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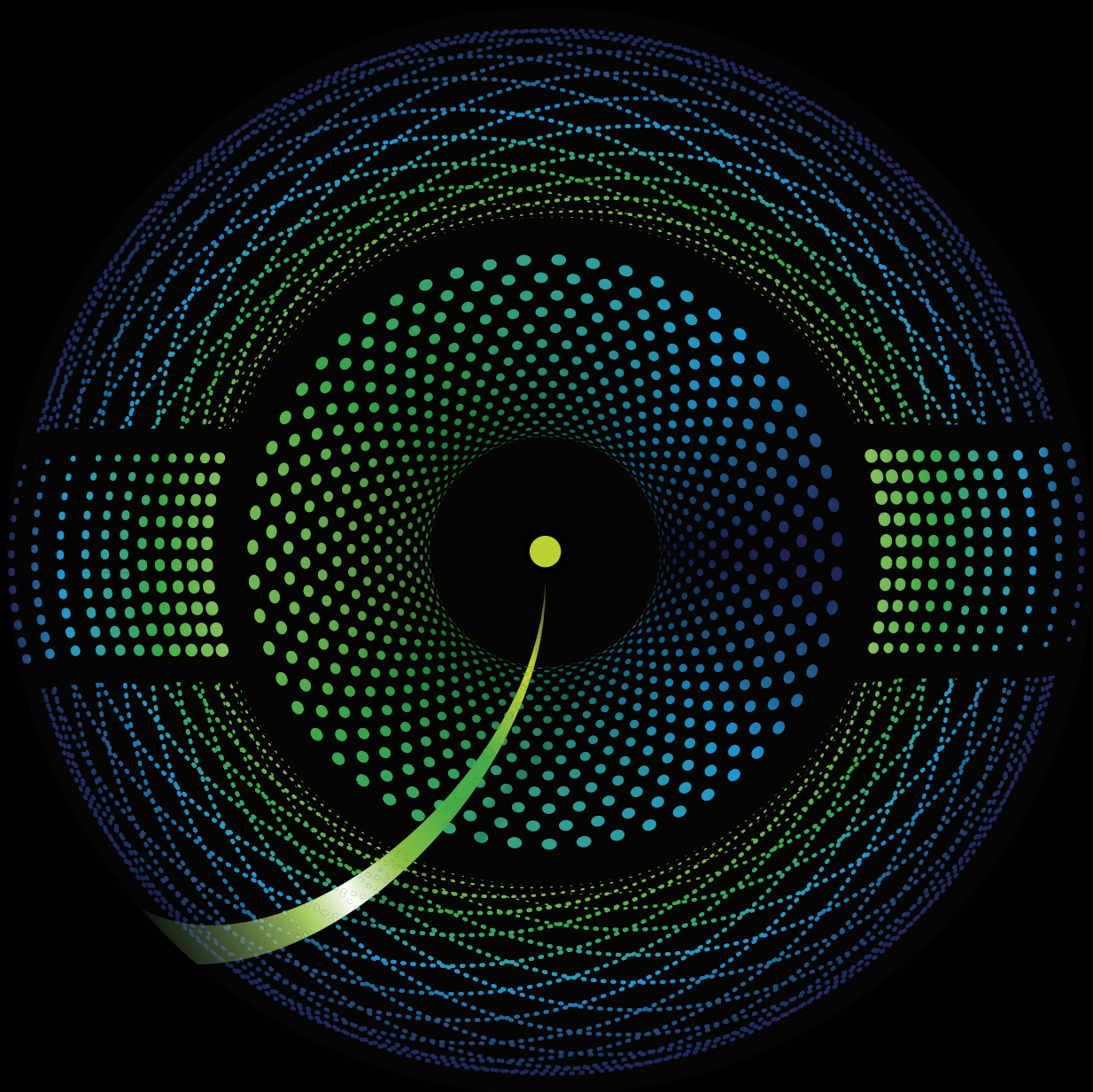

Buyer beware:

Considerations for New York's pass-through entity tax and related regimes

Introduction

In this article, we provide an overview of the origins of pass-through entity tax (PET) regimes and take a closer look at New York's recently enacted pass-through entity tax (NYPET) as updated by TSB-M-21(1)C, (1)I released on August 25, 2021. Through this lens, we will highlight considerations that should be made before electing into the NYPET. As with all things tax, it is important to consult with your adviser to appropriately plan and analyze the implications, if any, of electing into a new regime.

History of PET

The Internal Revenue Code (IRC) allows individual taxpayers who itemize their deductions to claim a federal income tax deduction for state and local taxes (SALT) paid.[1] Prior to the Tax Cuts and Jobs Act (P.L. 115-97) (TCJA), there was no limitation on the deduction, meaning taxpayers could deduct all their SALT payments paid during the calendar year to the extent of their federal taxable income.[2] TCJA limited an individual's aggregate deduction for tax years 2018 through 2025 (the SALT cap or SALT limitation).[3] As a result, SALT payments in excess of the SALT cap are not deductible on the federal income tax return, Form 1040, and thus provide no benefit to an affected taxpayer. Notably, the SALT limitation does not apply to real and personal property taxes paid or accrued in carrying on a trade or business or certain other activities relating to expenses for the production of income.[4]

Many states contemplated workarounds to the SALT cap to protect resident individuals from a potential increase in federal tax resulting from the limitation.

The most prevalent of these is the PET, which imposes a state and local income tax directly on the pass-through entity (PTE) as opposed to the partners, members, or shareholders.

On November 9, 2020, the IRS issued Notice 2020-75 (the Notice), in which the Department of the Treasury and the Internal Revenue Service announced an intention to issue proposed regulations to clarify that state and local income taxes imposed on and paid by a partnership or S corporation on its income are allowed as an entity-level deduction in computing non-separately stated taxable income or loss for the taxable year of payment.[5] The Notice adds that such payments made by a PTE to a state and local jurisdiction are generally not taken into account when applying the SALT limitation to any individual who is a partner, member, or shareholder of a pass-through entity, notwithstanding that the PET payments are creditable against the individual's state income taxes. The Notice prompted a wave of PET legislation across multiple states.

PET regimes

As of August 27, 2021, 19 states have enacted PET legislation.[6] While many of the state PETs target similar goals, each regime is unique, and the differences between them are often stark. These differences make the implications of electing into a PET dependent on the PTE's geographic footprint, income profile, and business needs, in addition to tax classifications, residencies, and activities of each of the PTE's partners, members, or shareholders. To better understand some of the moving pieces, let's take a closer look at New York's recently enacted PET as updated by TSB-M-21(1)C, (1)I.

New York's PET

The NYPET is effective for tax years beginning on or after January 1, 2021, for eligible entities that are required to file a New York return.[7] Entities opting to participate in the NYPET regime must make an annual election online, by March 15 of the tax year, at the same time that the first-quarter estimated payment is due.[8] The election to opt into the NYPET must be made by an authorized person on behalf of the eligible entity through the entity's Online Business Services account.[9] Once made, the NYPET election is irrevocable as to the tax year for which the election was made and is effective for all eligible partners.[10] For tax year 2021, the election is due on October 15, 2021.[11] As noted in Notice 2020-75, the PTE would need to pay its PET liability (or, in the case of accrual-basis PTEs, properly accrue the PET liability under the "recurring-item exception") during the calendar year the election is made for the PET to be deductible on the related federal tax return.[12] Starting December 15, 2021, PTEs can make payments online for the 2021 PET.[13]

The NYPET is imposed on income attributable to partners, members, or shareholders subject to tax under Article 22 (i.e., individuals, trusts, and estates).[14] PTEs with partners, members, or shareholders that are partnerships, tax-exempt entities, or corporations can still make an NYPET election. However, an electing partnership may not include in its PET income "any amounts of income, gain, loss, or deduction that flow through to a direct partner that is a partnership or an entity not subject to tax under Article 22, even if the income is ultimately taxable to a partner under Article 22 through tiered partnerships."[15] The NYPET taxable income base is only composed of the income from New York sources included in the taxable income of a nonresident partner plus all income included in the taxable income of a resident partner.[16] Members or partners may not be classified as part-year residents for NYPET purposes.[17] Instead, a member or partner will be treated as a New York resident if they were a resident of the state for at least half of the year in which the election applies.[18]

For S corporations, NYPET taxable income includes only income from New York sources for both resident and nonresident shareholders.[19]

Individual partners, members, or shareholders of electing pass-through entities are entitled to take a dollar-for-dollar credit against their New York personal income tax in the amount of the partner's direct share of NYPET paid by attaching Form IT-653, Pass-Through Entity Tax Credit, to their New York State personal income tax return.[20] The credit cannot be claimed on a Form IT-203-GR, *Group Return for Nonresident Partners*, or Form IT-203-S, *Group Return for Nonresident Shareholders of New York S Corporations*. Trusts that are direct partners, members, or shareholders in an electing entity (other than a trust that is disregarded for tax purposes) are permitted to take a NYPET credit on the trust's personal income tax return. The trust credit may not, however, be distributed to the trust's beneficiaries.[21] Partners of electing NYPET entities that are partnerships cannot claim an NYPET credit.[22]

Overpayments reflected at the individual level are either refunded or credited forward on the individual partner's personal income tax return, without interest.[23] An individual claiming a NYPET credit must add back the amount of the NYPET credit to their federal adjusted gross income in computing New York taxable income.[24]

For tax years beginning on or after January 1, 2021, New York residents can also claim a credit for entity-level taxes paid to other states that are "substantially similar" to the NYPET on account of income both derived from such other state and subject to tax under Article 22.[25] As of the date of this article, however, New York has not offered guidance on how "substantially similar" is to be interpreted, but the TSB-M indicates the Department will provide a list of substantially similar taxes on its website.[26] The resident partners must add back the other state's PET to their federal adjusted gross income in computing New York taxable income.[27]

For the 2021 tax year, an electing entity is not required to make NYPET estimated tax payments.[28] It may instead choose to make online estimated tax payments prior to December 31, 2021, using the online estimated tax application, which will be made available by December 15, 2021.[29] For tax years beginning on or after January 1, 2022, an electing entity will be required to pay estimated tax using New York's online application.[30] Quarterly estimated payments should equal at least 25% of the required annual payment for the taxable year.[31] The required annual payment is equal to the lesser of 90% of the PET required to be shown on the return of the electing entity for the taxable year, or 100% of the PET shown on the return of the electing entity for the preceding PET taxable year.[32]

If the electing entity's total PTE taxable income is zero or less, the eligible taxpayers are not entitled to any PET credits.[33] The electing entity may instead file an annual PET return to request a refund of any PET estimated tax payments it made.[34]

Issues and considerations

As with many new tax regimes, the NYPET is rife with issues that need to be analyzed and further clarified. The following are a few issues to consider in New York and discuss with your tax adviser before electing:

Group filing impact. For pass-through entities that have historically filed a group return in New York, TSB-M-21(1)C, (1) I states that the NYPET credit may not be taken on the group return. However, neither the statute nor the TSB-M comment specifically on how an overpayment from group estimated payments will be treated;[35] therefore, at the time of this writing, it is unknown whether the Department will need to consider whether to allow PTEs that make a PET election to transfer group return estimated tax payments to withholding payments for the partners or establish a mechanism for those payments to be refunded.

Nonresident issues. Putting aside filing mechanics, PTEs should also consider whether a partner, member, or shareholder that is not a resident of the state where the PET is being reported (whether electing in New York or other states) will be eligible to receive a resident tax credit for PET paid. If the partner's resident state does not allow a credit for another state's PET, the individual will effectively pay state tax twice on the income: once by the PTE (which is deducted from the partner's share of distributable income) and again by the individual partner, shareholder, or member to the resident state (to the extent the PET credit is disallowed in computing the resident's taxable income).

A state may decline to provide a resident tax credit for the PET because the PET is not imposed on the individual taxpayer, but instead, the PET is imposed on the partnership. The individual's New York tax liability is reduced by the PET credit. In many cases, the individual may not pay any New York tax because of the PET credit. If the partnership did not make the PET election, the individual taxpayer would have a New York tax liability that it could claim a credit for. However, if the partner's resident state only allows credits for taxes paid by the taxpayer and does not allow a credit for the individual's share of taxes imposed on the partnership, then the PET election results in the partner's income being subject to double tax.

To illustrate the importance of the resident tax credit in determining the impact of electing into a PET, let's consider an example with the NYPET. Assume we have an eligible partnership with two partners, each owning a 50% interest in the partnership. Both partners are New York nonresidents and live in states that have a tax rate equal to that of New York, but one is a resident of a state that provides a dollar-for-dollar credit for PET paid by the partnership (partner A), while the other is in a state that does not offer a credit for PET paid by a partnership (partner B). The partnership had $10 million of ordinary taxable income, $5 million of which is determined to be New York–sourced. The New York PET computation would be as follows:

Individual partners	Partner income allocation	PET tax base	NY PET
Partner A (credit) (50%)	5,000,000	2,500,000	213,250
Partner B (no credit) (50%)	5,000,000	2,500,000	213,250
NYPET tax base		**5,000,000**	
NYPET (@ 9.65%)			**426,500**

	States that DO allow residents to take a credit for PET (partner A)	States that DO NOT allow residents to take a credit for PET (partner B)
New York–sourced income	2,500,000	2,500,000
New York liability based on NY-sourced income	178,164	178,164
New York PET credit	213,250	213,250
Without NYPET election		
Net federal benefits	0	0
Credits for tax paid to other states	178,164	178,164
With NYPET election		
Net federal benefits	78,903	78,903
Credits for tax paid to other states	178,164	0
Net benefit (or loss) of electing PET	**78,903**	**(99,262)**

Partner A, being a resident of a state that allows a dollar-for-dollar credit for taxes paid at an entity level, will not be subject to double taxation on the partnership income, and will receive a federal benefit of $78,903 ($213,250 NYPET deduction multiplied by the top individual rate of 37%).

Partner B, being a resident of a state that ***does not*** allow a dollar-for-dollar credit for taxes paid at an entity level, will be subject to double taxation on the partnership income of $178,164. While partner B receives a $78,903 federal benefit, similarly to partner A, partner B is worse off by $99,262 ($178,164 detriment resulting from the resident tax credit denial, minus $78,903 federal benefit) because of the NYPET election. The above chart further details how the costs and benefits are computed for both partners.

This stresses how important it is to understand your partner base and the potential varying impact an election may have on one partner versus another. For partnerships with individual New York nonresident partners, it will be critical to analyze each partner's resident tax credit rules to determine whether electing into the NYPET would result in a net benefit or detriment for the individual partners. Partnerships should consult with their tax advisers in advance of making an election to quantify any impact and/or considerations.

Income or loss issue

Another PET consideration arises where one partner is in an income posture while the other is in losses. As enacted, the NYPET is based on the partnership's aggregated taxable income, and not the individual partner's, meaning the NYPET taxable base is calculated net of any losses. TSB-M-21(1)C, (1)I directs electing entities to compute each eligible taxpayer's profit and loss ownership percentage within that eligible taxpayer's PTE taxable income pool.

The inclusion of losses in the PET base lessens the NYPET due, and thus the corresponding credit and potential federal benefit for partners in income. Additionally, an individual income partner may be underpaid as a result of their NYPET income being reduced at the PTE level by the losses of other partners. This creates the potential that the NYPET credit that the individual income partner receives from the PTE will be less than the individual's New York personal income tax liability, as demonstrated in the following chart.

Partnership AB: New York PET filing	
Partner A New York PET income (or loss)	32,000,000
Partner B New York PET income (or loss)	(5,000,000)
Partnership AB New York PET base	27,000,000
Partnership AB New York PET liability	2,704,500

Partner A New York PET credit	2,704,500
Partner B New York PET credit	—
Partner A: New York resident filing	
Taxable income	32,000,000
New York personal income tax	3,242,414
PET credit	(2,704,500)
Balance due	**537,914**

As a result, the individual may be required to make additional payments and could possibly be subject to interest and penalties due to the reduced liability at the entity level.

A resident trust issue

As previously stated, the NYPET is applicable to all Article 22 taxpayers subject to personal income tax, including individuals, estates, and trusts. Electing into the NYPET may present an issue for New York exempt resident trusts that are partners in the electing partnerships and otherwise have no New York–sourced income.[36]

Despite their exemption from Article 22 taxation, as a "resident" partner, the trust's total distributable partnership income would be included in the NYPET taxable income base. The exempt resident trust's federal taxable income would be reduced by the amount of NYPET attributable to the trust and the trust would receive a corresponding NYPET credit. The New York exempt resident trust (assuming it still meets exempt status) would need to file in New York to report the NYPET credit and a corresponding overpayment equal to the amount of NYPET credit. Under the tax benefit rule, this would generally result in the New York exempt resident trust reporting federal taxable income equal to the amount of New York overpayment (as it relates to the New York PET credit). This could result in cash flow disruptions and potentially additional tax if federal income tax rates were to increase on a year-over-year basis. These issues could be exacerbated if the trust distributes 100% of its income to its beneficiaries.

Partnerships with New York exempt resident trusts anticipating making a NYPET election should analyze the potential implications of the PET for various partner fact patterns and consider structuring alternatives that provide partners with differing interests the ability to maximize benefits or minimize detriments of the PTE making the election.

Takeaways

These are just a few examples of the many items that need to be evaluated when considering whether or not to elect into the New York or other PET regimes. An election into a PET regime that benefits one partner, member, or shareholder may be detrimental to another. It is recommended that a careful analysis be undertaken before electing into any PET regime.

Endnotes

1. See generally IRC § 164(a).
2. Note, however, that the deduction will not be considered for purposes of determining an individual's alternative minimum tax unless the SALT deduction is allowable in computing adjusted gross income under IRC § 62. See IRC § 56(b)(1)(A)(ii).
3. IRC § 164(b)(B) ("the aggregate amount of taxes taken into account … for any taxable year shall not exceed $10,000 ($5,000 in the case of a married individual filing a separate return").
4. IRC § 164(b)(6)(B) (referring to taxes described in IRC § 164(a)(1) (real property taxes) and (a)(2) (personal property taxes)).
5. IRS Notice 2020-75, 2020-49 IRB 1453.
6. These include Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Georgia, Idaho, Illinois, Louisiana, Maryland, Minnesota, New Jersey, New York, Oklahoma, Oregon, Rhode Island, South Carolina, and Wisconsin. As of the same date, Massachusetts, Michigan, North Carolina, and Pennsylvania have proposed PET legislation. This is in addition to jurisdictions that already impose entity-level taxes, such as the District of Columbia, New Hampshire, New York City, Tennessee, and Texas.
7. New York Tax Law § 861; New York Tax Law § 860. Eligible entities generally include partnerships, limited liability companies treated as partnerships for federal income tax purposes, and New York S corporations (including limited liability companies treated as S corporations for federal income tax purposes that make the New York S corporation election). Entities may be required to file in New York when doing business in New York or having a resident partner within the state.
8. New York Tax Law § 861(c); TSB-M-21(1)C, (1)I.
9. Ibid.
10. Ibid.
11. New York Tax Law § 861(c).
12. 26 CFR § 1.461-5(b)(3).
13. TSB-M-21(1)C, (1)I.
14. New York Tax Law § 860(h).
15. TSB-M-21(1)C, (1)I.
16. New York Tax Law § 860(h)(1).
17. TSB-M-21(1)C, (1)I.
18. Ibid.
19. New York Tax Law § 860(h)(2).
20. New York Tax Law § 863; TSB-M-21(1)C, (1)I (noting that an electing partnership must take into account special allocations when computing the credits available to both resident and nonresident partners or members).
21. TSB-M-21(1)C, (1)I.
22. Ibid.
23. New York Tax Law § 620(b).
24. New York Tax Law § 860(g).
25. New York Tax Law § 620(b).
26. TSB-M-21(1)C, (1)I and New York Tax Law § 620(c).
27. TSB-M-21(1)C, (1)I.
28. Ibid.
29. Ibid.
30. Ibid.
31. Ibid.
32. Ibid.
33. Ibid.
34. Ibid.
35. PET estimated payments made on the composite return may push the group into an overpayment.
36. Pursuant to New York Tax Law § 605(b)(3)(D), a New York resident trust will be exempt from tax under Article 22 where all trustees are domiciled in a state other than New York; the entire corpus of the trusts, including real and tangible property, is located outside the state of New York; and all income and gains of the trust are derived from or connected with sources outside of the state of New York, determined as if the trust were a nonresident trust. See also *Mercantile-Safe Deposit and Trust Company v. Murphy*, 19 AD2d 765, aff'd. 15 NY2d 579 (July 30, 1963).

    Because S corporations are only subject to NYPET on New York–sourced income, and New York–sourced income will disqualify an exempt resident trust from exempt status, there would not be a NYPET electing S corporation with exempt resident trust members.

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