

July 15, 2021

New York State Tax Update: Pass-Through Entity Tax

Ever since the enactment of the Tax Cuts and Jobs Act of 2017 (the “TCJA”), states have been exploring ways to help taxpayers cope with the Federal \$10,000 limitation on the deductibility of state and local taxes. Among others, New Jersey and Connecticut enacted new legislation for entity-level income taxes on pass-through entities that provided a Federal tax deduction and tax credit for any income taxes indirectly paid by their owners. Under Internal Revenue Service (“IRS”) Notice 2020-75, the current Federal \$10,000 limitation on state and local tax deductions should not apply to these taxes paid by a pass-through entity.

On April 19, 2021, New York State (“NYS”) followed suit when Governor Andrew Cuomo signed the 2021-2022 fiscal year budget which included a new elective income tax on pass-through entities (“PTE”). Similar to other states, the NYS PTE intends to be a tax-deductible expense of the pass-through entity that falls outside the Federal \$10,000 limitation on state and local tax deductions at the individual owner level.

Although many questions remain, we summarize the general provisions of the NYS PTE and highlight some unanswered questions below. The information in this alert is only intended to be a high-level summary and does not cover all aspects of the NYS PTE legislation.

Eligible Entities and Estimated Tax Payments

The PTE applies to a pass-through entity (i.e., a partnership, a limited liability company taxed as a partnership, or a New York S corporation) for tax years beginning on or after January 1, 2021. An eligible pass-through entity intending to pay the PTE must make an annual election by March 15th. For tax year 2021, the PTE election must be made by October 15, 2021. A PTE election is irrevocable for that tax year.

Estimated PTE payments are due in four equal installments on March 15th, June 15th, September 15th, and December 15th of the tax year for which the pass-through entity has elected to pay the PTE. For the 2021 tax year, estimated PTE payments are not due until March 15, 2022.

Individual owners of pass-through entities that elect into the PTE for tax year 2021 are not relieved of their obligation to pay timely estimated NYS personal income tax payments on their share of pass-through entity income during the tax year. Thus, for 2021, pass-through entity owners should consider the possibility of paying NYS income tax twice; once through 2021 estimated

personal income tax payments and again with a 2021 PTE tax return.¹ Additionally, pass-through entities that use the cash-method of accounting should make PTE payments by December 31, 2021 in order to obtain a possible deduction for the 2021 tax year.

PTE Tax Base and Tax Rates

The PTE is based upon income attributable only to partners/shareholders that are individuals, trusts, and estates. PTE taxable income for a partnership includes NYS-source income for its NYS non-resident partners and all income for its NYS resident partners. An S corporation includes only NYS-source income for both NYS resident and non-resident shareholders in its PTE tax base. Also worth noting is that under current law, partnerships and S corporations do not determine NYS-source income in the same manner.

The PTE tax rates imposed on an eligible pass-through entity range anywhere from 6.85% on PTE taxable income less than \$2 million up to 10.9% on PTE taxable income over \$25 million. The PTE tax rate used by the pass-through entity may differ from the personal income tax rate used on an individual's NYS personal income tax return.

Taxpayers need to be aware that certain questions about the PTE tax base and deduction mechanics still remain unanswered. First, it is uncertain how income allocated to a part-year NYS resident partner is treated under the PTE rules. Second, since partnerships currently include all income (i.e., investment income and business income) in the PTE tax base for NYS resident partners, it is unclear whether PTE payments with respect to the investment income will be deductible for individual owners.² Therefore, it is not currently known whether investment partnerships and investment holding pass-through entities would qualify under the PTE.

Individual Tax Credit

A dollar-for-dollar tax credit is available for direct partners and shareholders of an electing pass-through entity. If the credit exceeds the personal income tax due for the applicable tax year, the excess amount is treated as a refundable overpayment. Pass-through entities should review and consider whether the PTE is creditable against the resident state tax liability of the NYS non-resident partners and shareholders. The 2021-2022 fiscal year budget also provides that NYS resident individuals should be allowed a credit against their NYS personal income tax for "substantially similar" pass-through entity taxes imposed by other states.

Planning Amid Uncertainty

While the PTE should be favorable to most NYS taxpayers and is a welcome addition to the NYS tax law, careful consideration of all the facts and circumstances is advised before a pass-through

¹ The New York State Bar Association has proposed solutions to this double tax payment inequity in a letter dated May 24, 2021 to the Acting Commissioner of Taxation and Finance. As of the date of this writing, no solution has been enacted.

² Portfolio deductions (determined under Internal Revenue Code section 212) which are miscellaneous itemized deductions are not deductible for individual taxpayers for tax years 2018 through 2025.

entity makes a PTE election. A pass-through entity with multi-state operations, NYS nonresident partners or shareholders, and/or investment income may not achieve the intended benefit to individual owners. Additionally, changes to the amount of the Federal state and local tax deduction limitation or a repeal of the limitation may limit, or eliminate, the benefits of the PTE. Finally, non-tax considerations such as liability for the PTE and authority to elect to pay the PTE should be discussed by all parties involved.

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For more information and a discussion on how this may affect you individually and your business, please contact the FLSV professional with whom you work or any of the FLSV professionals listed below.

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