STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
WILLIAM A. BAKER, JR. AND LUCELLE D. BAKER	:	DECISION
For Redetermination of a Deficiency or for Refund of Personal Income Tax under Article 22 of the Tax Law for the Years 1984 and 1985.	:	

Petitioners William A. Baker, Jr. and Lucelle D. Baker, 20 Alpine Lane, Chappaqua, New York 10514, filed an exception to the determination of the Administrative Law Judge issued on December 14, 1989 with respect to their petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the years 1984 and 1985 (File No. 805550). Petitioners appeared by M. Catherine Baker, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Michael J. Glannon, Esq., of counsel).

Petitioners filed a brief in support of their exception. A brief amicus curiae was filed by Roberts and Holland (Carolyn Ichel, Esq., of counsel). The Division of Taxation submitted a letter in lieu of a brief. Oral argument was heard, at the request of petitioners, on May 15, 1990.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether petitioners, S corporation shareholders, are entitled to a resident tax credit against personal income tax for taxes paid to New Jersey and Connecticut by the S corporation.

FINDINGS OF FACT

We accept and repeat the facts as determined by the Administrative Law Judge. We also make certain additional findings of fact which are stated below.

Petitioners, William A. Baker, Jr., and Lucelle D. Baker, filed New York State resident income tax returns for the years 1984 and 1985 under the status married filing separately on one

return. Petitioners were shareholders in Baker-Firestone, Inc., a New York S corporation, and in each year, petitioners reported income from that corporation.

Baker-Firestone elected subchapter S status under the Internal Revenue Code and the Tax Law. The corporation did business in New Jersey and Connecticut; however, neither New Jersey nor Connecticut recognizes subchapter S treatment of foreign corporations. Thus, Baker-Firestone was required to and did file Connecticut corporation tax returns and New Jersey corporation business tax returns for each year under consideration here. The corporation reported total tax due to Connecticut of $77,111.00 for the year 1984 and $28,352.00 for the year 1985. It reported total tax due to New Jersey of $141,974.00 for the year 1984 and $88,221.00 for 1985.

Petitioners, as shareholders of an S corporation, elected to include their pro rata share of the corporation's tax items, in computing their New York resident personal income tax. In addition, each petitioner filed separate claims for resident tax credits, based upon taxes paid by Baker-Firestone to Connecticut and New Jersey, as follows:

	1984		1985	
	New Jersey	Connecticut	New Jersey	Connecticut
L. Baker	$ 1,809.00	$ 945.00	$ 1,323.00	$ 388.00
W. Baker	80,930.00	42,284.00	56,241.00	16,637.00

Petitioners included the following explanation with their returns: "A portion of the taxpayers [sic] income . . . was reported and taxed by the States of Connecticut and New Jersey, inasmuch as these States do not recognize S corporations, the taxpayers herein are taking a credit for their pro rata share of the taxes paid on the income taxed by these other authorities."

On January 28, 1987, the Division of Taxation ("Division") issued to petitioners a Statement of Audit Changes, entirely disallowing the resident tax credits for both years. The statement explained: "The resident credits claimed on your 1984 and 1985 New York State tax returns are not allowed since they were paid by the subchapter S corporations and not by you as individuals." As a result of this disallowance, petitioners' tax liabilities were recalculated and the following deficiencies were determined:

	1984	1985
L. Baker	$ 2,591.00	$ 1,711.00
W. Baker	115,812.00	70,387.00

Based on the calculations shown in the Statement of Audit Changes, the Division, on May 1, 1987, issued to William A. Baker, Jr., a Notice of Deficiency, asserting tax due for the years 1984 and 1985 of $186,199.00 plus interest and a Notice of Deficiency to Lucelle D. Baker, asserting tax due for the years 1984 and 1985 of $4,302.00 plus interest.

We make the following additional findings of fact.

As noted above, Baker-Firestone reported total tax due to Connecticut of $77,111.00 for 1984 and $28,352.00 for 1985. These amounts were calculated entirely on the basis of entire net income and did not include a component based on net capital.

Baker-Firestone also reported total tax due to New Jersey of $141,974.00 for 1984 and $88,221.00 for 1985. These amounts include both a net income component and a net worth component as follows:

	Total Tax	Net Income Component	Net Worth Component
1984	$141,974.00	$126,415.00	$15,559.00
1985	$ 88,221.00	$ 78,916.00	$ 9,305.00

On their 1984 and 1985 New York State tax returns, petitioners did not add back to Federal adjusted gross income their pro rata share of the S corporation's Federal deduction for the taxes paid in New Jersey and Connecticut in calculating their New York adjusted gross income.

OPINION

In the determination below, the Administrative Law Judge found that petitioners were not entitled to claim the resident tax credit against personal income tax for the taxes paid by Baker-Firestone in New Jersey and Connecticut. Specifically, the Administrative Law Judge characterized the Connecticut and New Jersey taxes as franchise taxes rather than income taxes and, as a result, found that such taxes were not creditable under Tax Law § 620(a). In reaching that conclusion, the Administrative Law Judge relied on two cases in which courts in New Jersey

and Connecticut characterized the taxes at issue as franchise taxes. The Administrative Law Judge further observed that since the taxes paid by Baker-Firestone were franchise rather than income taxes, the add back modification in Tax Law § 612(b)(3) was inapplicable and petitioners were, therefore, not required to add back to Federal adjusted gross income their pro rata share of the S corporation's Federal deduction for the taxes paid in New Jersey and Connecticut. Lastly, the Administrative Law Judge rejected petitioners' contention that the denial of the resident tax credit to petitioners resulted in double taxation of New York S corporation shareholders.

In reliance on an advisory opinion of the Commissioner of Taxation and Finance (see, TSB-A-89-[5]I), petitioners assert on exception that the Division has recognized the principle that shareholders of an S corporation may take credit for income taxes paid by their S corporation to another state. Petitioners further contend that the Administrative Law Judge erred in relying on the two state court decisions in characterizing the taxes at issue as franchise taxes and that proper characterization of the Connecticut and New Jersey taxes requires an examination of the practical operation of those taxes. Because the taxes involved have a net income base and operate practically as income taxes, petitioners maintain that those taxes are properly characterized as "income" taxes for the purposes of the Tax Law § 620(a) credit. Accordingly, petitioners maintain that they are entitled to claim the resident tax credit against their New York personal income tax for the taxes paid by Baker-Firestone in New Jersey and Connecticut.

The amicus brief filed in this matter supports and enlarges upon those arguments raised by petitioners. In addition, the amicus brief suggests that we should be guided by analogous Federal income tax authority relating to the foreign tax credit in interpreting the phrase "income" tax as used in Tax Law § 620(a).

The Division chose not to file a brief in response to the arguments raised by petitioners or to those contained in the amicus brief. Instead, the Division requests by letter that the determination of the Administrative Law Judge be sustained in its entirety.

We reverse the determination of the Administrative Law Judge.

Pursuant to Tax Law § 660(a), the shareholders of a corporation which is an S corporation for Federal income tax purposes and which is otherwise subject to tax under Article 9-A may elect to have the corporation treated as an S corporation for New York tax purposes. If such election is made, the S corporation is not subject to the Article 9-A tax and the corporation's items of income, loss and deduction flow through to the shareholders for New York income tax purposes (Tax Law §§ 660[a] and 209[8]).

Tax Law § 620(a) provides a credit against New York income tax to a resident for "any income tax imposed for the taxable year by another state . . . upon income both derived therefrom and subject to tax under [Article 22]" (emphasis added). The record in this matter discloses that Connecticut and New Jersey imposed taxes on income derived from the business conducted by Baker-Firestone in those two states. In addition, this same income was held subject to New York income tax under Article 22 for the taxable years 1984 and 1985. Accordingly, petitioners' entitlement to the resident tax credit for those years turns on whether the Connecticut and New Jersey taxes are "income" taxes within the meaning of Tax Law § 620(a).

Before turning to this characterization question, however, we must first address the threshold issue raised by petitioners: that is, whether an individual shareholder of an S corporation is entitled to claim the resident tax credit for income taxes paid in another state by a separate entity, i.e., by a corporation. In reliance on an advisory opinion of the Commissioner of Taxation and Finance, petitioners argue that the Division has recognized the general principle that shareholders of an S corporation are entitled to a credit for income taxes paid by their S corporation to another state (see, TSB-A-89-[5]I [wherein a resident shareholder was found to qualify for the Tax Law § 620 credit for net income taxes paid to North Carolina by an S corporation]; see, e.g., Matter of Smith v. New York State Tax Commn., 120 AD2d 907, 503 NYS2d 169 [where the resident beneficiary of a trust qualified for the resident tax credit for income taxes paid by the trust to the State of Massachusetts]). In addressing this issue at oral

argument, counsel for the Division agreed with petitioners and stated the Division's position on this issue is that an individual shareholder is entitled to the credit where the tax was paid by an Scorporation in another state, provided the tax imposed by the foreign jurisdiction was characterized as an income tax (oral argument transcript, pp. 13-15). Accordingly, we find that under New York law a resident shareholder of an S corporation is eligible for a resident tax credit for taxes paid by the corporation in another state, provided that such taxes are "income" taxes. We note that this conclusion is also consistent with the Internal Revenue Code which provides that shareholders of an S corporation are entitled to a foreign tax credit for their share of foreign income taxes paid by an S corporation (see, IRC §§ 901[b][5] and 1373[a]).

We now turn to the question of whether the New Jersey and Connecticut taxes paid by the S corporation in 1984 and 1985 may be characterized as "income" taxes within the meaning of Tax Law § 620(a). For the years in question, the Connecticut Corporation Business Tax (hereinafter CCBT) imposed a tax on companies carrying on, or authorized to carry on, business in the State at 11.5% of entire net income attributable to Connecticut (Conn. Gen. Stat. § 12-214). The CCBT also imposed an add-on tax in the amount of any excess of (i) 3.1 mills per dollar of net capital allocated to Connecticut over (ii) the amount of tax computed on the basis of entire net income (Conn. Gen. Stat. § 12-219). For the years at issue, the taxes paid by Baker-Firestone were calculated entirely on the basis of entire net income pursuant to § 12-214. The Connecticut tax paid by Baker-Firestone did not include a component based on net capital because the add-on tax did not apply.

The New Jersey Business Tax statute (hereinafter NJCBT) imposed a tax on "every domestic or foreign corporation . . . for the privilege of having or exercising its corporate franchise in this state, or for the privilege of doing business, employing or owning capital or property, or maintaining an office, in this state" (N.J. Rev. Stat. § 54:10A-2). The amount of the tax was calculated based upon: (i) 9% of entire net income allocable to New Jersey; plus (ii) a tax computed on entire net worth allocated to the state under one of two apportionment formulas

depending on which produces the greater tax (N.J. Rev. Stat. § 54:10A-5). The majority of the tax paid by Baker-Firestone in New Jersey for the years in question was calculated on the basis of 9% of the entire net income allocable to New Jersey; the remainder was calculated based upon net worth.

In analyzing the character of the New Jersey and Connecticut tax statutes, the Division asserted at oral argument that the Tribunal should be bound by the foreign state's characterization of its own taxes. The Division apparently agrees with the conclusion reached by the Administrative Law Judge below that the taxes at issue may be characterized as franchise taxes based solely upon two cases in which courts in New Jersey and Connecticut found that the taxes at issue were franchise taxes (see, Hoeganaes Corp. v. Director of Div. of Taxation of Dept. of Treasury of State of N.J., 145 NJ Super 352, 367 A2d 1182; Connecticut Bank & Trust Co. v. Tax Commr. of State of Conn., 178 Conn 243, 423 A2d 883). Our review of the full scope of the case law, however, indicates that courts will often construe the same tax differently depending upon the precise issue before the court.[1] From this, we conclude that we should not attempt, nor purport, to characterize the New Jersey and Connecticut taxes for all purposes but instead recognize that our inquiry is limited to whether these taxes are income taxes as that term is used in Tax Law § 620(a). Moreover, we conclude that this issue has not yet been decided because none of the cases cited by the parties deal with the precise issue before us, i.e., the characterization of the New Jersey and Connecticut taxes in the context of the Tax Law § 620(a) credit (or other comparable provision).

In characterizing the taxes for the limited purpose of the resident tax credit, we find that the label of the tax is not conclusive (see, People ex rel. Alpha Portland Cement Co. v. Knapp,

---

[1]By way of illustration, petitioners and amicus point to the following line of cases in New Jersey: (see, Roadway Express v. Director, Div. of Taxation, 50 NJ 471, 236 A2d 577, appeal dismissed 390 US 745 [NJCBT is a corporate income tax and is constitutional as applied to interstate business]; Silent Hoist & Crane Co. v. Director, Div. of Taxation, 100 NJ 1, 494 A2d 775, cert denied 474 US 995 [validity of franchise tax assessment under NJCBT against a New York corporation doing business in New Jersey upheld against a Due Process and Commerce Clause challenge]; Garfield Trust Co. v. Director, Div. of Taxtion, 102 NJ 420, 508 A2d 1104, appeal dismissed 479 US 925 [NJCBT is a franchise tax and not preempted by the federal public debt statute]).

230 NY 48, 129 NE 202, cert denied 256 US 702), but rather that the nature and practical effect of the tax is determinative (see, Matter of O'Neill, State Tax Commn., December 31, 1982, citing Bishop v. District of Columbia, 401 A2d 955, 958, cert denied 466 US 966). We adopt this approach, which requires examination of the substance and practical impact of the tax, because it furthers the legislative purpose behind the enactment of the resident tax credit, that is, to avoid double taxation on the same income (see, Matter of Smith v. New York State Tax Commn., supra, 503 NYS2d 169, 171 citing Memoranda of State Department of Taxation and Finance, 1962 NY Legis Ann, at 233). With this purpose in mind, we conclude that to the extent the instant taxes were imposed on an income base, the nature and effect of the taxes are "income" taxes within the meaning of the resident tax credit.

This approach to the characterization question is supported by analogous Federal authority. Turning to Federal authority for guidance on this question is not only indicated by the Tax Law (see, Tax Law § 607[a] [any term used in Article 22 "shall have the same meaning as when used in a comparable context in the (Internal Revenue Code) . . . unless a different meaning is clearly required"]), but is also consistent with the well settled policy of courts to administer local tax statutes in a manner consistent with parallel Federal tax laws wherever reasonable and practical (Matter of Marx v. Bragalini, 6 NY2d 322, 189 NYS2d 846, 854; cf., Matter of Codata Corp. v. Commr. of Taxation and Fin., __ AD2d ___ [3d Dept July 19, 1990]). Moreover, this approach to the characterization question has been embraced by the Department of Taxation and Finance in analyzing the phrase "income tax" for the purposes of Article 22 (see, TSB-M-84 [characterizing the New York State Corporate Franchise Tax and New York City General Corporation Tax as not within the Federal definition of "income taxes"]; TSB-M-85-[2]-I [characterizing the Connecticut Capital Gains, Dividends and Interest Tax as an "income tax" for New York personal income tax purposes]).

In turning to Federal law for guidance in determining what is an income tax for purposes of the resident tax credit, we find that the most relevant authority on point is provided by the

comparable provision in Federal income tax law, the foreign tax credit. Pursuant to Internal Revenue Code § 901(b)(1), a citizen of the United States is entitled to a credit for "the amount of any income, war profits, and excess profit taxes paid or accrued during the taxable year to any foreign country" (emphasis added). Like the resident tax credit provided under New York law, the primary objective of the foreign tax credit is to prevent double taxation on the same income (see, Texasgulf, Inc. v. United States, 17 Cl Ct 275, 89-1 USTC ¶ 9385, at 88,083; Inland Steel Co. v. United States, 677 F2d 72, 82-1 USTC ¶ 9301, at 83,742; Matter of Smith v. New York State Tax Commn., supra, 503 NYS2d 169, 171).

In determining whether a foreign tax is an income tax for purposes of the foreign tax credit, it is clear that the label of the tax is not determinative (Inland Steel Co. v. United States, supra, 82-1 USTC ¶ 9301, at 83,742; Bank of Am. Natl. Trust & Sav. Assn. v. United States, 459 F2d 513, 72-1 USTC ¶ 9418, at 84,460, cert denied 409 US 949). It is further well settled that a court is not bound by the classification of the tax in question by the imposing country (Biddle v. Commr., 302 US 573). A foreign tax qualifies as a creditable income tax if the tax is "the substantial equivalent of an income tax as that term is understood in the United States" (Texasgulf, Inc. v. United States, supra, 89-1 USTC ¶ 9385, at 88,083, quoting Inland Steel v. United States, supra; see, Treas. Reg. § 1.901-2[a][1][ii] [a foreign levy is an income tax if "the predominant character of that tax is that of an income tax in the U.S. sense"]). The predominant character of a tax is that of an income tax in the United States sense if it is likely to reach net gain in the normal circumstances in which the tax applies (Texasgulf, Inc. v. United States, supra, 89-1 USTC ¶ 9385, at 88,083; Inland Steel v. United States, supra, 82-1 USTC ¶ 9301, at 83,742; Bank of Am. Natl. Trust & Sav. Assn. v. United States, supra, 72-1 USTC ¶ 9418, at 84,459 and cases cited therein; see, Treas. Reg. § 1.901-2[a][3][i]). Where the foreign law imposes a tax that is the sum of two or more separately computed amounts (i.e., the New Jersey tax imposed here), then each component is tested to determine if it qualifies as an income tax (Treas. Reg. §§ 1.901-2[d][1], 1.901-2[d][3] example [1]; see, Rev. Rul. 74-82, Rev. Rul. 68-318).

Turning first to the CCBT, we find that it constitutes an income tax within the above Federal guidelines. As noted above, the tax imposed on Baker-Firestone by Connecticut General Statute § 12-214 was measured on entire net income, defined as net earnings received during the income year and computed by subtracting allowable deductions from gross income (see, Conn. Gen. Stat. § 12-213). Accordingly, where the CCBT tax is computed on the basis of realized net income and thus is designed to reach net gain, we find that it constitutes an income tax for purposes of the New York resident tax credit. As to the NJCBT, we find that the portion of NJCBT which was calculated based upon entire net income allocable to New Jersey, constitutes an income tax. However, that portion which was calculated based upon entire net worth bears no relation to the income or profits of the corporation and does not in our opinion constitute an income tax for purpose of the resident tax credit. We, therefore, conclude that the CCBT and that portion of the NJCBT based on net income paid by Baker-Firestone in 1984 and 1985 are income taxes for purposes of Tax Law § 620(a).

Given the conclusion reached above, consistency of treatment between Federal income tax and Tax Law §§ 620(a) and 612(b)(3) requires that the amount of taxes paid by Baker-Firestone in New Jersey and Connecticut be added back to arrive at New York adjusted gross income to the extent it was deducted in arriving at Federal adjusted gross income (see, Tax Law § 612[b][3]) before petitioners may claim a resident credit under Tax Law § 620(a).[2]

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioners, William A. Baker, Jr. and Lucelle D. Baker, is granted;
2. The determination of the Administrative Law Judge is reversed;
3. The petition of William A. Baker, Jr. and Lucelle D. Baker is granted; and
4. The Division of Taxation is directed to recalculate the notices of deficiency dated

[2]At oral argument, counsel for petitioners conceded that consistency of treatment between the Tax Law provisions required that these adjustments be made to petitioners' tax returns (oral argument transcript, pp. 6-7).

May 1, 1987 by: (a) crediting petitioners, under § 620(a) of the Tax Law, with their pro rata share of the total Connecticut Corporation Business Tax paid by Baker-Firestone in 1984 and 1985 and with their pro rata share of the New Jersey Business Tax paid based on the net income component in 1984 ($126,415.00) and 1985 ($78,916.00); and (b) adding such amounts to petitioners' Federal adjusted gross income as required by § 612(b)(3) of the Tax Law.

DATED: Troy, New York
October 11, 1990

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner

/s/Maria T. Jones
Maria T. Jones
Commissioner