a part of the record in his examination of the proposal. Use of telecommunications worked well in this kind of proceeding where there is a specific focus on a proposal. In fact, the in-person participants expressed a desire that such witnesses should have been connected for the entire hearing rather than just for that portion of the hearing during which they were giving testimony. The Hearing Officer concurs in this observation but also notes that whether this kind of advanced use of telecommunications is reasonably feasible would have to be analyzed from a cost perspective.

¹⁰North Carolina enacted an earlier draft of MoSCITA. Prior to adopting MoSCITA, North Carolina did not recognize S corporations for purposes of state taxation. In addition, North Carolina did not adopt all of the concepts now found in MoSCITA.

because of its utilization of federal S corporation concepts. North Carolina noted that it was probably too early to know absolutely whether these preliminary observations were entirely true, because North Carolina was just now beginning to examine some of the returns that have been filed under the new law. Messrs. Hodges and Young did emphasize that North Carolina viewed uniformity in the area to be very important.

Messrs. Hodges and Young expressed their reaction to the Six Proposed Modifications. Modification # 1 (*IRC not in futuro*) was consistent with North Carolina law, which requires North Carolina to update its conformity to the Internal Revenue Code each year. Modification # 2 (entity level tax) did not appeal to North Carolina, because that state has no entity level tax. In addition, Messrs. Hodges and Young believed that an entity level tax raised considerable complexities into the law. Modification # 3 (no credit for entity level taxes) appeared to be inequitable. North Carolina seeks to avoid inequitable tax treatment of individuals. The problem Modification # 4 (no automatic deduction for state taxes) addresses is adequately handled under current North Carolina law. Modification # 4 would reinforce North Carolina's current position. An anomaly exists in North Carolina law that would impact Modification # 5 (federal entity level taxes do not reduce state income passed through). Under North Carolina law, federal entity level taxes would have to be added back with regard to Income Attributable to the State. No add back would be required for Income Not Attributable to the State. As a result North Carolina has aspects in its law which both follow and depart from Modification #5. Modification # 6 (informational returns) appeared unnecessary. In North Carolina's experience, the needed information thus far has been able to be secured from the shareholders of the S corporation.

The State of Idaho next appeared through the testimony of Phil Aldape. Mr. Aldape commenced his testimony by noting the technical validity of MoSCITA. This technical validity comes at a high price of complexity, however. A concern that a state like Idaho would have about MoSCITA, therefore, would be whether the benefits to be secured from the adoption of MoSCITA would outweigh the burdens of administration and compliance that would result. Only thirteen percent (13%) of the

approximately 6,300 S corporations filing in Idaho are multistate. Idaho only has a minimal number of auditors to audit all pass-through entities. The ability of Idaho to monitor tax compliance of pass-through entities is strained already. MoSCITA's complexity would add additional strain. In addition, MoSCITA would necessitate additional efforts in taxpayer services.

Idaho is concerned that MoSCITA would likewise impose a higher compliance burden on its S corporation population. Idaho would expect MoSCITA's complexity to encourage negative taxpayer reaction. As a result, Mr. Aldape suggested returns of poorer quality may well be filed, adding additional strain to Idaho's audit staff. Mr. Aldape acknowledged that Idaho's current approach of taxing S corporations was simpler and less precise. Indeed, Idaho has a composite return provision that in many respects is less generous to shareholders of S corporations than if the shareholders filed individually based upon the income passed through. Even in the face of a penalty, a fair number of S corporations elect to file composite returns to achieve reporting simplicity.

Mr. Aldape indicated that Idaho may not be all that anxious to change its practices in taxing S corporations notwithstanding the clear legal advantages that would accrue from adopting MoSCITA. Idaho is nonetheless committed to state tax uniformity and any state law that would promote uniform administration of the difficult area of state taxation of multistate S corporations would have to be looked at. Idaho would probably want a widespread showing of support for MoSCITA before acting to adopt it.

Mr. Michael H. Lippman was the next witness to testify. Mr. Lippman's testimony has been largely summarized in the context of his written statement. (*Exhibit L*). Two additional observations made by Mr. Lippman should be noted, however. One point not noted in Mr. Lippman's statement was his view that the complexity of MoSCITA varies depending upon the audience to whom you are talking. In describing how MoSCITA works to state tax practitioners who have no background in the federal rules governing S corporations, there is some initial difficulty

in comprehension. On the other hand, practitioners involved in completing federal forms 1120 (U.S. Income Tax Return for an S Corporation) have little or no difficulty in grasping how MoSCITA is intended to work.

Another point that Mr. Lippman emphasized in his oral statement is that any one provision of MoSCITA may be able to be picked apart and challenged. For example, some may question the equity of the initial zero basis rule for non-resident shareholders. The impact of that rule is considerably less, however, when you note that MoSCITA allows unused losses to be carried forward, *see* MoSCITA §1004(c), which is a result that is not permitted in many current state tax systems. The fairness of MoSCITA must be judged by its overall operation and not any single provision that is analyzed in isolation.

The final witness was Doug Bramhall of the California Franchise Tax Board. Mr. Bramhall noted that his comments were reflective of his personal views and some of the legislative choices that the State of California has already made.

Mr. Bramhall commenced his review of MoSCITA by noting that it was a fundamentally sound and internally consistent proposal. Mr. Bramhall was appreciative of MoSCITA's implicit adoption of a number of existing state concepts, including the use of UDITPA to apportion and allocate income, the characterization of income as apportionable or allocable, the employment of state adjustments to federal taxable income and the initial zero basis rule for non-resident shareholders of S corporations.

Mr. Bramhall also noted, however, that MoSCITA has adopted some approaches that are inconsistent with current California law or at least fail to solve persistent problems. The loss carryover provision of MoSCITA §1004(c), for example, conflicts with current California law that requires the existence of a federal loss carryover and further contains a fifty percent (50%) limitation. Mr. Bramhall mused that perhaps MoSCITA's approach is a reasonable alternative to relying on the AAA account or basis adjustment rules for seeing whether there is a true tax effect to the

disallowed losses. In addition, Mr. Bramhall noted that MoSCITA does not attempt to solve the problem of a resident shareholder who after enjoying the deductibility of losses in a taxing state moves from the taxing state before selling the stock of an S corporation and thereby avoids the recoupment that the initial zero basis rule understands will occur for resident shareholders.

Mr. Bramhall expressed his reaction to the Six Proposed Modifications as follows: Modification # 1 (*IRC not in futuro*) was consistent with California law, which requires California to update its conformity to the Internal Revenue Code each year. Mr. Bramhall favored Modification # 1. Modification # 2 (entity level tax) is also consistent with California law. Mr. Bramhall viewed adoption of Modification # 2 as essential for California to support MoSCITA. Modification # 3 (no credit for entity level taxes) was inconsistent with California law which does allow for such a credit. In addition, Mr. Bramhall believe the ABA drafters' statement with regard to Modification # 3 in *Exhibit O* had the more persuasive policy position. Mr. Bramhall expressed no position with regard to Modification # 4 (no automatic deduction for state taxes). He felt that the positions set forth in the MTC staff statement and the ABA drafters' statement with regard to Modification # 4 in *Exhibit O* adequately framed the issue for others to resolve the dispute. Modification # 5 (federal entity level taxes do not reduce state income passed through) reflects current California law. Mr. Bramhall believed Modification # 5 was consistent with the general rule of state taxes not to allow a deduction for federal taxes. The federal government yields to state taxes in the conflict of taxing sovereignty. Although Mr. Bramhall has researched Congressional legislative history to 1975 when federal entity level taxes were first introduced, he has found no support for the position taken by the ABA drafters' statement with regard to Modification # 5 in *Exhibit O*. The ABA drafters assert that the deductibility of federal entity level taxes for federal tax purposes was intended to replicate the earnings and profits scheme of taxation of C corporations. Mr. Bramhall finds just as persuasive in this context the MTC staff statement in *Exhibit O* that the deduction is tantamount to a recognition by the taxing sovereign (the federal government) that it has already received its measure of tax from income that otherwise would be

potentially deferred. Mr. Bramhall did not express a reaction to Modification # 6 (informational returns), because he believed someone in state tax compliance would have better insight than he as to its necessity.

Mr. Bramhall concluded his comments by noting that states may be feeling the effects of taxpayers being able to shift the location of state taxation by converting (through mechanics that have no federal or state tax toll) tangible and real property into intangible interests. Minnesota's [then applicable] approach to taxing the gain on the disposition of the sale of stock in an S corporation represents an attempt to address some of these concerns. California's rule with regard to the disposition of an interest in a partnership by a corporation is another instance of a state attempting to meet the issue head on. MoSCITA does not reflect any treatment of the problem and therefore is lacking. Mr. Bramhall nevertheless believed that the states were not yet ready to tackle the problem in its entirety and therefore he acquiesced in the notion that MoSCITA should not be held hostage to resolving this issue in its entirety. At some point, however, an attempt must be made to address this problem or the state tax base may be needlessly subject to further erosion through aggressive state tax planning by knowledgeable practitioners.

Hearing Officer's Analysis of Comments Received. The Hearing Officer is of the opinion that MoSCITA is a very credible answer to the states' present failure to address adequately state taxation of S corporations operating in a multistate environment (*i.e.*, having operations or shareholders in more than a single state). There can be little doubt the states' present system of taxation of S corporations needs to be overhauled to conform the applicable tax rules and administration to the current economic circumstances affecting the use of S corporations, a popular form of pass-through entity now utilized by business.

As there is little doubt of the need for a solution, there can be little doubt of the quality of MoSCITA as that solution. The Hearing Officer is in awe of the integral entirety, fairness, internal consistency and conciseness achieved by MoSCITA. Any person participating in the drafting of MoSCITA can feel justifiably proud of the end product. The Hearing

Officer believes, therefore, that MoSCITA should become a uniformity recommendation of the Multistate Tax Commission. And as will also be explained, the Hearing Officer also believes the Six Proposed Modifications should also be a part of that recommendation.

The Hearing Officer's endorsement of MoSCITA is not to say that some aspect of MoSCITA might not have been drafted differently, if each of the issues inherent in developing MoSCITA were to be re-examined one-by-one today. Indeed, some, including the Uniformity Committee with its Six Proposed Alternatives, have rightly pointed to deficiencies that exist with respect to some of the rules found in MoSCITA. This is to say no more than MoSCITA is not perfect. But such accusations hardly justify shunning MoSCITA. Rule by rule criticism of MoSCITA does not detract from the unity achieved by MoSCITA as a whole. The Hearing Officer in the face of the accomplishments of MoSCITA does not deign to suggest that any of the core provisions of MoSCITA should be altered. To tinker with the core of MoSCITA is to start loosening the lock nut that holds MoSCITA together and provides "for a system for state income taxation of S corporations and their shareholders that is reasonable, internally consistent, susceptible of compliance, and easily administrable." In the Hearing Officer's estimation, the excellence of MoSCITA is recommendation enough that it should be proposed as a uniform state law governing state taxation of S corporations.

The Hearing Officer heard nothing during the course of these proceedings that would dissuade him from these views. None of the commenting states urged rejection of MoSCITA, although the State of Idaho was concerned that MoSCITA might be an overkill in Idaho's relatively embryonic economy. Mr. Ryan of the public accounting firm of Grant Thornton is the only voice that has been raised in actual opposition to adopting MoSCITA in its present form. Mr. Ryan's bottom line position appears to be that while MoSCITA represents a tremendous leap forward, there are some rules that should be fixed in MoSCITA before MoSCITA is recommended as a uniform solution to address inadequate state rules governing taxation of S corporations and their shareholders. The Hearing Officer's reaction to Mr. Ryan's rule by rule criticism of MoSCITA follows.

Mr. Ryan's criticism of MoSCITA's initial zero basis rule reflects valid concerns. In the context of developing a complete solution, however, the Hearing Officer perceives Mr. Ryan's criticism as another person's view statement that he would have solved the problem of permitting the pass through of losses to non-resident shareholders of S corporations differently. The specific concerns raised by Mr. Ryan were considered by the ABA subcommittee in its development of MoSCITA and rejected.

The hearing Officer also believes Mr. Ryan's concerns in the end reflect a more fundamental problem that permeates state tax systems in general and not just S corporations--how states should situs gains realized from the disposition of intangibles. The Hearing Officer cannot quarrel with the solution offered by MoSCITA when measured against the principles that states now generally employ to answer this situsing issue.¹¹ The Hearing Officer concurs in the eloquent statement of Mr. Bramhall that MoSCITA should not be held hostage until the states have adequately addressed the more fundamental problem of how to situs gains realized from the disposition of intangibles. The period following state development of a new understanding surrounding the taxation of gains and losses derived from the disposition of intangibles will be time enough to reexamine the premise of MoSCITA in this area.

Mr. Ryan's criticism of the use of different income modifications depending upon whether the income is Income Attributable to the State or Income Not Attributable to the State also has some truth. The criticism may be more theoretical, however. The Hearing Officer believes the development of appropriate reporting forms will avoid much of the interpretative confusion that can arise out of consideration of statutory language used by MoSCITA. In this regard, the Hearing Officer believes Mr. Lippman's observation is most telling: he has found that those who

¹¹Many states employ the fiction of domicile, which can change, to situs such gains. Minnesota has apparently abandoned its experiment with tinkering with this traditional rule by its repeal of the rule that gains resulting from the sale of stock held in an S corporation are to be apportioned. Minnesota recently readopted the traditional rule of situsing gains realized by the disposition of S corporation stock based upon the domicile of the S corporation shareholder. See 1991 Minnesota Omnibus Tax Act.

have familiarity with the federal tax reporting concepts of S corporations easily understand MoSCITA.

The Hearing Officer believes that Mr. Ryan's opposition to MoSCITA's reliance on characterizing income at the corporate level as apportionable or allocable is at variance with precisely one of the reasons that MoSCITA is attractive to the states. MoSCITA respects the classification of income at the level where that income is earned. The Hearing Officer doubts seriously whether most states would be willing to accept MoSCITA with rules that abandoned the business and nonbusiness income distinction and instead were based on franchise tax concepts of "doing business." *Robert M. and Ann T. Bass, Cal. B.O.E. (01/29/89).*

Mr. Ryan rightly notes that MoSCITA does not address all of the state tax issues faced by S corporations. Included in Mr. Ryan's list of the missing were rules to govern under what circumstances S corporations should be subject to combined reporting and how the passive activity loss rules should be administered on a multistate basis. The Hearing Officer shares Mr. Ryan's sense that these issues are important enough to have uniform state rules developed. The Hearing Officer does not share Mr. Ryan's view that MoSCITA necessarily represents the best venue for securing state agreement as to what these rules should be.

MoSCITA should really be viewed as a product of minimalism. MoSCITA is limited to addressing the fundamental issues inherent in state taxation of S corporations as a distinct entity operating under federal tax law. In the Hearing Officer's view the drafters of MoSCITA properly have left to another day some issues that peripherally affect S corporations. Attempts to solve all issues affecting S corporations is fraught with the danger of alienating individual states that view the developed solution to the peripheral issues as being incorrectly made.¹² The existence of the Six Proposed Modifications is testimony enough that even a minimalistic MoSCITA may have gone too far for some states. The Hearing Officer

¹²This risk of going too far with the proposal was clearly within the thinking of the drafters of MoSCITA. See *Commentary to the Model S Corporation Income Tax Act*, 42 TAX LAW. 1009, 1019 (1989).

submits that state adoption of MoSCITA can proceed while at the same time those interested in developing uniform rules in the peripheral areas can proceed independently to develop additional proposed uniform rules that are not *per se* affected by MoSCITA.

Before addressing the Six Proposed Modifications, the Hearing Officer should note the State of Iowa's concern about the constitutionality of the initial zero-basis rule for nonresident shareholders. MoSCITA §1003(c). The issue raised by the State of Iowa is the subject of a lengthy analysis in the Memorandum from Culhane to Allen, regarding *Model S Corporation Income Tax Act--Constitutionality of Nonresident Zero-Basis Provision (Exhibit N)*. Mr. Culhane concludes that the initial zero-basis rule is constitutionally defensible. The Hearing Officer believes any state considering the adoption of MoSCITA should study *Exhibit N* to ensure that it can concur in the conclusions reached. The Hearing Officer believes the issues are reasonably framed in *Exhibit N* and that the conclusions reached are legitimate.

The Hearing Officer's belief that the Six Proposed Modifications should be a part of the uniformity recommendation of MoSCITA reflects the Hearing Officer's belief that the bulk of the criticism expressed against the Six Proposed Modifications is misplaced. Most have addressed their review of the Six Proposed Modifications from the viewpoint of what they either believe the correct state tax policy *should* be in the affected area or what their own state law is. The result of these perspectives is that the review of the Six Proposed Modifications has been mixed with each of the Six Proposed Modifications receiving the support of at least one party appearing at the Public Hearing.

The mixed response to the Six Proposed Modifications by even the limited audience participating in the Public Hearing suggests that the areas affected by the Six Proposed Modifications are unsettled. The Hearing Officer believes that the Commission would be performing a valuable service by including within its recommendation of MoSCITA proposed language that does not violate the otherwise tight language of MoSCITA. In this vein, it should be recalled that the Six Proposed Modifications are

not intended to replace the section of MoSCITA that the Modifications amend. Rather the Six Proposed Modifications are intended only as proposed language that will modify MoSCITA to conform it to an adopting state's *existing* state tax policy. The Six Proposed Modifications are not policy choices against the policy choices made by MoSCITA but policy alternatives to such policy choices.

The only argument advanced against inclusion of the Six Proposed Modifications as *policy alternatives* that causes some pause is that the inclusion of the Six Proposed Modifications will promote state tax diversity when the goal of MoSCITA is state tax uniformity. The Hearing Officer does not believe that inclusion of the Six Proposed Modifications as a part of the Commission's uniformity recommendation of MoSCITA will unduly detract from the utility of the uniformity otherwise being achieved by MoSCITA. In fact, the Hearing Officer believes the inclusion of the Six Proposed Modifications will promote more uniformity by permitting those states whose present tax policy is inconsistent with MoSCITA in the affected area to consider MoSCITA more seriously. The diversity contemplated by the Six Proposed Modifications is limited enough in the Hearing Officer's estimation that more uniformity potential is to be gained by their inclusion than their exclusion. This point was drawn home most vividly by Mr. Bramhall, who is affiliated with the California Franchise Tax Board. Mr. Bramhall at one point suggested that in his view inclusion of more than one of the Six Proposed Modifications was essential to the receipt of California's support of MoSCITA.

While the Hearing Officer deems the foregoing observations responsive to much of the opposition expressed against the Six Proposed Modifications, the Hearing Officer also believes the more substantive objections expressed against the Six Proposed Modifications are lacking.

Messrs. Allen and Schanlaber acknowledged that Modifications ## 1 (*IRC not in futuro*) and 4 (no automatic deduction for state taxes) address legitimate concerns. The dispute is over whether the Commission's recommendation of MoSCITA should include proposed statutory language to deal with the problem or only commentary. The Hearing Officer sees

no advantage to limiting the solution being offered to commentary that may well be overlooked or not understood. The presence of statutory language forces any adopting state to consider whether the provision is applicable to their circumstance. In effect, proposed statutory language is a more effective way to bring the message home and also allows an adopting state to use approved language, if it is germane, that will not unintendedly affect the operation of other provisions of MoSCITA.

Mr. Bramhall opined that the inclusion of Modification # 2 (entity level tax) was essential to securing California's support of MoSCITA. The Hearing Officer also notes that at least three other states impose entity level taxes on S corporations: Illinois, Massachusetts and New York. All of these jurisdictions are important to the promotion of state tax uniformity if for no other reason than the size of their economies. Messrs. Allen and Schanlauer opposed Modification # 2 on the ground of uniformity. The Hearing Officer believes securing California's endorsement, and possibly the endorsement of the other states imposing entity level taxes, to MoSCITA will do more to promote uniformity than to omit Modification # 2 from consideration as a policy alternative to MoSCITA. The Hearing Officer believes that MoSCITA should accommodate this existing state tax diversity.

Modification # 3 (no credit for entity level taxes) received the least support from those submitting statements to the Public Hearing. Yet more states responding to the MTC staff's MoSCITA survey objected to the rule that states must grant a credit for taxes imposed by a non-recognition state than they did to any other rule of MoSCITA included in the survey. The complaint lodged against Modification # 3 at the Public Hearing was that it was unfair not to grant a credit for non-recognition state taxes. Yet to the Hearing Officer fairness as a policy matter is not the critical issue here. In the face of the significant opposition expressed in the state response to the MTC staff survey on MoSCITA to being required by MoSCITA to grant a credit for non-recognition state taxes, the Hearing Officer believes that MoSCITA in the interest of promoting its serious consideration by the states should have an alternative policy choice available to states. The responses to the MTC staff MoSCITA survey suggest there are states that

are unable to accept yet the necessity of having to grant a credit for taxes paid to non-recognition states. And apart from this overriding consideration, the Hearing Officer also believes states can legitimately conclude that taxes paid by the corporation in one state should not form the basis for granting a credit to the corporation's shareholders in another state.

Mr. Bramhall suggested that California would feel strong about the necessity of including Modification # 5 (federal entity level taxes do not reduce state income passed through) in any Commission endorsement of MoSCITA. The drafters of MoSCITA have not brought any evidence to the Public Hearing to support their contention that the federal scheme intends to pattern federal entity level taxation of S corporations after the earnings and profits model used in the taxation of C corporations. In the absence of legislative history supporting the drafters' strenuous objections to Modification # 5, the Hearing Officer believes MoSCITA should accommodate differing state tax policies in this area. Nothing has been presented that suggests the rationale suggested by the MTC staff statement to Modification # 5 in *Exhibit O* is not as likely a correct view of the circumstance.

The opposition to Modification # 6 (informational returns) was expressed both in terms of a possible constitutional infirmity and there being no need for the information. As to whether there is a need for the information, the Hearing Officer would note that access to corporate-wide tax information may best be analyzed by the state in which the shareholders are resident, because that state may be the most logical state for examining the entire return of an S corporation operating in a multistate environment. It may be that such information could be secured from the shareholder, as for example by requiring the resident shareholder to append a copy of the S corporations returns to his/her state return. But it is not entirely clear that S corporations are legally required to give all shareholders access to their tax returns. See Model Business Corporation Act §52; *but see* Revised Model Business Corporation Act §16.02. In addition, as a general matter the Hearing Officer believes that placing the informational return requirement at the business entity level, as opposed to the shareholder

level, is more likely to result in compliance, because businesses are more likely to be familiar with reporting requirements.

The Hearing Officer likewise is unimpressed with the assertion that imposing a filing requirement upon the S corporation that is not operating in the state of the resident shareholder is unconstitutional. In the Hearing Officer's view, S corporations by their nature operate in the states of their shareholders' residence, because the system of taxation applicable to them purposively throws off tax incidents that impact those states' administration of their tax laws. It is inconceivable to the Hearing Officer that the Constitution would prohibit a state to which an S corporation purposively throws tax incidents from making that corporation account to it. *Cf. Burger King Corp. v. Rudzewicz*, 471 U.S. 462 (1985). Any other interpretation is tantamount to suggesting that a state of a resident shareholder in which the S corporation does not operate would have no jurisdiction to tax the S corporation. That proposition to the Hearing Officer borders on the preposterous. Finally, the Hearing Officer notes that at least one member state of the Commission, Idaho, imposes precisely this kind of requirement. Idaho Code §63-3030(a)(4) (1989). For the reasons already noted with regard to some of the other Modifications, the interest of Uniformity may best be promoted by accommodating this diversity that does not touch the core of MoSCITA.

In conclusion to the Hearing Officer's recommendation that all Six Proposed Modifications be made a part of the Commission's uniformity recommendation of MoSCITA, the Hearing Officer notes that none of the Six Proposed Modifications affect the core integrity of MoSCITA. All of the Six Proposed Modifications represent plausible policy alternatives to the choices made by MoSCITA. Adoption of the Six Proposed Modifications is more likely to promote serious consideration of MoSCITA and hence more uniformity among the states. The Six Proposed Modifications can in any event carry a legend that states they do not represent policy choices that are intended to replace the provisions of MoSCITA to be amended thereby. By carrying such a legend, the Six Proposed Modifications would indicate that they are intended only to offer suggested language that will permit the preservation of *existing* state policy

that is inconsistent with MoSCITA. The only change the Hearing Officer is suggesting with respect to MoSCITA with Six Proposed Modifications is the addition of a legend to the Six Proposed Modifications that clearly indicates their limited purpose. See *Exhibit Q* for a rendition of the Six Proposed Modifications that carry such a legend.

Additional Observations of the Hearing Officer. In the course of conducting the Public Hearing and preparing this Report, the Hearing Officer has identified some additional matters that are properly noted herein. In the Notice of Hearing the Hearing Officer raised two specific questions: (i) Does MoSCITA facilitate state tax administration, or would the states be better served by taxing S corporations as entities and refrain from attempting to develop specific rules to deal with the jurisdictional complexities that are present when S corporations have multistate operations and membership? (ii) Is "one stop" centralized filing for all states in which an S corporation has operations needed?

Few comments were received from interested parties with regard to the two questions posed. Given the low level of response received, the Hearing Officer does not believe it appropriate to comment further on the issues raised in the Notice of Hearing other than to note that administration of pass-through entities operating within a single jurisdiction is challenging enough. The Hearing Officer believes states would benefit from doing a complete reexamination of the benefits and costs associated with administering pass-through entity rules in the multijurisdictional environment.

RECOMMENDATION OF HEARING OFFICER

For the reasons noted above, the Hearing Officer recommends the Model S Corporation Income Tax Act ("MoSCITA") (*Exhibit A*) with the Six Proposed Modifications (*Exhibit Q*) be adopted by majority vote of the Multistate Tax Commission as a recommended measure promoting state tax uniformity in state income taxation of S corporations.

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Respectfully submitted,

Paull Mines
Hearing Officer

Dated: June 29, 1991

LIST OF EXHIBITS

Exhibit A--MoSCITA as referred to the Public Hearing.

Exhibit B--Six Proposed Modifications as referred to the Public Hearing.

Exhibit C--Executive Committee Resolution of August 29, 1991.

Exhibit D--Notice of Public Hearing.

Exhibit E--Certification of mailing of notice (per White), dated November 20, 1990.

Exhibit F--Mazerov memorandum to Mines re Certification of mailing of Notice, dated May 8, 1991.

Exhibit G--Roster of those attending the Public Hearing.

Exhibit H--Statement of State of Iowa.

Exhibit I--Statement of State of Colorado.

Exhibit J--Statement of State of Oregon.

Exhibit K--Statement of Stephen T. Ryan.

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Exhibit L--Statement of Michael H. Lippman.

Exhibit M--Commentary to the Model S Corporation Income Tax Act, 42 TAX LAW. 1009 (1989).

Exhibit N--Memorandum of Martin A. Culhane, III, to Garland H. Allen, dated 05/01/89, regarding Model S Corporation Income Tax Act--Constitutionality of Nonresident Zero-Basis Provision.

Exhibit O--Mines, MTC Considers Endorsing Modified MoSCITA, 1991 MULTISTATE TAX COMM'N REV. 30.

Exhibit P--Interim Hearing Officer's Report.

Exhibit Q--Six Proposed Modifications with Legend.

EXHIBIT A

**REPORT OF THE SUBCOMMITTEE ON STATE
TAXATION OF S CORPORATIONS: MODEL S
CORPORATION INCOME TAX ACT AND
COMMENTARY**

*American Bar Association
Section of Taxation
Committee on S Corporations
Subcommittee on the State Taxation of S Corporations
June 1989 (Revised)*

MODEL S CORPORATION INCOME TAX ACT

I. BASIC PROVISIONS

**SECTION 1000. TITLE; DEFINITIONS; FEDERAL CONFORMITY;
CONSTRUCTION**

(a) The title of this Part shall be the _____ [name of State]
S Corporation Income Tax Act.

(b) For purposes of this Part, the following terms shall have the following
meanings:

- (1) C Corporation: a corporation which is not an S Corporation.
 - (2) Code: the Internal Revenue Code of 1986, as amended and as applicable to the Taxable Period; references to sections of the Code shall be deemed to refer to corresponding provisions of prior and subsequent federal tax laws.
 - (3) Income Attributable to the State: items of income, loss, deduction or credit of the S Corporation apportioned to this State pursuant to [Section number—business income apportionment provision] or allocated to this State pursuant to [Section number—nonbusiness income allocation provision].
 - (4) Income Not Attributable to the State: all items of income, loss, deduction or credit of the S Corporation other than Income Attributable to the State.
 - (5) Post-Termination Transition Period: that period defined in Section 1377(b)(1) of the Code.
 - (6) Pro Rata Share: the portion of any item attributable to an S Corporation shareholder for a Taxable Period determined in the manner provided in, and subject to any election made under, Section 1377(a) or 1362(e), as the case may be, of the Code.
 - (7) S Corporation: a corporation for which a valid election under Section 1362(a) of the Code is in effect.
 - (8) Taxable Period: any taxable year or portion of a taxable year during which a corporation is an S Corporation.
- (c) Except as otherwise expressly provided or clearly appearing from the

context, any term used in this Part shall have the same meaning as when used in a comparable context in the Code, or in any statute relating to federal income taxes, in effect for the Taxable Period. Due consideration shall be given in the interpretation of this Part to applicable sections of the Code in effect from time to time and to federal rulings and regulations interpreting such sections, provided such Code, rulings and regulations do not conflict with the provisions of this Part.

(d) This Act shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject matter of this Act among States enacting it.

SECTION 1001. *TAXATION OF AN S CORPORATION AND ITS SHAREHOLDERS*

(a) [Alternative No. 1] An S Corporation shall not be subject to the tax imposed by [Section number—taxation of C Corporations].

(a) [Alternative No. 2] Except as provided in the following sentence, an S Corporation shall not be subject to the tax imposed by [Section number—taxation of C Corporations]. If an S Corporation is subject to federal income tax on any of its income, then the amount of such income, as modified pursuant to Section 1002 of this Part, that constitutes Income Attributable to the State shall be subject to the tax imposed by [Section number—taxation of C Corporations]. The S Corporations Income Attributable to the State shall be reduced by the amount of any tax imposed on the corporation pursuant to the preceding sentence.

(b) For purposes of [Section number—taxation of individuals], each shareholder's Pro Rata Share of the S Corporation's Income Attributable to the State and each resident shareholder's Pro Rata Share of the S Corporation's Income Not Attributable to the State, as modified pursuant to Section 1002 of this Part, shall be taken into account by the shareholder in the manner provided in Section 1366 of the Code.

(c) For purposes of determining the amounts taken into account by the shareholders of an S Corporation pursuant to subsection (b), the amount of any tax imposed on the S Corporation under the Code shall proportionately reduce the S Corporation's Income Attributable to the State and Income Not Attributable to the State.

SECTION 1002. *MODIFICATION AND CHARACTERIZATION OF INCOME*

(a) An S Corporation's Income Attributable to the State shall, for purposes of Section 1001 of this Part, be subject to the modifications provided in [Section number—corporate modifications].

(b) The Pro Rata Share of each resident shareholder of an S Corporation in the Income Not Attributable to the State shall, for purposes of Section 1001(b) of this Part, be subject to the modifications provided in [Section number—individual modifications].

(c) The character of any S Corporation item taken into account by a shareholder

of an S Corporation pursuant to Section 1001(b) of this Part shall be determined as if such item were received or incurred by the S Corporation and not its shareholder.

SECTION 1003. BASIS AND ADJUSTMENTS

(a) The initial basis in the hands of a resident shareholder of an S Corporation in the stock of the S Corporation and any indebtedness of the S Corporation to the shareholder shall be determined in the manner provided under the Code, and shall be determined as of the date (which may be before the effective date of this Part) that is the latest to occur of (1) the date on which the shareholder last became a resident of this State, (2) the date on which the shareholder acquired the stock or the indebtedness of the corporation, or (3) the effective date of the corporation's most recent S election under the Code.

(b) The initial basis of a resident shareholder in the stock and indebtedness of an S Corporation shall be adjusted after the date specified in subsection (a) in the manner and to the extent required by Section 1011 of the Code except that, with respect to any Taxable Period during which the shareholder is a resident of this State—

(1) any modifications made (other than for income exempt from federal or this State's taxation) pursuant to Section 1002 of this Part [(and any provision of prior State law similar to this subsection (b), without regard to subsection (b)(2))] shall be taken into account; and

(2) any adjustments made pursuant to Section 1367 of the Code for a Taxable Period during which this State did not measure the income of a shareholder of an S Corporation by reference to the S Corporation's income shall not be taken into account.

(c) The initial basis in the hands of a nonresident shareholder of an S Corporation in the stock of the S Corporation and any indebtedness of the S Corporation to the shareholder shall be zero as of the date (which may be before the effective date of this Part) that is the latest to occur of (1) the date on which the shareholder last became a nonresident of this State, (2) the date on which the shareholder acquired the stock or the indebtedness of the corporation, or (3) the effective date of the corporation's most recent S election under the Code.

(d) The initial basis of a nonresident shareholder in the stock and indebtedness of an S Corporation shall be adjusted after the date specified in subsection (c) as provided in Section 1367 of the Code, except that such adjustments shall be limited to that portion of the Income Attributable to the State that is taken into account by the shareholder pursuant to Section 1001(b) of this Part [(and any provision of prior State law similar to this subsection (d))]. In computing Income Attributable to the State for purposes of the preceding sentence, any modification made for income exempt from federal or this State's taxation shall not be taken into account.

(e) The basis in the hands of a resident shareholder of an S Corporation in the stock of the S Corporation shall be reduced by the amount allowed as a loss or deduction pursuant to Section 1004(d) of this Part.

(f) The basis in the hands of a resident shareholder of an S Corporation in the stock of the S Corporation shall be reduced by the amount of any cash distribution which is not taxable to the shareholder as a result of the application of Section 1006(b) of this Part.

(g) For purposes of this section, any person acquiring stock or indebtedness of an S Corporation by gift from a person who is a resident of this State at the time of the gift shall be considered to have acquired the stock or indebtedness at the time the donor acquired the stock or indebtedness.

SECTION 1004. *CARRYOVERS AND CARRYBACKS; LOSS LIMITATION*

(a) Carryforwards and carrybacks to and from Taxable Periods of an S Corporation shall be restricted in the manner provided in Section 1371(b) of the Code.

(b) The aggregate amount of losses or deductions of an S Corporation taken into account by a shareholder of the S Corporation for a Taxable Period pursuant to Section 1001(b) of this Part shall not exceed the shareholder's combined adjusted basis, determined in accordance with Section 1003 of this Part, in the stock of the S Corporation and any indebtedness of the S Corporation to the shareholder.

(c) Any loss or deduction of an S Corporation which is disallowed for a Taxable Period pursuant to subsection (b) shall be treated as incurred by the corporation in the succeeding Taxable Period with respect to that shareholder.

(d) (1) Any loss or deduction of an S Corporation which is disallowed pursuant to subsection (b) for the corporation's last Taxable Period as an S Corporation shall be treated as incurred by a shareholder on the last day of any Post-Termination Transition Period.

(2) The aggregate amount of losses and deductions taken into account by a shareholder pursuant to subsection (d)(1) shall not exceed the shareholder's adjusted basis in the stock of the corporation (determined in accordance with Section 1003 of this Part at the close of the last day of any Post-Termination Transition Period and without regard to this subsection (d)).

(e) [Optional subsection] Any loss or deduction of an S Corporation for a Taxable Period that is not taken into account by a shareholder of the S Corporation pursuant to [Section numbers—at-risk, passive loss, etc. limitations] shall be treated as incurred by the corporation in the succeeding Taxable Period with respect to that shareholder.

SECTION 1005. *PART-YEAR RESIDENCE*

For purposes of this Part, if a shareholder of an S Corporation is both a resident and nonresident of this State during any Taxable Period, the shareholder's Pro Rata Share of the S Corporation's Income Attributable to the State and Income Not Attributable to the State for the Taxable Period shall be further prorated between the shareholder's periods of residence and nonresidence during the Taxable Period, in accordance with the number of days in each period.

SECTION 1006. *DISTRIBUTIONS*

(a) Subject to subsection (c), a distribution made by an S Corporation with respect to its stock to a resident shareholder shall be taken into account by the shareholder for purposes of [Section number—taxation of individuals] to the extent that the distribution is treated as a dividend or as gain from the sale or exchange of property pursuant to Section 1368 of the Code.

(b) Subject to subsection (c), a distribution of money made by a corporation with respect to its stock to a resident shareholder during a Post-Termination Transition Period shall not be taken into account by the shareholder for purposes of [Section number—taxation of individuals] to the extent the distribution is applied against and reduces the adjusted basis of the stock of the shareholder in accordance with Section 1371(e) of the Code.

(c) In applying Sections 1368 and 1371(e) of the Code to any distribution referred to in subsection (a) or (b)—

(1) the term “adjusted basis of the stock” shall mean the shareholder’s adjusted basis in the stock of the S Corporation, as determined under Section 1003 of this Part; and

(2) the term “accumulated adjustments account” shall mean an amount that is equal to, and adjusted in the same manner as, the S Corporation’s accumulated adjustments account defined in Section 1368(e)(1)(A) of the Code, except that any modifications required to be made pursuant to Section 1002(a) of this Part shall be taken into account.

SECTION 1007. *RETURNS; SHAREHOLDER AGREEMENTS; MANDATORY PAYMENTS*

(a) An S Corporation which engages in activities in this State which would subject a C Corporation to the requirement to file a return under [Section number—taxation of C Corporations] shall file with the [State taxing authority] an annual return, in the form prescribed by the [State taxing authority], on or before the due date prescribed for the filing of C Corporation returns under [Section number—corporate tax return filing date]. The return shall set forth the name, address and social security or federal identification number of each shareholder; the Income Attributable to the State and Income Not Attributable to the State with respect to each shareholder as determined under this Part; the modifications required by Section 1002 of this Part; and such other information as the [State taxing authority] may by regulation prescribe. The S Corporation shall, on or before the day on which such return is filed, furnish to each person who was a shareholder during the year a copy of such information shown on the return as the [State taxing authority] may by regulation prescribe. The S Corporation shall also maintain the accumulated adjustments account described in Section 1006(c)(2) of this Part.

(b) The [State taxing authority] shall permit S Corporations to file composite returns and to make composite payments of tax on behalf of some or all of its nonresident shareholders. The [State taxing authority] may permit composite returns and payments to be made on behalf of resident shareholders.

(c) With respect to each of its nonresident shareholders, an S Corporation shall for each Taxable Period either (1) timely file with the [State taxing authority] an agreement as provided in subsection (d) or (2) make a payment to this State as provided in subsection (e). An S Corporation that timely files an agreement as provided in subsection (d) with respect to a nonresident shareholder for a Taxable Period shall be considered to have timely filed such an agreement for each subsequent Taxable Period. An S Corporation that does not timely file such an agreement for a Taxable Period shall not be precluded from timely filing such an agreement for subsequent Taxable Periods.

(d) The agreement referred to in subsection (c)(1) is an agreement of a nonresident shareholder of the S Corporation—

(1) to file a return in accordance with the provisions of [Section number—individual tax return filing requirement] and to make timely payment of all taxes imposed on the shareholder by this State with respect to the income of the S Corporation; and

(2) to be subject to personal jurisdiction in this State for purposes of the collection of income taxes, together with related interest and penalties, imposed on the shareholder by this State with respect to the income of the S Corporation.

The agreement will be considered to be timely filed for a Taxable Period (and for all subsequent Taxable Periods) if it is filed at or before the time the annual return for such Taxable Period is required to be filed pursuant to subsection (a).

(e) The payment referred to in subsection (c)(2) shall be in an amount equal to the highest marginal tax rate in effect under [Section number—individual tax rates] multiplied by the shareholder's Pro Rata Share of the Income Attributable to the State reflected on the corporation's return for the Taxable Period. An S Corporation shall be entitled to recover a payment made pursuant to the preceding sentence from the shareholder on whose behalf the payment was made. Any such payment for a Taxable Period must be made at or before the time the annual return for such Taxable Period is required to be filed pursuant to subsection (a).

(f) Any amount paid by the corporation to this State pursuant to subsection (b) or (e) shall be considered to be a payment by the shareholder on account of the income tax imposed on the shareholder for the Taxable Period pursuant to [Section number—taxation of individuals].

SECTION 1008. TAX CREDITS

(a) For purposes of [Section number—individual tax credit allowance provisions], each resident shareholder shall be considered to have paid a tax imposed on the shareholder in an amount equal to the shareholder's Pro Rata Share of any net income tax paid by the S Corporation to a state which does not measure the income of shareholders of an S Corporation by reference to the income of the S Corporation. For purposes of the preceding sentence, the term "net income tax" means any tax imposed on or measured by a corporation's net income.

(b) [Optional] Each shareholder of an S Corporation shall be allowed a credit against the tax imposed by [Section number—taxation of individuals] in an

amount equal to the shareholder's Pro Rata Share of the tax credits described in [Section number—policy tax credits available to a C Corporation].

II. ADDENDUM: CONFORMING PROVISIONS

A. LIFO RECAPTURE (OPTIONAL)

If a corporation is subject to LIFO recapture pursuant to Section 1363(d) of the Code, then—

- (1) any increase in the tax imposed by [Section number —taxation of C Corporations] by reason of the inclusion of the LIFO recapture amount in its income shall be payable in four equal installments;
- (2) the first installment shall be paid on or before the due date (determined without regard to extensions) for filing the return for the first taxable year for which the corporation was subject to the LIFO recapture;
- (3) the three succeeding installments shall be paid on or before the due date (determined without regard to extensions) for filing the corporation's return for the three succeeding taxable years; and
- (4) for purposes of computing interest on underpayments, the last three installments shall not be considered underpayments until after the payment due date specified above.

B. SAMPLE INDIVIDUAL INCOME TAX PROVISION

[To be inserted in the section determining State taxable income of individuals]

Notwithstanding any other provision of this statute [or other statute designation], a shareholder of an S Corporation (as defined in Section 1000(b)(7)) shall take into account the income, loss, deduction or credit of the S Corporation only to the extent provided in Section 1001(b).

C. SAMPLE CORPORATE INCOME TAX PROVISIONS

[Alternative A—to be inserted in the section determining State taxable income of corporations when an S Corporation is never subject to income tax]

Notwithstanding any other provision of this statute [or other statute designation], an S Corporation (as defined in Section 1000(b)(7)) shall not be subject to the income tax imposed under this section.

[Alternative B—to be inserted in the section determining State taxable income of corporations when an S Corporation will be subject to income tax]

Notwithstanding any other provision of this statute [or other statute designation], an S Corporation (as defined in Section 1000(b)(7)) shall be taxed on its income only to the extent provided in Section 1001(a).

EXHIBIT B

Multistate Tax Commission



SIX PROPOSED MODIFICATIONS TO MoSCITA

PROPOSED MODIFICATION #1

(Accommodating state restrictions against incorporation of the Internal Revenue Code *in futuro*)

Original Draft: Section 1000(b)(2)--

Code: the Internal Revenue Code of 1986, as amended and as applicable to the Taxable Period; reference to sections of the Code shall be deemed to refer to corresponding provisions of prior and subsequent federal tax laws.

Original Draft: Section 1000(c)--

Except as otherwise expressly provided or clearly appearing from the context, any term used in this Part shall have the same meaning as when used in a comparable context in the Code, or in any statute relating to federal income taxes, in effect for the Taxable Period. Due consideration shall be given in the interpretation of this Part to applicable sections of the Code in effect from time to time and to federal rulings and regulations interpreting such sections, provided such Code, rulings and regulations do not conflict with the provisions of this Part.

Optional Draft: Section 1000(b)(2) [MTC Alternative]--

Code: the Internal Revenue Code of 1986, as amended and as applicable to the Taxable Period pursuant to [Section number--state provision conforming state tax laws to the Internal Revenue Code as of a specified date including to the extent noted provisions amended, deleted, or added thereto prior to the applicable effective date].

Optional Draft: Section 1000(c) [MTC Alternative]--

Except as otherwise expressly provided in this Part or other applicable law or clearly appearing from the context, any term used in this Part shall have the same meaning as when used in a comparable context in the

Code, or in any statute relating to federal income taxes, in effect for the Taxable Period pursuant to [Section number--state provision conforming state tax laws to the Internal Revenue Code as of a specified date including to the extent noted provisions amended, deleted, or added thereto prior to the applicable effective date]. Due consideration shall be given in the interpretation of this Part to analogous sections of the Code and to federal rulings and regulations interpreting such sections, provided such Code, rulings and regulations do not conflict with the provisions of this Part.

PROPOSED MODIFICATION #2

(Permitting entity level taxation by states in addition to the taxation of federal built-in gains and excessive passive net income)

Original Draft: Section 1001(a) [Alternative No. 2]--

Except as provided in the following sentence, an S Corporation shall not be subject to the tax imposed by [Section number--taxation of C corporations]. If an S Corporation is subject to federal income tax on any of its income, then the amount of such income, as modified pursuant to Section 1002 of this Part, that constitutes Income Attributable to the State shall be subject to the tax imposed by [Section number--taxation of C corporations]. The S Corporations Income Attributable to the State shall be reduced by the amount of any tax imposed on the corporation pursuant to the preceding sentence.

Optional Draft A: Section 1001(a) [MTC Alternative A] --

An S Corporation's Income Attributable to the State shall be subject to the tax imposed by [Section number--special tax on the income of S Corporations] and, for purposes of determining the amounts taken into account by the shareholder of an S Corporation pursuant to subsection (b), the amount of the tax shall reduce the S Corporation's Income Attributable to the State. An S corporation shall not be subject to the tax imposed by [Section number--taxation of C Corporations].

Optional Draft B: Section 1001(a) [MTC Alternative B]--

An S Corporation shall not be subject to the tax imposed by [Section number--taxation of C Corporations], except:

(1) If an S Corporation is subject to federal income tax on any of its income, then the amount of such income, as modified pursuant to Section 1002 of this Part, that constitutes Income Attributable to the State shall be subject to the tax imposed by [Section number--taxation of C Corporations].

(2) An S Corporation's Income Attributable to the State, less the amount of income subject to the tax imposed under paragraph (1) of this subsection, shall be subject to the tax imposed by [Section number--special tax on income of S Corporations].

For purposes of determining the amounts taken into account by the shareholders of an S Corporation pursuant to subsection (b), the amount of any tax imposed pursuant to this subsection shall reduce the S Corporation's Income Attributable to the State.

PROPOSED MODIFICATION #3

(Providing for an alternative which denies resident shareholder credit for entity-level tax imposed by non-recognition state)

Original Draft: Section 1008(a)--

For purposes of [Section number--individual tax credit allowance provisions], each resident shareholder shall be considered to have paid a tax imposed on the shareholder in an amount equal to the shareholder's Pro Rata Share of any net income tax paid by the S Corporation to a state which does not measure the income of shareholders of an S Corporation by reference to the income of the S Corporation. For purposes of the preceding sentence, the term "net income tax" means any tax imposed on or measured by a corporation's net income.

Optional Draft: Section 1008(a) [MTC Alternative]--

For purposes of [Section number--individual tax credit allowance provisions], a net income tax imposed on an S Corporation by another state shall not be creditable against the shareholder's tax liability.

PROPOSED MODIFICATION #4

(Providing for an alternative that prevents an automatic deduction of another state's income taxes by reason of the operation of IRC § 164)

Original Draft: Section 1002(b)--

The Pro Rata Share of each resident shareholder of an S Corporation in the Income Not Attributable to the State shall, for purposes of Section 1001(b) of this Part, be subject to the modifications provided in [Section number--individual modifications].

Optional Draft: Section 1002(b) [MTC Alternative]--

The Pro Rata Share of each resident shareholder of an S Corporation in the Income Not Attributable to the State shall, for purposes of Section 1001(b) of this Part, be--

(1) subject to the modifications provided in [Section number--individual modifications]; and

(2) increased by the amount of the shareholder's Pro Rata Share of any income tax imposed on the corporation by another state.

PROPOSED MODIFICATION #5

(Alternative provision which prohibits reduction of state taxable income passed through to the shareholders for federal Code Section 1374 and 1375 taxes imposed on the corporation.)

Original Draft: Section 1001(c)--

For purposes of determining the amounts taken into account by the shareholders of an S Corporation pursuant to subsection (b), the amount of any tax imposed on the S Corporation under the Code shall proportionately reduce the S Corporation's Income Attributable to the State and Income Not Attributable to a State.

Optional Draft: Section 1001(c) [MTC Alternative]--

For purposes of determining the amounts taken into account by the shareholders of an S Corporation pursuant to subsection (b), the amount of any tax imposed on the S Corporation under the Code shall not reduce the S Corporation's Income Attributable to the State and Income Not Attributable to a State.

PROPOSED MODIFICATION #6

(Optional provision requiring informational return to be filed by S Corporation in states where it has resident shareholders even though S Corporation does not operate within such state)

Original Draft: Section 1007(a)--

An S Corporation which engages in activities in this State which would subject a C Corporation to the requirement to file a return under [Section number--taxation of C Corporation] shall file with the [State taxing authority] an annual return, in the form prescribed by the [State taxing authority], on or before the due date prescribed for the filing of C Corporation returns under [Section number--corporate tax return filing date]. The return shall set forth the name, address and social security or federal identification number of each shareholder; the Income Attributable to the State and Income Not Attributable to the State with respect to each shareholder as determined under this Part; the modifications required by Section 1002 of this Part; and such other information as the [State taxing

authority] may by regulations prescribe. The S Corporation shall, on or before the day on which such return is filed, furnish to each person who was a shareholder during the year a copy of such information shown on the return as the [State taxing authority] may by regulation prescribe. The S Corporation shall also maintain the accumulated adjustments account described in Section 1006(c)(2) of this Part.

Optional Draft: Section 1007(a) [MTC Alternative]--

Every S Corporation which engages in activities in this State which would subject a C Corporation to the requirement to file a return under [Section number--taxation of C Corporation] or which has a shareholder resident in this state shall file with the [State taxing authority] an annual return, in the form prescribed by the [State taxing authority], on or before the due date prescribed for the filing of C Corporation returns under [Section number--corporate tax return filing date]. The return shall set forth the name, address, social security or federal identification number, and last known address or residence of each shareholder; the Income Attributable to the State and Income Not Attributable to the State with respect to each shareholder as determined under this Part; the modifications required by Section 1002 of this Part; and such other information as the [State taxing authority] may by regulations prescribe. The S Corporation shall, on or before the day on which such return is filed, furnish to each person who was a shareholder during the year a copy of such information shown on the return as the [State taxing authority] may by regulation prescribe. The S Corporation shall also maintain the accumulated adjustments account described in Section 1006(c)(2) of this Part.

EXHIBIT C

Multistate Tax Commission



RESOLUTION OF THE EXECUTIVE COMMITTEE OF THE MULTISTATE TAX COMMISSION REGARDING THE HOLDING OF A PUBLIC HEARING UPON PROPOSED AMERICAN BAR ASSOCIATION MODEL S CORPORATION INCOME TAX ACT (MoSCITA)

As Modified by Alternative M.T.C. Provisions

WHEREAS, the Multistate Tax Commission (hereafter "Commission") possesses the authority pursuant to Article VI. of the Multistate Tax Compact (hereafter "Compact") to develop and recommend proposals for the purpose of increasing uniformity in the administration of state and local taxes; and

WHEREAS, the Uniformity Committee of the Commission has met on several occasions to study, develop and propose a uniform method for the taxation of income pertaining to S Corporations; and

WHEREAS, the Uniformity Committee has recommended to the Executive Committee that a public hearing be held upon the proposed American Bar Association Model S Corporation Income Tax Act (MoSCITA), as modified by alternative M.T.C. provisions, all attached hereto; and

WHEREAS, the Executive Committee determines that it is in the interest of state taxpayers and state tax administrators alike that the states determine the most appropriate and administratively feasible method for uniformly applying their tax to the multistate business that is carried on by S corporations; and

WHEREAS, it is in the public interest that a public hearing be held upon said proposed act in order to receive public comments thereon.

NOW, THEREFORE, BE IT RESOLVED THAT a public hearing upon said proposed American Bar Association Model S Corporation Income Tax Act (MoSCITA), as modified by alternative M.T.C. provisions, a copy of which is attached hereto, be held at a convenient location to the interested public on such date and time as determined by the Hearing Officer pursuant to the provisions contained in Article VII. of the Compact; and

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Telephone (312) 263-3232

Houston Audit Office:

15835 Park Ten Place, Suite 104
Houston, TX 77064
Telephone (713) 492-2260

BE IT FURTHER RESOLVED, Paul Mines, Counsel to the Commission, is hereby appointed to act as Principal Hearing Officer for the public hearing; that he is authorized to appoint such Assistant Hearing Officer or Officers as he deems necessary to execute his responsibilities herein; and that he is directed to submit his report and recommendations to the Executive Committee within a reasonable period of time following the completion of said public hearing and in advance of the Commission's Annual Meeting to be held in 1991.

Adopted by the Executive Committee this 29th day of August, 1990.

Dan R. Bucks
Executive Director

EXHIBIT D

Multistate Tax Commission



NOTICE OF PUBLIC HEARING

The Multistate Tax Commission will hold a public hearing at 221 N. LaSalle Street, LaSalle-Wacker Building, Room 1906, Chicago, Illinois 60601, from 10:00 A.M. to 2:00 P.M., on January 25, 1991, on the following subject:

★American Bar Association Model S Corporation Income Tax Act ("MoSCITA"), with six proposed modifications.

A copy of the proposed model statute with the six proposed modifications thereto may be obtained by writing to

Michael R. Mazerov
Director of Policy Research
Multistate Tax Commission
444 N. Capitol Street, N.W.
Suite 409
Washington, D.C. 20001

MoSCITA is the work product of the Subcommittee on the State Taxation of S Corporations, Committee on S Corporations, Section of Taxation, American Bar Association (Garland H. Allen, Chair). The House of Delegates of the American Bar Association approved MoSCITA as recommended legislation of the American Bar Association in February 1990. See 1990-2 Amer. Bar Ass'n. Rep. 109B. MoSCITA's stated objectives are "to provide a system for the state income taxation of S corporations and their shareholders that is reasonable, internally consistent, susceptible of compliance, and easily administrable." *Commentary to the Model S Corporation Income Tax Act*, 42 Tax Law. 1009 (1989).

The purpose of the hearing is to consider whether the Multistate Tax Commission should endorse MoSCITA as a uniformity recommendation of the Commission, thereby adding its approval to that of the American Bar Association. In assessing the suitability of making MoSCITA a uniformity recommendation of the Commission, six alternative modifications to MoSCITA have been proposed. If the Commission determines to endorse MoSCITA, its endorsement could include approval of one or more of these alternative modifications in addition to any other modifications that may be developed during the hearing process.

The six alternative modifications to be considered at the hearing in addition to MoSCITA itself are as follows:

•Accommodation of state restrictions against incorporation of the Internal Revenue Code in futuro;

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Fax (312) 283-3441

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- Recognition of possible entity-level taxation by the states in addition to state taxation of built-in gains and excess passive net income;

- Provision for an alternative that would deny a resident shareholder credit for an entity-level tax imposed by a state not recognizing S corporations as pass-through entities;

- Provision for an alternative that would prevent an automatic deduction of another state's income taxes by reason of the operation of IRC §164;

- Provision for an alternative that would prohibit reduction of state taxable income passed through to shareholders for IRC §§ 1374 and 1375 taxes imposed on the corporation; and

- Provision for requiring an informational return to be filed by an S corporation in states where it has resident shareholders even though the S corporation itself does not operate in such states.

A discussion of these six alternative provisions in addition to other matters affecting the state income taxation of S corporations and their shareholders is set forth in the article, *MTC Considers Endorsing Modified MoSCITA*, to be published in the next issue of the Multistate Tax Commission Review. The article may also be obtained by writing Michael Mazerov, Director of Policy Research, at the Commission.

The specific proposed language of MoSCITA and the six alternative modifications that are available as noted above should be consulted to understand the intended reach of the proposals under consideration.

The Commission invites all interested parties to participate in the hearing. Those desiring to make oral presentations to the Hearing Officer must notify him in writing on or before January 17, 1991. An attempt will be made to accommodate those who wish to testify but are unable to travel to the hearing location in Chicago, Illinois. Any person desiring to testify by the use of telecommunications should make that desire known at the time he/she discloses an interest in making a presentation. Depending upon feasibility, an attempt will then be made to assign specific time slots to those parties requesting the opportunity to testify by telecommunications. Anyone desiring to submit written comments may do so to the Hearing Officer prior to January 25, 1991.

In inviting participation in the hearing, the Hearing Officer specifically notes the Commission's interest in receiving comments on whether states should attempt to administer state income taxes with regard to S corporations and/or on new methods of administration that might be adopted. This interest is reflected in the following two questions (and others that are not stated

here): Does MoSCITA facilitate state tax administration, or would the states be better served by taxing S corporations as entities and refrain from attempting to develop specific rules to deal with the jurisdictional complexities that are present when S corporations have multistate operations and membership? Is "one stop" centralized filing for all states in which an S corporation has operations needed?

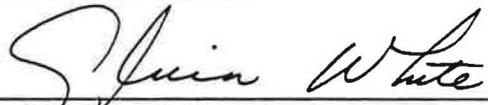
The Commission and the Hearing Officer may be contacted by writing to:

Paull Mines
Multistate Tax Commission
444 No. Capitol Street, N.W.
Suite 409
Washington, D.C. 20001
Tel.: (202) 624-8699

EXHIBIT E

CERTIFICATION OF MAILING

I, Sylvia L. White, do hereby certify that a true and complete copy of the Notice of Public Hearing of the American Bar Association Model S Corporation Income Tax Act ("MoSCITA"), with six proposed modifications, Exhibit "A" hereto, was mailed to the individuals and offices set forth on the MoSCITA Mailing List, Exhibit "B", by depositing the same in a preaddressed envelope, first class mail, postage prepaid on the 20~~th~~ day of November 1990.



Sylvia E. White

Dated: Nov. 20, 1990.

Exhibit A



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here): Does MoSCITA facilitate state tax administration, or would the states be better served by taxing S corporations as entities and refrain from attempting to develop specific rules to deal with the jurisdictional complexities that are present when S corporations have multistate operations and membership? Is "one stop" centralized filing for all states in which an S corporation has operations needed?

The Commission and the Hearing Officer may be contacted by writing to:

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MULTISTATE TAX COMMISSION
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MULTISTATE TAX COMMISSION
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Drendel, Schanlaber, et. al.
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Aurora, IL 60506

TO: Benjamin O. Schewendener, Jr.
Schwendener & Walade, P.C.
Dart Management Bldg.
Mason, MI 48854

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MULTISTATE TAX COMMISSION
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TO: Editor "Tax Calendar"
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EXHIBIT B

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MULTISTATE TAX COMMISSION
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TO: James Edward Maule
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TO: Theodore R. Kowalski
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TO: Judy Langston
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TO: Glen L. Bower
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MULTISTATE TAX COMMISSION
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TO: Paul Waddell
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TO: Timothy Leathers
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MULTISTATE TAX COMMISSION
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TO: Larry Looney
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MULTISTATE TAX COMMISSION
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MULTISTATE TAX COMMISSION
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MULTISTATE TAX COMMISSION
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TO: Benjamin Redmond
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MULTISTATE TAX COMMISSION
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BT Alternates

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MULTISTATE TAX COMMISSION
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MULTISTATE TAX COMMISSION
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TO: Phil Aldape
Audit Bureau Chief
Income & Heritance Taxes
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MULTISTATE TAX COMMISSION
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Audit Division
State of ME Bureau of Taxation
Maine Bureau of Taxation
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TO: Ron Larson
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TO: Richard Chiogioji
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Exhib. 1 B

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MULTISTATE TAX COMMISSION
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MULTISTATE TAX COMMISSION
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MULTISTATE TAX COMMISSION
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MULTISTATE TAX COMMISSION
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Exhibit B

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EXHIBIT F

Multistate Tax Commission



January 29, 1991

TO: Paul Mines, Counsel, and Hearing Officer for proposed MTC adoption of American Bar Association Model S Corporation Income Tax Act as a MTC uniformity recommendation

FROM: Michael Mazerov, Director of Policy Research *Michael Mazerov*

SUBJECT: Certification of mailing of Notice of Public Hearing on said proposal

In compliance with Multistate Tax Commission Bylaw 7, the attached Notice of Public Hearing was mailed to the following elements of the mailing lists maintained by the MTC on the following dates:

On November 15, 1990

- 1) To the chief tax administrators of all 50 states and the District of Columbia
- 2) To all Alternates designated by the chief tax administrators of full member states and, where a designation was made, of associate member states.
- 3) To current members of all standing MTC committees (Audit, Uniformity, Litigation, and Nexus Advisory)
- 4) To the members of the Subcommittee on the State Taxation of S Corporations, Committee on S Corporations, Section of Taxation, American Bar Association.

On December 26, 1990

- 1) To all paying subscribers to the Multistate Tax Commission Review (approximately 300 individuals, nearly all of whom are private sector state and local tax practitioners)
- 2) To all individuals/organizations in the non-profit sector receiving the Multistate Tax Commission Review on a complementary basis (approximately 150 names, most of whom are academics or staff at research organizations)

NOTICE OF PUBLIC HEARING

The Multistate Tax Commission will hold a public hearing at 221 N. LaSalle Street, LaSalle-Wacker Building, Room 1906, Chicago, Illinois 60601, from 10:00 A.M. to 2:00 P.M., on January 25, 1991, on the following subject:

★American Bar Association Model S Corporation Income Tax Act ("MoSCITA"), with six proposed modifications.

A copy of the proposed model statute with the six proposed modifications thereto may be obtained by writing to

Michael R. Mazerov
Director of Policy Research
Multistate Tax Commission
444 N. Capitol Street, N.W.
Suite 409
Washington, D.C. 20001

MoSCITA is the work product of the Subcommittee on the State Taxation of S Corporations, Committee on S Corporations, Section of Taxation, American Bar Association (Garland H. Allen, Chair). The House of Delegates of the American Bar Association approved MoSCITA as recommended legislation of the American Bar Association in February 1990. See 1990-2 Amer. Bar Ass'n. Rep. 109B. MoSCITA's stated objectives are "to provide a system for the state income taxation of S corporations and their shareholders that is reasonable, internally consistent, susceptible of compliance, and easily administrable." *Commentary to the Model S Corporation Income Tax Act*, 42 Tax Law. 1009 (1989).

The purpose of the hearing is to consider whether the Multistate Tax Commission should endorse MoSCITA as a uniformity recommendation of the Commission, thereby adding its approval to that of the American Bar Association. In assessing the suitability of making MoSCITA a uniformity recommendation of the Commission, six alternative modifications to MoSCITA have been proposed. If the Commission determines to endorse MoSCITA, its endorsement could include approval of one or more of these alternative modifications in addition to any other modifications that may be developed during the hearing process.

The six alternative modifications to be considered at the hearing in addition to MoSCITA itself are as follows:

•Accommodation of state restrictions against incorporation of the Internal Revenue Code in futuro;

- Recognition of possible entity-level taxation by the states in addition to state taxation of built-in gains and excess passive net income;

- Provision for an alternative that would deny a resident shareholder credit for an entity-level tax imposed by a state not recognizing S corporations as pass-through entities;

- Provision for an alternative that would prevent an automatic deduction of another state's income taxes by reason of the operation of IRC §164;

- Provision for an alternative that would prohibit reduction of state taxable income passed through to shareholders for IRC §§ 1374 and 1375 taxes imposed on the corporation; and

- Provision for requiring an informational return to be filed by an S corporation in states where it has resident shareholders even though the S corporation itself does not operate in such states.

A discussion of these six alternative provisions in addition to other matters affecting the state income taxation of S corporations and their shareholders is set forth in the article, *MTC Considers Endorsing Modified MoSCITA*, which can be found beginning on page *** of this issue of the Review. The article may also be obtained by writing Michael Mazerov, Director of Policy Research, at the Commission.

The specific proposed language of MoSCITA and the six alternative modifications that are available as noted above should be consulted to understand the intended reach of the proposals under consideration.

The Commission invites all interested parties to participate in the hearing. Those desiring to make oral presentations to the Hearing Officer must notify him in writing on or before January 17, 1991. An attempt will be made to accommodate those who wish to testify but are unable to travel to the hearing location in Chicago, Illinois. Any person desiring to testify by the use of telecommunications should make that desire known at the time he/she discloses an interest in making a presentation. Depending upon feasibility, an attempt will then be made to assign specific time slots to those parties requesting the opportunity to testify by telecommunications. Anyone desiring to submit written comments may do so to the Hearing Officer prior to January 25, 1991.

In inviting participation in the hearing, the Hearing Officer specifically notes the Commission's interest in receiving comments on whether states should attempt to administer state income taxes with regard to S corporations and/or on new methods of administration that might be adopted. This interest is reflected in the following two questions (and others that are not stated here): Does MoSCITA facilitate state tax administration, or would

the states be better served by taxing S corporations as entities and refrain from attempting to develop specific rules to deal with the jurisdictional complexities that are present when S corporations have multistate operations and membership? Is "one stop" centralized filing for all states in which an S corporation has operations needed?

The Commission and the Hearing Officer may be contacted by writing to:

Paul Mines
Multistate Tax Commission
444 No. Capitol Street, N.W.
Suite 409
Washington, D.C. 20001
Tel.: (202) 624-8699

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EXHIBIT G

Multistate Tax Commission



**PERSONS ATTENDING MTC PUBLIC HEARING ON
MoSCITA WITH SIX PROPOSED MODIFICATIONS**

(Chicago, IL--January 25, 1991)

<i>Name</i>	<i>Address</i>
Paul Mines	Multistate Tax Commission 444 No. Capitol St., N. W. Suite 409 Washington, DC 20002 202-624-8699
Garland Allen	Hopkins & Sutter Suite 4300 3 First National Plaza Chicago, IL 60602 312-558-6740
William C. Schlanlaber	Drendel, Schanlaber, Horwitz Tatnall & McCracken 520 Redwood Drive P.O. Box 4101 Aurora, IL 60507-4010 708-844-0800
William Seitz	Illinois Department of Revenue 100 West Randolph Street Suite 7-900 Chicago, IL 60601 312-814-7054
Michael H. Lippman	KPMG Peat Marwick 2001 M Street, Northwest Washington, DC 20036 202-467-3802
Stephen Ryan	Grant Thornton 700 One Prudential Plaza 130 E. Randolph Drive Chicago, IL 60601-6203 312-856-0200
Joseph E. McMenamin	Illinois Department of Revenue 101 W. Jefferson Springfield, IL 62704

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EXHIBIT H



DEPARTMENT OF REVENUE AND FINANCE
GERALD D. BAIR, DIRECTOR

January 11, 1991

Paul Mines
Multistate Tax Commission
444 No. Capitol Street, N.W.
Suite 409
Washington, D.C. 2001



Dear Mr. Mines:

I appreciate the opportunity to comment on the American Bar Association's Model S Corporation State Income Tax Act. Iowa has followed the Model Act for several years and made comments to Garland H. Allen of Hopkins & Sutter in the past which has resulted in some changes in the Model Act.

In regards to the proposed modifications to the Model Act, Iowa is especially interested in the first proposed modification. The Iowa Constitution prohibits the reference to any other law to fix a tax. The Attorney General has opined that this provision prevents the Legislature from adopting the Internal Revenue Code in futuro but must, each year, determine if new provisions of the IRC are to be adopted.

The other five proposed modifications would not have an effect on Iowa based upon current Iowa law. However, because one can not predict what changes a future legislature may make, Iowa would be in favor of adoption of these proposed modifications.

In the past, I have expressed concern that there may be a constitutional problem in the taxation of nonresidents. The Model Act provides for different ways for a resident and a nonresident to compute their initial basis in the stock of a S corporation. The resident uses the initial investment plus any indebtedness of the corporation to the shareholder and guaranteed corporate debt, while the nonresident's initial basis is zero. This prevents a nonresident from offsetting income from other sources within the state by losses generated by the S corporation from activities within the state. This creates the situation where a resident

Mr. Mines
Page 2
January 11, 1991

will pay less Iowa income tax than a nonresident although they may have the same income and losses attributable to the state. This type of situation would appear to violate the equal protection and possibly the commerce clauses of the United States Constitution.

Sincerely,



Gerald D. Bair, Director
Iowa Department of Revenue and Finance

WP6

EXHIBIT I

STATE OF COLORADO

DEPARTMENT OF REVENUE
Taxpayer Service Division

204 Capitol Annex,
1375 Sherman St.
Denver, Colorado 80261
Phone (303) 866-5565



James R. Davis
Director

January 16, 1991

*Rec'd
01/23/91
Jm*

Mr. Paul Mines
Multistate Tax Commission
444 N. Capitol Street, NW, Suite 409
Washington, DC 20001

RE: ABA Model S Corporation Income Tax Act (MoSCITA)
MTC Public Hearing on Proposals Regarding MoSCITA

Dear Mr. Mines:

The below listed persons constitute an ad hoc committee consisting of members of the Colorado Department of Revenue, the Colorado Bar Association Tax Section and the Colorado Society of Certified Public Accountants. The committee expects to review MoSCITA at greater length this spring for presentation of a proposal to the Colorado Legislature in the fall of 1991 or spring of 1992. In the meantime, the committee has reviewed the Model Act and the Exhibit C of the MTC Resolution dated August 29, 1990 and offers this letter as testimony to the Public Hearing to be held by the MTC.

As a preliminary comment, we believe that the state of Colorado favors uniformity in this area. We would urge the MTC to limit the potential alternatives to the absolute minimum. The growth in the use of pass-through entities such as S corporations and the need to be competitive in the global marketplace virtually mandates that the states minimize the conflicts between taxing jurisdictions.

With regard to the specific proposal designated MTC Amendment #1, Colorado would allow the Model Act, and we think that it makes sense from an administrative standpoint. If the MTC approves the language of the Alternative, the Commentary should be clear that the Model Act is preferred and that the alternative is to be used only where mandated by constitutional necessities.

With regard to the specific proposal designated MTC Amendment #2, we adopt the comments of the ABA drafters. If and only if it is absolutely necessary to adopt the alternative, we recommend the adoption of Optional Draft B.

Mr. Paul Mines
January 16, 1991
Page 2

With regard to the specific proposal designated MTC Amendment #3, for the reasons stated in the ABA drafters comments, we believe that the MTC should stick with the original proposal, without providing the alternative.

With regard to the specific proposal designated MTC Amendment #4, we do not believe the proposal is necessary. As suggested in the ABA drafters comments, Colorado already addresses the problems; and the alternative language would be more confusing than helpful.

With regard to the specific proposal designated MTC Amendment #5, we are confident that Colorado will ultimately adopt the original language of the Model Act.

With regard to the specific proposal designated MTC Amendment #6, in the interest of brevity, we again adopt the comments of the ABA drafters.

Sincerely,



James R. Davis
Chairman

James R. Davis
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1375 Sherman St., Rm. 204
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303/866-5565
Fax: 866-3211

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303/894-8612
Fax: 894-8563

Scott W. Stauffer, JD, CPA
2851 S. Parker Road, #720
Aurora, CO 80014
303/337-2323
Fax: 750-5544

EXHIBIT J



Oregon Department of Revenue

REVENUE BUILDING
955 CENTER STREET, N.E.
SALEM, OREGON 97310



February 12, 1991

Pauli Mines
Multistate Tax Commission
444 N Capitol Street, NW, Suite 409
Washington, D.C. 20001

Enclosed are Oregon's responses to the modifications proposed by the MTC to the ABA Model S Corporation State Income Tax Act (MoSTICA).

I regret that our responses were delayed. If you have any questions concerning these responses, please call Don McNeal, supervisor of Corporation Policy and Analysis, or myself at (503) 378-3745.

Paul J. Guthrie
Paul J. Guthrie
Corporation Auditor
Audit Division

Telephone: (503) 378-3745

rk1/0455u

Enclosures

OREGON RESPONSES TO MTC PROPOSED MODIFICATIONS TO
ABA MODEL S CORPORATION STATE INCOME TAX ACT

PROPOSED AMENDMENT #1

Acceptable. Oregon updates its tie to federal tax law every two years.

PROPOSED AMENDMENT #2

Unacceptable. Oregon tax law (ORS 317.732) does not allow the taxation of S corporations except for the \$10 minimum tax and in cases of built-in gains and excessive passive net income.

Allowance of an entity level tax by the model act, in addition to that on federally taxable S corporation income, would not promote uniformity with federal and other states' laws.

PROPOSED AMENDMENT #3

Unacceptable. Oregon tax law (ORS 316.062) allows a credit to resident shareholders for entity-level taxes imposed by non-recognition states. The proposal would not promote federal-state or state-to-state uniformity among recognition states. The credit is necessary for fair integration of taxation by recognition and non-recognition states.

PROPOSED AMENDMENT #4

Unacceptable. Oregon tax law (ORS 317.314) provide that income taxes of other states on corporations must be added back to the corporation's federal taxable income. Under ORS 316.082(4), the tax of other states, including tax on an S corporation, for which an Oregon credit was given to individuals, must be added back, as well. The amendment appears to be unnecessary.

PROPOSED AMENDMENT #5

Unacceptable. Oregon tax laws (ORS 316.013 and 314.734) provide for the reduction of built-in gain and excessive passive investment income, passed through to the shareholders, by both federal and Oregon state taxes on such taxable income. The drafters' argument against the amendment is persuasive.

PROPOSED AMENDMENT #6

Accountable. Oregon would appreciate the amendment for purposes of shareholder filing compliance.

ADMINISTRATIVE QUESTION #1

Does MOSCITA facilitate state tax administration, or would the states be better served by taxing S corporations as entities and refrain from attempting to develop specific rules to deal with the jurisdictional complexities that are present when S corporations have multistate operations and membership?

Response: MOSCITA would facilitate taxpayer compliance by eliminating the complexities from many different policies regarding taxation of S corporations by the states.

ADMINISTRATIVE QUESTION #2

Is "one stop" centralized filing for all states in which an S corporation has operations needed?

Response: No. Oregon has no real problem with S corporation filing. One stop filing would be feasible if all states had uniform provisions and no modifications applying to built-in gains and excess passive investment income. Since there will be varying modifications to such income, the requirement for separate state taxable income computations would greatly reduce the advantage of one stop filing.

One stop centralized filing would require an administrative effort to receive returns, copy for the appropriate states and forward payments. This would increase the lead time necessary between completion of the return by the taxpayer and the due date of the return.

One stop centralized filing for non-resident shareholders would also be unwieldy due to differing state modifications to federal taxable income. One stop centralized filing for resident shareholders in Oregon is not desirable under current law. Such a filing would either be very complex or unfair to taxpayers (due to lost opportunities to offset income and losses), reducing the value of making a single filing by the corporation.

EXHIBIT K

Grant Thornton 

Accountants and
Management Consultants

The U.S. Member Firm of
Grant Thornton International

January 18, 1991

Mr. Paull Mines, Hearing Officer
Multistate Tax Commission
444 North Capitol Street N.W., Suite 409
Washington D.C. 20001

Re: Model S Corporation Income Tax Act

Dear Paull:

Please find enclosed our written comments concerning the Model S Corporation Income Tax in connection with the Public Hearing scheduled for January 25, 1991. I apologize for the delay in submitting the comments to you, but, as usual, we were faced with a heavy workload at year end.

I will contact you in a few days to ensure that you have received our written comments and to discuss the scheduling of my oral presentation at the Public Hearing. I am looking forward to seeing you in Chicago and I appreciate your assistance in this matter. If you have any questions or comments, please contact me at (312) 616-7032.

Sincerely,


Stephen Ryan
Senior Manager

/dkh

cc: J. Thomas Johnson

Multistate Tax Commission

Model S Corporation Income Tax Act

Public Hearing - January 25, 1991

Stephen T. Ryan, Senior Manager, Grant Thornton

I. The Model Act's Objective is Merited

The objective of the Model S Corporation Income Tax Act (Act) is to provide rational and uniform state income tax treatment for S corporations and their shareholders. The Act recognizes that many states have yet to focus on the unique tax characteristics of S corporations and their shareholders and stresses the need for states to directly address the tax treatment of S corporations and their shareholders.

While certain of the Act's provisions are controversial, and in many taxpayers' and practitioners' opinion inequitable, the Act is a much needed vehicle to achieve fair and simpler tax treatment of S corporations and their shareholders and more efficient administration by state Revenue Departments. Regardless of whether certain of the Act's provisions require modification to achieve their stated purpose, the Act should be viewed as the proper vehicle to facilitate the states' addressing the tax treatment of S corporations and their shareholders.

II. Initial "Zero Basis" for Nonresident Shareholders Is Impractical

The Act proposes that a nonresident shareholder take an initial basis of zero in stock and debt in each state and adjust that basis only to reflect the state income (loss) of the same S corporation. This initial "zero basis" rule proscribes nonresident shareholders of offsetting an S corporation loss against other income in the nonresident state. Any losses not allowed can be carried forward to future years, but such losses can only be offset against income from the same S corporation. The apparent intent of the rule is to neutralize a perceived advantage for nonresidents to use S corporation losses to shelter unrelated income without suffering taxation of the recapture of such losses upon the sale of the S corporation stock and/or taxable distributions. Since states generally do not tax nonresidents on gains arising from the sale of intangible personal property such as S corporation stock, the states have no opportunity to "recapture" and tax the previously utilized losses.

The initial zero basis rule results in tax consequences divergent from the federal tax consequences. These divergent tax effects violate the Act's objective of providing a system for the state

income taxation of S corporations and their shareholders that is "reasonable, internally consistent, susceptible of compliance, and easily administrable". The Act is (and should be) premised on conforming to the principles and concepts of the Internal Revenue Code. To promote tax consequences that diverge from federal tax consequences is to add to, rather than subtract from, the lack of uniformity at the state level that presently generates unfair tax treatment of S corporations and their shareholders.

It should be noted that Section 1003(c) of the Act provides that a nonresident shareholder receives an initial basis of zero as of the latest date to occur of (1) the date on which the shareholder became a nonresident of the state, (2) the date on which the shareholder acquired the stock or the indebtedness of the corporation, or (3) the effective date of the corporation's most recent S election. In addition, the Act provides that this date may be before the effective date of the Act. Thus, it appears that this provision operates to require amended returns where a nonresident shareholder has previously utilized losses which are now limited. If so, this provision creates undue complexity for the state Revenue Departments and the S corporations and their shareholders, especially in consideration of the tax dollars involved.

If it is not the intention of the Act to provide for such treatment, then it is suggested that the Act be clarified to make the provision more clear.

The initial zero basis rule requires a separate basis computation for each S corporation for each state. The administrative burden involved, for both the nonresident shareholders and the state Revenue Departments, is mind-boggling. As a practical matter, the accounting tasks involved make the initial zero basis rule unenforceable by the state Revenue Departments.

Credit for taxes paid to nonresident states

The Act and the Commentary do not appear to fully recognize the operation of the credit for taxes paid to other states. That is, most states tax residents on their entire net income and allow for a credit for taxes paid to nonresident states on such income. Therefore, even though a nonresident shareholder may escape taxation in the nonresident state on income arising from the sale of S corporation stock, the shareholder is subject to tax in his (her) resident state on such income. Accordingly, state tax is payable on such income and is not being avoided.

The Act's concern that nonresidents receive an advantage over residents does not take into account the fact that tax paid to the nonresident state reduces the tax payable to the resident state. Thus, the overall state tax liability will, in most cases, not be materially different regardless of which state taxes the income.

After taking into account the operation of the credit for taxes paid to nonresident states and the nonresident reciprocal credit (discussed below), it does not appear that the overall tax liabilities involved are material enough to warrant the imposition of such a drastic measure as the initial zero basis rule.

Nonresident reciprocal credit

There appears to be a growing trend for states to provide a credit to nonresidents for taxes paid to their resident state on income subject to tax in the nonresident state; provided that the resident state allows a similar credit or does not tax income of nonresidents. This credit can be referred to as the "nonresident reciprocal credit". Approximately ten states presently provide for this credit in some manner. Since most states tax residents on their entire income and allow a credit for taxes paid to nonresident states on such income, it appears that the nonresident reciprocal credit was enacted to secure the resident state's tax revenue and minimize the compliance burden of administering the credit for taxes paid to nonresident states.

The Act and the Commentary do not appear to have taken into account the nonresident reciprocal credit. It appears the credit operates to alleviate the Act's concern that nonresidents receive an unfair advantage over residents on the disposition of S corporation stock. The nonresident reciprocal credit also appears to alleviate nonresident shareholder concerns regarding the compliance burden of multistate tax filings.

It should be noted that the nonresident reciprocal credit may not operate to completely eliminate the nonresident state's tax liability. That is, where the nonresident state's tax liability exceeds the resident state's tax liability, the credit reduces, but does not eliminate the nonresident state tax liability and, thus, a filing requirement may continue to exist. However, because any remaining tax liability will not, in most cases, exceed the threshold amount necessary to establish a filing requirement; the nonresident reciprocal credit should operate to significantly reduce the compliance burden on the nonresident shareholders and state Revenue Departments. The credit also allows for the state to better estimate and ensure a more steady stream of tax revenues since the resident states will no longer be providing tax credits for taxes paid to nonresident states.

Minnesota provisions

It also appears possible to meet the Act's objective of effectively taxing a nonresident on income from the sale of S corporation stock and/or distributions by enacting provisions similar to the Minnesota provisions which attribute the income (loss) from the sale of S corporation stock to the nonresident state based upon certain ratios of the S corporation's activities within and without the nonresident state. Although these provisions are administra-

tively burdensome, they are preferable to the initial zero basis rule in terms of overall fairness.

It is noted that the Commentary to the Act expresses concern regarding the constitutionality of such provisions. While these concerns are beyond the scope of these comments, it appears that these concerns can be satisfactorily addressed to allow for the provisions to be operable.

Taxation as C corporations

The Multistate Tax Commission (MTC) raises the question whether the states would be better served by taxing S corporations as C corporations and refrain from attempting to develop specific rules to deal with the jurisdictional complexities that are present when S corporations have multistate operations and membership? This alternative diverges from federal tax treatment and will result in double taxation unless the shareholders' resident states allow a tax credit for taxes paid by the corporation. However, the alternative is definitely preferable to the imposition of the initial zero basis rule since it alleviates the compliance burden on the state Revenue Departments and nonresident shareholders.

Summary

In summary, the initial zero basis rule is a drastic measure aimed at remedying what is, at best, a marginal tax benefit for nonresident shareholders. It appears that the Act's stated purpose would be better served if the Act promoted the adoption of the nonresident reciprocal credit. By doing so, the states would be able to secure a more steady stream of tax revenues and the compliance burden for both the state Revenue Departments and the S corporation shareholders would be minimized.

III. Imposition of Corporate and Individual Modifications is Unduly Burdensome

The Act presently provides that corporate modifications apply to the S corporation income that is apportioned and/or allocated to a state by the S corporation ("Income Attributable to the State"). Individual modifications apply to the remaining S corporation income ("Income Not Attributable to the State") on the basis that such income is taxable only to the resident shareholders. The effect of all this is that an S corporation must (1) monitor both the corporate and individual modifications that a state applies and (2) take both of these modifications into account in determining the S corporation income reportable to resident shareholders. As a practical matter, compliance with these rules appears highly unlikely.

Under the taxing scheme currently used by most states, residents are subject to tax on their entire federal income and apply individual modifications to such income. Although not perfect,

this system is definitely preferable to the Act's proposal for applying both individual and corporate modifications. Where the S corporation is taxable as a C corporation (built-in gains, etc.), it appears consistent with federal treatment to provide that corporate modifications apply to such income.

IV. Attribution of Nonbusiness Income at the S Corporation Level

The act provides that the determination of whether income is business or nonbusiness income and the allocation and/or apportionment of such income will be made at the S corporation level. In general, this treatment appears to be the most reasonable and the most susceptible of compliance.

However, the attribution of income by the S corporation presupposes that the S corporation is engaged in an active trade or business. It is possible, especially where the S corporation was formed solely to conduct passive investment activities, that the S corporation may not be engaged in an active trade or business. In these situations, it appears more proper, and is required by certain states such as Illinois, to treat the income as being received by the shareholders directly. That is, an S corporation that is in receipt of income from purely passive investments passes this income directly through to the shareholders in their states of residence. The appeal of Robert M. and Ann T. Bass, et al. v. California State Board of Equalization, January 29, 1989, illustrates a scenario where this treatment is mandated.

It appears that the Act's present provision should be expanded to allow for the attribution of income at the shareholder level in the proper situations.

V. S Corporations Should Not Be Combined

The Act has not, at present, addressed the unitary combination of S corporations. Most states hold, either formally or informally, that S corporations are not required or allowed to be members a unitary group. It appears that Illinois is the only state that authoritatively provides for the combination of S corporations based upon the unitary principle. It is of note that Illinois provides for the unitization of S corporations with C corporations as well as with other S corporations. California requires combination only where the S election was made for tax avoidance purposes.

For administrative ease and general conformity with federal provisions, the Act should include an optional provision that provides that S corporations may not be combined unless tax avoidance motives are found to exist.

VI. Nonresident Withholding Requirements

The state Revenue Departments, understandably, desire withholding to ensure that nonresident shareholders file returns and pay tax on their S corporation income. Since the Act provides for the nonresident shareholders to sign agreements to file returns, pay tax, and consent to be subject to the nonresident state's jurisdiction, it appears that the states' concerns are satisfied and the withholding provisions are not necessary. The repeal of these withholding requirements alleviates the compliance burden for both the state Revenue Departments and the S corporation.

VII. Passive Activity Loss (PAL) Limitations Need to be Addressed

Section 469 of the Internal Revenue Code imposes limitations on the ability of individuals (and certain other taxpayers) to use PALs. The manner in which these limitations are applied for state purposes can have a significant tax effect. Most states apply the limitations to income (loss) derived solely from their state. Other states, such as Illinois, apply the limitations without regard to the source of the PAL (i.e., if the PAL is deducted for federal purposes, it is deducted for Illinois purposes). Most states have not addressed this issue in an authoritative manner.

S corporation shareholders are presently faced with inconsistent state application of the PAL limitations. The effect of the first method described above is that a nonresident shareholder is faced with the administrative burden of maintaining separate state PAL carryover computations. The effect of the second method is that where the PAL is not completely offset by passive income, and unutilized PAL remains for carryover, the nonresident shareholder will have to determine which state PALs have been used. Presumably this will be done on a pro rata basis comparable to the way federal computations are done.

It does not appear that one method is definitely preferable to the other method, but rather it is more important that the same method be applied uniformly. It is suggested, at least through optional provisions, that the Act recommend adoption of a uniform method for applying the PAL limitations.

VIII. "One-Stop" Filing for S Corporations Requires Administrative Reorganization

The question has been raised whether the reporting and administrative difficulties encountered by both the state Revenue Departments and S corporations and their shareholders can be lessened by providing for "one-stop" filing for S corporations engaging in multistate activities? The benefits of one-stop filing are substantial. However, it appears that the administrative costs involved in restructuring to properly implement one-stop filing are, at the present time, in excess of the benefits to be derived.

It appears that efforts may be better focused on promotion of other provisions, such as the nonresident reciprocal credit, to achieve the goal of reducing the administrative burden of multistate filings.

VI. MTC Proposed Amendments Require Consideration

The MTC staff has proposed six modifications to the Act. These modifications are addressed below.

Proposed Amendment #1

The Proposed Amendment #1 is proper and should be included as an optional provision.

Proposed Amendment #2

The Proposed Amendment #2 is proper and should be included.

Proposed Amendment #3

The Proposed Amendment #3 allows for, rather than reduces, inconsistent state treatment and double taxation. The ABA drafters' statement on Proposed Amendment #3 is proper and adequately reviews the ramifications of enacting the amendment.

Proposed Amendment #4

The Proposed Amendment #4 appears to be proper and should be included as an optional provision. The MTC staff's statement on Proposed Amendment #4 adequately explains the necessity of the amendment.

Proposed Amendment #5

The Proposed Amendment #5 represents a departure from federal treatment and, therefore, should not be adopted. The ABA drafters' statement adequately explains the reasons for nonadoption.

Proposed Amendment #6

The Proposed Amendment #6 operates to increase the compliance burden for both the state Revenue Departments and the S corporations. As the ABA drafters' statement indicates, the proposed amendment is unnecessary and constitutionally suspect.

Multistate Tax Commission
Model S Corporation Income Tax Act
Public Hearing - January 25, 1991
Stephen Ryan, Grant Thornton

I. Application of the Initial Zero Basis Rule

Example 1: Mr. Jones is the sole shareholder of an S corporation (S) which does business solely in State B. Mr. Jones is a resident of State A and earns \$100,000 for services provided in State B. S has \$25,000 of ordinary loss after deducting Mr. Jones' compensation of \$100,000 and no other items of income, loss, or expense. The tax consequences to Mr. Jones in State A are that the S loss of \$75,000 cannot offset the \$100,000 of compensation.

Assuming that Mr. Jones has sufficient basis in S and that there are Mr. Jones' only items of income and loss, Mr. Jones' tax consequences are divergent from his federal tax consequences. That is, for federal purposes the \$75,000 S loss can offset the \$100,000 of compensation.

Example 2: ABC corporation (ABC) is an S corporation doing business solely in State A. ABC leases its building and land from XYZ partnership. Mr. Jones is a 50% shareholder of ABC and a 50% partner of XYZ.

Assuming that \$1,000 of rent is charged for the property and that the other operations of ABC and XYZ break-even, Mr. Jones' tax consequences in State B is that his \$500 ABC loss ($\$1,000 \times 50\%$) cannot be offset against his \$500 XYZ income ($\$1,000 \times 50\%$). These tax consequences diverge from federal treatment (assuming that the federal recharacterization rules are not applicable).

II. Application of Corporate and Individual Modifications

Example: An S corporation (S) conducts business in a state such as California which does not recognize MACRS depreciation and does not exempt U.S. interest income for C corporation purposes, but does for individual purposes. S has \$100 of ordinary income before taking into account a \$20 MACRS depreciation addition modification and \$30 of U.S. interest income. S has a California apportionment factor of 40%. Mr. Jones is a 10% shareholder and a California resident. Mr. Jones' income is determined as:

Ordinary income before modifications	\$100
X shareholder interest	<u>x10%</u>
	<u>\$10</u>
Corporate modifications:	
MACRS depreciation	\$ 20
U.S. interest income	<u>30</u>
	\$ 50
X apportionment factor	<u>x40%</u>
	\$ 20
X shareholder interest	<u>x10%</u>
	<u>\$ 2</u>
Individual modifications	<u>\$ 0</u>
Total income	<u>\$ 12</u>

Additional Issues

- (1) Methodology of computation where shareholder changes residency during the year? Are modifications prorated, specifically accounted for, or both?
- (2) Nonbusiness income is generally attributed by the S corporation so corporate modifications would apply, but what if Bass doctrine requires attribution by the shareholders?

III. Application of Passive Activity Loss (PAL) Limitations

<u>Nonresident Individual Income (Loss)</u>	<u>California</u>	<u>Illinois</u>	<u>Other States</u>	<u>Total (Federal)</u>
Passive income	\$ -	\$ -	\$200	\$200
Passive loss	(100)	(100)	-	(200)
Portfolio income	<u>100</u>	<u>100</u>	<u>-</u>	<u>200</u>
Total income (loss)	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$200</u>	<u>\$200</u>
Taxable income	<u>\$100</u>	<u>\$ 0</u>	<u>\$200</u>	<u>\$200</u>

The differing applications result in aggregate state taxable income of \$300, whereas federal taxable income is \$200.

Note: The above assumes:

1. Zero state modifications to federal income (loss).
2. Zero PAL phase-in allowed.

EXHIBIT L

Testimony of

**Michael H. Lippman
KPMG Peat Marwick
Washington National Tax Practice**

Before the

Multistate Tax Commission

Hearings on

**The Model S Corporation Tax Act
(MoSCITA)**

**January 25, 1991
Chicago**

Testimony of KPMG Peat Marwick

Mr. Chairman:

My name is Michael H. Lippman of KPMG Peat Marwick. KPMG Peat Marwick is an international professional services firm with major operations in the United States. I am a partner in the firm's Washington National Tax Practice, and frequently advise businesses--including small and medium-sized businesses--about the impact of state and local taxes. Included within the firm's diverse client base is a significant number of businesses that have elected or have considered electing S corporation status.

On behalf of KPMG Peat Marwick, I would like to thank the Commission for granting this opportunity to present our views on the American Bar Association's Model S Corporation Income Tax Act ("MoSCITA"), which is currently under consideration for possible adoption as a uniformity recommendation. MoSCITA is the product of the Subcommittee on the State Taxation of S Corporations, Committee on S Corporations, Section of Taxation, American Bar Association ("Subcommittee").

Beginning with a graduate paper prepared on this subject, I have maintained a longstanding interest in the state taxation of multistate S corporations, both as a theorist and a tax practitioner. Indeed, in 1987 I presented the results of a comprehensive 50-state survey on the taxation of multistate S corporations at the Commission's Twentieth Annual Meeting held in Washington, D.C. I have addressed the state taxation of S corporations and partnerships at a number of other national forums, including the National Association of State Tax Bar Sections, the Federation of Tax Administrators, and the Georgetown Institute on State and Local Taxation. I am also the author of Chapter 19, "Multistate Taxation of S Corporations," S Corporations, Tax Practice Series, Copyright 1989, Tax Management Inc.

As a practitioner, I have advised and assisted many companies and their owners with respect to their state tax obligations and opportunities either preparatory to or following a federal S corporation election. I have rendered advice in diverse areas, ranging from the advisability (from a state tax perspective) of making an election, use of multiple corporations to avoid state-level double taxation, and use of composite returns to ameliorate cumbersome filing requirements. I have also prepared and processed numerous state ruling requests to obtain desperately needed guidance and clarification.

We are aware that a number of speakers today will address the technical aspects of MoSCITA. While we in no way minimize the importance of these concerns, it is not our intention to

analyze either specific provisions of MoSCITA or the alternative provisions currently under consideration by the Commission. Rather, our message is quite simple--that is, enactment of MoSCITA, as proposed by the ABA, is reasonable, rational, timely and correct. MoSCITA is a vast improvement over the status quo.

THE QUAGMIRE

The problems associated with the state taxation of S corporations are typified by the following statement presented at the Commission's 1987 Annual Meeting:

"It [The state taxation of S corporations] is an area of tax administration and procedure that is crying for uniformity, but, like many issues facing multistate businesses, uniformity is the exception rather than the rule. Until uniformity prevails, asymmetrical taxing systems present opportunities for tax savings, but also pitfalls that may result in duplicate taxation at the corporate and shareholder levels."

This somewhat conclusory observation was based both on the dearth of formal authority addressing issues fundamental to the wave of multistate businesses making S elections following the federal Tax Reform Act of 1986 and problems in applying existing authority. Illustrations of these fundamental problems include:

- Inadvertent failure to secure state-level S status due to divergent conditions precedent to the state election and differing federal and state due dates.
- Double taxation in recognition states resulting from a shareholder's inability to claim a resident tax credit for corporate-level taxes paid in non-recognition states.
- Ability of well-advised taxpayers to structure operations or transactions to completely avoid the state taxation of S corporation income. Of course, businesses not seeking outside assistance frequently fell into traps for the unwary, resulting in multiple burdens.
- Ill-defined procedural guidelines, including withholding provisions that are not statutorily tied to income taxable in the state and standards that create incentives not to file on a composite basis. Without composite returns, a ten-shareholder S corporation operating in 20 states would be required to file 220 returns (including

nonresident individual returns) compared with 30 returns prior to the S election.

- Over- or under-taxation caused by failure to reflect state income and modifications in the basis and AAA calculations.

While electing S status is almost always driven by federal tax benefits, it is interesting to note that the tax problems associated with multistate S corporations have been cited as a reason not to make the federal election. The state issues are complex. There is a perception that the rules, as they exist today, operate in an unfair manner and that certain taxpayers can avoid paying their fair share of the tax burden. Further, the compliance requirements associated with multistate S status are best characterized as a nightmare. As we deviate so significantly from the tax policy objectives of simplicity and fairness, the result--whether intentional or unintentional--is noncompliance.

MoSCITA--A SOLUTION

The objectives of MoSCITA are to provide a system for the state income taxation of S corporations and their shareholders that is reasonable, internally consistent, favorable to compliance, and easily administrable. We applaud the efforts of the Subcommittee and have concluded that the Model Act not only achieves these objectives, but is also rational in its approach and strikes a healthy balance both between the competing interests of the states as well as between the interests of the states and taxpayers.

MoSCITA is fair to both the states and the taxpayers. The provisions of the Model Act are clear. Since the decision to make an S election is typically based on federal tax considerations, under MoSCIA taxpayers will not be frustrated by the current confusion surrounding the state tax rules. Further, automatic federal conformity will keep taxpayers from being deprived of S status due to little-known nuances in state laws, such as filing separate consents or elections. The requirement to allow composite returns will further facilitate compliance. The enforcement mechanism for defaulting nonresident shareholders--a payment by the corporation on the shareholders' behalf--is also fair and reasonable, since a default does not terminate S status. This protects other S corporation shareholders from intended or inadvertent acts of a noncomplying member and, in a sense, removes the ability of an S corporation to willfully elect out of S status for state purposes only.

MoSCITA's use of corporate modifications for "income attributable to the state" is consistent with the premise that such income is allocated and apportioned solely as a result of the corporation's activities in the state. Likewise, the use of individual modifications for "income not attributable to the state" is supported by the premise that such income only becomes taxable as a result of an individual's residence in that state, not as a result of corporate activities. While admittedly the basis and AAA provisions of MoSCITA (as well as the bifurcated approach to modifications) add an additional layer of complexity to this area, we recognize the need for these provisions as an adequate measure to ensure that a taxpayer does not pay state tax twice on the same income or avoid tax altogether. Also fair, reasonable, and consistent with the state policy objectives for adopting S corporation provisions (*i.e.*, avoiding double taxation on income earned in corporate form) is the requirement that the state provide a resident credit for corporate income tax paid to non-conforming states.

We also support MoSCITA for what it does not include. Appropriately, MoSCITA does not interfere with broader state tax policies, such as allocation and apportionment, nexus standards, tax rates, loss carryforwards, unitary combination, and the definition of residence. The potential application of certain rules (*e.g.*, passive activity limitations) reaches far beyond S corporation taxation and also affects investments in partnerships, real estate, and the like. We believe it would be inappropriate to suggest legislative changes that would require adjustments for only one segment of the affected population. Unequal treatment may also raise constitutional concerns.

MoSCITA translates a complex area of federal tax law into a state legislative proposal that operates in sync with the federal provisions, while respecting the legal and constitutional restraints encountered at the state level. While the proposed model is reasonable and rational in its approach, we also take note that it is complex--but in contrast to views expressed in recent commentary, not unduly so. Because of its adherence to federal concepts, we anticipate that most practitioners will find MoSCITA understandable and workable. Further, we do not believe that tracking state-level modifications, basis, and AAA will produce inordinate burdens. MoSCITA, in our view, strikes a reasonable balance between simplicity and correctness.

CONCLUSION

In summary, KPMG Peat Marwick believes that on an overall basis MoSCITA offers a well-balanced approach to the state taxation of S corporations and their shareholders. It is reasonable, rational, fair, and is an improvement over the diverse practices existing at the state-level today.

We encourage the Commission to adopt MoSCITA as a uniformity recommendation.

EXHIBIT M

COMMENTARY TO THE MODEL S CORPORATION INCOME TAX ACT

I. EXECUTIVE SUMMARY

The Model S Corporation Income Tax Act (Model Act) attempts to provide a system for the state income taxation of S corporations and their shareholders that is reasonable, internally consistent, susceptible of compliance, and easily administrable. To the extent possible, the Model Act conforms to the principles, concepts, and language of subchapter S of the Internal Revenue Code of 1986, as amended (Code).

S corporations and their shareholders encounter a wide variety of state rules with respect to each of many issues and transactions. This lack of uniformity generates unfairness, particularly in cases in which the differences are the unintended consequences of failure to address the issue. It creates opportunities for S corporations having access to sophisticated advisors that are not available to S corporations that lack access to such advisors. Additionally, it results in noncompliance, since taxpayers often erroneously assume that all states treat the same issue in a similar manner.

As the result of internal inconsistency within the income tax laws of individual states, S corporations and their shareholders often find no specific provision dealing with an issue, but discover that conflicting answers result from reasoning by analogy from other state income tax provisions. This problem is a general one, but it afflicts the S corporation area quite significantly.

Compliance with state income tax laws by S corporations and their shareholders also needs to be improved. In addition to the unintentional noncompliance arising from lack of uniformity among states and consistency within states, there appears to be some degree of intentional noncompliance.

The taxation of S corporation shareholders poses a variety of administrative problems. States must resolve the treatment of nonresidents, the computation of income and loss, the adjusted bases of shareholders, the selection of income modifications and similar items. Unfortunately, most states have not directly addressed one or more of these matters, leaving the development of S corporation state income taxation to tax forms and instructions, informal revenue department guidance and reasoning by analogy. In every state there is a need for rules that are easily understood, applied and interpreted.

The approach taken by the Model Act to ameliorate the major problems are as follows:

(1) Most states recognize the S election; a few do not. Some states require separate state S elections, and a few directly or indirectly permit an election not to be treated as an S corporation. Some states impose additional qualification requirements, and some provide for novel termination conditions. Under the Model Act, recognition of the federal S election is automatic, state elections are

not provided and additional qualification or termination conditions are not allowed.

(2) Few state statutes specify whether corporate income tax or individual income tax modifications apply to S corporation income passed through to the shareholder. Among those states that do provide rules, some use corporate, some use individual, and a few use a hybrid of both. The Model Act provides that corporate modifications apply to income attributable to a state, since it is the corporation's activities that make the income allocable or apportionable to the state. The Model Act also provides that individual modifications apply to income not attributable to the state, since such income is taxed by the state only because it "belongs to" residents, who are taxed in their capacity as individuals and not because of the corporation's activities.

(3) State rules for determining a shareholder's tax basis in S corporation stock and debt range from automatic adoption of federal adjusted basis, even though state taxable income differs from federal taxable income by reason of state modifications, to separate state computation under rules similar to the federal S corporation adjusted basis rules. In between are many states that modify federal adjusted basis only in the event of a sale of stock or other property, creating a significant inconsistency within each such state. The Model Act gives each resident shareholder a beginning adjusted basis equal to federal adjusted basis as of the latest of three dates: (1) the date the shareholder became a resident, (2) the date of the shareholder's stock acquisition, or (3) the date the corporation's most recent S election became effective. Nonresidents receive a beginning adjusted basis of zero, since states generally do not tax nonresidents on corporate distributions or stock sale gains and thus have no opportunity to "recapture" and tax any losses deducted against unrelated income derived from the state. For all shareholders, the Model Act provides that state basis is adjusted in the same manner as federal basis, but using amounts equal to income or loss taxable in the state, rather than the amounts used for federal adjusted basis increases and decreases.

(4) There exists with respect to the accumulated adjustments account (AAA) the same set of problems that exists with respect to adjusted basis. Most states use federal AAA, or perhaps modified federal AAA, despite differences in the amounts of income and loss passed through to the shareholders for federal and state income tax purposes. No state directly addresses the treatment of AAA as it applies to resident and nonresident shareholders. The Model Act provides that the S corporation's state AAA must reflect state modifications made to that portion of the corporation's income attributable to the state.

(5) Currently, there is little or nothing that prevents shareholders from electing, or not electing, to use the "interim closing" method of allocating income among shareholders for federal income tax purposes when there is a change in ownership or S status, and then taking the opposite position for state income tax purposes. Under the Model Act, the choice made for federal income tax purposes is binding for state income tax purposes.

(6) If an S corporation does business in a state that does not recognize the S

election and its shareholders reside in a state that does, then the corporation is taxed at the former state's corporate rates and the shareholders are also taxed at the latter state's individual rates. Some states permit shareholders to claim a credit for the taxes paid by the S corporation, while others do not. Most states, however, do not address the issue. Following the recent trend, the Model Act provides for a credit to the shareholder in this situation.

In addition, the Model Act, addressing other issues as to which states commonly fail to provide guidance:

(1) uses the post-termination transition period as defined for federal income tax purposes, based on the use of federal qualification and election provisions;

(2) uses the federal mechanism for determining shareholders' pro rata shares of the corporation's income and other items;

(3) permits the state to choose between imposing no tax on the corporation at all or imposing tax only with respect to built-in gains or excess net passive income that are taxed to the corporation for federal purposes;

(4) requires separate statement of tax items that may have significance for state income tax purposes;

(5) provides that the corporation's income will be characterized or classified (e.g., as business or nonbusiness income) at the corporate level and without regard to the activities of the shareholders;

(6) adopts federal limitations on the carryover of losses to and from periods for which the corporation is an S corporation;

(7) limits the pass-through of losses to state adjusted basis, even if federal adjusted basis and use of losses differ;

(8) carries forward losses disallowed as the result of the state's adjusted basis loss limitation;

(9) treats carryforward losses as incurred on the last day of the post-termination transition period, and limits deductibility to state adjusted basis as of that date;

(10) provides a more rational rule for the taxation of shareholders who gain or lose residence during the S corporation's tax year;

(11) requires an S corporation to file an information return in each state in which a return would be required if it were a C corporation;

(12) requires the state to permit S corporations to file composite returns on behalf of nonresident shareholders, and authorizes (but does not require) the state to allow composite returns to be filed on behalf of resident shareholders;

(13) requires every nonresident shareholder to execute a consent to pay tax and file returns in the state, and imposes an obligation on the corporation to pay a tax computed at the highest marginal rate on behalf of any nonresident shareholder who fails to do so;

(14) treats any amount paid by the S corporation on a composite return with respect to a shareholder, or as a result of nonresident's failure to file a consent, as paid on behalf of the shareholder and thus as a credit on the shareholder's individual return;

(15) requires the state, in an optional provision, to pass "policy" tax credits through to the shareholders; and

(16) provides, in another optional provision, a four-year period for the payment of state income taxes due on LIFO recapture resulting from an S election, as is provided for federal income tax purposes.

The Model Act does not attempt to reform state income tax rules that reach beyond the scope of S corporations and their shareholders. For example, the Model Act does not try to achieve uniformity in state rules governing apportionment and allocation, rates of tax, use of losses and availability of loss carryforwards, definitions of resident and nonresident, and eligibility for credits for taxes paid on S corporation income to other states.

II. BACKGROUND

The Model Act is the product of an extended study undertaken by the American Bar Association Section of Taxation's Committee on S Corporations during the period 1982 through 1988. The initial study, conducted by the Committee's Subcommittee on the State Taxation of S Corporations, resulted in a report published in 1984 (Maule, *Effect of State Law on the Use of S Corporations*, 37 TAX LAWYER 535 (1984)). The report demonstrated the need for a model act to address the many problems caused by the prevailing lack of conformity between the federal and state rules governing S corporations, as well as the nonuniformity among and inconsistency within the states in the treatment of S corporations and their shareholders for income tax purposes.

Lack of uniformity and consistency is a concern for several reasons. First, it creates "unfairness" in the sense that persons choosing to do business in S corporation form encounter different, and often indefensible, variations in tax consequences. Second, lack of uniformity and consistency create tax planning opportunities that are overlooked by S corporations that lack sophisticated advisors. Finally, compliance problems arise from the difficulty encountered in ascertaining and conforming to such a wide variety of rules.

Some problems caused by state-to-state nonuniformity and state inconsistency with federal treatment pose significant concerns. A major problem arises when an S corporation that does business in more than one state is taxed by a state not recognizing the S election, while the shareholders are taxed by states of residence that do recognize the S election. Only a few states permit the shareholders to claim a credit for the taxes paid by the corporation, which is a different taxpayer from the shareholders, thus preventing the shareholders from utilizing the basic credit provision.

Another problem is the lack of guidance in states that recognize the S election with respect to the application of individual income tax or corporate income tax modifications to the S corporation's income. In addition, the absence of specific S corporation shareholder basis rules in most states results in the application of adjusted basis rules that are not appropriate in the S corporation context. Similar problems arise from the lack of uniform accumulated adjustments account treatment. Finally, difficulties arise from the lack of any mechanism to prevent inconsistent interim closing/pro rata elections from being made in different states,

when a shareholder disposes of all of his stock or the S election terminates in the middle of a taxable year.

In light of these problems and the increasing utilization of S corporations, the cumulative result of changes in the federal tax laws made between 1981 and 1986, the Subcommittee determined that a model act project should be undertaken. The Subcommittee identified and studied the issues to be addressed and drafted the Model Act and Commentary between January 1987 and August 1988. After review at its August 1988 meeting in Toronto, the Committee on S Corporations authorized the Subcommittee to publish the Model Act and Commentary as a report. The Subcommittee's report was initially released in September 1988. After receiving a number of useful suggestions and comments from the Section of Taxation's Committee on Government Submissions and others, the Subcommittee issued this revised Report in June 1989.

The Subcommittee members responsible for the Model Act and Commentary were:

Garland H. Allen, Chair
Mark E. Berg
Martin A. Culhane III
Jeffrey B. Detwiler
Bruce P. Ely
Prof. Edward R. Hayes
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Invaluable assistance was provided by Professor James Edward Maule, Villanova University School of Law, Villanova, Pennsylvania, the Subcommittee's consultant and former chair; Michael W. Freeland, Philadelphia, Pennsylvania, chair of the Committee on S Corporations; C. Wells Hall, III, Charlotte, North Carolina, chair of the North Carolina State Bar Tax Section; Phillip M. Tatarowicz, Washington, D.C. liaison to the Subcommittee from the Section of Taxation's Committee on State and Local Taxes; Michael H. Lippman, C.P.A., Ernst & Whinney National Tax Department, Washington, D.C.; Thomas J. Nichols, Milwaukee, Wisconsin; and Marilyn D. Franson, Chicago, Illinois. Principal drafters of the Model Act were William C. Schanlaber, Frank J. Matune and Garland H. Allen. Principal authors of the Commentary were Professor James Edward Maule and Garland H. Allen.

III. MAJOR POLICY DECISIONS

In order to understand the Model Act, it is important to appreciate the principal policy decisions reflected in the Model Act. The most important decisions are:

- (1) mandatory S status;
- (2) entity v. aggregate taxation;
- (3) corporate income tax modifications for income attributable to the state and individual modifications for income not attributable to the state;
- (4) state adjusted basis and state accumulated adjustments account; and
- (5) initial "zero basis" for nonresident shareholders.

A. Mandatory S Status

The Model Act requires the enacting state to recognize a federal S election for state income tax purposes. That is, the Model Act does not permit state S status in the absence of a federal S election and does not permit shareholders of a federal S corporation to elect out of S status for state purposes. The Model Act also prohibits the state from imposing additional or different requirements for the recognition of S status.

The principal justification for mandatory state recognition of S status is to conform the state tax treatment of S corporations and their shareholders to the federal treatment. Permitting shareholders to elect out of S status at the state level, or to avoid such status by failing to meet additional state requirements, reduces federal-state conformity, promotes nonuniformity from state to state, and creates opportunities for noncompliance.

Elective S status at the state level would also require the enactment of complex rules to govern corporations switching from one status to the other, such as rules adjusting the shareholders' stock and debt basis and accumulated adjustments account for state purposes. Further, elective S status at the state level would require the state to decide whether the shareholders should be able to claim credit against home state taxes for taxes paid by the S corporation to states in which the election was not in effect.

Finally, many states have made S status elective out of concern that the state could not constitutionally tax, or collect tax from, a nonresident shareholder in the absence of the shareholder's affirmative consent. The Model Act assumes, as have the great majority of states that require no state consent or election, that a state may constitutionally tax nonresident shareholders on S corporation income derived from the state notwithstanding the absence of any other connection with the state. At the same time, the Model Act addresses state enforcement concerns by requiring that the nonresident shareholder consent to the state's taxing jurisdiction or, in the case of failure to consent, that the corporation pay on the nonresident's behalf a tax on the nonresident's share of the S corporation's income attributable to the state.

B. Entity v. Aggregate Taxation

Under the Model Act, S corporation income items passed through to shareholders are characterized at the corporate level, are subjected to corporate (rather than individual) income tax modifications and are apportioned and allocated to the state using the state's corporate (rather than individual) tax apportionment and allocation rules. By providing that characterization, modification, and ap-

portionment and allocation of income take place at the corporate level, using the rules already in place in the state's income tax law, the Model Act provides clear answers to issues (see sections 1000 and 1002) that currently are not satisfactorily addressed by most state statutes.

Both theoretical and practical reasons justify the Model Act's "entity" approach to state taxation of S corporations. The entity-level characterization of income follows the principle of section 1366 of the Code, which applies at the corporate level. Moreover, since the business is conducted in corporate form, the state should, in general, modify, apportion, and allocate the S Corporation's income in the same manner as the income of corporations that are subject the state's tax on corporations. On a more practical level, most states have given greater attention to the taxation of multistate income in their corporate income tax statutes than in their individual income tax laws; hence, the entity approach helps to ensure that the most appropriate state rules will apply in the S corporation context.

C. Corporate Income Tax Modifications for Income Attributable to the State; Individual Modifications for Income not Attributable to the State

Consistent with constitutional limitations on state jurisdiction to tax, a state may tax a foreign corporation or nonresident individual only on that portion of the person's income derived from or connected with sources within the state. By contrast, almost every state taxes a resident individual on 100% of worldwide income and then grants the resident credit against the state income tax liability for income taxes paid to other states on the same income. This regime generally ensures that no state will impose a second tax on income clearly derived from and taxed in another state, but leaves each state free to tax its residents on all income not clearly derived from any other state (*i.e.*, to tax residents on certain income simply because of their residence).

The Model Act does not affect this basic scheme. It does, however, prescribe whether the addition and subtraction "modifications" provided by the taxing state for corporate taxpayers, or those applicable to individuals, apply to the federal S corporation items passed through to shareholders. Under the Model Act, corporate modifications apply to the portion of the corporation's income that is apportioned or allocated to the state under the state's own apportionment and allocation rules (*i.e.*, Income Attributable to the State), while individual modifications apply to S corporation items not so apportioned or allocated but that nonetheless are taxed to those shareholders who are *residents* of the taxing state (*i.e.*, Income Not Attributable to the State).

The Model Act's approach has a theoretical basis. Under the prevailing state scheme for the taxation of multistate income earned by nonresident individuals, the state applies its peculiar state modifications (and its income tax) only to income of the nonresident that is attributable to the taxing state. Similarly, the state taxes and modifies the income of corporations, both foreign and domestic, generally only to the extent such income is derived from the state. Stated another way, the state applies its policy choices about how to define income, or to modify

federally taxed income, only to that portion of the nonresident's income derived from the state. Accordingly, the Model Act applies the state's own modifications to that portion of the S corporation's Income Attributable to the State and then passes the income as modified through to resident and nonresident shareholders. Consistent with the Model Act's "entity" taxation principle, the modifications applied to such income are those prescribed by the state for corporate taxpayers.

The state, however, has much less justification for applying its own income tax policies, particularly those developed for corporations doing business in the state, to income clearly not derived from the state. The resident is taxed on such income not because of any relationship between the corporation's business and the state (indeed, by definition such income is deemed by the state to have been earned elsewhere), but simply because the individual shareholder resides there. Hence, the Model Act applies the state's *individual* income tax modifications to such income, just as a state would apply individual modifications to investment or nonbusiness income earned by a resident individual.

On a practical level, it would have been simpler to apply corporate modifications to all S corporation income and loss earned by resident shareholders, rather than applying individual modifications to items taxed to the resident solely by reason of his residence. It was thought, however, that doing so would yield illogical results.

Example 1

Assume that a resident of state *Y*, who is the sole shareholder of an S corporation that does 100% of its business in state *Z*, has \$100 of federally taxed S corporation income before state modifications. Also assume that state *Y* has a corporate income addition modification equal to the excess of federal accelerated depreciation over straight-line depreciation, which in the case of the S corporation would be \$25, but requires no such modification for individual taxpayers. The assumption underlying the Model Act is that it is not appropriate to apply state *Y*'s policies, designed for the taxation of corporations doing business in state *Y*, to income derived by a state *Y* resident from a corporation that does all of its business in state *Z*. Therefore, state *Y*'s corporate modification would not apply and state *Y* would tax the shareholder on \$100 of income (rather than \$125).

D. State Adjusted Basis and State Accumulated Adjustments Account

The Model Act requires that state income modifications (*i.e.*, any differences between the tax items passed through to shareholders for federal purposes and those passed through for state purposes) be reflected in the calculation of each shareholder's adjusted basis in the stock and debt of the corporation. Similarly, the Model Act requires the state corporate income modifications made to the corporation's Income Attributable to the State to be reflected in the calculation of the state AAA, which must be maintained by the corporation in order to determine the tax treatment of distributions to shareholders who are residents of the taxing state.

For federal income tax purposes, the S corporation shareholder's basis in the stock of the corporation, as well as in any debt owed to the shareholder by the corporation, has three functions: (1) the shareholder's combined stock and debt basis limits the amount of losses and deductions (technically, the amount of net negative tax items) that pass through to the shareholder and may offset other income of the shareholder for the current tax year, (2) the shareholder's basis in stock and debt determines the shareholder's gain or loss from a sale, exchange or redemption of such stock or debt, and (3) the shareholder's stock basis determines the amount of income or gain recognized by the shareholder upon a distribution of money or property by the corporation.

In general, the federal AAA is the running tally or record of the net amount of the federal income, loss and deduction items passed through by the corporation to its shareholders under federal subchapter S as in effect since 1982, less any distributions thereof made to shareholders. For an S corporation that has earnings and profits for federal tax purposes, as well as for a former S corporation during a limited period after it ceases to be an S corporation, the federal AAA generally determines the extent to which a distribution by the corporation represents amounts already taxed to its shareholders, and therefore may be distributed to the shareholders free of further taxation.

Federal basis in stock and debt and federal AAA are both functions of the amounts passed through to the corporation's shareholders for federal tax purposes. Since states tax shareholders on amounts that may be significantly greater or smaller than the federal amounts, implementation of the same concepts at the state level requires that state basis and AAA be adjusted to reflect state modifications to federal tax items.

E. Initial "Zero Basis" for Nonresident Shareholders

Losses passed through to shareholders for federal purposes, which generally reduce the shareholder's basis in stock, are ordinarily "recaptured" and taxed at such time as the shareholder recovers the loss through a sale or redemption of the stock at a gain, or through the receipt of distributions from the corporation in excess of AAA. In the case of nonresident shareholders, however, the same recapture does not usually occur at the state level because the states generally do not, and may not have constitutional authority to, tax a nonresident on income from sales of or distributions in respect of S corporation stock or debt. In order to neutralize an advantage a nonresident would have—using losses passed through from an S corporation to shelter unrelated income derived from the state without risk of recapture—the Model Act requires that the nonresident take a beginning "zero basis" in his or her stock and debt, and adjust that basis only to reflect income of the same S corporation that is thereafter passed through to the nonresident for purposes of that state's tax.

Consistent with potential constitutional limits on state power to tax nonresidents on income from intangibles and consistent with the prevailing state practice, the Model Act assumes that the enacting state does not attempt to tax a nonresident on income from sales of or distributions with respect to S corporation stock or

debt. In such a state, if a \$100 loss incurred by an S corporation in state X (where the shareholder resides) is permitted to reduce the shareholder's stock basis for purposes of the tax laws of state Y (where the shareholder is a nonresident), state Y will never be able to tax the recovery of the \$100 loss through a later sale, redemption, or distribution with respect to that stock. Accordingly, the Model Act gives the shareholder a zero beginning basis for purposes of the income tax of any state in which the shareholder is a nonresident, and provides that such basis is increased or decreased thereafter only by tax items actually passed through for purposes of that state's tax. In this way, the shareholder receives a pass-through of a loss for state purposes only after "earning" that right by taking at least the same amount of the S corporation's income into account in computing taxable income for purposes of that state.

Example 2

Assume that A and B each contributes \$20,000 to form S corporation. During Year 1, S does 100% of its business in state X, which recognizes the S election. A resides in a state in which S does not do business. Since A is a nonresident of state X, A's beginning state basis for state X income tax purposes is zero.

In Year 1, S has nonseparately stated business income of \$200,000 for federal income tax purposes. A reports \$100,000 (50% of \$200,000) of income for federal income tax purposes and increases her federal adjusted basis from \$20,000 to \$120,000. Net subtraction modifications of \$130,000 apply for state X purposes, so A reports only \$35,000 (50% of (\$200,000 - \$130,000)) for state X income tax purposes, and increases her state X adjusted basis from zero to \$35,000.

In Year 2, S has a \$100,000 business loss and no modifications apply. Assuming that no at-risk and passive loss limitations apply, for federal income tax purposes a \$50,000 (50% of \$100,000) loss passes through to A (presumably offsetting other income in the current year) and reduces her federal adjusted basis from \$120,000 to \$70,000. For state X purposes, A may claim only \$35,000 of the loss. If A were permitted to claim the entire \$50,000 loss for state X purposes and then were to sell her stock for \$50,000 or more, state X would never be able to tax A's recovery of the excess of the \$50,000 loss over the \$35,000 on which A paid state X tax (*i.e.*, \$15,000).

Any loss disallowed by virtue of the nonresident shareholder's lack of state basis is suspended, carried over and deemed incurred by the corporation with respect to the shareholder in the next taxable year. Thus, losses subject to disallowance as a result of the "initial zero basis" rule can be carried forward indefinitely until the S corporation earns income in the state. Since many states effectively preclude a nonresident individual from carrying over a loss incurred in a year in which he has no other in-state income to absorb it (a rule that the Model Act would not change), the Model Act's "carryover" rule should generally permit greater utilization of such losses.

The zero basis rule may prevent a nonresident from using a current S cor-

poration loss to offset in-state income derived by the nonresident from other sources. The propriety of the resulting "discrimination" against the nonresident has been considered and a determination made that the Model Act's nonresident initial zero basis provision is constitutionally sound. Moreover, alternative methods of achieving the objective of the initial zero basis provision are either constitutionally suspect or much more difficult for the state to administer.

F. Broader Issues not Addressed

The Model Act does not alter state law rules that, while significantly affecting the taxation of S corporations and their shareholders, are broadly applicable to all taxpayers. Examples are state rules governing (1) who is taxed as a "resident" for state purposes; (2) how a part-year resident is taxed; (3) whether a taxpayer is entitled to credit for any taxes paid to another state; (4) when an S corporation becomes subject to the state's taxing jurisdiction; (5) whether state taxable income is determined by reference to the Code; (6) rates of tax; (7) the extent to which the Uniform Division of Income for Tax Purposes Act (UDITPA) applies for apportionment and allocation purposes; (8) the extent to which federal redemption and reorganization definitions apply; (9) specific state modifications; and (10) state "policy" tax credits. While uniform multistate resolutions of some of these issues are clearly needed, for example, in the taxing of part-year residents, the Subcommittee concluded that addressing such broader issues might jeopardize its objective of achieving uniformity in the state tax rules primarily affecting S corporations and their shareholders.

IV. EXPLANATION OF THE MODEL ACT'S PROVISIONS

The purpose of the Model Act is to provide rational and uniform state income tax treatment for S corporations and their shareholders. The Model Act is also intended to provide rules for resolving issues that arise in all states but that in many states are not addressed by statute, regulation or even administrative guidance. Thus, another premise of the Model Act is that S corporations and their shareholders should be addressed directly, rather than through the application by analogy of general state income tax principles developed outside the S corporation environment.

Because of the variety of ways in which state revenue laws are drafted, most states will need to tailor the Model Act to their own statutory terminology. For example, the Model Act uses "Code" to refer to the federal Internal Revenue Code of 1986, as amended, whereas some states use "Code" to refer to their own statutes and use another term, such as "IRC" or "Internal Revenue Code," to refer to the federal Internal Revenue Code. A state that takes the latter approach must replace their term "Code" in the Act with "IRC," "Internal Revenue Code" or other appropriate term. Another example is the states' use of different terms to describe the income of a multistate taxpayer subject to formula apportionment, with most states following the "business income" terminology of UDITPA and others using different terms. States using other terminology may

wish to alter the definition of "Income Attributable to the State" in section 1000.

Except where indicated, the Model Act is intended to be adopted as a whole and is not intended to be used as a mere reference for the ad hoc resolution of discrete issues. Only if states adopt the Model Act as drafted will the objective of uniformity be achieved.

Section 1000(a)

The Model Act in many places references itself by the phrase "this Part." If the state places the Act in a "subtitle," "subdivision," or other statutory structure, this provision must be conformed to that terminology.

Section 1000(b)(1)

The definition of "C Corporation" is matched to the definition of "S Corporation" (see section 1000(b)(7)), which parallels the definitional approach of federal subchapter S.

Section 1000(b)(2)

The Model Act refers to the Internal Revenue Code of 1986, as amended and in effect for the taxable period in question. This is not the approach nor, in a few instances, the terminology used by states that conform to some variation of the federal income tax law. Nonetheless, even in a state that refers to the Internal Revenue Code as of a particular date (and periodically revises that date), it is permissible, barring a state constitutional provision to the contrary, to incorporate the federal subchapter S in the manner provided, regardless of what is done with respect to the rest of the state's income tax law.

The few states that do not conform to the Internal Revenue Code, either in the taxation of corporations or in the taxation of individuals, can adapt the Model Act for use in the state by eliminating unnecessary references to state "modifications" to federal income (*i.e.*, by eliminating the reference to section 1002 from section 1001(b); by eliminating section 1002(a) and (b); and by amending sections 1003(b)(1) and 1006(c)(2) to take "differences between state and federal taxable income" of the resident shareholder, instead of the "modifications" of section 1002, into account in computing the shareholder's stock basis and AAA). An alternative, but less desirable, method of adaptation would be to enact statutory provisions paralleling those of federal subchapter S. (Note that although Alabama and Pennsylvania have adopted the latter approach, their statutes fail to address several issues, such as nonresident shareholder adjusted basis.)

Section 1000(b)(3)

A new term introduced by the Model Act, "Income Attributable to the State," describes the portion of an S corporation's income deemed earned within the state by virtue of the S corporation's activities. The portion attributable to the state is determined by using the state's apportionment and allocation rules applicable to C corporations, and by modifying federal income by the state additions

and subtractions applicable to C corporations. Since residents are typically taxed on all income from whatever source derived, including their entire share of S corporation income (see section 1001(b)), this definition has its most important application in the taxation of nonresident shareholders. The term, however, also describes the portion of every shareholder's income that the Model Act subjects to corporate modification provisions (see section 1002).

No attempt was made to revise the state's apportionment and allocation rules as they apply to S corporations and their shareholders. These rules are not uniform among the states (though most states generally follow the provisions of UDITPA) and the resulting state-to-state inconsistencies are unabated by the Model Act.

Section 1000(b)(4)

This definition matches that of "Income Attributable to the State" (see section 1000(b)(3)).

Section 1000(b)(5)

The definition of "Post-Termination Transition Period" (PTTP) corresponds to the federal definition. As under the federal rule, one purpose of this provision is to allow a former S corporation to distribute previously taxed income to its resident shareholders free of a second tax during a limited period after termination of the corporation's S status (or after a federal determination that the S status has been terminated). Another is to allow a shareholder of a former S corporation additional time to increase his or her stock basis in order to utilize a loss disallowed during the corporation's last tax year as an S corporation. Since S status for federal and state purposes is coterminous under the Model Act, the PTTP provided by federal law is sufficient for state purposes.

Section 1000(b)(6)

The Model Act adopts the federal definition for computing a shareholder's "Pro Rata Share," though it does not adopt the dollar amount computed for federal income tax purposes. Under federal tax law, the entire amount of income of the corporation is included in the pro rata share computation. For state income tax purposes, this occurs for a nonresident shareholder only if the corporation's entire income is attributable to the state (see section 1001(b)).

The Model Act also makes applicable for state income tax purposes any interim closing of the books elected under section 1377(a)(2) of the Code for federal income tax purposes, as well as any interim closing elected or required by section 1362(e)(3) or (e)(6)(D) of the Code upon the termination of a corporation's S status. This avoids potential inconsistent treatment in states that provide, explicitly or implicitly, for separate state elections with respect to an interim closing.

Example 3

A is the sole shareholder of an S corporation that does business in states X and Y. Assume that the apportionment and allocation rules of states X and Y are identical, that there are no income modifications for state purposes, and that

one-third of *A*'s business income of \$100,000 for Year 1 is attributable to state *X* and two-thirds is attributable to state *Y*. Midway through Year 1, *A* sells her stock to *B*.

Pursuant to an interim closing election made for federal income tax purposes, *A*'s distributive share of the Year 1 income is \$75,000, and *B*'s is \$25,000. Under the Model Act, an interim closing of the books must be made for purposes of the income taxes imposed by states *X* and *Y*, and the apportionment and allocation rules are then applied. Accordingly, state *X* taxes *A* on \$25,000 ($1/3 \times \$75,000$) and *B* on \$8333 ($1/3 \times \$25,000$). State *Y* taxes *A* on \$50,000 ($2/3 \times \$75,000$), and *B* on \$16,667 ($2/3 \times \$25,000$). (Note that the ordinary apportionment fraction determined for the entire year is applied to determine the portion of income on either side of the interim closing date that is attributable to the state.)

If the federal interim closing election is not made (see section 1377(a)(1) of the Code), *A*'s as well as *B*'s distributive share for federal income tax purposes would be \$50,000 ($1/2 \text{ year} \times \$100,000$). Under the Model Act, no interim closing election may be made for state purposes. Under the assumed apportionment and allocation rules, state *X* would tax each of *A* and *B* on \$16,667 ($1/3 \times \$50,000$) of income, and State *Y* would tax each of *A* and *B* on \$33,333 ($2/3 \times \$50,000$) of income.

Section 1000(b)(7)

Under the Model Act, if a corporation is an S corporation for federal income tax purposes, it is automatically an S corporation for state purposes. The Model Act thus dispenses with the need to file separate state elections, as well as "protective elections" in states in which the corporation intends to begin business after the due date prescribed for a separate election. The Model Act similarly does not permit a negative S election (*i.e.*, an election to be treated as a regular or C corporation), an option that has been made available to S corporation shareholders in two states, one of which quickly repealed it.

A state under the Model Act may not impose additional qualification requirements or, as a few states do, terminate the corporation's state S status for the violation of conditions (such as the corporation's receipt of excess net passive income where there are no C corporation earnings and profits or a nonresident's failure to pay state tax) that do not cause termination of the election for federal purposes.

Under the Model Act, the state is free to require each S corporation subject to its jurisdiction to file proof of its federal S election and related documents. Such rules, already adopted in many states, permit the states to identify such corporations.

Section 1000(c)

This section parallels provisions enacted in most states that have adopted provisions of the Code by reference. It may be omitted if such a provision already

exists in the state's income tax law and by its terms applies to the portion of the state law in which the Model Act appears.

Section 1001(a)

The Model Act allows the state an option as to the taxation of the S corporation itself. The state's choice of either alternative has no adverse impact on the Model Act's goals of uniformity, consistency and compliance in the taxation of income earned by S corporations.

Under the first alternative, which has been selected by the majority of states, the S corporation is absolved from all taxes on its income. This option eliminates complexity without the sacrifice of significant tax revenue.

Under the second alternative, the S corporation is subject to corporate income tax if the corporation is subject to an entity-level tax for federal purposes, but then only to the extent that its federally taxed income, as modified for state purposes, is attributed to the taxing state under the state's apportionment and allocation rules. Under current law, this means that an S corporation may be subject to the state tax only if it has "built-in gains" or "excess net passive income" within the meaning of sections 1374 and 1375 of the Code.

Example 4

S corporation is not subject to the federal income tax on excess net passive income because its passive investment income is less than 25% of its gross receipts. See section 1375(a)(2) of the Code. All other conditions for such taxation are met. After apportioning and allocating the appropriate portions of the corporation's state-modified income to state *X*, however, it is determined that more than 25% of *S*'s investment income attributable to the state is passive. Accordingly, if only the state *X* amounts were taken into account, *S* would be subject to state *X* tax on a portion of its excess net passive income. However, the Model Act provides that, because no income is taxed to the corporation for federal income tax purposes, state *X* may not impose a tax.

The Model Act does not permit the selective imposition of entity-level taxes that occurs in many states. Thus, states will no longer be able to tax only excess passive income, only built-in gains or as some states do, excess passive income and capital gains. Such individualization of S corporation taxation merely causes confusion, and often is merely the result of a time lag between federal changes and state conforming legislation.

If the state does tax the S corporation, the state income tax paid by such corporation reduces the Income Attributable to the State, which is passed through and taxed to the shareholders. This rule ensures that the corporation's income is not subjected to a greater state income tax than income earned and distributed by a C corporation, and parallels the federal treatment of federal taxes imposed on the corporation by sections 1374 and 1375 of the Code (see section 1366(f)(2) and (3) of the Code). Note that this rule applies whether or not the state permits individual taxpayers to deduct income taxes imposed by the state. If the state

already permits the deduction of the state's own tax, however, the state should consider a provision expressly precluding double exclusion of state tax from the shareholders' income.

Similarly, the Model Act provides that any federal taxes imposed on the S corporation under section 1374 or 1375 of the Code reduce the corporation's Income Attributable to the State and Income Not Attributable to the State for purposes of determining the amount passed through and taxed to the shareholders for state purposes, whether or not the state permits a deduction for federal income taxes (see section 1001(c)).

The Model Act imposes no restrictions on the rate of tax that a state may impose on income subject to taxation at the corporate level. That is an issue that can be resolved by each state without adversely affecting the Model Act's premises of uniformity and consistency.

Section 1001(b)

Under the Model Act, every shareholder who is a resident of the state reports and pays individual state income tax with respect to the shareholder's entire Pro Rata Share of the S corporation's income, losses, deductions and credits, as characterized and modified for state purposes under section 1002. In other words, a resident reports both his share of the corporation's Income Attributable to the State and his share of its Income Not Attributable to the State. By contrast, a shareholder who is a nonresident pays individual tax only on the nonresident's share of that portion of the corporation's income or loss derived from sources within the state (*i.e.*, Income Attributable to the State). This basic difference in the treatment of residents and nonresidents is reflected in the income tax laws of every state and is commonly thought to be justified by differences in the state's constitutional power to tax residents and nonresidents.

Thus, each nonresident shareholder is taxed on the portion of the shareholder's share of the S corporation's income, subject to the appropriate state modifications, which is attributable to the taxing state. The portion attributable to the state is determined in accordance with the state's apportionment and allocation rules applicable to C corporations (see section 1000(b)(3)). The Model Act does not prescribe the method by which the state determines the tax to be paid by the nonresident on the Income Attributable to the State (*e.g.*, by applying the state's tax rates to the nonresident's worldwide income and then multiplying the result by a fraction representing the portion of worldwide income attributable to the state).

The Model Act requires that S corporation income, loss and deduction items included in the shareholder's taxable income be separately stated to the extent there is state tax significance in the separate statement (*e.g.*, U.S. government bond interest and state enterprise zone expenditures). Accordingly, certain items must be separately stated for state income tax purposes even though they are not separately stated for federal income tax purposes. This result is achieved through the cross reference to section 1366 of the Code, which adopts the provisions of section 702 of the Code requiring separate statement of an item

whenever separate statement might have a different effect on the shareholder's tax consequences than would occur if the item were not separately stated.

The provisions of the Model Act are "inclusion" provisions. To the extent the state defines state taxable income by reference to federal gross, adjusted gross, or taxable income, inclusion of the amounts treated as taxable under the Model Act would be duplicative. Accordingly, these states must remove the duplication by providing a "modification" addition or subtraction, as the case may be, for all items of an S corporation otherwise included in the shareholder's income. Model provisions are included in the Addendum to the Model Act.

Section 1002(a)

Income Attributable to the State is subject to the state income modifications applicable to corporations. Thus, every nonresident shareholder uses only the corporate modifications, and every resident uses the corporate modifications to the extent of the resident's share that is attributable to the state. Corporate modifications are used because the income being taxed and modified is income subject to taxation by reason of the corporation's activities in the state. If the corporation does not conduct any activities in the state, none of its income is taxed by the state except to the extent resident shareholders are taxable by reason of their residence.

Example 5

S corporation conducts business in state X and another state. S has two equal shareholders: A, a resident of state X, and B, a nonresident of state X. S has federal taxable income of \$160, which includes \$100 of business income and \$60 of nonbusiness capital gains income. S's state X apportionment factor for business income is 90%. S's nonbusiness income is allocated under state X's laws to S's state of commercial domicile, which is not state X. State X provides a \$20 addition modification equal to the excess of accelerated depreciation over straight-line depreciation, which applies to corporate, but not individual, taxpayers. State X also provides an individual subtraction modification for 60% of capital gains income, which does not apply to corporations.

For state X purposes, only 90%, or \$90, of the portion of S's unmodified federal income that constitutes business income is attributable to state X. Accordingly, only 90% of state X's \$20 corporate modification is taken into account in computing the shareholders' state X income. Thus, resident A is taxed on \$54 of business income attributable to X (50% share × 90% state X apportionment factor × (\$100 business income + \$20 corporate modification)). In addition, A is taxed on \$5 of S's business income not apportioned to state X (50% share × (\$100 unmodified business income - \$90 unmodified business income attributable to X)), which is subject to no individual modification under state X's assumed law. A is also taxed on \$12 of S's nonbusiness income not attributable to X (50% × (\$60 capital gains - \$36 individual modification)).

Nonresident B is also taxed on \$54 of S's modified business income attributable to X. State X does not tax B on his remaining \$5 share of S's unmodified business

income or his \$30 share of unmodified nonbusiness income, since neither is attributable to state X.

Section 1002(b)

Income Not Attributable to the State is subject to the modifications applicable to individuals. Thus, a resident uses the individual modifications to the extent of the portion of the resident's distributive share that is not attributable to the taxing state. Individual modifications are used because the income is subject to taxation by reason only because of the shareholder's residence in the state (see example 5 above).

Section 1002(c)

Under the Model Act, S corporation income and other tax items are characterized at the corporate level and passed through to the shareholders retaining such characterization. This is the approach taken for federal income tax purposes (see section 1366(b) of the Code) and by many states for state income tax purposes. Accordingly, in classifying income as business or nonbusiness income, only the corporation's activities are taken into account, and the shareholders are not treated as directly engaging in the corporation's transactions.

Section 1003(a)

Under the Model Act, a resident shareholder's initial or beginning state adjusted basis in the corporation's stock (and in the corporation's indebtedness to the shareholder) is equal to his or her adjusted basis for federal income tax purposes. Under section 1003(a), a resident shareholder determines the initial adjusted basis as of the latest to occur of three dates:

- (1) the date the shareholder last became a resident of the state;
- (2) the date the shareholder acquired the stock or indebtedness; or
- (3) the effective date of the corporation's most recent federal S election.

The date on which the resident shareholder's initial basis is determined may be before or after the effective date of the Model Act in the state. Thereafter, the shareholder's initial basis is adjusted pursuant to section 1003(b) to reflect corporate tax items passed through to him or her for purposes of the state's income tax. For a discussion of the effect on basis of a shareholder's change of state residence, see the explanation of section 1003(c) below.

Section 1003(b)

A resident shareholder's initial basis in the corporation's stock and indebtedness, as determined under section 1003(a), is adjusted for the same reasons that the shareholder's federal adjusted basis is adjusted. The Model Act incorporates all relevant adjustments by incorporating section 1011 of the Code by reference. The federal adjustments are modified, however, to take into account the state income modifications applicable to the resident shareholder (except modifications for income that is exempt from taxation by the United States

government or the state). Accordingly, the shareholder may have a different adjusted basis for federal income tax purposes than for state income tax purposes.

The following examples illustrate the effect of reflecting state income modifications in the shareholder's stock and debt basis:

Example 6

B, a resident of state Y, is the sole shareholder of S corporation, which does all of its business in state Y. At the beginning of Year 1, B's adjusted basis for federal and state income tax purposes is \$100. During Year 1, S's nonseparately stated income for federal income tax purposes is zero; there are no separately stated items. S also has \$90 of excess depreciation, which is a corporate "addition modification" under state Y's income tax law. Thus, B's state Y income for Year 1 is \$90.

Assume B sells her stock in S on the first day of Year 2 for \$300. For federal income tax purposes, B's gain is \$200 (\$300 - \$100 federal adjusted basis). If B's state adjusted basis is not adjusted by taking the modification into account, B's gain for state Y income tax purposes would also be \$200, even though B already paid tax on an additional \$90 of income. By taking the modification into account, B's state Y adjusted basis at the end of Year 1 is \$190 (\$100 + \$90), and B's gain on the sale of the stock is only \$110.

Example 7

C is the sole shareholder of S corporation, which does all of its business in state Z. At the beginning of the year, C's adjusted basis for federal and state income tax purposes is \$100. During the year, S's nonseparately stated income for federal income tax purposes is zero. There is one separately stated item: \$60 of interest on state Z bonds, which is not taxed for federal income tax purposes but is taxed by state Z. Thus, after the \$60 "addition modification" under Z's income tax law, C's state Z income is \$60.

Assume C sells her stock in S corporation on the first day of the following year for \$300. For federal income tax purposes, C's gain is \$140 (\$300 - \$160 federal adjusted basis). This is also the correct answer for state purposes. Since the income that is exempt for federal purposes already increased C's basis from \$100 to \$160 (see section 1367(a)(1)(A) of the Code), no additional state basis increase is made under the Model Act for state Y's addition modification for such income.

Example 8

A is the sole shareholder of S corporation, which does all of its business in state X. For federal income tax purposes, S's transactions for the year generated \$50,000 of nonseparately stated taxable income and \$10,000 of taxable U.S. government bond interest. S's adjusted basis for federal income tax purposes is increased by the entire \$60,000. State X may not tax interest on federal bonds, and has a subtraction modification to that effect. Section 1003(b) does not reduce A's basis for state purposes by the amount of the subtraction modification for

federal obligation interest, however, since the Model Act parallels federal law in increasing state stock basis by income that is exempt from state income tax (see Code section 1367(a)(1)(A)).

Under the Model Act, federal adjustments made under section 1367 of the Code with respect to any period prior to the Model Act's effective date (while the shareholder was a resident) during which the state did not recognize S elections, or during which the state permitted S elections but the particular S corporation did not have an election in effect for state purposes, are not reflected in state basis. Since the shareholder did not take the corporation's income into account during the period, the shareholder's basis should not reflect such income.

Sections 1003(b)(1) and 1003(d) provide optional statutory language under which similar state basis modifications made pursuant to a pre-Model Act state statute would be reflected in the state stock and debt basis of resident and nonresident shareholders. Thus, if the state's prior law contained a basis adjustment provision similar to section 1003(b)(1) or (d), the state may wish to include appropriate language in the Model Act incorporating the basis adjustments made under that provision.

Example 9

A, a resident of state Y, owns 100% of the stock of S corporation. A formed S on January 1, 1980 with a capital contribution of \$100. Although the corporation elected S status for federal purposes, state Y did not recognize the S election and did not tax A on S's income. State Y amended its income tax laws to recognize S corporations beginning January 1, 1985; however, state Y's law did not contain a provision similar to section 1003(b)(1), which requires state adjustments to basis. State Y later replaced its S corporation law with the Model Act effective January 1, 1989. For federal income tax purposes, S earned and accumulated \$1000 of income during the period 1980-1984 and another \$500 during 1985-1988, so that A's federal adjusted basis in his stock as of January 1, 1989 is \$1600.

Section 1003(a) provides that A's initial basis is \$100 as of January 1, 1980. Section 1003(b) requires A's initial basis to be adjusted by the \$1500 of Code section 1367 adjustments made through the end of 1988. While no adjustments are made under section 1003(b)(1) (since section 1002 did not exist in state Y prior to January 1, 1989 and state Y's prior law contained no similar provision), section 1003(b)(2) mandates that the \$1000 of federal adjustments made prior to January 1, 1985, when state Y first recognized S's federal election, must be disregarded. Thus, A's basis as of January 1, 1989 is \$600 (\$100 + \$1500 - \$1000).

Note that, in this example, if state Y's prior law had contained a provision similar to section 1003(b) and state Y had adopted the optional provision explained above, any state Y income modifications taken into account by A during 1985-1988 would have affected A's state stock and debt basis as of January 1, 1989.

Section 1003(c)

For a shareholder who is a nonresident of a state, the sole function of adjusted basis in stock and debt of the corporation is to limit the pass-through of losses for purposes of the state's tax. Under the Model Act, a shareholder who is not a resident of the taxing state has an initial basis of zero for purposes of that state's income tax. The shareholder receives no basis in that state until he or she "earns" it by including the S corporation's income in the shareholder's taxable income for that state.

Example 10

C, a resident of state Y, is the sole shareholder of S corporation, which does all of its business in state Y. On the last day of Year 1, C's adjusted basis in the stock of S for federal and state income tax purposes is \$100. On the first day of Year 2, C causes S to move its entire business to state Z. During Year 2, S incurs a \$50 operating loss (nonseparately stated) and has no separately stated items or items requiring modifications. C, in her individual capacity, also has \$40 of rental income from rental property located in state Z.

Because C's adjusted basis in the stock of S in state Z is zero, C may not deduct for state Z income tax purposes any of the \$50 loss attributable to state Z. The loss will be carried forward and treated as though it were incurred for state Z purposes in the next year (see section 1004).

If C were permitted to use the \$50 loss for state Z purposes to shelter the \$40 of unrelated income, which would occur if C were given her federal basis of \$100, C would have a potential double benefit. The premise of adjusting stock basis to reflect a loss is that the shareholder will pay tax on any recovery of that loss made through a later sale of the stock or distribution from the corporation. Since C is not a resident of state Z, C will never be required to pay state Z tax on a later stock sale or distribution and, therefore, should not be given basis for state Z purposes beyond that created by the pass-through to C of S's income attributable to state Z.

The initial zero basis rule for nonresident shareholders may deprive the shareholder of the benefit of a loss in a state in which the shareholder has other unrelated income (e.g., if the corporation never generates income in the state). The Model Act's rule, however, that a loss disallowed due to a lack of state basis carries forward to the next year (section 1004) makes it likely that a disallowed loss eventually will generate a benefit, i.e., when the S corporation does generate income in the state. The rule also makes it more likely that all nonresident shareholders of an S corporation will benefit equally from the corporation's losses, since the existence of other in-state income in the year of loss will not determine whether the loss may be utilized.

Under the Model Act, a shareholder who changes status from a nonresident to a resident of the state loses his "nonresident" basis and acquires a new initial resident basis equal to his basis for federal purposes at that time (section 1003(a)).

Similarly, a resident who becomes a nonresident of the state loses his prior basis and begins anew with a zero basis (section 1003(c)).

Section 1003(d)

A nonresident shareholder's initial zero basis in the corporation's stock and indebtedness, determined as of the date specified in section 1003(c), is adjusted in the same manner as the shareholder's federal basis. The Model Act accomplishes this by referencing section 1367 of the Code. The extent to which the federal adjustment is made, however, takes into account the limited state income taxation of the nonresident shareholder. Accordingly, the nonresident usually will have a different adjusted basis for federal income tax purposes than for state income tax purposes.

Specifically, Code section 1367 adjustments are modified (except for income exempt from federal or state tax) to reflect the state's income modifications. (This is accomplished through section 1003(d)'s reference to section 1001(b), which in turn incorporates the modification provisions of section 1002.) Moreover, federal adjustments, as modified for state purposes, are taken into account in computing state basis only to the extent that they are passed through to the nonresident shareholder (*i.e.*, only to the extent of the nonresident's Pro Rata Share of the corporation's Income Attributable to the State). The nonresident is not subject to state tax on Income Not Attributable to the State and thus properly ignores such income in computing stock basis for purposes of the state's income tax.

As indicated previously in Example 8, the nonresident shareholder adjusts basis under federal principles for items passed through from the S corporation that are attributable to the state, even if those items are tax exempt or do not generate a tax liability. For example, if the corporation has interest income attributable to the state that is tax-exempt for federal purposes, the nonresident's adjusted basis for purposes of the state's income tax reflects the amount of such income.

Section 1003(e) and (f)

For federal purposes, during a "post-termination transition period" (PTTP) a shareholder of a former S corporation (1) may receive the benefit of a loss disallowed during the last S period due to the shareholder's lack of stock and debt basis, to the extent the shareholder makes capital contributions to the corporation during the PTTP (section 1366(d)(3)(B) of the Code), and (2) may receive distributions free of tax, to the extent such distributions do not exceed the corporation's AAA (see sections 1368(c) and 1371(e) of the Code). Section 1003(e) and (f) provides analogous rules for purposes of the state's income tax. Since nonresident shareholders are not taxed with respect to transactions in the stock and debt of the corporation (as distinguished from transactions engaged in by the S corporation), these rules apply only to resident shareholders.

Section 1003(g)

This section clarifies that a shareholder may not increase (or decrease) the state basis determined under section 1003 simply by making a gift of the stock or indebtedness. This rule parallels the federal rule requiring the donee of property to take a carryover basis.

Section 1003 itself is not intended to give any basis effect to transfers that should not affect basis. For example, a distribution of S corporation stock by a qualified subchapter S trust (within the meaning of section 1361(d)(3) of the Code) to a beneficiary who was treated as the stock's owner prior to the distribution is not and should not be treated as an "acquisition" of stock by the shareholder for purposes of section 1003(a) or (c).

Section 1004(a)

Under the Model Act, federal income tax limitations on the use and application of loss carryovers to and from periods for which the S election is in effect are adopted for state income tax purposes. A majority of states have taken this approach, either through specific provisions or the application of general principles, but a specific provision is more appropriate. This provision would overrule several state laws that permit the carrying of losses from C years to S years and vice versa. Such provisions, usually the result of applying general principles, create significant conflict and inconsistency among the states, which is contrary to the uniformity premise underlying the Model Act.

Section 1004(b)

The Model Act follows the federal income tax principle that limits the pass-through of losses and deductions from the S corporation to the amount of the shareholder's adjusted basis in the stock of the corporation and indebtedness of the corporation to the shareholder. The Model Act provides, however, that the limiting adjusted basis is determined under the Model Act, not under the Code. Since the Model Act applies separately in each state in which it is adopted, a shareholder potentially will have a separate loss limitation in each state in which the shareholder is subject to tax.

Section 1004(c)

The Model Act follows the federal income tax principle of permitting unlimited carryforward of losses disallowed to the shareholder because of the section 1004(b) adjusted basis limitation. The carryforward is computed separately for each state, just as the section 1004(b) basis limitation is computed separately with respect to each state.

The Model Act does not affect any state rule of general applicability governing the carryover of a loss by a nonresident who derives no other income from the state in the year of the loss. If the shareholder has sufficient basis under section 1004(b) that the loss passes through, the state's general loss carryover rule will

determine whether, and to what extent, such loss may be carried over for use in other years.

Section 1004(d)(1)

The Model Act follows the federal income tax rule that permits S corporation shareholders to treat a loss carried forward due to the adjusted basis limitation as incurred on the last day of any PTP.

Section 1004(d)(2)

The Model Act follows the federal rule limiting the amount of loss treated as incurred on the last day of a PTP to the shareholder's adjusted basis in the stock of the corporation on that day. The adjusted basis for this purpose is the adjusted basis for purposes of the taxing state's income tax, rather than federal adjusted basis. This rule is necessarily applied separately with respect to each state, since the underlying limitation is applied separately in each state.

Section 1004(e) (Optional)

This is an optional provision for those states that impose additional restrictions on a shareholder's use of the S corporation's losses. These might include state passive loss rules, state at-risk rules, or special state loss limitations. Under the optional provision, a loss disallowed under such rules is deemed to be incurred by the shareholder in the succeeding year, at which time a separate determination is made with respect to the utilization of the loss.

Section 1005

A baffling diversity in state definitions of "residence" for state income tax purposes can cause two states to treat the same individual as a tax resident for all or part of the same tax year, with the result that the individual may be required to pay two state taxes on the same income without being able to take a credit in either state for tax paid to the other state. Moreover, most state statutes fail to provide how the individual's income from an S corporation should be allocated between the part of the individual's tax year in which he or she is considered to be a tax "resident" (when the state imposes a tax on 100% of his or her worldwide income) and the part in which he or she is a "nonresident" (when the state imposes a tax only on income attributable to the state). The Model Act does not address the former problem—which is admittedly more serious, but which afflicts taxpayers other than shareholders of S corporations—but it does make an important improvement over the present situation by providing a clear solution to the latter allocation-of-income problem.

Under the Model Act, a "resident" of the state (under the state's own definition) for part of the S corporation's taxable year must allocate his or her share of the corporation's Income Attributable to the State and Income Not Attributable to the State between the two periods based on the number of days in each period. Note that this provision does not change the year in which the corporation's income is taxed for state purposes: under the Model Act income from an S

corporation is taxed to the shareholder—as under federal law—in the year in which the last day of the S corporation's federal tax year ends.

Example 11

A is the sole shareholder of S, a calendar-year S corporation that does business in states X and Y. During a leap year, A is a resident of state X from January 1 through May 1 (122 days), and a resident of state Z from May 2 through December 31 (244 days). During the year S has \$400,000 of federal income, all of which is classified as business income and is subject to no state income modifications. Under the apportionment and allocation rules of those states, which happen to be identical, 25% (\$100,000) of S's business income for the year is apportioned to state X and 75% (\$300,000) is apportioned to state Y.

For purposes of computing A's taxable income in state X for the year that A's state of residence changes, section 1005 provides that S's \$400,000 of income for the year (technically, S's \$100,000 of income attributable to state X and \$300,000 of income not attributable to state X) is deemed to be earned one-third during A's period of residence in state X (122/366 days) and two-thirds during A's period of nonresidence (244/366 days). Thus, of the \$100,000 of S's income attributable to state X, \$33,333 ($1/3 \times \$100,000$) is deemed to be earned during A's period of residence and \$66,667 during A's period of nonresidence. With respect to the remaining \$300,000 of S's income, which is not attributable to state X, A is deemed to have earned \$100,000 while a resident of X ($1/3$ resident days \times \$300,000) and \$200,000 while a nonresident. Thus, A's taxable income for state X purposes is \$200,000 (\$33,333 attributable to state X while a state X resident + \$66,667 attributable to state X while a state X nonresident + \$100,000 of nonattributable income earned while a state X resident). The remaining \$200,000 of S's income, which is not attributable to state X and which is considered under section 1005 to have been earned during A's period of nonresidence, is not subject to taxation by state X.

The Model Act does not change any state's definition of "resident," "residence," "nonresident," or "nonresidence." Thus, in a state that treats a taxpayer as a resident for the entire year if the person has an abode in the state for more than a certain period (e.g., 6 months or 183 days), the shareholder is treated under the Model Act as a resident of the state for the entire year. If the S corporation's taxable year does not coincide with the shareholder's taxable year, the shareholder would not be a resident for the entire S corporation taxable year.

Example 12

A is the sole shareholder of S corporation, which does business in states X, Y, and Z. S's taxable year is a fiscal year ending on January 31, while A's taxable year is the calendar year. For many years, A has been a resident of state X. On July 28, 1989, A moves to state W. Under the state X residence definition, A is deemed to be a resident for the entire 1989 calendar year because A had an abode

in state *X* for more than 183 days. Also assume that state *W* treats *A* as a nonresident for 1989.

A is a resident of state *X* for only a portion of *S*'s taxable year ending January 31, 1990. This is the result even though *A* was a resident of state *X* for an entire calendar year (1989) and a resident of state *W* for an entire calendar year (1990), and might not otherwise be perceived as a part-year resident. Accordingly, the Model Act's part-year residency rules apply in determining *A*'s liability for state *X* and state *W* tax on *S*'s income for the corporation's taxable year ending January 31, 1990.

A continuation of the above example illustrates the application of the Model Act's part-year residency rules:

Example 13

Assume that in the preceding example, *S* had \$600,000 of nonseparately stated business income for its taxable year ending January 31, 1990. Assume that states *X*, *Y*, and *Z* use the same apportionment formula, and that *S*'s income is apportioned 10%, 20%, and 70%, respectively, to those states. *S* has no separately stated income and no items requiring state modification in any of the three states. In addition, *S* does no business in state *W*.

Of the \$600,000 passed through to *A* for *S*'s year ending January 31, 1990, section 1005 of the Model Act treats 334/365, or approximately \$550,000, as earned during *A*'s period of residence in state *X* and 31/365, or approximately \$50,000, as earned during his period of nonresidence in state *X*. *A* must include the entire \$550,000 in taxable income on his 1990 state *X* return, since *A* was a "resident shareholder" within the meaning of section 1001(b) during the corresponding portion of *S*'s tax year. *A* includes only \$5000 of the remaining \$50,000 in his state *X* income for calendar year 1990, since *A* was a "nonresident shareholder" for the corresponding period and only 10% (*S*'s state *X* apportionment percentage) of *S*'s income for the period was attributable to state *X*.

On *A*'s 1990 tax return for state *W*, *A*'s current state of residency, *A* includes approximately \$50,000 ($31/365 \times \$600,000$), representing the 31-day portion of *S*'s January 31, 1990 taxable year in which *A* was a resident of state *W*. *A* also reports the \$540,000 of *S*'s income not attributable to state *X* ($(20\% + 70\%) \times \$600,000$) in states *Y* and *Z* as a nonresident.

As a result of differing state residency rules, a shareholder may pay a double tax on income from an S corporation doing business in several states. In the most extreme case, two state taxes would be payable on the same income. For example, if the shareholder's former home state treats anyone who had an abode in the state for more than 183 days as a resident for the entire year, while his new home treats anyone domiciled in the state at any time during the year as a resident for the entire year, the shareholder will be subject to double tax. While most states grant credits for tax paid by a resident to another state on the same income, many states deny any credit for tax paid to another state in which the

individual was taxed as a resident. While beyond the scope of the Model Act, a uniform resolution of such part-year residency issues clearly is needed.

Section 1006(a)

Under the Model Act, a resident shareholder usually is not taxed on a distribution from an S corporation to the extent that the distribution is made out of the S corporation's state AAA. Note, however, that under the principles of section 1368 of the Code, a resident shareholder's state stock basis, as determined under section 1003, limits the extent to which a distribution of state AAA will be free of state income tax.

Example 14

A, a resident of state *P*, is the sole shareholder of *S* corporation. *S* has a state *P* AAA of \$325 and state *P* earnings and profits exceeding \$200. *A*, who has a state *P* stock basis of \$150, receives a distribution from *S* of \$325. Even though the distribution to *A* does not exceed *S*'s state *P* AAA, under Section 1006(a) the distribution is tax-free to *A* only to the extent of *A*'s stock basis of \$150. The other \$175, which would be treated as taxable gain from the sale or exchange of property under federal tax principles (see section 1368(c) of the Code) is taken into account for state *P* tax purposes pursuant to general state *P* principles.

Like federal AAA, state AAA is a corporate-level account that records the income, losses and deductions passed through to the corporation's shareholders under the subchapter S regime, as well as distributions to the shareholders, and is computed in the manner prescribed under section 1368 of the Code. Initially, state AAA is equal to federal AAA. Adjustments to state AAA reflect certain state income modifications required to be made under the state's tax law. Under section 1006(c)(2), however, the only state modifications made to federal AAA are those required by section 1002(a), *i.e.*, the corporate income tax modifications made to S corporation's Income Attributable to the State. Individual tax modifications made to S corporation's Income Not Attributable to the State, which are taken into shareholders' income for state tax purposes only to the extent the corporation is owned by residents of the taxing state, do not affect state AAA.

Example 15

Assume that *A*, a resident of state *X*, is the sole shareholder of *S*, a C corporation that has earnings and profits and that makes a federal S election effective the first day of Year 1. At the beginning of Year 1, *A*'s state *X* basis in *S*'s stock is zero. During Year 1, *S* has \$1000 of federal or unmodified business income and apportions 25% of that income to state *X* as required under state *X* law. State *X* has a corporate income tax addition modification for the excess of accelerated over straight-line depreciation, which in *S*'s case is \$160. State *X* also has an individual income tax addition modification of \$30.

Under section 1001(b), *A* must pay state *X* tax on both *S*'s Income Attributable to the State and *S*'s Income Not Attributable to the State. Under the assumed

facts, 25%, or \$250, of *S*'s taxable income for federal purposes is Income Attributable to the State and 75%, or \$750, is Income Not Attributable to the State. Section 1002(a) requires *A* to increase her \$250 of Income Attributable to the State by \$40 (25% apportionment factor \times \$160 corporate modification for excess depreciation), while section 1002(b) requires *A* to increase her \$750 of Income Not Attributable to the State by \$22.50 (75% \times \$30 individual tax modification). Thus, *A*'s state *X* income for Year 1 is \$1062.50 (\$1000 federal income + \$40 Income Attributable to the State modification + \$22.50 Income Not Attributable to the State modification).

Under section 1006(c)(2), *S*'s state AAA is \$1040 (*S*'s federal income of \$1000 plus *S*'s Income Attributable to the State modification of \$40). If *S* distributes \$1062.50 to *A* on the last day of Year 1, \$1040 of that amount will be a tax-free distribution of state AAA and the remaining \$22.50 will be taxed to *A*, in addition to the \$1040, in accordance with general state *X* principles (e.g., as a dividend). The increase in *A*'s state *X* stock basis by the entire \$1062.50 of state modified income taxed to her (see previous explanation of section 1003(b)), would not prevent the taxation of *A* by state *X* on the additional \$22.50.

Because the state AAA is a corporate-level account that is not attached to any particular shareholder or shares, any distribution made by the *S* corporation to a shareholder, including a shareholder who is not a resident of the state, reduces the corporation's state AAA and affects subsequent distributions to residents.

Example 16

Assume that *S* corporation is owned 25% by *A*, a resident of state *X*, and 75% by *B*, a resident of state *Y*. *S*'s federal AAA is \$100, *S*'s state *X* AAA is \$150 (e.g., reflecting a section 1002(a) addition modification of \$50), and *S*'s earnings and profits from former subchapter C years are \$300. Assume further that *S* makes a non pro rata distribution of \$110 to *B* in Year 1.

Even though *B* is not a resident of state *X* and *A* is not involved in the distribution, the distribution reduces *S*'s state *X* AAA from \$150 to \$40. Assume that in Year 2, *S* has no income but makes a \$60 pro rata distribution to *A* and *B*. Of the \$15 distributed to *A*, only \$10 ($\$40/\$60 \times \15) is a tax-free distribution out of AAA for state *X* tax purposes (assuming *A*'s basis exceeds \$10). The other \$5 distributed to *A* would be taxed to *A* under general state *X* principles.

The Model Act's definition of state AAA (federal AAA plus or minus Income Attributable to the State modifications) potentially allows an *S* corporation to distribute free of state tax all income generated by the corporation in years prior to the effective date of the Model Act. A state that previously recognized *S* status will ordinarily have no problem with the Model Act's definition of AAA. A state that did not recognize the corporation's *S* status in a prior year, however, may object to the Model Act's failure to tax prior year earnings, on which resident shareholders paid no state tax, on the ground that the state's prior tax

policy requires the imposition of a second tax on such income at the shareholder level.

The Model Act's policy in this regard is justified by practical and theoretical considerations and will not result in the avoidance of a second tax on the prior year income in most cases. Taxing distributions of earnings from pre-Model Act years during which the state treated federal *S* corporations as *C* corporations would add complexity to the law, would result in a lack of uniformity in the state taxation of *S* corporation distributions and, to the extent such taxes were not avoided simply by limiting distributions, would constitute a penalty upon the ownership of *S* corporations contrary to the central policy of the Model Act. Moreover, had the Model Act adopted a rule taxing distributions of pre-Model Act earnings, equitable concerns likely would have led to the enactment of relief for certain shareholders, i.e., those shareholders who had paid tax on pre-Model Act earnings as residents of other states that did recognize the *S* corporation's pass-through status. This relief, in turn, would have resulted in either an undesirable "personalization" of state AAA or creation of a set of complex tax credit provisions.

Furthermore, under the principle of section 1368 of the Code, the resident shareholder's state stock basis limits the extent to which a distribution of AAA can be received free of state tax. Under section 1003(b)(2), federal adjustments to stock basis made for a prior year during which the state did not recognize the corporation's *S* status are omitted from the shareholder's basis, provided the shareholder owned the stock and was a resident of the state during the prior year. As a result, a distribution of the entire federal AAA could be taxed by the state due to a lack of state stock basis, unless the shareholder has basis from other sources or contributes additional capital to the corporation.

Under the Model Act, a resident shareholder who receives a distribution from an *S* corporation includes in taxable income the portion of any distribution that constitutes a dividend or gain from the sale of property for federal income tax purposes, taking into account state adjusted basis and AAA (see section 1368(b) and (c) of the Code). A shareholder who receives a distribution that generates taxable income (such as a dividend or gain from the sale of property) includes those amounts in taxable income only in the state of residence. The Model Act does not change the policy followed by virtually every state of not taxing nonresident shareholders on dividends distributed by corporations doing business in the state. Similarly, the Model Act does not change the policy followed by virtually every state of not taxing nonresident shareholders of *S* corporations within the state's taxing jurisdiction on gain from the nonresident's sale of the corporation's stock.

Section 1006(b)

The Model Act, as does the Code, excludes from taxation *S* corporation distributions made to a resident shareholder during a PTP to the extent that the corporation's state AAA equals or exceeds the amount of the distribution (see section 1371(e) of the Code). This provision, which applies only to resident

shareholders, is consistent with the Model Act's rule permitting a resident shareholder's loss disallowed due to lack of state basis to be carried forward and deducted during a PTPP (see the previous explanation of section 1003(e) and (f)).

Section 1006(c)(1)

For purposes of applying the Model Act's distribution rules, adjusted basis is the basis determined under the Model Act and not federal adjusted basis. Thus, a distribution might generate more or less gain or loss for state income tax purposes than for federal income tax purposes.

Section 1006(c)(2)

The Model Act requires an S corporation to maintain an AAA for each state in which one or more of its shareholders resides. Since the only state modifications to the AAA are the corporate income tax modifications made to the S corporation's Income Attributable to the State, the state AAA maintained for a state in which a shareholder resides, but in which the corporation itself has never done business, would be equal to the corporation's federal AAA.

Section 1007(a)

Every S corporation that engages in activities in the state that would require a C corporation to file a return is required to file an information return with the state. The return must be filed by the due date (including extensions) provided for C corporation returns. The corporation's return must include identifying information with respect to each shareholder, a statement of the corporation's Income Attributable to the State and Income Not Attributable to the State, and other information that the state's revenue department may require by regulation. The Model Act also requires the corporation to furnish a copy of its information return to each shareholder. These requirements parallel the federal requirements (see sections 6037 and 6071 of the Code).

The Model Act does not require a corporation to file an annual information return with a state with which it has no contact except a shareholder who resides in the state. It is evident, however, that such a resident shareholder needs certain information, particularly with regard to individual modifications, to compute his individual tax liability in such state. States are encouraged to address this problem by, for example, developing a uniform schedule similar to the federal Schedule K, which would detail the S corporation tax items that typically are the subject of individual income tax modifications at the state level (e.g., federal obligation interest and expense, accelerated and straight-line depreciation, and state income taxes paid). The inclusion of such a schedule in the annual return to be filed and provided to shareholders in other states should provide sufficient information for every shareholder to comply with the filing requirements of his state of residence.

Section 1007(b)

Under the Model Act, every S corporation must be permitted to file composite returns and to make composite tax payments on behalf of some or all of its nonresident shareholders. Because composite filing benefits the state at least as much as it benefits taxpayers, the state is not permitted to impose additional conditions upon this privilege (e.g., to require that a nonresident included in a composite return have no other in-state income or to require that all nonresidents be included in a composite return). However, the state remains free to protect itself against loss of revenue by for example, requiring that the tax rate applicable to persons included in a composite return be computed at the highest marginal rate applicable to individuals. In addition, the state must permit each shareholder included in a composite return to claim credit for a proportionate share of the tax paid by the corporation to the state (see section 1007(f)).

The Model Act also authorizes the state revenue department to permit composite returns to be filed on behalf of resident shareholders, as well as nonresidents. The state, however, is not obligated to provide this opportunity. Moreover, the Model Act does not address the issue of charging an administrative fee for the privilege of filing a composite return, as is the practice in some states.

The Model Act does not provide penalties for infractions of its provisions, such as failure to file information returns or to provide copies to shareholders, late filings, or late payment of taxes paid on behalf of nonresident shareholders. Each adopting state should amend its existing penalty provisions to bring non-compliance with the Model Act within their scope.

Section 1007(c), (d), and (e)

With respect to each of its nonresident shareholders, every S corporation subject to the state's taxing jurisdiction must either (1) procure from the shareholder and timely file with the state an agreement of the shareholder (a) to file individual tax returns with the state, (b) to pay state individual income taxes on the shareholder's share of the S corporation's income, and (c) to become subject to the personal jurisdiction of the state for tax collection purposes (section 1007(d)), or (2) pay to the state on behalf of the shareholder an amount equal to the product of (a) the shareholder's Pro Rata Share of the corporation's Income Attributable to the State and (b) the highest marginal tax rate applicable to individuals (section 1007(e)).

An agreement of a nonresident shareholder is timely filed for a taxable year of the S corporation if it is filed by the due date for the corporation's annual return for the taxable year under the Model Act and, once filed, is considered to be timely filed for all subsequent taxable years. An S corporation that does not timely file a shareholder's agreement (and thus makes the required payment) for one taxable year may file such an agreement to be effective for all subsequent taxable years.

Any payment required by reason of a failure to file a shareholder's agreement is due by the due date for the corporation's annual return under the Model Act.

The required payment is based on the amount shown on the corporation's information return, even though that amount might be changed on a subsequent audit. The corporation's obligation under this provision with respect to each nonresident shareholder terminates when the required agreement is filed or payment is made.

In keeping with the Model Act's premise that a federal S election should be binding, a corporation's S election continues to be recognized even if the corporation fails to file agreements or to make payments with respect to one or more nonresident shareholders. Otherwise, an opportunity to terminate the S election for state purposes would exist. Moreover, the Model Act does not adopt the mechanism of taxing the S corporation itself on income attributable to nonresident shareholders who fail to provide an agreement. Such an approach would unfairly shift a portion of the economic burden of the noncomplying shareholders' tax liability to the other shareholders.

The Model Act expressly grants the corporation the right to collect any required payment from the nonresident shareholder on whose behalf the payment was made. Even absent this provision, it is anticipated that a corporation's legally required payment of a shareholder's tax liability under the Model Act would, under the laws of most states, give rise to a right of recovery (*e.g.*, a right of equitable subrogation) in favor of the corporation against the shareholder on whose behalf the payment was made. In order to prevent abuse of the statutory mechanism by recalcitrant shareholders, S corporations and their shareholders should consider a shareholders' agreement provision formalizing the corporation's right as a debt owed by the shareholder to the corporation, including a provision for interest. The corporation should also treat the payment as a debt for accounting and other purposes. As in other cases in which a corporation fails to pursue a debt owed to it by its shareholder, the corporation's failure to pursue repayment of a mandated state tax payment conceivably could cause the payment to be recharacterized as a distribution to the shareholder (although this should not give rise to a second class of stock issue).

Section 1007(f)

Under the Model Act, any amount paid by an S corporation to a state with respect to any shareholder included in a composite return, or any amount paid with respect to a nonresident shareholder who fails to furnish the required consent agreement, is treated as tax, interest or penalty, as the case may be, paid on behalf of the shareholder. Accordingly, the shareholder may claim a credit for those payments on any individual tax return subsequently filed with the state for the same tax year. This provision of the Model Act should also assist a nonresident shareholder in establishing entitlement to a credit for taxes so paid in the shareholder's state of residence (see the explanation of section 1008(a)).

Section 1008(a)

Although typically taxed on 100% of his or her Pro Rata Share of the S corporation's taxable income, a resident shareholder is also usually entitled to

claim a credit against the state tax liability for any income tax imposed on and paid by the shareholder to another state on the same income. The Model Act does not require the state to grant such credits to its residents (or to nonresidents) or prescribe the manner in which such a credit is calculated. If the state does grant such credits, however, section 1008(a) requires the state to treat the shareholder's Pro Rata Share of any tax paid by the corporation to a state that does not recognize S corporations in the same manner as a tax imposed directly on the shareholder.

Thus, a resident shareholder may claim a credit for the shareholder's proportionate share of any net income tax paid by the S corporation to another state, but only if such state does not recognize the S election. The reason for this limitation is that a corporate tax imposed by a state that does not recognize S status is a substitute or proxy for the tax imposed directly on the shareholders in states that recognize S status and should be treated as such in states adopting the Model Act. By contrast, no credit is given for any corporate tax imposed by a state that does recognize the corporation's S status, such as a corporate tax paid on excess net passive income or built-in gains, or an additional tax imposed on S corporations generally (as in Illinois and California).

While most states do not currently allow a resident shareholder to receive credit for any tax imposed on the S corporation by another state (as distinguished from a tax imposed on the shareholder), the Model Act's more liberal rule reflects the approach taken in more recent state enactments.

Section 1008(b)

This optional provision requires the state to grant S corporation shareholders the benefit of policy tax credits (*e.g.*, credits for investment in enterprise zones and job training expenditures) that the state makes available to C corporations. While this provision is justified by the "entity" approach of the Model Act and is usually consistent with the purpose of such credits, the provision is made optional because such tax credits have often been designed to reflect the higher (or sometimes lower) tax rates applicable to C corporations and may therefore require extensive revision to yield the appropriate level of economic incentive to S corporation shareholders.

Optional LIFO Recapture Provision

The Revenue Act of 1987 requires every corporation making an S election on or after December 17, 1987 to recognize income that the corporation has deferred through the use of the LIFO method of inventory accounting. To ease the burden of this provision, federal law permits the tax on the deferred income to be reported over four taxable years, beginning with the corporation's last year as a C corporation. This optional provision provides the same four-year spread for state purposes. In the absence of such a provision, if the state's corporate income tax act adopts the federal tax base but not its deferral provisions, tax on the entire deferred amount would be payable when the corporation files its return for its last taxable year as a C corporation.

EXHIBIT N

To: **Garland H. Allen**Date: **May 1, 1989**From: **Martin A. Culhane, III**Subject: **Model S Corporation Income Tax Act--Constitutionality of
Nonresident Zero-Basis Provision**

This Memorandum will analyze the constitutionality of the provision contained in the Model S Corporation Income Tax Act which provides that a nonresident of a state has an initial zero basis in his or her S corporation stock and debt, irrespective of the amount of basis the nonresident has for federal income tax purposes. In particular, the memorandum will focus on the possibility that such a provision could be attacked under the Privileges and Immunities Clause of the United States Constitution, since it is believed that the Privileges and Immunities Clause offers the strongest and most likely basis of attack for a nonresident shareholder claiming that a tax law disadvantages the nonresident as compared to the treatment accorded resident shareholders.

I. BACKGROUND

A. The Zero-Basis Provision.

The Model S Corporation Income Tax Act (the "Act") provides that the initial basis of a nonresident shareholder in the stock of an S corporation and in any indebtedness of the corporation to the shareholder shall be zero. Act § 1003(c). The initial zero basis is adjusted based on operations of the S corporation in a manner similar to the adjustments allowed for resident shareholders and similar to the basis adjustment provisions of Section 1367 of

the Internal Revenue Code of 1986, as amended (the "Code"), except that adjustments to basis for the nonresident shareholder with respect to any state are limited to the "Income Attributable to the State" taken into account by the shareholder under Act Section 1001(b). Act § 1003(d). "Income Attributable to the State" means items of income, loss, deduction or credit of the S corporation apportioned to the state or allocated to the state pursuant to the state's standard corporate allocation and apportionment provisions. Act § 1000(b)(3). Thus, the initial zero basis of a nonresident shareholder is subsequently adjusted in a manner that reflects the actual scope of the state's jurisdiction to tax such nonresident.

With respect to any nonresident shareholder, the initial basis of zero is determined at the later of the date on which: (i) the shareholder acquired the stock or the indebtedness of the corporation, (ii) the corporation last became an S corporation, or (iii) the shareholder last became a nonresident of the state. Act § 1003(a). Thus, for states that have recognized S corporation status for a number of years, with nonresident shareholders who have held stock in such S corporations for many years, enactment of the Act will generally require a recomputation of each nonresident shareholder's basis to reflect an initial basis of zero. Act § 1003(d). In the case of a former resident shareholder who becomes a nonresident shareholder the new nonresident

shareholder obtains a zero basis at the time he or she leaves the state. Act § 1003(c). (A nonresident shareholder who becomes a resident shareholder immediately obtains an initial basis equal to the shareholder's federal basis in the S corporation stock. Act § 1003(a).)

B. Rationale of Zero-Basis Treatment For Nonresidents.

The differing treatment of resident and nonresident shareholders was not intended to disadvantage nonresident shareholders and work to the advantage of resident shareholders. The differing treatment was simply designed to reflect the differing jurisdictional basis of taxation over resident and nonresident shareholders. From an administrative standpoint, most states do not attempt to tax nonresidents on dividend distributions or stock sale gains presumably because they do not believe that they have jurisdiction over such transactions when the transaction does not occur within their borders. Whether a state is limited by the United States Constitution from taxing a nonresident on the receipt of dividend distributions or the sale of intangible assets, such as corporate stock, appears to be an open question.

The zero-basis provision is intended to prevent a nonresident from using losses passed through from an S corporation to shelter unrelated income derived from the same state, without risk that

such losses will someday be subject to recapture by the state through the taxation of distributions in excess of the accumulated adjustments account and the shareholder's basis or through the taxation of gain on the sale or redemption of the shareholder's stock at a gain. Such gain on out-of-state transactions is widely regarded as being outside of the taxing reach of the state where the S corporation merely conducts business. The Act, therefore, allows a nonresident shareholder to utilize losses from the S corporation only to the extent that the shareholder has "earned" the right to receive a pass-through of loss by having previously taken into income an amount of the S corporation's Income Attributable to the State.

The zero-basis provision also applies to a resident who leaves the taxing state and becomes a nonresident. Thus, irrespective of the former resident's basis prior to the time he or she leaves the taxing state, the resident will be deemed to have a zero-basis in the S corporation stock as of the date he or she becomes a nonresident, again reflecting the presumed lack of jurisdiction the state has over the individual as soon as he or she becomes a nonresident.

C. Example of Practical Impact of Zero-Basis Provision.

The primary impact of the zero-basis provision is to deny a nonresident the opportunity to offset certain S corporation losses from the state against other income, if any, sourced to the taxing state. Thus the rule operates to prevent aggregation of all of a nonresident's activities in the taxing state when an S corporation has operated at a cumulative deficit.

For example, if a State I resident is a shareholder in a newly-formed State W corporation, which conducts all of its business in State W, the State I resident will have an initial basis of zero for purposes of taxation of such nonresident by State W despite the existence of a substantial federal tax basis. If, in the first year of operations, the S corporation generates taxable operating losses, the State I resident will not be entitled to utilize such losses for state W tax purposes (but will be entitled to a loss carryover) because of the presumed initial zero basis. The inability to utilize state W losses from the S corporation will only be of concern to the State I resident if the State I resident has other State W source income, such as income from a rental property unrelated to the S corporation investment. If the State I resident has no other State W source income, the zero-basis provision will have no impact on the individual, since he would have no State W tax liability in any event.

To the extent income from, for example, a rental property in State W does result in State W source income and State W tax liability for the State I resident, the zero-basis provision will operate to prevent the State I individual from utilizing the State W net operating loss from the S corporation to offset the State W sourced rental income. In contrast, a resident of State W with the same financial circumstances (i.e., a net operating loss from a newly formed S corporation doing business in State W and rental income from a State W rental property) would be entitled to utilize the net operating loss passed through from the S corporation to the full extent of the State W resident's federal adjusted tax basis, resulting in a lower current tax liability to the resident shareholder.

The current year disadvantage suffered by the State I resident in the preceding example may only be temporary, however. The loss disallowed due to the nonresident shareholder's lack of State W basis is suspended and deemed incurred in the next taxable year for State W tax purposes. Act § 1004(c). The State W loss carryover may be carried over indefinitely by the State I resident and utilized against future income that the S corporation may earn in State W. If the S Corporation ultimately generates cumulative net income, the nonresident will suffer no tax disadvantage except,

of course, for the economic impact of the timing of such taxation. In a year that a nonresident shareholder is entitled to offset State W source income from the S corporation with suspended loss carryovers, the nonresident shareholder would likely pay less State W tax than a similarly situated State W resident who would be unlikely to have any suspended losses available to offset income from the S corporation.

D. Discrimination Prevents "Windfall" to Nonresidents.

When a nonresident shareholder is not allowed to net losses against other income from the state where such losses were sourced, but a resident would be allowed to net such losses against other income, the statute is blatantly discriminatory against nonresidents. This methodology, however, is simply a theoretically correct response to the differing scope of jurisdiction claimed by the states over residents and nonresidents. The zero-basis provision simply prevents the nonresident from obtaining a "windfall" by being allowed to utilize losses which a state will then not be able to "recapture" upon a subsequent event triggering gain such as the nonresident's sale of stock. Without the zero-basis provision, a nonresident taxpayer could shelter substantial unrelated taxable income by offsetting such income with losses from an S corporation. The nonresident could then sell his shares in the S corporation at a gain which would not be taxable by the state

where such losses were used to shelter other income since the sale of an intangible by a nonresident is not generally taxable by any state other than the taxpayer's state of residence.

The zero-basis provision is designed to be the most practical available alternative to achieve the state's legitimate purpose of distributing the tax burden in an equitable manner between residents and nonresidents, while preventing nonresidents from avoiding taxation due to limits on a state's jurisdictional reach. A possible alternative is to allow nonresidents an immediate deduction of all net operating losses with the expectation that gain on a subsequent sale of the S Corporation stock would be subject to taxation at the time of sale. This alternative suffers from at least two defects. First, the ability of a state to levy tax on the sale of corporate stock by a nonresident is highly questionable. The constitutionality of such an attempted tax levy on a nonresident would raise significantly greater constitutional concerns than the zero-basis provision itself. Secondly, the state would be faced with severe administrative problems if it was required to "track" all S Corporation stock sales by nonresidents holding stock in S corporations domiciled or otherwise doing business in the state.

With respect to a former resident shareholder leaving the state and becoming a nonresident, the immediate imposition of a zero basis on such departing shareholder continues to be theoretically justifiable based on the limited scope of the state's claimed taxing jurisdiction over the new nonresident. Thus, the zero-basis provision of the Act is not intended to operate as a disincentive for a resident to leave the state, but simply reflects the state's determination that it is not permissible nor administratively feasible to levy tax on subsequent gains realized by the departing shareholder.

E. Zero-Basis Provision May Benefit Certain Nonresidents.

In some states the combination of the zero-basis provision and the indefinite carryover available for suspended losses of S corporations may result in nonresident shareholders obtaining more favorable treatment than that which exists under current law. An indefinite suspended loss carryover would be allowed by the Act despite the absence of any federal net operating loss. By contrast, many states do not allow a nonresident individual to carry over an unused loss, unless the nonresident had an overall federal net operating loss for the year, which usually does not exist despite the unused state loss. For an example of such a limitation see the discussion below addressing the Aranov case. The Act will also result in all nonresident shareholders of an S

corporation being more equally treated with respect to the S corporation's losses, since a nonresident with other income sourced to the taxing state will not be allowed to utilize losses immediately to offset such income and will be required to carry over losses like those nonresidents without other income from the state.

II. ISSUE

Does the differing treatment of resident and nonresident shareholders of S corporations due to the Act's zero-basis provision result in a violation of the provisions of the United States Constitution?

III. SUMMARY OF CONCLUSION

The strongest attack by a nonresident shareholder against the zero-basis provision would be made under a Privileges and Immunities Clause challenge. The Privileges and Immunities Clause, however, is not an absolute bar to discrimination between residents and nonresidents. Discrimination is allowed against nonresidents where: (i) there is a substantial reason for the difference in treatment; and (ii) the discrimination practiced against nonresidents bears a substantial relationship to the state's objective.

Since the adoption of the zero-basis provision is clearly not designed solely to disadvantage nonresidents vis-a-vis residents, but is simply a mechanical provision designed to conform the nonresident's tax computation to the claimed jurisdictional reach of the taxing state, it appears that the zero-basis provision is an allowable form of discrimination against nonresidents under the Privileges and Immunities Clause. The potential loss of state revenue offers a "substantial reason" for a state to treat residents and nonresidents differently. The method of discrimination also appears to be a reasonable means to address the differing jurisdictional reach of the state and therefore bears a "substantial relationship" to the state's objective of eliminating any potential tax advantage to nonresidents.

IV. DISCUSSION

A. Analysis of Likely Grounds for Constitutional Challenge.

A nonresident who believes that he or she is discriminated against as a result of the application of the zero-basis provision of the Act has a number of constitutional provisions at his or her disposal which would likely be asserted in an action against the state imposing the zero-basis provision. Under the United States Constitution, a Due Process Clause, Equal Protection Clause, Commerce Clause and Privileges and Immunities Clause challenge would be expected. In addition, state constitutions impose a number of similar limitations, with many states having "uniformity" clauses that may or may not be construed consistently with similar provisions under the United States Constitution.

In analyzing the zero-basis provision of the Act, in light of the various anticipated constitutional challenges, it appears that the Privileges and Immunities Clause offers a nonresident individual taxpayer the most significant weapon to strike down an allegedly discriminatory statute. As discussed below, the Privileges and Immunities Clause requires a "substantial reason" for the State to discriminate against nonresidents and, if a reason exists, the discrimination must bear a "substantial relationship" to the asserted reason. Thus, the Privileges and Immunities Clause requires more than simply a rational basis for the State's taxing

scheme, but mandates a higher level of scrutiny when a state tax discriminates against out-of-state individuals. Neither the Equal Protection Clause nor the Due Process Clause mandate as restrictive a level of scrutiny when examining a state tax classification that discriminates against nonresidents. If the discrimination against nonresidents is viewed as discrimination against interstate commerce, the Commerce Clause will provide for enhanced scrutiny which appears to be at a level which is at least equal to the scrutiny required under a Privileges and Immunities clause analysis.

1. Commerce Clause.

An analysis of state taxation schemes under the Commerce Clause generally is made under the four-prong test set forth in Complete Auto Transit v. Brady, 430 U.S. 274 (1977). Under the Complete Auto Transit test, a state tax will be valid only if (i) there is a substantial nexus between the activity taxed and the taxing state, (ii) the tax is fairly apportioned, (iii) the tax does not discriminate against interstate commerce, and (iv) the tax is fairly related to the services provided by the state.

With respect to the zero-basis provision and its impact on nonresident individuals, it appears that a state implementing the zero-basis provision would rather easily be able to demonstrate

that it met three prongs of the Complete Auto Transit test. Taxation of a nonresident individual will be allowed due to the nonresident earning income sourced to the taxing state, thus presenting no nexus problem; the tax will be "fairly apportioned" since a nonresident is only taxable on income sourced to the taxing state; and, the taxing state will likely be able to easily demonstrate that sufficient services are provided by the state to justify the imposition of a tax on a nonresident's income sourced to that state. In contrast, the "discrimination" prong of the Complete Auto Transit test may be more difficult to meet. Indeed, it may be argued that an absolute prohibition against discriminatory taxation of interstate commerce is imposed by the discrimination prong of the test, resulting in greater scrutiny of such discrimination than that made under a Privileges and Immunities Clause analysis.

It does not appear reasonable to view the discrimination prong of the Complete Auto Transit test as implementing an absolute ban on all discriminatory state tax statutes. Such a reading would overrule a number of the existing authorities considered under the Privileges and Immunities Clause where discrimination against interstate commerce was also at issue. The Privileges and Immunities Clause allows discriminatory taxing statutes (including those statutes that may arguably interfere with interstate

commerce) when the state can demonstrate substantial reasons for the discrimination and demonstrate that the state tax scheme bears a substantial relationship to such reasons.

Unfortunately, it does not appear that any decision has clearly addressed the relationship between the discrimination clause of the Complete Auto Transit test and the permissible discrimination allowed under the Privileges and Immunities Clause. This is because cases asserting a Commerce Clause challenge by a corporation will not normally include a Privileges and Immunities Clause claim, since corporations are not viewed as "citizens" entitled to Privileges and Immunities Clause protection. Hemphill v. Orloff, 277 U.S. 537 (1928); Waters-Pierce Oil Co. v. Texas, 177 U.S. 28 (1900). Therefore, the many challenges to state taxing statutes brought by corporations under the Commerce Clause do not contain a companion challenge based on the Privileges and Immunities Clause. The converse is often true for challenges to state taxing schemes by nonresident individuals who bring a Privileges and Immunities Clause challenge, but do not bring a Commerce Clause challenge since it may not be clear that discrimination against interstate commerce is involved.

A position that the discrimination prong of the Complete Auto Transit test does not provide for some flexibility in analyzing

discriminatory state tax legislation is unwarranted. The discrimination prong of the Complete Auto Transit test is not a novel doctrine. For over a century, the United States Supreme Court has invalidated taxes that discriminate against interstate commerce in violation of the Commerce Clause. See Welton v. Missouri, 91 U.S. 275 (1876). The four-prong test adopted in Complete Auto Transit merely articulated long-standing Commerce Clause doctrine. Rigid application of the discrimination prong of the Complete Auto Transit test should not apply to render unconstitutional the zero-basis provision. In the first place, it is not entirely clear that a state's taxation of a nonresident's source income in that state implicates interstate commerce, thus imposing a fundamental roadblock to a Commerce Clause challenge. A nonresident raising a Commerce Clause challenge could persuasively argue, however, that a discriminatory tax on a nonresident shareholder in an S corporation interferes with interstate capital flows and tax-neutral decision-making thereby affecting a nonresident's S corporation investment decision.

Assuming that a nonresident could create a link between the challenged taxing scheme and interstate commerce, it would be unreasonable for the Commerce Clause to impose a greater level of scrutiny than the Privileges and Immunities Clause. A position that both clauses impose the same level of heightened scrutiny is

consistent with the historical underpinnings of each clause. Both the Commerce Clause and the Privileges and Immunities Clause were derived from the same provision of Article IV of the Articles of Confederation. Both Clauses have been viewed by the Court to have a "mutually reinforcing relationship" as a result of their common origin and "their shared vision of federalism." Hicklin v. Orbeck, 437 U.S. 581, 531-532 and n.16 (1978); Service Employees International Union v. District of Columbia, 608 F. Supp. 1434, 1439 (D.D.C. 1985) (noting relevance of Privileges and Immunities Clause cases to plaintiff's Commerce Clause claim and stating that "neither the commerce clause nor the privileges and immunities clause precludes disparity of treatment when there are valid independent reasons for it,")

Although the Court, in recent Commerce Clause decisions relying on the Complete Auto Transit test, has not clearly provided for any flexibility when analyzing a discriminatory taxing scheme under the Commerce Clause, it would be reasonable for the Court to adopt a "balancing approach" in situations where a state could meet a Privileges and Immunities Clause challenge. The recent cases, however, generally involved no significant attempt by the state to justify the discrimination found by the Court.

In the Court's most recent Commerce Clause analysis, upholding a challenged Illinois tax on the gross receipts from interstate and intrastate telecommunications, the Court apparently allowed for some flexibility when considering the discrimination prong of the Complete Auto Transit test. See Goldberg v. Sweet, 109 S.Ct. 582 (1989). In considering the argument that the Illinois tax put a larger share of the tax burden on interstate telephone calls, and thus operated in a discriminatory manner against interstate commerce even though the statute was not facially discriminatory, the Court distinguished the Illinois tax from the flat registration tax imposed on all trucks operating in Pennsylvania which was found unconstitutional in American Trucking Associations v. Scheiner, 107 S.Ct. 2829 (1987). Goldberg, 109 S.Ct. at 591.

Presumably, for analysis purposes, the Goldberg Court accepted the assertion that the Illinois tax imposed a greater burden on interstate telecommunications than on intrastate telecommunications. Even so, the Court determined that no impermissible discrimination existed under the Commerce Clause. The Court noted that it was administratively impossible to trace or record "the exact path of thousands of electronic signals" in the telecommunications industry, as compared to the Pennsylvania tax on trucks where in-state and out-state mileage could fairly easily be compiled. Id. Therefore, for the same reason that it

did not require apportionment, the Goldberg Court found that the Illinois tax was not discriminatory under the discrimination prong of the Complete Auto Transit test. Id. Goldberg, therefore, supports a position that discriminatory state tax provisions do not per se result in a Commerce Clause violation.

A recent decision by the United States Supreme Court which found an Ohio state tax credit for domestic ethanol producers to be in violation of the Commerce Clause, would appear to sanction some level of discriminatory treatment by a state when enacting tax legislation. See New Energy Co. of Indiana v. Limbach, 108 S.Ct. 1803 (1988). In New Energy, although a detailed Commerce Clause analysis of the challenged taxing statute was made, the Complete Auto Transit test was not used as a framework for the Court's analysis in the opinion written by Justice Scalia. Moreover, although the tax credit statute at issue was found to violate the Commerce Clause, the Court adopted language which indicates that some flexibility exists for analyzing discriminatory state taxing statutes under the Commerce Clause.

Noting that the purposes of the "negative" aspect of the Commerce Clause is to prohibit economic protectionism, the Court stated that "state statutes that clearly discriminate against interstate commerce are routinely struck down, . . . unless the

discrimination is demonstrably justified by a valid factor unrelated to economic protectionism." New Energy, 108 S.Ct. at 1807 (citations omitted) (emphasis added). In discussing a test which appears to be quite like the test utilized in a Privileges and Immunities Clause analysis, the New Energy Court noted that "[o]ur cases leave open the possibility that a State may validate a statute that discriminates against interstate commerce by showing that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives." New Energy, 108 S.Ct. at 1810 (citing Maine v. Taylor, 477 U.S. 131, 138 (1986)).

New Energy supports a Commerce Clause analysis that considers the state's justification for a discriminatory taxing statute before it is found unconstitutional. A discriminatory taxing statute that is enacted for purposes of economic protectionism will not survive Commerce Clause scrutiny. New Energy, supra; Westinghouse Electric Corporation v. Tully, 466 U.S. 388 (1984) (New York tax credit on accumulated DISC income discriminated against export shipping from other states); Maryland v. Louisiana, 451 U.S. 725 (1981) (Louisiana's "First Use" tax--imposing a tax on natural gas brought into the state while giving local users a series of exemptions and credits--discriminated against non-Louisiana natural gas); Boston Stock Exchange v. State Tax

Commission, 429 U.S. 318 (1977) (New York stock-transfer tax that reduced tax payable by nonresidents when the tax involved an in-state (rather than out-of-state) sale was found to unfairly discriminate against out-of-state transactions).

On the other hand, a state enacting a discriminatory taxing statute (such as the zero-basis provision) which is not enacted for purposes of economic protectionism will be given the opportunity to present valid non-protectionist factors supporting the constitutionality of the statute. New Energy, 108 S.Ct. at 1807, 1810; Maine v. Taylor, 106 S.Ct. at 2440, 2455 (1986) (Maine statute prohibiting importation of out-of-state baitfish was not merely arbitrary discrimination against interstate commerce but was justified by legitimate reasons that could not adequately be served by available nondiscriminatory means); Pike v. Bruce Church, 397 U.S. 137, 143-145 (1970) (Arizona statute prohibiting Arizona fruit grower from shipping fruit in open containers to its nearby California packing facility was unconstitutional given state's "tenuous" legitimate interest in ensuring that high-quality fruit bore Arizona identification to enhance reputation of Arizona growers in general--Court noted statute was unrelated to public health or safety concern).

The patent lack of economic protectionism as a reason for enacting the zero-basis provision allows the states to justify the discriminatory effect of the statute. The limited jurisdictional reach of the state over subsequent stock sales by nonresidents is the only reason that the zero-basis provision exists. Furthermore, the zero-basis provision is the only administratively feasible alternative to ensure that the state meets its legitimate interest in equitably distributing the state's tax burden on residents and nonresidents.

2. Equal Protection Clause.

The Equal Protection Clause of the United States Constitution has long played a subsidiary role in challenges to state taxing schemes. Businesses commonly relied on the Commerce Clause to protect against state tax discrimination, while discrimination against individuals has been challenged under the Privileges and Immunities Clause. On the other hand, the "rational basis" test generally associated with the Equal Protection Clause has seldom resulted in the United States Supreme Court overturning state laws solely on the grounds that they violate the Equal Protection Clause. The equal protection standard requires only that the challenged taxing statute be rationally related to a legitimate state purpose. Western & Southern Life Ins. Co. v. State Bd. of Equalization, 451 U.S. 648 (1981); New Orleans v. Dukes, 427 U.S.

297 (1976). Other constitutional challenges thus offer a greater likelihood of success for most businesses and individuals.

It is possible that the Court has increased the scrutiny required under the Equal Protection Clause in certain situations. In Metropolitan Life Insurance Co. v. Ward, 470 U.S. 869 (1985), the Court in a 5 to 4 decision, addressed the constitutionality of an Alabama tax on insurers which imposed a greater tax on out-of-state insurers than that on domestic companies. Id. at 872. Since an insurance company is not protected from state taxation by the Commerce Clause due to the McCarren-Ferguson Act, Metropolitan Life was not entitled to rely on the increased scrutiny which may have been available under the Commerce Clause. Metropolitan Life was however, successful in striking down the discriminatory state statute on Equal Protection grounds. Id. at 883. A strong dissent is likely to limit the future application of Metropolitan Life outside of the insurance industry. In any event, it does not appear at this time that the Equal Protection Clause would provide any greater rights to a nonresident individual challenging the zero-basis provision of the Act than would otherwise be available under the Privileges and Immunities Clause or Commerce Clause.

In summary, despite recent increases in the apparent power of the Equal Protection Clause to be used as a weapon to challenge

state taxation schemes, and the high scrutiny imposed on discriminatory taxation by the Commerce Clause, it appears that a nonresident individual challenging the zero-basis provision would still have the greatest chance of success by challenging the statute under the Privileges and Immunities Clause. Accordingly, the balance of this memorandum is devoted to analyzing the ability of an individual to challenge the zero-basis provision under the Privileges and Immunities Clause.

B. The Privileges and Immunities Clause.

Article IV, § 2, of the United States Constitution provides that the "Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States." Under this clause, the terms "citizen" and "resident" are used interchangeably. Supreme Court of New Hampshire v. Piper, 470 U.S. 274, 279 n.6 (1985). The intent of the Privileges and Immunities Clause was to "fuse into one Nation a collection of independent, sovereign states." Toomer v. Witsell, 334 U.S. 385, 395 (1948) ("It was designed to insure to a citizen of State A who ventures into State B the same privileges which the citizens of State B enjoy."). The Privileges and Immunities Clause "was intended to create a national economic union." Piper, 470 U.S. at 279-280. Accordingly, a State must accord resident and nonresidents equal

treatment "[o]nly with respect to those privileges and 'immunities' bearing on the vitality of the Nation as a single entity." Piper, 470 U.S. at 279 (quoting Baldwin v. Montana Fish & Game Commission, 436 U.S. 371, 383 (1978)).

C. Permissible Discrimination.

The Court has long recognized that the Privileges and Immunities Clause is not an absolute and "[t]he Clause does not preclude discrimination against nonresidents where (i) there is a substantial reason for the difference in treatment; and (ii) the discrimination practiced against nonresidents bears a substantial relationship to the State's objective." Piper, 470 U.S. at 284; see also Toomer v. Witsell, 334 U.S. at 396 (The Privileges and Immunities Clause "does not preclude disparity of treatment in the many situations where there are perfectly valid independent reasons for [discrimination].") When applying the above two-prong test to a tax statute "a court may examine the entire taxing structure of the state and must give due regard to the practical effect and operation of the statute." Clark v. Lee, 273 Ind. 572, 406 N.E.2d 646, 651 (1980) (citing Shaffer v. Carter, 252 U.S. 37, 55 (1920)). The existence of a "substantial reason" for the state's action does not allow the state to employ any means to reach its objective. In deciding whether the claimed discrimination bears a close or substantial relationship to the state's objective, the potential

availability of less restrictive means to accomplish the objective may be considered by the Court. Piper, 470 U.S. at 284 and n.17 ("In some cases, the State may be required to achieve its legitimate goals without unnecessarily discriminating against nonresidents.").

In Austin v. New Hampshire, 420 U.S. 656 (1975), the United States Supreme Court made its most recent Privileges and Immunities Clause analysis of a taxing statute when the Court addressed the constitutionality of the New Hampshire Commuter's Income Tax against a challenge that the tax violated both the Privileges and Immunities Clause and the Equal Protection Clause of the United States and New Hampshire Constitutions. Id. at 657. The Court found that the tax was unconstitutional based on the Privileges and Immunities Clause and was, therefore, not required to address the Equal Protection Clause issue. Id. at 668.

New Hampshire imposed its Commuters Income Tax at a 4% rate on the New Hampshire derived income of nonresidents in excess of \$2,000. Id. at 657-658. The tax rate would be reduced, however, to the rate at which such income would be taxed in the nonresident's home state had the income been earned in the home state. Id. at 658. The statute also purported to tax New Hampshire residents on income they earned outside of New Hampshire,

however, various exemption features resulted in no resident of New Hampshire being subjected to the Commuters Income Tax. Id. at 658-659. Moreover, New Hampshire residents were not otherwise subject to tax on any of their New Hampshire earned income. Id. at 659. In contrast, Maine imposed an income tax on its residents but allowed a credit to residents for income taxes paid on income earned in other states. Id. at 659 and n.4.

The New Hampshire Commuters Income Tax operated, therefore, in practical effect, to tax only the income of nonresidents working in New Hampshire. Id. at 659. The tax was challenged through a class action by residents of Maine who were employed in New Hampshire and who were subject to the tax. Id. at 657. Although the tax at issue only had an impact on nonresidents, New Hampshire attempted to justify the tax by pointing to the tax credit that the Maine residents received, in Maine, resulting in their overall tax burden being unchanged, but with a shift of tax payments from Maine to New Hampshire. Id. at 665-666. Although noting this argument had an "initial appeal," the Court rejected the State of New Hampshire's purported justification for the Commuter's Income Tax since it could not "be squared with the underlying policy of comity" required by the Privileges and Immunities Clause. Id. at 666.

While the Austin Court found the tax on nonresidents to be unconstitutional, the case does not stand for the simple proposition that disparate treatment between residents and nonresidents in taxation areas mandates a finding of unconstitutionality. In discussing prior decisions under the Privileges and Immunities Clause with respect to state tax measures, the Austin Court provided guidance which supports justifiable discrimination such as that contained in the zero-basis provision of the Act, by emphasizing that "[i]n resolving constitutional challenges to state tax measures this Court has made it clear that 'in taxation, even more than in other fields, legislatures possess the greatest freedom in classification.'" Austin, 420 U.S. at 661-662 (quoting Madden v. Kentucky, 309 U.S. 83, 88 (1940)). The Court's "review of tax classifications has generally been concomitantly narrow, therefore, to fit the broad discretion vested in the state legislatures." Austin, 420 U.S. at 662.

For example, the Austin Court cited with approval the case of Travelers' Insurance Co. v. Connecticut, 185 U.S. 364 (1902), where the Court upheld a taxing scheme on the value of stock held in local insurance companies. Nonresident stockholders were assessed on the fair market value of their shares but resident stockholders were assessed at fair market value subject to a proportionate reduction for real estate held by the corporation on which the corporation had paid a local property tax. The Court upheld the taxing scheme as a fair and reasonable attempt to balance the state's tax burden and noted that no intentional discrimination was made against nonresidents. See Austin, 420 U.S. at 663-664. The Austin Court appears to have retained the ability of a state to demonstrate the validity of a tax that is facially discriminatory by showing that residents are burdened by offsetting taxes creating "practical equality" between residents and nonresidents. Austin, 420 U.S. at 665 and n.10.

Two earlier companion decisions of the United States Supreme Court were relied on in Austin to delineate the fine line between valid and invalid tax discrimination between residents and nonresidents. In Shaffer v. Carter, 252 U.S. 37 (1920), the Court considered against an Equal Protection, Due Process, Commerce Clause and Privileges and Immunities Clause challenge, the issue as to whether Oklahoma could constitutionally tax an Illinois

resident on income he received from an Oklahoma oil business. Oklahoma levied an income tax on residents based on their entire net income from all sources and on nonresidents based upon their net income from Oklahoma property and from any Oklahoma business, trade or profession. Id. 44-45. In rejecting the argument that such taxation violated the Privileges and Immunities Clause, as well as the other constitutional challenges, the Court established the now familiar proposition that a state has jurisdiction to tax nonresidents to the extent of "their property owned within the state and their business, trade, or profession carried on therein, and the tax is only on such income as is derived from those sources." Id. at 57.

The Shaffer Court was careful to note that the Privileges and Immunities Clause did not provide nonresidents with "entire immunity from taxation, nor to any preferential treatment as compared with resident citizens." Id. at 53. In response to the Illinois resident's argument that Oklahoma residents were entitled to deduct losses incurred outside the state of Oklahoma, but nonresidents were denied an offset of losses unrelated to their Oklahoma source income against their Oklahoma tax liability, the Court justified such differential treatment by noting that "[t]he difference, however, is only such as arises naturally from the extent of the jurisdiction of the state in the two classes of

cases, and cannot be regarded as an unfriendly or unreasonable discrimination." Id. at 57. So too, the zero-basis provision of the Act is necessary only due to "natural" differences in a state's jurisdiction over resident and nonresident shareholders of S corporations. Moreover, it is important to note that the provision will only operate to affect a limited group of nonresidents--those with cumulative S corporation operating losses but with other income from the taxing state. The statute does not operate to discriminate against all nonresidents, just those who would be entitled to make use of losses without any chance by the state to recoup the allowed loss upon a subsequent sale of the S corporation stock at a gain by the nonresident.

An unconstitutional taxing statute was examined in the companion case of Travis v. Yale & Towne Manufacturing Co., 252 U.S. 60 (1920), which addressed the constitutionality of provisions of the New York tax statutes which granted personal tax exemptions (\$1,000 for single persons, \$2,000 for married persons, and \$200 for each dependent) to New York taxpayers, but denied such exemptions in total to nonresidents, even though they were employed in New York and earned New York source income. Id. at 79. A provision in the New York statute provided for a credit against a nonresident's tax to the extent that the nonresident paid income tax to his home state and such state granted a "substantially

similar" credit to New York residents. Id. at 74. At that time, neither New Jersey nor Connecticut had an income tax law and New York's Attorney General noted that the intent of the disparate treatment of nonresidents was to encourage border states to adopt similar legislation. Id. at 81-82. The Court clearly rejected any claim that an attempt by a taxing state to influence legislation in another state could support a discriminatory statute. Id. at 82. Indeed, the Court noted, the prevention of retaliatory legislation by the states was "one of the chief ends sought to be accomplished by the adoption of the Constitution." Id. In sum, no reasonable basis for the discrimination was offered by New York in support of the discrimination and accordingly the Court held the discrimination to be a violation of the Privileges and Immunities Clause. Id. at 82 (the taxpayer had "abandoned" a Commerce Clause challenge prior to reaching the United States Supreme Court).

In summary, therefore, the United States Supreme Court has established a rule of law which allows for discriminatory tax treatment between residents and nonresidents, but only if there is a substantial reason for discrimination and the actual discrimination bears a substantial relationship to that reason. A review of the various state cases upholding and rejecting Privileges and Immunities Clause challenges is in order as a basis

to consider the susceptibility of the zero-basis provision of the S Corporation Model Income Tax Act to challenge.

D. State "Commuter Tax" Cases.

More recently, in reliance on Austin v. New Hampshire, *supra*, the Supreme Court of New Jersey found that state's Emergency Transportation Tax to violate the Privileges and Immunities Clause. Salorio v. Glaser, 93 N.J. 447, 461 A.2d 1100, cert. denied 464 U.S. 993 (1983) (In an earlier decision in the same case the New Jersey Supreme Court held that the Emergency Transportation Tax did not violate the Equal Protection Clause but remanded for development of a complete record the issue as to whether the tax violated the Privileges and Immunities Clause.) The Emergency Transportation Tax, in practical effect, resulted in a tax obligation levied on New Jersey-source income which was payable only by New York residents. Id., 461 A.2d at 1101. A New York resident commuter was required to pay the higher of the Emergency Transportation Tax or the New Jersey Gross Income Tax on his New Jersey source income. Id. New Jersey Residents were only required to pay the Gross Income Tax. Id. at 1105, n.8.

In contrast to the New Hampshire commuter tax statute addressed in Austin, New Jersey attempted to justify the tax on commuters by asserting that "commuting has created the need for

additional facilities to meet the commuting crunch between New York and New Jersey during certain peak hours in the morning and afternoon." Id., 461 A.2d at 1105-1106. After summarizing a number of decisions upholding discriminatory tax statutes, the Salorio court found that the relationship between the Emergency Transportation Tax receipts and transportation costs allocable to New York-based commuters was too attenuated to withstand constitutional challenge. Id., 461 A.2d at 1108. Thus, although the effect on transportation facilities and expenditures of nonresident commuters provided a "substantial reason" for discriminatory taxation of such nonresidents, the Emergency Transportation Tax was not "substantially related" to the problems caused by the commuters and was found to be unconstitutional.

An Indiana "commuters tax" suffered a similar fate when a class of nonresidents demonstrated that certain credit provisions operated to tax only the occupation incomes of nonresidents working in Indiana. Clark v. Lee, 273 Ind. 572, 406 N.E.2d 646 (1980). The challenged tax empowered local governmental entities to impose a 1.5% tax on the "occupation income" of both residents and nonresidents who devoted more than 50% of the time they worked to services within the jurisdiction of the local government. Id., 406 N.E.2d at 648. However, a credit against the Occupation Income Tax liability was available to the extent of an individual's

Indiana Adjusted Gross Income Tax. Id. Due to reciprocal arrangements with bordering states allowing the state of residence to tax a commuter's Indiana source income, a nonresident who worked in Indiana would not be entitled to offset the Occupation Income Tax, since he or she would pay no Indiana Adjusted Gross Income Tax, while residents would virtually always have a complete offset. Id. at 650. Relying on the authority of Austin v. New Hampshire, the Supreme Court of Indiana struck down the tax since no justifiable basis for the discriminatory taxation of nonresidents working in Indiana could be demonstrated by the State of Indiana. Id., 406 N.E.2d at 652.

E. State Decisions Upholding Constitutionality of Discriminatory Taxation.

1. Discrimination With Respect to Losses, Deductions, Exemptions and Credits.

A number of Privileges and Immunities Clause challenges have been based on limitations imposed on nonresidents with respect to their entitlement to certain deductions, personal exemptions and credits. For example, a New Hampshire resident who worked in Maine was required to prorate his deductions and exemptions according to the ratio of his Maine income to his total income when computing his Maine tax liability. Barney v. State Tax Assessor, 490 A.2d 223 (Me. 1985), cert. denied 474 U.S. 828 (1985). His New Hampshire income was not subject to tax in either Maine or New

Hampshire, since it was outside of Maine's jurisdictional reach and New Hampshire had no state tax on earned income. Id., 490 A.2d at 225. Therefore, the nonresident was allowed a smaller amount of deductions and exemptions than would have been allowed to a Maine resident earning the same amount of Maine-source income and having the same deductions and personal exemptions. Id., 490 A.2d at 224-225. In reliance on the authority of Austin v. New Hampshire, supra, Shaffer v. Carter, supra, and Travis v. Yale & Towne Manufacturing Co., supra, the Supreme Judicial Court of Maine rejected the taxpayer's argument that the proration provision violated the Privileges and Immunities Clause. Id. at 226.

The Barney court noted that "a State need not allow deductions not incurred in producing income within the State." Barney, 490 A.2d at 225 (quoting Shaffer v. Carter, 252 U.S. at 57). In contrast, a state may not entirely deny personal exemptions to all nonresident taxpayers, but may "disallow that portion that corresponds to their actual out-of-state income." Barney, 490 A.2d at 226 (citing Travis v. Yale & Towne Manufacturing Co., 252 U.S. at 79-81); see also, Lung v. O'Chesky, 94 N.M. 802, 617 P.2d 1317, 1319 (1980), appeal dismissed, 450 U.S. 961 (1981) (holding that New Mexico's refusal to grant grocery and medical rebates to Texas residents who were employed in New Mexico did not violate Privileges and Immunities Clause and that proration of exemptions

and deductions based on New Mexico source income was proper); Anderson v. Tiemann, 182 Neb. 393, 155 N.W.2d 322 (1967), appeal dismissed, 390 U.S. 714 (1968) (Limitation of food sales tax credit as offset to only resident's income tax liability did not violate Privileges and Immunities Clause or Equal Protection Clause).

The Barney court also noted the constitutionality of taxation statutes upheld in several states which denied nonresidents any deductions not connected with producing income in the taxing State. Barney, 490 A.2d at 226 n.3; see Goodwin v. State Tax Commission, 286 App. Div. 694, 146 N.Y.S.2d 172 (1955), aff'd. mem., 1 N.Y.2d 680, 150 N.Y.S.2d 203, 133 N.E.2d 711 (1956), appeal dismissed, 352 U.S. 805 (1956); Berry v. State Tax Commission, 241 Or. 580, 397 P.2d 780 (1964), reh'g. denied, 241 Or. 580, 399 P.2d 164, appeal dismissed, 382 U.S. 16 (1965). But see Spencer v. South Carolina Tax Commission, 281 S.C. 492, 316 S.E.2d 386 (1984), aff'd per curiam 471 U.S. 82, reh'g. denied, 471 U.S. 1112 (1985) (rejecting, as a violation of the Privileges and Immunities Clause, South Carolina's attempt to wholly deny a nonresident any itemized deductions where the nonresident's home state did not provide reciprocal treatment for apportionment and allocation of nonbusiness deductions (the court was not required to reach the taxpayer's Equal Protection, Due Process and Commerce Clause claims).)

The power of a state to determine a nonresident's tax liability by reference to extraterritorial values was recently reemphasized in Aronov v. Secretary of Revenue, 332 N.C. 132, 371 S.E.2d 468 (1988), cert. denied, 109 S.Ct. 1568 (1989). Aronov addressed the issue as to whether a nonresident could be required to reduce his distributive share of his North Carolina partnership's net operating loss allocated to him to the extent that he had non-North Carolina income in excess of the North Carolina loss during the years at issue. Id., 371 S.E.2d at 469. The Supreme Court of North Carolina, reversing the North Carolina Court of Appeals, determined that the requirement did not violate the Due Process Clause of the United States Constitution nor the Law of the Land Clause of the North Carolina Constitution. Id. at 472. Apparently, a Privileges and Immunities Clause challenge was not raised.

The taxpayer in Aronov was an Alabama resident who was allocated losses of \$260,000 from a North Carolina shopping center limited partnership during the 1975, 1976 and 1977 taxable years. Id. at 469. During each year the taxpayer had income from sources outside of North Carolina well in excess of the North Carolina loss. Id. The venture proved unsuccessful and in 1978 the partnership tendered its property to its lender under a deed in

lieu of foreclosure. Id. The partnership realized substantial cancellation of indebtedness income in 1978, and the Alabama partner's share thereof was approximately \$260,000. Id. The nonresident claimed a loss carryover from 1975, 1976 and 1977 to offset all of the 1978 income. Id. North Carolina disallowed the net operating loss deduction because the taxpayer had not shown "net economic loss" from all sources in the prior years. Id.

The taxpayer in Aronov argued that the denial of a net operating loss carryover due to his substantial non-North Carolina income was nothing more than the imposition of a North Carolina tax on income earned outside its borders. Id. at 470. In rejecting the taxpayer's argument, the Aronov court noted that "when a state levies taxes within its authority, property not in itself taxable by the state may be used as a measure of the tax imposed." Id. at 471 (citing Maxwell v. Bugbee, 250 U.S. 525 (1919)). The Aronov Court viewed the state's consideration of non-North Carolina income as merely using such income to determine "his properly taxable income, which in turn determines the rate of the tax to be applied to that amount." Id. at 472.

2. Special Nonresident Tax Computations.

In Wheeler v. State, 127 Vt. 361, 249 A.2d 887, appeal dismissed, 396 U.S. 4, reh'g. denied 396 U.S. 949 (1969), the

Supreme Court of Vermont held that a special taxing methodology for nonresidents imposed by Vermont did not violate the Privileges and Immunities Clause. Instead of simply applying their Vermont source income to the graduated rate tables, Vermont required nonresident taxpayers to measure their tax liability by reference to federal taxable income, which invariably included non-Vermont source income. The nonresident determined the appropriate tentative Vermont tax at the graduated rates applicable to all of his or her income and then reduced this overall tentative tax liability based on the percentage that Vermont source income was to the nonresident's overall gross income. Id., 249 A.2d at 888. Though the nonresident taxpayer in Wheeler could demonstrate that the taxing methodology would result in him paying a higher tax liability on his Vermont source income than would a resident taxpayer earning a similar amount of Vermont source income (with no other income), the court, viewing the matter as simply a challenge to the use of graduated rates based on a perceived ability to pay, rejected the claimed unconstitutionality of the provision under the Due Process Clause, Equal Protection Clause and the Privileges and Immunities Clause. Id. at 890-891.

3. Denial of Income Averaging.

The denial of income averaging for state tax purposes served as a basis for analyzing the discriminatory tax treatment of former

residents who became nonresidents of California. In Davis v. Franchise Tax Board, 71 Cal. App. 3d 998, 139 Cal. Rptr. 797, 800 (Ct. App. 1977), appeal dismissed, 434 U.S. 1055 (1978), the California Court of Appeals upheld a provision of the California Revenue and Taxation Code which restricted the benefits of eligibility for "income averaging" to only those taxpayers who were California residents during the five years comprising the year of taxation and four prior taxable years. The specific matter addressed by the Davis court involved former California residents who had filed resident state income tax returns for the taxable years 1969 through 1972. Id. at 798. In late 1972, the taxpayers moved to Nevada and, accordingly, for the 1973 taxable year they filed a nonresident return as a result of their California-source income. Id. The taxpayers challenged their inability to utilize income averaging when determining their 1973 tax liability. Id.

In determining that the California statute requiring California residency throughout the five-year base period, before income averaging would be allowed, did not violate the Privileges and Immunities Clause, the California Court of Appeals considered California's overall tax structure with respect to nonresidents. Davis, 139 Cal. Rptr. at 799. The court noted that California residents and nonresidents were subject to the same graduated tax

rates although the tax brackets were made applicable to nonresidents only by reference to their income from sources within California. Id. The court then noted that California was not constitutionally compelled to utilize such a system since it obviously provided a benefit to nonresidents with substantial non-California income. Id. The court therefore found that the utilization of income averaging, in addition to being allowed to utilize tax brackets only to the extent of California-source income, would result in the nonresidents having greater options to reduce their California tax liability than a resident taxpayer and thus reduce the parity of treatment between such taxpayers. Accordingly, the court determined that the provision denying income averaging to anyone who was a nonresident at any time during the base measurement period was constitutional. Id. at 799. Valid and independent reasons existed for denying income averaging, thereby supporting the state's objective of parity of treatment between resident and nonresident taxpayers. Id. at 799.

The cases discussed above support the proposition that a state, implementing the zero-basis provisions of the Act in a desire to keep revenues on a parity basis between residents and nonresidents, would be entitled to utilize a zero-basis methodology given the limited jurisdiction of the state to assess tax on future gain recognition by the nonresident shareholder. Increased current

taxation of certain nonresidents, who are limited by the zero-basis provision from offsetting losses against other source income from the taxing state, must be balanced against the increased future taxation of residents who are allowed to offset similar losses currently, but who must pay state tax on the ultimate disposition of their stock. The cases which follow also generally uphold discriminatory treatment, and are grounded in the limited jurisdictional reach of a state's taxing power. The following cases, however, primarily involve situations where nonresidents or their property have or are about to leave the state. The decisions consider the state's ability to levy tax on the nonresidents on a discriminatory basis as a "last ditch" effort prior to the state losing jurisdiction over the individual or the property.

4. Wisconsin's "Outbound" Taxation Cases.

(a) Purchase of Principal Residence Outside the State.

Several decisions of the Supreme Court of Wisconsin have broadly defined the state's ability to engage in discriminatory taxation when its jurisdiction to levy taxes in the future is likely to be limited. In Taylor v. Conta, 106 Wis. 2d 321, 316 N.W.2d 814 (1982), the Wisconsin Supreme Court was asked to consider the constitutionality of two statutes which discriminated against nonresidents. The first statute levied state tax on gain on the sale or exchange of a principal residence, which otherwise

would be deferred for federal income tax purposes, if the new residence was located outside of Wisconsin. Taylor, 316 N.W.2d at 817. Secondly, moving expenses which were deductible for federal tax purposes were not allowed as a deduction for state tax purposes if the expenses were incurred to move from the state of Wisconsin. Id.

In analyzing these clearly discriminatory statutes, the court considered the state's asserted objective to "raise revenue by means of a tax system which equitably allocates the burden of taxation." Id. at 825. The Taylor Court noted that, for tax statutes, "no discrimination exists if the state secures a reasonably fair distribution of burdens between residents and non-residents." Id. at 820. In support of this objective, the state offered two possible justifications for the tax provision levying tax on the gain on the sale of a principal residence. First, unless gain was taxed immediately, the state would lose jurisdiction to tax the gain realized on the sale of the Wisconsin residence when the taxpayer left the state. Secondly, if it was necessary to "track" former residents until the taxability of the "deferred gain" for Wisconsin purposes was conclusively determined, the state would be faced with significant administrative problems. Id. at 827.

In holding that these justifications supported the state's objective the Taylor court noted:

Given this problem the legislature was appropriately concerned that unless it taxed the former residents immediately they would escape all Wisconsin tax on the gain, while persons continuing to reside in Wisconsin would not necessarily escape all Wisconsin tax on the deferred gain. The privileges and immunities clause protects the non-resident "against discriminatory taxation, but gives him no right to be favored by discrimination or exemption"

Taylor, 316 N.W.2d at 827 (footnote and citations omitted). Continuing, the Taylor court observed that "[b]y denying deferral to the former resident, Wisconsin treats resident and former resident[s] as fairly as possible within our federal system." Id.

Although recognizing that it was bound to follow the Taylor v. Conta decision, the Court of Appeals of Wisconsin distinguished the record before it from that considered in Taylor and found that the taxation of former residents on their gain from the sale of their Wisconsin principal residence did result in a violation of the Privileges and Immunities Clause. Kuhnen v. Musolf, 143 Wis.2d 134, 420 N.W.2d 401 (Wis. App. 1988). The Kuhnen court reemphasized the basic principles set forth in Taylor which addressed the statute as of 1975, but then determined that the statute as of 1980 "no longer meets the legitimate state objective of raising revenues by a tax system which equitably allocates the tax burden." Kuhnen, 420 N.W.2d at 407. (The Kuhnen court was

also aware that the Wisconsin Legislature had subsequently limited the statute to only taxable years before 1982 in part on the basis that repeal "would improve the equity of the Wisconsin income tax system." Id. at n.13.)

The taxpayer in Kuhnen produced facts indicating that few if any residents of Wisconsin ever sold their residences prior to age fifty-five in a sale that would subject them to Federal or Wisconsin tax. Id. Furthermore, those resident taxpayers that did make a taxable sale were entitled to pay tax based on reduced capital gains rates. Id. Thus, the Kuhnen court viewed the substantive effect of the tax in 1980 as "a migration or exit tax, payable almost exclusively by the nonresident and at rates higher than his or her resident counterpart." Id. (footnote omitted).

The Kuhnen court also rejected the state's claim of administrative convenience. Id. at 408. Due to its reliance on Taylor, the state did not present a substantial record addressing the issue of administrative convenience. Id. The Kuhnen court found the administrative convenience argument lacking when noting that a policy taxing all individuals leaving the state on their gain on the sale of their principal residence, while the record indicated that, based on Wisconsin's experience with its residents, the deferred gain would seldom be triggered no matter what state

the taxpayer relocated to, does not have a substantial relationship to the state's legitimate objective of raising revenue on an equitable basis from residents and nonresidents. Id. The Kuhnen case points out that a state adopting the zero-basis provision must be prepared to demonstrate that residents do pay tax to the state as a result of their sale of stock in an S corporation while nonresidents do not. Moreover, the administrative difficulty imposed on a state in attempting to identify and levy tax on a nonresident's taxable sale of stock must be carefully documented by a state seeking to uphold the zero-basis provision.

(b) Moving Expenses Incurred in Moving Outside of the State.

The Taylor court was joined by the Kuhnen court in upholding the disparate treatment with respect to moving expenses incurred by a former resident to leave the state. Taylor, 316 N.W.2d at 829-830; Kuhnen, 420 N.W.2d at 408-409. Relying on Shaffer v. Carter, the Taylor and Kuhnen courts concluded that because Wisconsin did not tax income earned by former residents in their new domicile, Wisconsin was not obligated to allow deductions for expenses that were incurred to generate income that was beyond its taxing jurisdiction. Id. In accord Harris v. Commissioner, 257 N.W.2d 568 (Minn. 1977) (Moving expenses incurred during move to Georgia from Minnesota were not deductible in Minnesota; Commerce Clause, Due Process Clause, Equal Protection Clause, Privileges and

Immunities Clause and right to travel claims rejected.); but see Golden v. Tulley, 88 A.D.2d 1058, 452 N.Y.S.2d 748, aff'd 58 N.Y.2d 1047, 449 N.E.2d 406 (1983) (Failure of state to offer any rationale for denial of moving expenses, except nonresidency, resulted in finding of Privileges and Immunities Clause violation.)

(c) Corporate Liquidating Distributions to Nonresidents.

A Wisconsin statute which paralleled former Section 337 of the Code and which allowed certain tax-free, 12-month liquidations of corporations without recognition of corporate-level gain or loss on the sale or exchange of property as a result of such liquidations, served as the basis for consideration of another Privileges and Immunities Clause challenge. See WKBH Television, Inc. v. Wisconsin Department of Revenue, 75 Wis. 2d 557, 250 N.W.2d 290 (1977). In contrast to the federal rule under former Section 337, however, the Wisconsin liquidating corporation was only entitled to avoid recognition of gain "to the extent that such gain or loss is participated in by Wisconsin resident shareholders." WKBH, 250 N.W.2d at 292. Therefore, the corporation was taxed with respect to the amount of gain related to its percentage of nonresident shareholders.

In 1969 and 1970 WKBH Television adopted a plan of liquidation and liquidated within the requisite 12-month period. Id. at 291-

292. Approximately 46% of the outstanding shares of the corporation were owned by nonresidents of Wisconsin. Id. at 292. Accordingly that percentage of gain was subjected to corporate level tax. Id. WKBH paid the tax and filed for a refund basing its claim on violations of the Equal Protection Clause, the Commerce Clause, and, with respect to its shareholders who indirectly paid the tax, the Privileges and Immunities Clause. Id. at 291. The court upheld the statutory provision in the face of the various constitutional challenges. Id. at 298-299.

In analyzing the purpose of the statute, the WKBH court noted that although the corporate-level gain or loss was tax-free, the distribution to shareholders was a taxable event for federal purposes (since it was viewed as a sale or exchange of their corporate stock). Accordingly, nonresident shareholders would not be subjected to Wisconsin tax upon a distribution triggering gain since such taxation of stock sales by nonresidents was outside of Wisconsin's taxing jurisdiction. Accordingly, Wisconsin opted to tax the corporation on liquidation, as measured by the nonresident shareholder's percentage interest, as a proxy for not being able to tax the nonresident shareholder on the liquidating distribution. The court found that the statute provided for a source of revenue having a direct relationship to the event taxed and avoided a tax windfall for the nonresident. Id. at 296-297. The court viewed

the statute as "neutralizing" a tax advantage for nonresidents and therefore upheld it. Id. at 297-298.

In a recent case, however, the same statute came under challenge by a nonresident shareholder who successfully demonstrated a Privileges and Immunities Clause violation with respect to the statute under certain fairly unusual factual circumstances. Polan v. Wisconsin Department of Revenue, 433 N.W.2d 640 (Wis. App. 1988). In Polan, the statute itself was not declared unconstitutional per se, but was only deemed to be unconstitutional as applied to the specific nonresident shareholder. In order to reach a Privileges and Immunities Clause analysis, the administrative history of Polan must be considered. Polan was the sole shareholder of an Illinois corporation operating a camp in Wisconsin. Polan, 433 N.W.2d at 642. Polan's corporation adopted a former Code Section 337 plan of liquidation and sold its Wisconsin real estate at a substantial gain. Id. For federal purposes, the corporate-level gain went untaxed. Id. However, distribution of the net remaining assets of the corporation to its sole shareholder, Polan, resulted in an individual loss on the distribution since the remaining assets were less than the shareholder's basis in her corporate shares. Id. Thus, the corporation generated a gain on the liquidation, but the sole shareholder had a loss on liquidation. Id.

The Wisconsin Department of Revenue levied an assessment against Polan individually under a statute providing for transferee liability for taxes imposed on a liquidated corporation. Id. at 642-643. Since Polan was an individual taxpayer, she was entitled to maintain a Privileges and Immunities Clause challenge even though a technical reading of the statute would indicate that the tax was levied on the corporation and she was merely liable for the tax as an individual transferee. Id. at 645-646.

In contrast to the WKBH Television decision, which was not overruled but which was distinguished by the Polan court, the Privileges and Immunities Clause challenge by the nonresident shareholder was squarely addressed by the court. Polan was able to demonstrate that she was treated differently than a resident taxpayer in identical circumstances, since a similar liquidation by a Wisconsin resident shareholder would have resulted in no taxable gain to the corporation and a capital loss to the transferee shareholder. In contrast, the Wisconsin Department of Revenue ignored her individual loss on the liquidation and attempted to levy the corporate tax solely due to her position as a nonresident sole shareholder. Id. at 646. Thus, in the relatively unusual circumstances where a nonresident shareholder has a loss but the corporation has a gain on liquidation, the

statute operates to discriminate against nonresidents vis-a-vis residents. Id. In contrast, if both the corporation and its nonresident shareholders have gain, the statute has a legitimate objective of preventing a nonresident shareholder from escaping Wisconsin tax (even though the gain may be computed differently at the corporate level than the actual gain on distribution to nonresident shareholders).

Thus, the liquidation statute was not viewed to be unconstitutional per se, but only unconstitutional when applied to a nonresident in a situation like Ms. Polan. The WKBH and Polan decisions therefore support discriminatory treatment of nonresidents when transfers of property out-of-state would result in the inability of the state to tax such property in the future. But see Columbia Motor Hotels v. State, 3 O.T.R. 48 (Or. Tax Ct. 1967) (holding, in a questionable decision, that a similar Oregon statute taxing gains related to nonresident shareholders was unconstitutional under the Equal Protection Clause because "[n]o substantial reason for the difference in treatment between the two classes of corporations can be suggested except that the state did not want to lose the revenue and did not have jurisdiction to tax the income of the nonresident stockholders.")

5. Receipt of Out-of-State Property On Like-Kind Exchanges.

In a more recent decision by the Oregon Tax Court, which was affirmed by the Supreme Court of Oregon, the court considered a provision which disallowed nonrecognition treatment on a like-kind exchange when Oregon property was transferred for property outside of Oregon. Wilson v. Department of Revenue, 10 O.T.R. 17 (Or. Tax Ct. 1985), aff'd. 302 Or. 128, 727 P. 2d 614 (1986). The Oregon Tax Court, citing to the Wisconsin "principal residence" case of Taylor v. Conta, supra, found that the statute protected a "legitimate state interest" of raising revenue. The court noted:

Recognition of the gain is required if property newly acquired is outside the jurisdiction of Oregon in order to insure that gains realized on investment property in Oregon are recognized and taxes on such gain are paid. If the gain is deferred and taxed in a subsequent sale, the state could be without jurisdiction to tax that portion of the gain attributable to Oregon since it might be a sale by a nonresident of out-of-state property.

Wilson, Id., Lexis slip op. at 2. The Oregon Supreme Court affirmed the Oregon Tax Court after considering on appeal the taxpayer's challenge under the Equal Privileges and Immunities Clause and Uniformity Clause of the Oregon Constitution, and the Commerce Clause of the United States Constitution. Wilson, 727 P. 2d at 616-620. The Privileges and Immunities Clause of the United States Constitution was not addressed, most likely because the taxation of like-kind exchange property located outside of Oregon applied equally to residents and nonresidents and the challenger at issue was an Oregon resident.

In summary, therefore, disparate treatment of residents and nonresidents by states on "outbound" transfers in an effort to secure tax which may be avoidable in the future by nonresidents have been upheld under a variety of constitutional challenges, including the Privileges and Immunities Clause.

F. Other State Decisions Finding Discriminatory Tax Statutes Unconstitutional.

While the previous cases would appear to adequately support the zero-basis provision of the S Corporation Model Income Act, a review of certain additional state cases which have found discriminatory state statutes to be unconstitutional is in order. In addition to the "commuter tax" cases represented by Austin v. New Hampshire, supra, Salorio v. Glaser, supra, and Clark v. Lee, supra, several other tax statutes that were blatantly discriminatory against nonresidents have been struck down by the courts.

1. Solar Energy Credit Residency Requirement.

In Bagley v. Vermont Department of Taxes, 146 Vt. 120, 500 A. 2d 223 (1985), a Vermont statute conditioned the availability of a solar energy system tax credit on the requirement that the taxpayers were resident individuals for the entire calendar year. Bagley, 500 A. 2d at 224. The taxpayers moved to Vermont from

another state in mid-1979 and built a new home in Vermont in which they installed a qualifying solar energy system. Id. The taxpayers claimed that denial of the credit, on the grounds that they were not residents for the entire taxable year, violated the Privileges and Immunities Clause as well as the Equal Protection Clause of the United States Constitution. Although the court did not reach the Privileges and Immunities Clause claim since their basic claim was that the statute discriminated between new residents and long-term residents, not residents and nonresidents, the court did strike down the statute on equal protection grounds. Id. at 226. The Bagley court determined that no rational basis existed for the pre-installation residency requirement and the provision had no relation to the statutory purpose of implementing the solar tax credit. Id.

2. Residency Requirement For Routine Licensing.

The Supreme Court of Arkansas determined that a one year Arkansas residency requirement in order for an individual to obtain a music machine operator's permit was violative of the Privileges and Immunities Clause. Ragland v. Forsythe, 282 Ark. 43, 666 S.W.2d 680 (1984). In holding that the disparate licensing treatment with respect to nonresidents was not governed by the state's police power, and was not reasonably related to any legitimate state interest, the residency requirement was held

unconstitutional under the Privileges and Immunities Clause (citing Austin v. New Hampshire) and the Equal Protection Clause. Id. at 682.

3. Property Tax Credit.

Finally, in Borden v. Seldon, 259 Iowa 808, 146 N.W.2d 306 (1966), the Supreme Court of Iowa considered the constitutionality with respect to nonresident landowners of a land tax credit which was amended and thereby made applicable only to Iowa residents. Id. at 309. Plaintiffs, who were individual nonresident owners of agricultural land in Iowa, brought suit claiming that the restriction of the credit to only residents was a violation of the Privileges and Immunities Clause and Due Process Clause of the United States Constitution. Id. at 309-310. The Iowa Supreme Court limited its inquiry to only the Privileges and Immunities Clause and determined that restriction of the credit to only residents could not be justified by any of the purported rationale advanced by the State of Iowa. Id. at 312-314. Accordingly, the statute's attempt to limit the credit only to residents was declared unconstitutional. Id. at 314.

V. CONCLUSION

A wide variety of state taxing statutes which discriminated between resident and nonresident individuals have been attacked under the Privileges and Immunities Clause of the United States Constitution thus providing a reasonable framework in which to analyze the potential exposure to such a constitutional attack should a state adopt the zero-basis provision contained in the Act. Virtually all of the decisions upholding facially discriminatory statutes considered the state's entire taxing scheme which invariably included the limited constitutional jurisdiction over nonresidents.

In situations where states are prevented by jurisdictional limitations from levying tax on nonresidents, the courts have been reasonable in recognizing discriminatory taxation as a proper method to ensure that the nonresident pays his or her fair share of the tax to the state prior to, or as a result of, the nonresident being able to avoid the state's jurisdictional reach on all of his or her non-state income. The zero-basis provision of the Act is simply a recognition of the limited jurisdictional reach of states over S corporation shareholders. The provision is designed to prevent a nonresident shareholder from gaining a windfall by being entitled to offset operating losses which have not been "earned" through prior taxable income from an S

corporation, by other unrelated source income from the state in which the S corporation losses were generated. If such netting were allowed, the nonresident shareholder would likely obtain a windfall since the state would not be able to "recapture" the benefit of such losses when the nonresident shareholder sold his or her stock at a substantial gain.

The zero-basis provision simply provides a mechanism whereby resident and nonresident shareholders will obtain some measure of parity vis-a-vis the taxing state. In addition, adoption of the zero-basis provision provides a clear entitlement for nonresident shareholders to carry over suspended net operating losses limited due to the zero-basis limitation. This loss carryover is for an indefinite period and such a provision will often be a distinct advantage over prior law, especially for those nonresident shareholders with little or no other source income from the taxing state. Thus, the losses limited by the zero-basis provision are not necessarily completely denied to the nonresident and will often be fully utilized in subsequent years. The zero-basis provision, therefore, implements an allowable form of discrimination against nonresidents since it is intended to provide a mechanical adjustment to a nonresident's state tax liability computation which prevents the nonresident from taking advantage of the state's limited jurisdictional reach.

EXHIBIT O

MTC Considers Endorsing Modified MoSCITA

by Paull Mines, MTC Counsel

Commission Review of MoSCITA. The Multistate Tax Commission is actively considering the American Bar Association's Model S Corporation Income Tax Act ("MoSCITA")¹ for possible adoption as a uniformity recommendation of the Commission. In keeping with the Commission's bylaws, the Executive Committee of the Multistate Tax Commission referred MoSCITA, together with six possible alternative provisions, to a public hearing. This hearing was held in Chicago, Illinois, on January 25, 1991.

Following the public hearing and the Commission's consideration of MoSCITA, the Commission may determine to adopt one of several possible courses of action: (i) MoSCITA could be recommended without any change; (ii) MoSCITA could be recommended with one or more, or even all, of the proposed modifications; (iii) MoSCITA could be recommended with modifications derived from comments received during the hearing process; (iv) MoSCITA could be recommended with modifications that reflect a combination of possibilities (ii) and (iii); or (v) the Commission could determine that it was inappropriate to recommend MoSCITA at all. The whole purpose of the public hearing process is to receive public comment on a proposed uniform rule for state taxation with a view to determine its suitability. The hearing process is a completely open process and no results are inevitable.

MoSCITA is the product of the Subcommittee on the State Taxation of S Corporations, Committee on S Corporations, Section of Taxation, American Bar Association (Garland H. Allen, Chair). The American Bar Association's House of Delegates in February 1990 approved MoSCITA as recommended state legislation of the ABA. See 1990-2 *Amer. Bar Ass'n Report* 109B. Favorable action by the Multistate Tax Commission on MoSCITA, or a modified MoSCITA that would reflect one or more of the six alternative provisions, would add the MTC's endorsement to the ABA's.

The six alternative provisions now being considered by the hearing officer, any, all or none of which may eventually receive Commission approval, resulted from discussions among the state representatives of the MTC's Uniformity Committee and the MTC staff. Before referring MoSCITA and the six alternative provisions to a public hearing, the Uniformity Committee, through the Commission's staff, discussed the Committee's proposed modification of MoSCITA with the ABA Subcommittee on State Taxation of S Corporations. This dialogue resulted in the development of an issue paper discussing the six proposed modifications to MoSCITA point by point. (The issue paper that was developed is included as a part of this article, below.) The issue paper discusses the considerations which led to the suggestion of the six modifications by the Uniformity Committee and the ABA drafters' reaction to the proposed modifications.

Although in its discussions with the Commission staff the ABA Subcommittee on State Taxation of S Corporations generally opposed any modification to MoSCITA, the drafters of MoSCITA did recognize a need to deal with some of the issues raised by the Uniformity Committee of the Commission.² The preference of

the drafters of MoSCITA would have been to account for the issues raised by the Uniformity Committee to which they had no conceptual opposition through additional commentary to MoSCITA rather than through the development of proposed modifications to the model act. Notwithstanding the opposition of the ABA Subcommittee on State Taxation of S Corporations to modifying the model act, *qua* a model act, the ABA Subcommittee assisted the MTC staff in formulating model alternative language appropriate to the issues being raised. The members of the ABA Subcommittee assisted the Commission's staff in developing model statutory language to lessen the potential for unintended results to flow from modifying MoSCITA, which is a fully-integrated and tightly-written statute.

Issue Paper. The issue paper the Commission staff developed through its dialogue with the drafters of MoSCITA is reproduced immediately below.³ In reviewing the issue paper and the six proposed modifications, it should be kept in mind that none of the six proposed modifications have yet been approved by the Commission. The public hearing is being held to receive comment on the six proposed modifications and whether the Commission should endorse MoSCITA, modified or not. The issue paper is organized, first, by setting forth the original provision of MoSCITA sought to be modified and the proposed modification thereto; next, by discussing the considerations that led the Uniformity Committee of the Commission to propose the modification (*MTC staff's comment*); and finally, by setting forth the ABA drafter's reaction to the proposed modification (*ABA drafters' response*). It should be noted that the ABA drafters' response is the exact written response developed by the ABA Subcommittee on State Taxation of S Corporations and not an editorial interpretation of that Committee's position by the Commission's staff.

[The Issue Paper]

PROPOSED AMENDMENT #1

(Accommodating state restrictions against incorporation of the Internal Revenue Code *in futuro*)

Original MoSCITA Draft: Section 1000(b)(2)—

Code: the Internal Revenue Code of 1986, as amended and as applicable to the Taxable Period; reference to sections of the Code shall be deemed to refer to corresponding provisions of prior and subsequent federal tax laws.

Original MoSCITA Draft: Section 1000(c)—

Except as otherwise expressly provided or clearly appearing from the context, any term used in this Part shall have the same meaning as when used in a comparable context in the Code, or in any statute relating to federal income taxes, in effect for the Taxable Period. Due consideration shall be given in the interpretation of this Part to applicable sections of the Code in effect from time to time and to federal rulings and regulations interpreting such sections, provided such Code, rulings and regulations do not conflict with the provisions of this Part.

See MoSCITA, Page 31.

MoSCITA, from Page 30.

Proposed Modification: Section 1000(b)(2) [MTC Alternative]—Code: the Internal Revenue Code of 1986, as amended and as applicable to the Taxable Period pursuant to [Section number—state provision conforming state tax laws to the Internal Revenue Code as of a specified date, including to the extent noted provisions amended, deleted, or added thereto prior to the applicable effective date].

Proposed Modification: Section 1000(c) [MTC Alternative]—Except as otherwise expressly provided in this Part or other applicable law or clearly appearing from the context, any term used in this Part shall have the same meaning as when used in a comparable context in the Code, or in any statute relating to federal income taxes, in effect for the Taxable Period pursuant to [Section number—state provision conforming state tax laws to the Internal Revenue Code as of a specified date, including to the extent noted provisions amended, deleted, or added thereto prior to the applicable effective date]. Due consideration shall be given in the interpretation of this Part to analogous sections of the Code and to federal rulings and regulations interpreting such sections, provided such Code, rulings and regulations do not conflict with the provisions of this Part.

COMMENTARY TO AMENDMENT #1

MTC staff's statement: Several of our members have existing restrictions against *in futuro* incorporation of the Internal Revenue Code. While the commentary to MoSCITA acknowledges this fact, the statute itself should contemplate this restriction.

ABA drafters' statement: None.

PROPOSED AMENDMENT #2

(Permitting entity level taxation by states in addition to the taxation of federal built-in gains and excessive passive net income)

Original MoSCITA Draft: Section 1001(a) [Alternative No. 2]—Except as provided in the following sentence, an S Corporation shall not be subject to the tax imposed by [Section number—taxation of C corporations]. If an S Corporation is subject to federal income tax on any of its income, then the amount of such income, as modified pursuant to Section 1002 of this Part, that constitutes Income Attributable to the State shall be subject to the tax imposed by [Section number—taxation of C corporations]. The S Corporations [sic] Income Attributable to the State shall be reduced by the amount of any tax imposed on the corporation pursuant to the preceding sentence.

Proposed Modification A: Section 1001(a)[MTC Alternative A]—

An S Corporation's Income Attributable to the State shall be subject to the tax imposed by [Section number—special tax on the income of S Corporations] and, for purposes of determining the amounts taken into account by the shareholder of an S Corporation pursuant to subsection (b), the amount of the tax shall reduce the S Corporation's

Income Attributable to the State. An S Corporation shall not be subject to the tax imposed by [Section number—taxation of C Corporations].

Proposed Modification B: Section 1001(a) [MTC Alternative B]—

An S Corporation shall not be subject to the tax imposed by [Section number—taxation of C Corporations], except:

(1) If an S Corporation is subject to federal income tax on any of its income, then the amount of such income, as modified pursuant to Section 1002 of this Part, that constitutes Income Attributable to the State shall be subject to the tax imposed by [Section number—taxation of C Corporations].

(2) An S Corporation's Income Attributable to the State, less the amount of income subject to the tax imposed under paragraph (1) of this subsection, shall be subject to the tax imposed by [Section number—special tax on income of S Corporations].

For purposes of determining the amounts taken into account by the shareholders of an S Corporation pursuant to subsection (b), the amount of any tax imposed pursuant to this subsection shall reduce the S Corporation's Income Attributable to the State.

COMMENTARY TO AMENDMENT #2

MTC staff's statement: At least one of our members which recognizes S corporations currently imposes a separate entity level S corporation tax. The authorization of an entity level S corporation tax in MoSCITA does not detract from the proposal in any significant manner. While S corporations and their shareholders obviously are interested in reducing their levels of taxation, MoSCITA should not be perceived as an attack on any existing state legislative decision to impose a supplemental entity level S corporation tax. After all, S corporations do in some sense complicate state tax administration and S corporations still do far better than C corporations in avoiding two levels of taxation.

The intent of the amendment is to allow states that elect to have entity level taxes to elect separately whether they wish to impose additionally the special taxes on excess net passive income and built in gains. Thus, states electing to impose a entity level S corporation tax can elect or not elect to have the state equivalent of the federal entity level taxes. Thus, this amendment is presented in the alternative. Many believe state equivalents of the federal entity level taxes are inappropriate for states, because of the added complexity these taxes bring to state taxation and the minimal revenues which have been historically realized from these taxes, even at the federal level.

ABA drafters' statement: Corporate-level taxes on S corporations (such as those enacted by IL, MA, CA and NY) need not interfere on a mechanical level with the operation of MoSCITA's comprehensive regime for taxing S corporation income. At the same time, for reasons noted in the Commentary, the drafting committee recommends that states not adopt such taxes, since they undermine the Model Act's goals of federal-state conformity and state-to-state uniformity in the taxation of S corporations and their shareholders.

See MoSCITA, Page 32.

MoSCITA, from Page 31.

PROPOSED AMENDMENT #3

(Providing for an alternative which denies resident shareholder credit for entity level tax imposed by non-recognition state)

Original MoSCITA Draft: Section 1008(a)—

For purposes of [Section number—individual tax credit allowance provisions], each resident shareholder shall be considered to have paid a tax imposed on the shareholder in an amount equal to the shareholder's Pro Rata Share of any net income tax paid by the S Corporation to a state which does not measure the income of shareholders of an S Corporation by reference to the income of the S Corporation. For purposes of the preceding sentence, the term "net income tax" means any tax imposed on or measured by a corporation's net income.

Proposed Modification: Section 1008(a) [MTC Alternative]—

For purposes of [Section number—individual tax credit allowance provisions], a net income tax imposed on an S Corporation by another state shall not be creditable against the shareholder's tax liability.

COMMENTARY TO AMENDMENT #3

MTC staff's statement: Other states should not be compelled to finance in advance another state's decision to preserve the entity framework of S corporations. Conceptually in the prevalent tax systems of distinguishing between entities and individuals, there is in fact no double taxed income. States recognizing S corporations generally forgive the taxation of distributions of previously taxed income by electing to treat entity level income as personal income. In the absence of perfect corporation-shareholder integration, states should be free to require shareholders of S corporations operating in states where pass-through status is not recognized to achieve their economic savings through the mechanism of the basis and AAA rules.

ABA drafters' statement: Section 1008(a) assumes that, by enacting a provision granting its residents credit for taxes imposed by other states on the same income, the State has already made a broad policy decision to avoid double taxation of income by yielding priority of taxation to the states in which residents are deemed to earn that income. In the context of S corporations, this necessarily means that the State has made a decision to avoid imposing double tax on a resident shareholder with respect to his income from the S corporation by yielding priority of taxation to the recognition state in which the corporation does its business. Section 1008(a) merely provides that, consistent with this policy, the State must allow a resident the same credit for his or her share of any tax imposed on the S corporation entity to a state which does not recognize S corporation status as the State allows for a tax imposed on the resident himself to another state that does recognize the corporation's S status. The corporate-level tax is the only tax that a nonrecognition state imposes on the resident's income. Accordingly, the State's refusal to grant a credit for a nonrecognition state tax—based on the technicality that the tax is imposed on the corporation rather than the shareholder—is inconsistent with the policy of its credit provision.

The State's decision to recognize S corporations is likewise inconsistent with Proposed Amendment 3. The State's decision

to recognize S corporations reflects a second policy choice, to tax S corporation income once and only once, at the shareholder level and at the shareholder's rates. Certainly this is what the State does if its resident owns all of the stock of an S corporation that conducts 100% of its business within the State. If the State does not grant a credit for tax imposed on the S corporation by a nonrecognition state, a second or double taxation of S corporation income always occurs; that is, the State taxes 100% of its resident's S corporation income and the nonrecognition state taxes a portion of the same income a second time.

The argument that Section 1008(a) compels a state to "finance . . . another state's decision" not to recognize S corporation status proves too much. The State's existing credit provision could just as well be said to compel the state to "finance other states' decisions" to tax nonresidents on income from sources within their states.

PROPOSED AMENDMENT #4

(Providing for an alternative that prevents an automatic deduction of another state's income taxes by reason of the operation of IRC § 164)

Original MoSCITA Draft: Section 1002(b)—

The Pro Rata Share of each resident shareholder of an S Corporation in the Income Not Attributable to the State shall, for purposes of Section 1001(b) of this Part, be subject to the modifications provided in [Section number—individual modifications].

Proposed Modification: Section 1002(b) [MTC Alternative]—

The Pro Rata Share of each resident shareholder of an S Corporation in the Income Not Attributable to the State shall, for purposes of Section 1001(b) of this Part, be—

- (1) subject to the modifications provided in [Section number—individual modifications]; and
- (2) increased by the amount of the shareholder's Pro Rata Share of any income tax imposed on the corporation by another state.

COMMENTARY TO AMENDMENT #4

MTC staff's statement: The problem addressed by this optional provision is to alert adopting states to the fact that under IRC § 164 state income taxes are deductible. The practical effect of this federal scheme is to give a shareholder of an S corporation an implicit deduction in the taxing state for another state's income taxes which are imposed on the S corporation. MoSCITA has the potential of allowing this implicit deduction with regard to Income Not Attributable to the State even where an adopting state's tax policy is not to permit other state income taxes to be deducted. The potential arises, because under MoSCITA an S corporation's shareholder's pro rata share of Income Not Attributable to the State is generally determined under federal law and is adjusted by *individual*, not corporate, modifications. State individual modifications may not require a shareholder to add-back entity (corporate) taxes. The proposal seeks to allow adopting states the opportunity to examine this issue as a part of adopting MoSCITA. Adopting states which elect to include this proposal can negate the implicit deduction which MoSCITA might otherwise allow.

See MoSCITA, Page 33.

MoSCITA, from Page 32.

An example of where this modification would prove useful is in a state which allows a credit for other state income taxes and additionally requires these other state income taxes to be added back, thereby forestalling a possible double benefit consisting of both a credit and a deduction. If the individual modifications of the taxing state do not require an *individual* to add back *corporate* level taxes, adoption of the proposal would accomplish that result.

The proposal operates as a warning to adopting states to analyze the issue being raised in light of the adopting state's existing tax policy and is not intended to encourage states to adopt the proposal independent of their existing tax policy. Without some alert to this issue, states adopting MoSCITA without modification could unsuspectingly allow an implicit deduction for entity level income taxes imposed by other states which are inappropriate in light of their existing tax policy.

It is incorrect to say Alternatives #3 and #4 are inconsistent without making reference to the rules which govern the creditability and deductibility of state taxes in the state adopting MoSCITA. This much is implicitly admitted by the ABA drafters' suggested additional commentary found in the indented paragraph in the ABA drafters' statement to this proposal, below.

ABA drafters' statement: The principal problem addressed by Amendment #4 is the "double benefit" problem, that is, the "double benefit" that could result if the State's existing modification provisions do not prevent the resident shareholder from obtaining a deduction or exclusion for the same foreign nonrecognition state tax (imposed on the S corporation) for which the resident shareholder receives the tax credit contemplated by Section 1008(a).

The problem contemplated by Proposed Amendment 4 will not exist if (i) the State already requires individuals to add back all creditable state taxes, or (ii) the State's existing modifications for state income taxes have already been interpreted to apply to other states' taxes imposed on flow-through entities. In these cases, enactment of a mandatory Proposed Amendment 4, as suggested, would be "overkill" or, worse, might be interpreted as requiring a double addback.

Further, the problem addressed by Proposed Amendment 4 is unlikely ever to arise. Proposed Amendment 4 assumes that states have individual modifications requiring the addback of income taxes imposed by other states, but that the states will not be able or willing to interpret the addback to apply to a tax technically imposed on the corporation rather than the shareholder, thus resulting in a double benefit. This assumption gives the states too little credit. State tax authorities have a clear interest in interpreting their credit and addback provisions consistently, that is, so that they either (i) allow a credit and require an addback or (ii) deny a credit and require no addback. Moreover, courts are not likely to accept a contrary assertion about legislative intent, *i.e.*, that the legislature intended to allow both a credit and a deduction for the same tax, unless the statutory language is unmistakable.

If the State generally allows residents to deduct other state taxes for which the State grants tax credits, this policy decision should also apply to resident S corporation shareholders, even if

the result could be viewed as conferring a double benefit. In this case, no change to MoSCITA would be appropriate.

The drafting committee faced a similar double benefit problem in Section 1001(a), Alternative 2, which requires that the State reduce Income Attributable to the State passed through to the shareholders by the amount of any state-level BIG/ENPI tax imposed at the corporate level. The committee handled the problem in the *Commentary* (42 TAX LAWYER 1001, 1023-24 (1989)), by noting that a double benefit could result if the State otherwise permitted the deduction of such taxes (*e.g.*, by piggybacking on the federal income tax base and not also having an addback) and advising a State in this situation to consider amending its statutory provisions to prevent a double exclusion from income. Here, the drafting committee failed to include a similar admonition in the *Commentary* to Section 1008(a). Such an admonition would be appropriate.

The potential problem addressed by Proposed Amendment 4 should be handled by an additional comment to Section 1008(a) (tax credits) and Section 1002(a) and (b) (income modifications), more or less as follows:

If the State's modification provisions do not already require the addback of foreign state taxes imposed on the S corporation, the State may wish to consider a statutory amendment to its income modification provisions or to the Model Act. Such an amendment may be appropriate (i) if the State allows its resident shareholder a tax credit for a foreign state tax imposed on the S corporation, to prevent the resident from receiving a double benefit in the form of an implicit income deduction or exclusion for the same tax, or (ii) if the state generally prohibits the deduction of foreign state taxes, to prevent resident and nonresident shareholders from obtaining an implicit income deduction for a foreign state tax imposed on the S corporation.

The proposed statutory language is deficient in that, for example, (i) since the addback is mandatory, the proposal may unfairly deny an implicit deduction for a nonrecognition state tax, contrary to an existing State policy *allowing* foreign state taxes to be deducted; (ii) since the addback is mandatory, the proposal may cause a "double detriment" if the State already requires the addback of creditable state taxes; and (iii) in a State that generally forbids the deduction of foreign state taxes, the proposal may fail to prevent a shareholder from obtaining an implicit deduction for a tax imposed on the corporation by a recognition state (such as IL, CA, MA and NY).

Note that Proposed Amendments 4 and 3 are mutually exclusive and should not be enacted together. Proposed Amendment 4 assumes that the State has enacted Section 1008(a), granting the resident a credit for nonrecognition state tax, and is intended to ensure that the resident does not also obtain a full deduction for the same tax. By contrast, Proposed Amendment 3 would repeal Section 1008(a) of MoSCITA, thus denying a resident shareholder a tax credit for a nonrecognition state tax and obviating any double benefit problem. Enactment of both would result in a "double detriment"—denial of a credit and a deduction.

See MoSCITA, Page 34.

PROPOSED AMENDMENT #5

(Alternative provision which prohibits reduction of state taxable income passed through to the shareholders for federal Code Section 1374 and 1375 taxes imposed on the corporation.)

Original MoSCITA Draft: Section 1001(c)—

For purposes of determining the amounts taken into account by the shareholders of an S Corporation pursuant to subsection (b), the amount of any tax imposed on the S Corporation under the Code shall proportionately reduce the S Corporation's Income Attributable to the State and Income Not Attributable to a State.

Proposed Modification: Section 1001(c) [MTC Alternative]—

For purposes of determining the amounts taken into account by the shareholders of an S Corporation pursuant to subsection (b), the amount of any tax imposed on the S Corporation under the Code shall not reduce the S Corporation's Income Attributable to the State and Income Not Attributable to a State.

COMMENTARY TO AMENDMENT #5

MTC staff's statement: States should not be required to finance the federal government's entity level tax burden. The basis and AAA rules will give the S corporation shareholder an adjustment when a state does not reduce pass throughs for federal entity level taxes, so that the economic issue really becomes one of timing. The federal government's imputed deduction for these taxes in IRC sections 1366(f)(2) and 1366(f)(3) is no more than a recognition by the taxing sovereign imposing the tax (*i.e.*, the federal government) that the taxing sovereign has already received its tax share of what would otherwise be potentially deferred income. The states on the other hand may well delay recognition of this income to a much later time. Perhaps some consideration should be given to requiring a reduction of state pass throughs when the state also elects to tax built-in gains and excessive net passive income. This possible modification for states adopting the IRC sections 1374 and 1375 scheme should be analyzed for its complexity/benefit effect, however. (Note that states adopting Proposed Amendment #2 without further change would establish this rule.)

ABA drafters' statement: Proposed Amendment 5 is based on a misunderstanding of the reason for MoSCITA Section 1001(c), which reduces state pass throughs by the amount of any federal BIG/ENPI taxes imposed on the S corporation. The rationale is that, when the S corporation earns the type of income on which these federal taxes are imposed, it is appropriate to treat the S corporation and its shareholders as though they were subject to the double-tax regime applicable to C corporations. Under that regime, one tax is imposed immediately at the corporate level on 100% of the corporation's pre-federal tax earnings for the year. A second tax is imposed at the shareholder level at the time the year's earnings are distributed to the shareholders.

By definition, a corporation's distribution to shareholders out of a single year's earnings cannot be more than the amount of such earnings less the federal tax already paid thereon by the corporation. It is for this reason—to make sure that the corporation's income for the year is not subjected to a greater total tax burden

than income earned and distributed by a C corporation—that Code Sections 1366(f)(2) and (3) reduce the amounts passed through and taxed to the shareholders for federal tax purposes by the amount of these taxes. (Note: No similar reduction is required for state income taxes paid by the corporation, since the Code already allows a deduction for such taxes and a similar reduction in pass throughs would give a double benefit. Since no federal deduction is allowed for federal taxes, however, the reduction provision is needed to achieve the correct result.)

MoSCITA Section 1001(c) is no more, and no less, than a parallel provision at the state level, to make sure that the total state tax burden on earnings subject to the federal BIG/ENPI taxes is not greater than the State would impose on a C corporation and its shareholders with respect to the same earnings.

The last sentence of Section 1001(a), Alternative 2, similarly requires the State to reduce income passed through to the shareholders by the amount of state BIG/ENPI taxes imposed on the corporation. Although some states allow deductions for their own taxes, most do not and a specific pass through reduction provision is therefore necessary.

The argument for Proposed Amendment 5 states that the analogous federal rule is a "recognition by the taxing sovereign that it has already received tax on what would otherwise be deferred income." This is wrong, for the reasons explained above. If this were true, it would justify reducing the pass through by the entire amount of income taxed at the corporate level, not just the tax imposed on that income. This argument confuses the single-tax S corporation regime with the double-tax regime being applied whenever the BIG/ENPI taxes are imposed.

The MTC's rationale for proposed Amendment #5 (to avoid requiring the State to finance a federal government tax on the S corporation) would be appropriate if MoSCITA contained a provision requiring a state to permit shareholders to deduct federal income taxes imposed on the S corporation in computing their income. MoSCITA does not contain such a provision. That rationale is not appropriate with respect to Section 1001(c), which is designed simply to implement the C corporation double tax regime for the portion of the S corporation's income subjected to federal tax.

As the foregoing explanation indicates, MoSCITA Section 1001(c) is not intended to preempt the State's rule on the deductibility of federal taxes.

PROPOSED AMENDMENT #6

(Optional provision requiring informational return to be filed by S Corporation in states where it has resident shareholders even though S Corporation does not operate within such state)

Original MoSCITA Draft: Section 1007(a)—

An S Corporation which engages in activities in this State which would subject a C Corporation to the requirement to file a return under [Section number—taxation of C Corporation] shall file with the [State taxing authority] an annual return, in the form prescribed by the [State taxing authority], on or before the due date prescribed for the filing of C Corporation returns under [Section number—corporate tax return filing date]. The return

See MoSCITA, Page 35.

shall set forth the name, address and social security or federal identification number of each shareholder; the Income Attributable to the State and Income Not Attributable to the State with respect to each shareholder as determined under this Part; the modifications required by Section 1002 of this Part; and such other information as the [State taxing authority] may by regulations prescribe. The S Corporation shall, on or before the day on which such return is filed, furnish to each person who was a shareholder during the year a copy of such information shown on the return as the [State taxing authority] may by regulation prescribe. The S Corporation shall also maintain the accumulated adjustments account described in Section 1006(c)(2) of this Part.

Proposed Modification: Section 1007(a) [MTC Alternative]—

Every S Corporation which engages in activities in this State which would subject a C Corporation to the requirement to file a return under [Section number—taxation of C Corporation] or which has a shareholder resident in this state shall file with the [State taxing authority] an annual return, in the form prescribed by the [State taxing authority], on or before the due date prescribed for the filing of C Corporation returns under [Section number—corporate tax return filing date]. The return shall set forth the name, address, social security or federal identification number, and last known address or residence of each shareholder; the Income Attributable to the State and Income Not Attributable to the State with respect to each shareholder as determined under this Part; the modifications required by Section 1002 of this Part; and such other information as the [State taxing authority] may by regulations prescribe. The S Corporation shall, on or before the day on which such return is filed, furnish to each person who was a shareholder during the year a copy of such information shown on the return as the [State taxing authority] may by regulation prescribe. The S Corporation shall also maintain the accumulated adjustments account described in Section 1006(c)(2) of this Part.

COMMENTARY TO AMENDMENT #6

MTC staff's statement: S corporations necessarily must be viewed as operating in states in which their shareholders are found even though the S corporation as a corporate entity does not operate within that state. Not allowing a state of a resident shareholder to require this information of an S corporation is akin to saying that the state of a resident shareholder may not gain access to the books and records of an S corporation not operating within the state. Such a conclusion would fly in the face of state accommodation of multistate S corporations. Comparable provisions are found for partnerships with resident partners in a state in which the partnership does not operate. The distinction between S corporations and partnerships (corporation/shareholder versus aggregation of individuals) does not justify the distinction in treatment. The state of a resident shareholder has a legitimate need to know how an S corporation has calculated, apportioned and allocated its

income and has determined the pro rata share of income, losses, deductions and credits for its shareholders.

ABA drafters' statement: It is generally accepted that a state acquires no jurisdiction to tax or regulate a C corporation by virtue of the fact that one of its shareholders is a resident of the state. As a matter of due process, it is hard to find any authority for a different nexus rule in the case of an S corporation, despite differences in the way C and S corporations and their shareholders are taxed. The fact that a number of states have asserted nexus over partnerships based solely on the residence of a partner does not provide authority for basing nexus over an S corporation upon the residence of a shareholder, since for state tax and federal constitutional purposes partners have traditionally been viewed as directly conducting the business of the partnership.

It is also difficult to understand why states need the right to impose this reporting burden on S corporations. Every resident shareholder has the duty to prepare a proper return containing all relevant information which the taxing authority may by regulation require (see MoSCITA Section 1007). Every shareholder would also seem to have the legal right to require the corporation to provide the information he needs to prepare his return or to justify his return on audit. While the state may lack the power to subpoena the corporation directly, it retains broad powers vis-a-vis the resident shareholder and can impose sanctions for failure to substantiate S corporation items on his return. Accordingly, and wholly apart from the question of whether Proposed Amendment 6 is constitutional, the drafting committee could find no justification for including this requirement in the Model Act.

Additional Issues Raised by MoSCITA. The issue paper reproduced above does not limit the debate to be conducted during, nor define the scope of, the public hearing on MoSCITA. In addition to considering the six alternatives discussed in the issue paper reproduced immediately above, there are any number of other possible issues which may be raised during the course of the public hearing. Some of these issues have been received by the staff in the form of informal comments on MoSCITA during the time that MoSCITA has been under staff review. These additional issues range from observations on the administrability of MoSCITA to suggestions for further modification of MoSCITA. Without attempting to discuss the implications of these additional issues here, a listing of some of these additional issues follows:

- Can state tax administrators reasonably apply state income taxes to multijurisdictional pass-through entities or, given the level of state tax administration staffing, is it unrealistic to expect that most states can successfully apply their laws to pass-through entities?
- Could the reporting and administrative difficulties encountered by both tax administrators and S corporations be appropriately lessened by providing for one-stop filing for S corporations engaged in multi-jurisdictional business?
- Would it be better to source gains from the sale or disposition of stock in an S corporation according to an entity level formula (e.g., a formula that takes into account the underlying assets and/or the operational history of the S corporation) than to treat the

MoSCITA, from Page 35.

sale or disposition of S corporation stock as a sale or disposition of an intangible?

- How well does the zero basis rule work for non-resident shareholders in the context of the profit environment which now exists for S corporations following the curtailment of most tax shelters, the adoption of the Tax Reform Act of 1986 and its repeal of the *General Utilities* doctrine and the difference between corporate and individual rates?
- Is it appropriate to limit adjustments to the income of a resident shareholder of an S corporation to "income attributable to a state" in light of a state's desire to impose tax policy limitations on its residents regardless of the source of their income?
- Does MoSCITA properly treat non-business income which is derived entirely from a passive investment, *i.e.*, should such income be passed through directly to an S corporation shareholder in a manner similar to what was adopted in *Appeal of Bass*, Cal. B.O.E. (January 29, 1989) (partnership case)?
- Are MoSCITA's state specific rules governing basis and the accumulated adjustment account too complex to be reasonably administrable?
- How well would MoSCITA operate in a state employing combined reporting for a unitary business?
- Would uniformity be better promoted by including within MoSCITA a rule which indicated how IRC §469's limitation on the use of passive activity losses is to be administered in the pass-through area—*i.e.*, on a state-by-state basis or a federal rule basis without regard to the geographical source of the passive income or losses?

Conclusion. There is no question that MoSCITA is a fine work of legal draftsmanship. The drafters of MoSCITA undoubtedly faced the ever-present tension that exists when attempting to develop a proposed uniform state tax rule—how far to press for uniformity in light of existing, divergent state tax policies. The MTC, if it endorses MoSCITA after the public hearing, may allow additional policy room to the adopting states by providing for possible modifications in its endorsement. The provision of modifications would not be a criticism of MoSCITA, but rather a reflection of the fact that some of the choices made by the ABA Subcommittee on State Taxation of S Corporations may not be

totally acceptable to all states in the current state tax policy climate. Additionally, in reviewing MoSCITA, the Commission will also consider the advisability of attempting to apply state income tax laws at all to pass-through entities engaged in multijurisdictional business. Serious tax administration questions exist as to whether it would be more sensible to eliminate pass-through treatment in favor of entity taxation at the state level. This part of the public hearing may portend even greater long-term significance for state tax administration in this area of federal conformity, which has developed increased importance under the policy of the Internal Revenue Code of 1986.

Post script: From some of the comments received on the proposed amendments to MoSCITA being considered by the Multistate Tax Commission, it is apparent that the general intention of the amendments is not clear. The amendments are not proposed as absolute changes to MoSCITA. Thus, none of the proposed amendments are suggested as substitutes that would entirely replace the comparable provision of MoSCITA. Rather, the amendments have been developed as possible changes to MoSCITA for states to consider when consistent with their existing state S corporation tax policy. If a state's existing tax policy is better served by the proposed amendment rather than the original provision included in MoSCITA, the necessary statutory language has been developed. On the other hand, if MoSCITA as originally drafted better reflects a state's existing tax policy, then no suggestion is made by the proposed amendments to change MoSCITA. The amendments have been developed to assist the states to modify MoSCITA in those areas in which it was anticipated there might be some diversity in tax approaches of the states. In this manner the proposed amendments, if they are approved by the Commission, will lessen the need of states to tinker with the fully-integrated and tightly-written statute.

FOOTNOTES

1. MoSCITA is reproduced in its entirety as a part of the *Report of the Subcommittee on State Taxation of S Corporations: Model S Corporation Income Tax Act and Commentary*, 42 TAX LAW. 1001 (1989).
2. The drafters of MoSCITA were also opposed outright to some of the proposed modifications and, with respect to these proposed modifications, the drafters saw no need to modify MoSCITA by additional commentary or otherwise. The ABA drafters' statements that are a part of the issue paper that follows in this article clearly identify which of the six proposed modifications the ABA Subcommittee would not oppose as additional commentary and which of the six proposed modifications the ABA Subcommittee would oppose as additional commentary or otherwise.
3. Additional comments on other aspects of MoSCITA immediately follow this article's reproduction of the issue paper.

NOTICE OF PUBLIC HEARING

The Multistate Tax Commission will hold a public hearing upon proposed M.T.C. Regulation IV.18.(j): Attribution of Income from the Business of Print Media. The hearing will be held at the following locations and times:

Thursday, March 28, 1991 at the Hall of the States, 444 No. Capitol St., N.W., Ste. 341, Washington, D.C. beginning at 10:00 AM.

Tuesday, May 7, 1991 at the Offices of the California Franchise Tax Board, Ronald Reagan State Office Bldg., South Tower, 5th Fl., 300 So. Spring St., Los Angeles, California beginning at 10:00 AM.

The proposed regulation addresses issues concerning the apportionment of net income derived from the multistate sale and distribution of printed material of all kinds, including the advertising revenue derived

therefrom. A copy of the proposed regulation may be obtained by contacting Michael Mazerov, Director of Policy and Research, Multistate Tax Commission, 444 No. Capitol St., N.W., Suite 409, Washington, D.C. 20001, Tel.: 202-624-8699.

The Commission invites all interested parties to participate in the hearing. Those desiring to make oral presentations to the Hearing Officer are requested to notify him at least ten days prior to the scheduled hearing session. Anyone desiring to submit written comments may do so with the Hearing Officer prior to May 7, 1990.

The Hearing Officer is: Alan H. Friedman, 386 University Avenue, Los Altos, CA 94022, Tel.: (415)-941-0556 or 1-800-327-1258 (outside California).

EXHIBIT P

Multistate Tax Commission



MEMORANDUM

TO: Members, Executive Committee

FROM: Paull Mines, Counsel

SUBJECT: Model S Corporation's Income Tax Act ("MoSCITA")--Interim Hearing Officer's Report

DATE: April 29, 1991

The hearing on the Model S Corporation Income Tax Act ("MoSCITA") with six proposed alternatives was held in Chicago, IL, on January 25, 1991. In addition to the receipt of written comment, six witnesses appeared before the hearing officer, including three representatives of state tax agencies. These latter witnesses appeared by telephone. . .

The hearing officer anticipates completing the hearing officer's report in time for the Executive Committee to consider the proposal in connection with the Annual Meeting in late July 1991 and, if so determined, to refer the proposal (as it may be modified) to a vote by the full Commission.

uc/msctahrg.irp
04/91

EXHIBIT Q

Multistate Tax Commission



SIX PROPOSED MODIFICATIONS TO MoSCITA

[NOTE THAT THE SIX PROPOSED MODIFICATIONS CONTAINED IN THIS DOCUMENT HAVE BEEN DEVELOPED TO SUGGEST AMENDATORY LANGUAGE TO STATES CONSIDERING MoSCITA THAT WOULD BE CONSISTENT WITH *EXISTING* STATE TAX POLICY. IN THIS SENSE, AN ADOPTING STATE IS NOT ENCOURAGED TO ADOPT ANY OF THE SIX PROPOSED MODIFICATIONS UNLESS THE MODIFICATION BEING CONSIDERED IS CONSISTENT WITH *EXISTING* STATE TAX POLICY OF THE STATE AND THE ADOPTING STATE WISHES TO PRESERVE THE *EXISTING* POLICY CHOICE REPRESENTED BY ONE OR MORE OF THE SIX PROPOSED MODIFICATIONS.]

PROPOSED MODIFICATION #1

(Accommodating state restrictions against incorporation of the Internal Revenue Code *in futuro*)

Original Draft: Section 1000(b)(2)--

Code: the Internal Revenue Code of 1986, as amended and as applicable to the Taxable Period; reference to sections of the Code shall be deemed to refer to corresponding provisions of prior and subsequent federal tax laws.

Original Draft: Section 1000(c)--

Except as otherwise expressly provided or clearly appearing from the context, any term used in this Part shall have the same meaning as when used in a comparable context in the Code, or in any statute relating to federal income taxes, in effect for the Taxable Period. Due consideration shall be given in the interpretation of this Part to applicable sections of the Code in effect from time to time and to federal rulings and regulations interpreting such sections, provided such Code, rulings and regulations do not conflict with the provisions of this Part.

Optional Draft: Section 1000(b)(2) [MTC Alternative]--

Code: the Internal Revenue Code of 1986, as amended and as applicable to the Taxable Period pursuant to [Section number--state provision conforming state tax laws to the Internal Revenue Code as of a specified

date including to the extent noted provisions amended, deleted, or added thereto prior to the applicable effective date].

Optional Draft: Section 1000(c) [MTC Alternative]--

Except as otherwise expressly provided in this Part or other applicable law or clearly appearing from the context, any term used in this Part shall have the same meaning as when used in a comparable context in the Code, or in any statute relating to federal income taxes, in effect for the Taxable Period pursuant to [Section number--state provision conforming state tax laws to the Internal Revenue Code as of a specified date including to the extent noted provisions amended, deleted, or added thereto prior to the applicable effective date]. Due consideration shall be given in the interpretation of this Part to analogous sections of the Code and to federal rulings and regulations interpreting such sections, provided such Code, rulings and regulations do not conflict with the provisions of this Part.

PROPOSED MODIFICATION #2

(Permitting entity level taxation by states in addition to the taxation of federal built-in gains and excessive passive net income)

Original Draft: Section 1001(a) [Alternative No. 2]--

Except as provided in the following sentence, an S Corporation shall not be subject to the tax imposed by [Section number--taxation of C corporations]. If an S Corporation is subject to federal income tax on any of its income, then the amount of such income, as modified pursuant to Section 1002 of this Part, that constitutes Income Attributable to the State shall be subject to the tax imposed by [Section number--taxation of C corporations]. The S Corporations Income Attributable to the State shall be reduced by the amount of any tax imposed on the corporation pursuant to the preceding sentence.

Optional Draft A: Section 1001(a) [MTC Alternative A] --

An S Corporation's Income Attributable to the State shall be subject to the tax imposed by [Section number--special tax on the income of S Corporations] and, for purposes of determining the amounts taken into account by the shareholder of an S Corporation pursuant to subsection (b), the amount of the tax shall reduce the S Corporation's Income Attributable to the State. An S corporation shall not be subject to the tax imposed by [Section number--taxation of C Corporations].

Optional Draft B: Section 1001(a) [MTC Alternative B]--

An S Corporation shall not be subject to the tax imposed by [Section number--taxation of C Corporations], except:

(1) If an S Corporation is subject to federal income tax on any of its income, then the amount of such income, as modified pursuant to Section 1002 of this Part, that constitutes Income Attributable to the State shall be subject to the tax imposed by [Section number--taxation of C Corporations].

(2) An S Corporation's Income Attributable to the State, less the amount of income subject to the tax imposed under paragraph (1) of this subsection, shall be subject to the tax imposed by [Section number--special tax on income of S Corporations].

For purposes of determining the amounts taken into account by the shareholders of an S Corporation pursuant to subsection (b), the amount of any tax imposed pursuant to this subsection shall reduce the S Corporation's Income Attributable to the State.

PROPOSED MODIFICATION #3

(Providing for an alternative which denies resident shareholder credit for entity-level tax imposed by non-recognition state)

Original Draft: Section 1008(a)--

For purposes of [Section number--individual tax credit allowance provisions], each resident shareholder shall be considered to have paid a tax imposed on the shareholder in an amount equal to the shareholder's Pro Rata Share of any net income tax paid by the S Corporation to a state which does not measure the income of shareholders of an S Corporation by reference to the income of the S Corporation. For purposes of the preceding sentence, the term "net income tax" means any tax imposed on or measured by a corporation's net income.

Optional Draft: Section 1008(a) [MTC Alternative]--

For purposes of [Section number--individual tax credit allowance provisions], a net income tax imposed on an S Corporation by another state shall not be creditable against the shareholder's tax liability.

PROPOSED MODIFICATION #4

(Providing for an alternative that prevents an automatic deduction of another state's income taxes by reason of the operation of IRC § 164)

Original Draft: Section 1002(b)--

The Pro Rata Share of each resident shareholder of an S Corporation in the Income Not Attributable to the State shall, for purposes of Section 1001(b) of this Part, be subject to the modifications provided in [Section number--individual modifications].

Optional Draft: Section 1002(b) [MTC Alternative]--

The Pro Rata Share of each resident shareholder of an S Corporation in the Income Not Attributable to the State shall, for purposes of Section 1001(b) of this Part, be--

(1) subject to the modifications provided in [Section number--individual modifications]; and

(2) increased by the amount of the shareholder's Pro Rata Share of any income tax imposed on the corporation by another state.

PROPOSED MODIFICATION #5

(Alternative provision which prohibits reduction of state taxable income passed through to the shareholders for federal Code Section 1374 and 1375 taxes imposed on the corporation.)

Original Draft: Section 1001(c)--

For purposes of determining the amounts taken into account by the shareholders of an S Corporation pursuant to subsection (b), the amount of any tax imposed on the S Corporation under the Code shall proportionately reduce the S Corporation's Income Attributable to the State and Income Not Attributable to a State.

Optional Draft: Section 1001(c) [MTC Alternative]--

For purposes of determining the amounts taken into account by the shareholders of an S Corporation pursuant to subsection (b), the amount of any tax imposed on the S Corporation under the Code shall not reduce the S Corporation's Income Attributable to the State and Income Not Attributable to a State.

PROPOSED MODIFICATION #6

(Optional provision requiring informational return to be filed by S Corporation in states where it has resident shareholders even though S Corporation does not operate within such state)

Original Draft: Section 1007(a)--

An S Corporation which engages in activities in this State which would subject a C Corporation to the requirement to file a return under [Section number--taxation of C Corporation] shall file with the [State taxing authority] an annual return, in the form prescribed by the [State taxing authority], on or before the due date prescribed for the filing of C Corporation returns under [Section number--corporate tax return filing date]. The return shall set forth the name, address and social security or federal identification number of each shareholder; the Income Attributable to the State and Income Not Attributable to the State with respect to each shareholder as determined under this Part; the modifications required by Section 1002 of this Part; and such other information as the [State taxing authority] may by regulations prescribe. The S Corporation shall, on or before the day on which such return is filed, furnish to each person who was a shareholder during the year a copy of such information shown on the return as the [State taxing authority] may by regulation prescribe. The S Corporation shall also maintain the accumulated adjustments account described in Section 1006(c)(2) of this Part.

Optional Draft: Section 1007(a) [MTC Alternative]--

Every S Corporation which engages in activities in this State which would subject a C Corporation to the requirement to file a return under [Section number--taxation of C Corporation] or which has a shareholder resident in this state shall file with the [State taxing authority] an annual return, in the form prescribed by the [State taxing authority], on or before the due date prescribed for the filing of C Corporation returns under [Section number--corporate tax return filing date]. The return shall set forth the name, address, social security or federal identification number, and last known address or residence of each shareholder; the Income Attributable to the State and Income Not Attributable to the State with respect to each shareholder as determined under this Part; the modifications required by Section 1002 of this Part; and such other information as the [State taxing authority] may by regulations prescribe. The S Corporation shall, on or before the day on which such return is filed, furnish to each person who was a shareholder during the year a copy of such information shown on the return as the [State taxing authority] may by regulation prescribe. The S Corporation shall also maintain the accumulated adjustments account described in Section 1006(c)(2) of this Part.