

Summer SaLT Update Webinar

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CREDIT FOR TAX PAID AND THE LOCAL TAX CONUNDRUM

Income Tax Credits For Residents

- Residents are subject to tax on all income earned anywhere
 - Nonresidents are subject to tax on income from sources in the state
 - This includes wages and income/gain from business or real property
 - But not income from intangibles (investments)
- States generally allow their residents a credit for taxes paid to other states
- Credit cannot exceed the tax due in state of residency
- But what if the tax paid to the other state is a local income tax?
- Credit is usually based on the home state's allocation rules
- A few states allow a credit for tax paid to another state on income not sourced to that state under home state rules (intangible income)
 - New Jersey

Reciprocal Tax Agreements

- Under a reciprocal tax agreement, an employer is required to withhold and an employee is required to pay state income tax only in employee's state of residency even if employee works in another state.
- Reciprocal tax agreements typically exist only between neighboring states, but not all neighboring states have them
- Usually not applicable to local taxing jurisdictions or income earned in a state that is not party to the agreement

Reciprocal Tax Agreements

<u>STATE</u>	<u>RECIPROCITY STATES</u>
Arizona	California, Indiana, Oregon and Virginia
Illinois	Iowa, Kentucky, Michigan and Wisconsin
Indiana	Kentucky, Michigan, Ohio, Pennsylvania and Wisconsin
Iowa	Illinois
Kentucky	Illinois, Indiana, Michigan, Ohio, Virginia, West Virginia and Wisconsin
Maryland	Pennsylvania, Virginia, Washington, D.C. and West Virginia
Michigan	Illinois, Indiana, Kentucky, Minnesota, Ohio and Wisconsin
Minnesota	Michigan and North Dakota
Montana	North Dakota
New Jersey	Pennsylvania
North Dakota	Minnesota and Montana
Ohio	Indiana, Kentucky, Michigan, Pennsylvania and West Virginia
Pennsylvania	Indiana, Maryland, New Jersey, Ohio, Virginia and West Virginia
Virginia	Kentucky, Maryland, Pennsylvania, Washington, D.C. and West Virginia
Washington, D.C.	Maryland and Virginia
West Virginia	Kentucky, Maryland, Ohio, Pennsylvania and Virginia
Wisconsin	Illinois, Indiana, Kentucky and Michigan

CREDIT FOR LOCAL TAXES

State Credit for Local Taxes Paid

- A total of 12 states allow some type of local tax to qualify for a state credit.
- Illinois, Iowa, Kansas, Maryland, and North Dakota allow a credit for taxes paid to municipalities and local government of another state.
- Seven states allow a credit for tax paid to a political subdivision of a state.
- Political subdivision is generally defined to include any state or local governmental entity including any state agency, board, commission, state-supported institution of higher education, city, county, township, or municipal corporation, and any other body that is responsible for government activities in a geographical area smaller than that of the state
- These states are Connecticut, Maine, Michigan, Missouri, Nebraska, New Jersey, and New York.

Comptroller of the Treasury v. Wynne, (US Supreme Court 2015)

- Married couple were Maryland residents who received income from an S corporation and filed income tax returns in 39 states.
- Taxpayers received a credit for taxes paid to other states against their Maryland *state* income tax but not against their *county* income tax.
- Taxpayers alleged that Maryland's failure to provide a credit the county portion of their income tax was unconstitutional.
- The Court held that Maryland's tax scheme violated the dormant Commerce Clause because it "had the potential to result in discriminatory double taxation of income earned out of state and created a powerful incentive to engage in intrastate rather than interstate economic activity."

Indiana DOR, Letter of Findings No. 01-20160254 (Feb. 1, 2017)

- Indiana resident claimed a credit for income taxes paid to Georgia and Alabama against their Indiana county income tax.
- Credit against Indiana state income tax allowed for GA and AL state level tax
- But no credit allowed against Indiana county income taxes or a credit for out-of-state local income taxes against Indiana state-level income taxes.
- “Any disparate treatment of interstate income in Indiana could only result from the interaction of differing state tax structures, not from anything inherent in Indiana’s tax structure.
- The “apples to apples” approach: “Indiana maintains symmetry in allowing credits at both the state-to-state level and the county-to-county level.”
- Indiana’s tax system is different than Maryland’s: “In Indiana, each county chooses whether to impose a county-level income tax. Indiana's local-option income taxes are not part of a single state-imposed income tax scheme.”

California Franchise Tax Board Legal Ruling 2017-01

- California allows a credit for taxes paid to other states, but not for taxes that are imposed by and paid to a city, county or other locality.
- FTB distinguished *Wynne*
- Although Maryland imposed a "so-called 'county' tax" upon its residents, the tax was actually a state tax imposed by and paid to the state of Maryland, "[d]espite the name[s] that Maryland has assigned."
 - "When a tax operates as a tax imposed by and/or collected by a county, city, or other locality, the tax is not imposed by and paid to the other state, so a credit is not available for payment of the tax. In contrast, if the tax is imposed by a state statute and paid to the state, the tax is deemed a tax imposed by and paid to the state, even if the tax is labeled a county, city, or other locality tax."

Zilka v. Tax Review Board, Nos. 1063 CD 2019, 1064 CD 2019 (Jan. 7, 2022)

- As a Philadelphia resident, Ms. Zilka paid tax to both Pennsylvania and Philadelphia
- But she worked in Wilmington (DE) and paid both Delaware and Wilmington tax as a nonresident
- Philadelphia generally allows a credit against its Wage Tax for tax paid to other localities, but it does not allow a credit against its Wage Tax for taxes paid to other states.
- That is in fact what happened to Ms. Zilka: she received full credit for tax paid to Wilmington but no credit for tax paid to Delaware
- Zilka argued that the state and county taxes must be treated as a single tax
- Is Philadelphia's position consistent with *Wynne*?
- Pennsylvania Commonwealth Court: yes, it is consistent

Zilka v. Tax Review Board, Nos. 1063 CD 2019, 1064 CD 2019 (Jan. 7, 2022)

- “Although the *Wynne* Court held that Maryland was required to offset its so-called “county” tax against other “state” taxes, the “county” tax was actually a state tax because it was administered, adopted, mandated, and collected by the state. Here, both the Philadelphia Wage Tax and Wilmington Tax are municipal taxes. As the trial court aptly observed, it is a “simple ‘apples to apples’ approach – state taxes to state taxes and local taxes to local taxes.” Based upon our reading of *Wynne*, such an approach is reasonable and passes constitutional muster.”
- “Philadelphia is not taxing Taxpayer’s income ‘more heavily when it crosses state lines than when it occurs entirely within the State.’ Rather, Philadelphia is taxing Taxpayer the same as other residents who worked intrastate — 3.92 percent. Although we recognize that Taxpayer pays 1.93 percent more than her intrastate counterparts, that is because Taxpayer chose to work in Delaware, which charges a higher income tax than Pennsylvania.”

WHAT ABOUT A CREDIT FOR TAXES PAID TO ANOTHER COUNTRY?

Steiner v. Utah State Tax Commission, No. 20180223, Supreme Court of Utah (August 14, 2019)

- **FACTS:** The Steiners filed joint tax returns as Utah residents. Mr. Steiner was a shareholder of Steiner, LLC, an S corp that does business globally. On their federal return, they claimed and received a tax credit for business income taxes paid to foreign jurisdictions. On their state return, they claimed and received a credit for taxes paid to other states but failed to receive an equitable adjustment to exclude foreign income.
- The Supreme Court of Utah held that Utah's tax scheme was valid because it complied with the Commerce Clause.
- Internal consistency requires an analysis of the inherent characteristics of the state tax system. Under this analysis, Utah courts assume that every state uses Utah's tax system, and assesses whether, in this hypothetical world, there is systematic discrimination against interstate commerce.
- A court cannot infer, absent some explicit directive from Congress, that the states must conform their taxes to federal practice.

PTET and CREDITS FOR TAX PAID BY THE ENTITY

Smith v. Robinson, No. 2018-CA-0728, Supreme Court of Louisiana (December 5, 2018)

- **FACTS:** Taxpayers are Louisiana residents and part owners of several entities that transact business in Texas, Arkansas, and Louisiana. In 2015, they paid both Texas franchise taxes based on their entities' Texas-sourced income and Louisiana's income tax for income derived both outside and inside Louisiana. Louisiana denied the taxpayers' claim for credit because a statute stated that credits are only available for income taxes paid to a state that offers a reciprocal credit. Texas did not offer such a credit.
- The Louisiana Supreme Court held that the statute violated the U.S. Commerce Clause because it failed to apportion out-of-state income and exposed income of Louisiana residents to double taxation.
- Louisiana residents who earn interstate income are double taxed on all or a portion of their interstate income, whereas Louisiana residents with only intrastate income are not.

Goggin v. State Tax Assessor, BCD-17-459, Maine Supreme Court (August 2, 2018)

- **FACTS**: The Goggins were residents of Maine. Ann Goggin held an interest in an LLC formed in New Hampshire. New Hampshire imposed on the LLC a business profits tax and business enterprise tax. On their federal return, the Goggins reported income from the LLC that was proportional to Ann’s membership interest. On their Maine tax returns, the Goggins claimed a credit for the New Hampshire business tax.
- The Maine Supreme Court held that the business taxes paid in New Hampshire did not qualify the Goggins for a tax credit against Maine income taxes.
- Maine resident taxpayer holding an interest in an LLC was not entitled to a credit for personal income tax for business taxes paid to New Hampshire because the Maine definition of “income tax” applies only to income taxes paid by an individual.
- In interpreting a tax statute, a court looks first to its plain meaning to give effect to the Legislature's intent. The plain meaning of an "income tax imposed on an individual" excludes taxes that are imposed on, and paid by, business entities.

No Uniform Rule: Out-of-State PTE Tax Credits

State PTE Tax Law Involving Out-of-State Partnerships

- States that allow residents a credit to residents for PTE paid to other states include Arkansas, Arizona, California, Colorado, Idaho, Illinois, Kansas, Maryland, Minnesota, New Jersey, New York, Rhode Island, Utah, and Virginia.
 - For example, New York’s statutory credit rule says: “A taxpayer subject to tax under article twenty-two of this chapter that is a direct partner or member in an electing partnership or a direct shareholder of an electing S corporation subject to tax under this article shall be allowed a credit against the tax imposed pursuant to article twenty-two of this chapter”
 - “[T]he term "income taxes" in subparagraph (A) of this paragraph shall not include pass-through entity taxes substantially similar to the tax imposed pursuant to article twenty-four-A of this chapter imposed by another state of the United States”
- Only New York and Illinois have identified “substantially similar” states.
- North and South Carolina expressly prohibit residents from claiming a credit.

OTHER ISSUES

Credits for Taxes Paid to States with a “Convenience of the Employer” Rule

- The “Convenience of the Employer” rule subjects an individual to tax where the employer is located. This, at times, creates a double taxation problem for those who then live in a different state.
- Delaware, Nebraska, New York, and Pennsylvania have adopted the “Convenience” rule, and Connecticut applies the rule only if the resident state of the taxpayer applies a similar rule with respect to work done for a Connecticut employer.
- Some states give their residents a credit for the full amount of tax paid in a state that has a “Convenience of the Employer” rule. New Jersey and Connecticut are two such states.
 - For example, residents of New Jersey may claim a credit for taxes paid to New York despite the remote work’s performance in New Jersey.

Taxpayer's Out-of-State SGO Contribution is a Tax Burden for In-state Tax Credit Purposes

Gillian Goodrich and Robert Bernard III v. Robinson, (La. Bd. Tax App. 03/10/22)

- Taxpayers, Louisiana residents, contributed \$30,000 of their \$63,319 owed to Alabama to a qualified Scholarship Granting Organization (SGO)
- Louisiana disallowed the \$30,000 as a tax credit
- The Taxpayers appealed, and the Board of Tax Appeals for the State of Louisiana held in favor of the Taxpayers, stating that the Taxpayers' payment to the SGO qualified as "net income taxes imposed by and paid to another state" because:
 - \$63,319 was a compulsory payment, partly to the state of Alabama and partly to the SGO. Disallowance of the credit would be double taxation.
 - Relevant case law emphasizes the tax classification's "operational and consequential effect," and that the \$30,000 payment had the "operational effect" of a payment of Alabama income taxes.
 - Federal treatment supports the above determination of the tax's "operational effect."
 - "From a fundamental fairness perspective, the disallowance of the credit would result in the Taxpayers paying their overall state income tax liability twice."



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