STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
WILLIAM A. BAKER, JR. AND LUCELLE D. BAKER	:	DETERMINATION
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 a 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).

A hearing was held before Jean Corigliano, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on May 16, 1989 at 1:15 P.M., with all briefs to be submitted by September 8, 1989. Petitioners appeared by Donald B. Keelan, C.P.A. The Division of Taxation appeared by William F. Collins, Esq. (Michael J. Glannon, Esq., of counsel).

ISSUE

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

FINDINGS OF FACT

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 New Jersey	1985 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.

SUMMARY OF THE PARTIES' POSITIONS

The Division disallowed petitioners' claims for resident tax credits on the ground that the taxes upon which the credits were claimed were franchise taxes imposed upon and paid by Baker-Firestone, and, as such, they did not qualify for any credit against personal income tax provided for in the Tax Law. The Division contends that it was incumbent upon petitioners to cite a particular tax statute entitling them to the credits and that they were unable to do so.

Petitioners' claims for resident tax credits are premised on the following arguments:

(a) Petitioners argue that the taxes paid by Baker-Firestone to New Jersey and Connecticut were income taxes, rather than franchise taxes, and that, as such, they qualified for a credit against New York resident income tax.

(b) It is petitioners' position that where a Subchapter S election is made the corporate entity is ignored and the shareholders are taxed as though the corporation did not exist; thus the taxes paid by Baker-Firestone should be treated as though they were income taxes paid by petitioners to Connecticut and New Jersey. Petitioners note that as fiduciaries of the corporation they were personally liable for taxes due to New Jersey and Connecticut from the corporation. On that basis, they contend that they could have paid themselves an amount equal to the taxes due in New Jersey and Connecticut and then paid the taxes imposed on the corporation from their personal income; they maintain that had they done so the taxes paid would have qualified for the New York resident tax credit.

(c) Petitioners contend that the Division's denial of the resident tax credit is contrary to the purpose embedded in New York's recognition of the Subchapter S corporation, which they characterize as the elimination of double taxation on New York residents who are S corporation shareholders.

CONCLUSIONS OF LAW

A. Under Federal corporate income tax provisions, a corporation pays a tax on its taxable income, and its shareholders pay personal income tax on distributions from the corporation. However, subchapter S of chapter 1 of the Internal Revenue Code provides an alternative to this pattern of double taxation for certain small business corporations. For tax purposes, the qualifying S corporation is treated as a pass-through entity similar to a partnership, and items of income, loss, gain, deduction and credit pass through to the shareholders, who include the items in their personal income (IRC § 1366). Thus, the income of an S corporation, with some exceptions, is not taxed at the corporate level, but is taxed to its shareholders.

In 1981, the Tax Law was amended to conform New York corporation franchise tax and personal income tax to the Federal Subchapter S rules (L 1981, ch 103, eff May 15, 1981). A New York S corporation is not subject to the franchise tax imposed under article 9-A of the Tax Law (Tax Law § 209.8). If an election has been made to be treated as an S corporation for New York purposes, the shareholders must include in New York income the S corporation's items of income, loss and deduction to the extent reported for Federal income tax purposes (Tax Law § 660[a]). Although the New York income tax scheme is patterned after the Federal income tax, all items of income, loss and deduction are not treated identically for Federal and State purposes. Pursuant to Tax Law § 617(a), the S corporation pass-through items included in Federal adjusted gross income are modified in computing New York income in the same ways applicable to all such items whether or not derived from S corporations.

B. A tax credit, like a deduction from income, is a form of exemption from taxation. Accordingly, a taxpayer's claim for a credit against tax must rest upon applicable State Tax Law in effect for the year when the credit is claimed, and the burden of proving entitlement to a claimed credit is upon the taxpayer (see, Matter of Golden v. Tully, 88 AD2d 1058, 452 NYS2d 748, affd 58 NY2d 1047, 462 NYS2d 626). Petitioners admit that the Tax Law is silent as to the credit claimed by them. In other words, the Tax Law does not explicitly provide for a resident tax credit on the basis of taxes paid by a New York S corporation to another state. Petitioners nonetheless argue that the statutory scheme for taxation of S corporations provided for in article 22 provides the basis for their position.

C. Tax Law § 620 provides a credit against New York income tax to a resident for any income tax paid to another state, its political subdivision or the District of Columbia. The statute explicitly limits the credit to taxes paid on income derived from the other taxing jurisdiction and "subject to tax under [article 22]" (Tax Law § 620[a]). Petitioners argue that taxes paid by Baker-Firestone to New Jersey and Connecticut were income taxes, although the relevant state statutes refer to them as franchise taxes.[1] Petitioners cite Matter of Daniel J.

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[1]NJ Rev Stat § 54:10A-2 provides:

> "Every domestic or foreign corporation which is not hereinafter exempted shall pay an annual franchise tax...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."

O'Neill (State Tax Commission, December 31, 1982 [TSB-H-82(357)I]) for the general proposition that a business franchise tax computed on the basis of entire net income is an income tax for New York State purposes. The State Tax Commission determination does not support that conclusion. The Commission did find that the tax imposed by the District of Columbia on unincorporated professionals and personal service businesses was an income tax, although denominated a franchise tax. That finding was based on a decision of a District of Columbia court (see, Bishop v. District of Columbia, 401 A2d 955, affd on rehearing 411 A2d 997, cert denied 466 US 966). The court held that it is the nature and effect of a tax, not its label, which determines whether the tax is an income tax or not, and after some analysis of the history, nature and effect of the tax under consideration, the court declared it to be an income tax (Bishop v. District of Columbia, supra). In contrast, a New Jersey court held that New Jersey's corporation franchise tax is a tax for the privilege of conducting corporate business, employing or owning capital or

property, or maintaining an office in New Jersey and not a levy on the underlying assets or income (Hoeganaes Corp. v. Director of Division of Taxation of Dept. of Treasury, 145 NJ Super 352, 367 A2d 1182). Likewise, a Connecticut court held that Connecticut's business corporation tax is not a direct tax upon allocated income, but a tax for the privilege of exercising a corporate franchise in Connecticut (Connecticut Bank and Trust Co. v. Tax Commr., 178 Conn 243, 423 A2d 883). Based on the interpretations of the New Jersey and Connecticut courts, it is concluded that the taxes paid by Baker-Firestone were franchise taxes. This conclusion undermines petitioners' other arguments regarding the proper treatment of these taxes for purposes of calculating New York taxable income.

D. Petitioners argue that the New Jersey and Connecticut taxes paid by Baker-Firestone were taxes on income that flowed into their New York State resident income tax return. They further contend that under sections 617(b) and 620(a) of the Tax Law they are entitled to a credit against New York tax for taxes paid to another jurisdiction on any income includable in New York taxable income. Petitioners cite Matter of W. Mason Smith v. New York State Tax Commission (120 AD2d 907, 503 NYS2d 169) in support of their position. In that case, Mrs. Smith, a New York resident, received an accumulated distribution of $248,744.00 from a trust. Prior to making this distribution, the trust paid $24,902.00 in fiduciary income taxes to Massachusetts. On the Article 78 proceeding before the Supreme Court, Appellate Division, the parties agreed that Mrs. Smith was required to include the taxes paid to Massachusetts in her New York adjusted gross income. Petitioners contended that Mrs. Smith should have received a credit under Tax Law § 620(a) for the $24,902.00 which was paid by the trust as fiduciary income tax to Massachusetts. The court agreed with petitioners' position, rejecting the argument of the Division that since Massachusetts had imposed the tax upon the trust, not upon Mrs. Smith, Mrs. Smith had not paid any income tax to Massachusetts and was not entitled to the section 620(a) credit.

The court found that the purpose of Tax Law § 620(a) was to protect New York residents from being subjected to double taxation. It held that because Mrs. Smith had borne the burden

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Conn Gen Stat § 12-214 imposes upon a company:

> "carrying on, or having the right to carry on, business in this state...a tax or excise upon its franchise for the privilege of carrying on or doing business...within the state, such tax to be measured by the entire net income...received by such corporation or association from business transacted within the state during the income year...."

of the Massachusetts income tax she had "constructively paid 'income tax imposed for the taxable year by another state' and thus [was] entitled to a credit under Tax Law § 620(a)" (Matter of W. Mason Smith v. New York State Tax Commn., 120 AD2d 907, 503 NYS2d 169, 170, supra).

Petitioners analogize Mrs. Smith's situation to their own, arguing that because they were required to include income received from Baker-Firestone in New York income, they are entitled to a credit for taxes paid by Baker-Firestone to New Jersey and Connecticut. Several factors, however, distinguish Mrs. Smith's circumstances from petitioners' own. First, Mrs. Smith's income consisted of an accumulated distribution from a trust. "A trust is a right of property, real or personal, held by one person for the benefit of another" (61 NY Jur, Trusts, § 4). Thus, the income tax paid to Massachusetts was paid by the trust on behalf of and for the benefit of Mrs. Smith. Baker-Firestone did not have the same relationship to petitioners as the fiduciary trust had to Mrs. Smith. While petitioners may, as they argued, have some fiduciary duty to satisfy the tax liabilities of Baker-Firestone, the corporation did not hold property or pay tax on behalf of petitioners as would a trust. Second, the taxes paid to Massachusetts were income taxes, whereas the taxes paid by Baker-Firestone were franchise taxes. Mrs. Smith was required to include the taxes paid by the trust to Massachusetts in her New York income. Since Baker-Firestone paid franchise taxes, rather than income taxes, petitioners were not required to include in their New York income the taxes paid by Baker-Firestone (this will be explained in greater detail below). Because of these differences, the present case does not raise the same issues of double taxation that were present in the Smith case. A review of the relevant provisions of article 22 clarifies the correct treatment under the Tax Law of the franchise taxes paid to New Jersey and Connecticut.

E. Section 601 of the Tax Law imposes a tax on the New York taxable income of resident individuals. Tax Law § 611(a) defines New York taxable income of a resident individual as "his New York adjusted gross income less his New York deduction and New York personal exemptions." Tax Law § 612(a) states: "The New York adjusted gross income of a resident individual means his federal adjusted gross income" with modifications provided for in paragraphs (b), (c) and (d) of section 612. An S corporation shareholder's Federal adjusted gross income includes a pro rata share of the S corporation's income, loss, deduction or credit (IRC § 1366[a]). Pursuant to sections 164(a) and 212 of the Internal Revenue Code, Baker-Firestone was entitled to a deduction for franchise taxes paid to New Jersey and Connecticut. Thus, petitioners' Federal adjusted gross income, as reported on their State income tax returns, reflected the Federal deduction for the taxes paid.

Under Tax Law § 617(a) shareholders of a New York S corporation are required, in determining New York adjusted gross income, to make any modifications described in section 612(b),(c) or (d) or section 615(c) or 615(d)(2) or (3). Tax Law § 612(b)(3) contains a modification increasing Federal adjusted gross income for income taxes imposed by a state, local or foreign jurisdiction, to the extent those income taxes were deductible in determining federal adjusted gross income. Since the taxes paid by Baker-Firestone were franchise taxes, rather than income taxes, the section 612(b)(3) modification does not apply, and petitioners were not required to add to federal adjusted gross income their pro rata share of the S corporation's Federal deduction for franchise taxes paid to New Jersey and Connecticut. In sum, to calculate their New York adjusted gross income, petitioners began with Federal adjusted gross income. Their Federal adjusted gross income reflected the deduction taken for the franchise taxes paid to New Jersey and Connecticut. Because no modification was required under section 612(b)(3), petitioners' New York taxable income did not include the franchise taxes.

Petitioners' contention that denial of the resident tax credit results in double taxation of New York S corporation shareholders is untenable. The purpose of the S corporation election is

to avoid double taxation when the corporation pays tax on its taxable income and the shareholder pays personal income tax on its distributions from the corporation. By its New York S corporation election, Baker-Firestone avoided paying New York franchise tax under article 9-A. Any disadvantage to petitioners which may exist results from New Jersey's and Connecticut's non-recognition of the S corporation concept. Petitioners' claim, essentially on equitable grounds, that they should be permitted to claim a credit for taxes paid by a New York S corporation to states which do not recognize Federal S corporation tax treatment. This claim must be rejected absent an explicit statutory enactment permitting such a credit.

Petitioners have cited an Advisory Opinion of the Commissioner of Taxation and Finance (TSB-A-89-[5]I) holding that New York residents receiving income from a Federal S corporation not doing business in New York were entitled to the resident tax credit for income taxes paid by the corporation to North Carolina. In that opinion the Commissioner found that the tax paid to North Carolina was an income tax, subject to the section 612(b)(3) modification (i.e., the Federal deduction was properly added back to calculate New York taxable income), and the tax paid was thereby includable in the taxpayer's New York adjusted gross income. The result was an increase in New York income and a decrease in New York tax by the amount of the income tax paid to North Carolina. While Advisory Opinions have no precedential value, it is noted that the cited Opinion is not inconsistent with this determination.

Finally, petitioners cite Tax Law § 617(b) for the proposition that, for New York tax purposes, they were entitled to treat the taxes paid by Baker-Firestone as though they were income taxes paid by petitioners. Tax Law § 617(b) provides:

> "Character of items. Each item of...S corporation income, gain, loss, or deduction shall have the same character for a...shareholder under this article as for federal income tax purposes. Where an item is not characterized for federal income tax purposes, it shall have the same character for a...shareholder as if realized directly from the source from which realized by the...S corporation or incurred in the same manner as incurred by the...S corporation."

As stated above, the taxes paid by Baker-Firestone were franchise taxes. Baker-Firestone was entitled to deduct those taxes in computing its ordinary income for Federal income tax purposes (IRC § 164[a]). The character of those taxes did not change from franchise to income taxes by virtue of being treated as though they were taxes incurred directly by petitioners in accordance with section 617(b). Finally, petitioners' fiduciary duty to pay taxes owed by Baker-Firestone in no way affects the character or nature of the tax due.

F. The petition of William A. Baker, Jr. and Lucelle D. Baker is denied in all respects, and the notices of deficiency issued on May 1, 1987 are sustained.

DATED: Troy, New York
December 14, 1989

/s/ Jean Corigliano
ADMINISTRATIVE LAW JUDGE