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Legal Update

It's Personal: Planning for New York's Pass-Through Entity Tax

New York taxpayers generally do not greet new taxes with enthusiasm, but New York's new pass-through entity tax ("PET") is poised to provide some relief to rising personal tax rates and an exception to this rule. As we discussed in a December 2020 Legal Update, New York and other US states have been exploring ways to help their residents manage the federal $10,000 limitation on state and local tax deductions. Connecticut and New Jersey enacted new entity-level taxes on pass-through entities that effectively create a deductible and creditable business income tax for their residents and business owners, and New York State (the "State") has now followed suit. The PET is retroactive to January 1, 2021, and can be very effective for residents and nonresidents alike.[1] Under IRS Notice 2020-75, the current $10,000 limitation on state and local tax deductions would not apply to tax that the entity pays, which means the PET may be a deductible expense of the partnership that flows through to its owners without the same limitation that would apply to them individually. The availability of a personal income tax credit does not affect this deduction under current guidance. The PET therefore looks like a "win-win" for the State, as it has the potential to pass through a federal tax deduction that more than offsets the cost of Personal Income Tax ("PIT") increases[2] in the 2021-2022 State budget (A3009C/S2509C).[3] To take advantage, many taxpayers will want to form their own personal partnerships.

Basic PET Mechanics

The PET may apply to partnerships or S-corporations, but, as explained below, partnerships will generally be preferable. Here's how the PET works for partnerships:[4]

- Any entity that is a partnership for federal income tax purposes, by election or otherwise, may annually elect into the PET by March 15—this includes limited partnerships, limited liability companies, and limited liability partnerships, among others;
- The entity pays PET on the income that will be taxable to its direct resident and nonresident individual or trust owners ("pass-through owners") under the PIT—that is the sum of NY source income allocated to nonresident pass-through owners and all income allocated to resident pass-through owners;
- The PET does not apply to income allocated to corporate or partnership partners;
- The tax rates are graduated and depend on the entity's taxable income for the year;

- The pass-through owners claim PIT credits for the PET that the entity pays with respect to their shares of partnership income, as well as similar tax paid by the entity to other states; and
- The entity—under current IRS guidance—claims a deduction for the PET in determining the non-separately stated income that flows through to its owners for federal income tax purposes. (That deduction is, however, added back to income for PIT purposes to prevent a double benefit.)

The New York PET has been years in the making.[5] Over that time, it has evolved into a form that is flexible and potentially effective at managing the net effect of State tax liabilities. This particular structure is a change from prior State proposals because, among other things, the tax is electable, the credit fully offset the PET and may be allowed for pass-through tax paid to other states, and the base is specifically linked to the PIT, which allows resident pass-through owners to get the benefit of PET on income from investments, including income from a carried interest, and income sourced to other states.[6] NYC should build on this framework and adopt an elective surcharge for the income allocable to NYC residents, and then provide its residents with a credit.

Example

Your Real Estate, LLC, owns an office building in Philadelphia and another office building in NYC, through separate disregarded entities. It has three partners—individual A (NY nonresident), individual B (NY resident), and C Corp. A and B each receive 25% allocations of profit, loss, deduction and credit, and C Corp. receives a 50% allocation of the same, other than the PET expense, which is allocated to each partner in proportion to that partner's share of income subject to tax. Your Real Estate, LLC, elects to pay PET, and, in 2022, recognizes $10 million of rental income from the Philly property, $10 million of rental income from the NYC property, and a $100 million gain from a sale of the NYC property. Your Real Estate, LLC, would determine its PET as follows:

Member	Income Allocation	Art. 22 Income	PET
A	$30,000,000.00	$27,500,000.00	$2,997,500.00
B	$30,000,000.00	$30,000,000.00	$3,270,000.00
Corp C.	$60,000,000.00	$0.00	$0.00
PET taxable income		$57,500,000.00	
PET rate		10.90%	
Total PET			*$6,267,500.00*
Fed. tax savings, Assuming a 40% tax rate			*$2,507,000.00*

Under this example, for New York PIT purposes, A and B would be eligible for PET credits equal to the amount of PET attributable to their shares of PET taxable income. Those credits would be applied against A and B's New York PIT liability, which would be determined without any deduction for the PET expense. Any credits in excess of PIT liability would then be refundable (without interest).[7] A's PIT income is smaller than B's because A would allocate $2,500,000 in rental income to Pennsylvania (i.e., outside New York) but B would include all income from all sources under the PIT.

For federal income tax purposes, Your Real Estate, LLC, would presumably allocate the PET expense to Ms. A and Mr. B based on their shares of the PET expense and adjust capital accounts accordingly. PET deductions of $2,997,500 and $3,270,000 would flow through to Ms. A and Mr. B, respectively, through each member's distributive share of non-separately stated income or loss, which would be reflected on their Form K-1s.

Note that we have chosen income from real estate, and omitted any other expenses or deductions, to simplify this example. In particular, income from a multistate services business would require determining the NY source income for Ms. A pursuant to a more complex three-factor apportionment formula composed of property, payroll and sales.

S Corporations

As mentioned above, PET is also available for New York "S" corporations,[8] but the taxable income of an S corporation is calculated differently for this purpose—it only includes income sourced to NY customers. That means, under current law, the S corporation would potentially have a much smaller tax base than its resident owners, and the owners' PET benefit would be constrained by the S corporation's sourcing and customer base.[9] By way of example, a resident pass-through owner of an S corporation that earns 10% of its income from NY sources would pay PIT on 100% of his or her income from the corporation, but the corporation would only pay PET on 10% of its income. As a result, while a New York S corporation may allow taxpayers to take advantage of the SALT workaround, its resident shareholders may not get the benefit of a PET deduction on all of the income they report for PIT purposes.

Maximizing the PET

The owners of a business may have different needs, based on their own geographies and profiles, and electing to pay the PET may not work for all of them at the same time. For example, under current state rules, an asset manager with California partners would likely prefer that its New York pass-through owners form their own personal holding companies, or New York resident holding companies, to receive their shares of fees and carried interest income. This is because the California pass-through owners cannot claim a state income tax credit for PET under current California law, and the PET would represent a net tax increase—in effect double state tax on their New York source income.

The key to unlocking the PET in these circumstances is electability, and it will often work best if each pass-through owner of a business forms his or her own partnership (or S corporation) to elect to pay the PET and claim the corresponding credit.

By allowing New York residents to separately plan for the PET, multi-state businesses avoid potential trade-offs between New York and non-New York pass-through owners. Under this approach, each pass-through owner would form a separate personal partnership to align the tax base and rate with his or her share of the underlying entity's income. For New Jersey residents, a personal partnership, or resident-only partnership, may be the only path to achieving a SALT deduction for the full income they report on their New Jersey returns.[10] This approach also avoids involving the other owners and the larger entity in the risks and compliance associated with his or her planning. Risks include a change in IRS policy. After all, it is possible the IRS could reverse its position in Notice 2020-75, which confirms that the current $10,000 limitation on state and local tax deductions does not apply to tax that an entity pays, and assert partnership-level assessments under the new partnership audit regime, and that is an outcome some non-New York or non-pass-through owners may want to avoid.

Allowing New York residents to form resident-only partnerships may also work and provide some pass-through owners with an arbitrage opportunity—if the PET rate exceeds a partner's PIT rate, the excess credit may be applied against income from other sources.

In the event a partnership ultimately includes New York resident and nonresident pass-through owners, it would want to specially allocate any PET expense to the partners based on their shares of income subject to the PET. These allocations would be necessary to match the PET expense with the pass-through owners' shares of the income subject to tax, and credit claimed, at the PIT level. These allocations would need to observe Subchapter K requirements, including the rules governing substantial economic effect.

Descriptions of Additional Relevant Mechanics

- **Eligible Entities:** All entities taxed as partnerships for federal income tax purposes (other than publicly traded partnerships) that have NY source income or a resident partner are eligible to elect to pay the PET. New York S corporations (i.e., federal S corporations that have elected New York S corporation status) that are subject to NY Corporate Franchise Tax are also eligible.[11]
- **Election Timing:** The election to pay the PET must be made annually by the due date of the first estimated payment of tax (March 15), and by October 15, 2021, for the 2021 tax year. Once an election is made for any particular year, it is irrevocable for that year.[12]
- **PET Rates:**[13]
    - 6.85% for electing entities with taxable income of $2 million or less;
    - 9.65% for electing entities with taxable income over $2 million but not over $5 million;
    - 10.3% for electing entities with taxable income over $5 million but not over $25 million; and
    - 10.9% for electing entities with taxable income over $25 million.
- **Liability:** Electing partnerships and S-corporations are directly liable for the PET. In addition, any taxpayer eligible to claim a credit pursuant to the PET is severally liable for his or her share of PET to the extent not paid by the corresponding electing partnership or S-corporation. Furthermore, certain "controlling partners"[14] have joint and several liability for any unpaid PET.[15]
- **PET Credit:** The credit is allowed only to direct pass-through owners. The credit is equal to the amount of PET calculated on the income that is taxable to the pass-through owner under the PIT. An individual may aggregate credits from multiple pass-through entities. If the individual's aggregate credit exceeds his or her PIT liability, the excess may be considered an overpayment to be credited or refunded without interest. The aggregate credits for income from any electing entity cannot exceed the entity's PET liability.[16]

- **Out-of-State Credit:** Resident pass-through owners may claim a PIT credit for any similar pass-through taxes imposed on the income of a partnership or S-corporation of which the resident is a pass-through owner, provided such taxes are substantially similar to the PET.[17] This credit is limited to the tax due in NY and is not refundable. Currently, there is no guidance from the State as to which pass-through taxes it will consider sufficiently similar.[18]
- **Reporting Requirements:** No PET credit shall be allowed to a taxpayer unless the electing entity provides sufficient information to identify the taxpayer on its PET tax return.[19] Generally, the information that is required to be included on the return of an electing entity includes the tax due, identifying information of each pass-through owner, the assumed residency status for each pass-through owner, and each pass-through owner's share of PET.[20] Special requirements apply to pass-through owners that are disregarded entities that roll up into PIT filers.[21]
- **Estimated Tax Installments:** An electing pass-through entity must make four estimated payments of tax on March 15, June 15, September 15, and December 15. Each installment must be 25% of the required annual payment, which is the lesser of 90% of the tax shown on the return for the taxable year or 100% of the tax shown on the return of the electing entity for the preceding year. No estimated PET payments are due for 2021, but PIT estimated tax payments are due without regard to any PET elections for 2021.[22] Estimated tax penalties will be calculated as if a PIT credit for PET does not apply.
- **Amended Returns:** Amended returns may only be filed with the consent of the Commissioner.[23]

Further Observations

- Partnerships are generally more efficient than S corporations due to NYC tax regimes applicable to partnerships and S corporations. Partnerships pay a 4% Unincorporated Business Tax ("UBT") while S corporations pay an 8.85% General Corporation Tax ("GCT"). In addition to a higher rate, the GCT also has a broader base and applies to income from investments in stocks, bonds, securities and real estate that might otherwise be exempt under the UBT. While S corporations may achieve some self-employment tax benefits that are not available to members of LLCs or partners of LLPs, those benefits may not make up for the additional NYC tax.
- As indicated above, the PET rate may differ from an owner's PIT rate. This may occur more often for entities that do not adopt a personal partnership approach. It should not be a disadvantage because the PET is refundable; it may even be an advantage to the extent it generates excess credit that can be applied to income from other sources.
- Limited partnerships may also achieve self-employment tax benefits, but they may not be feasible for all professional services firms.
- Investment income and active business income should be recognized through separate partnerships that do not converge in a common holding company, in order to ensure NYC does not assert UBT on the investment income.
- For highly paid individuals that are compensated as employees, such as portfolio managers at banks or other financial services firms, interposing a partnership may raise employment,

insurance, self-employment tax and deferred income issues, and will require the input of employment specialists.

- Tax year 2021 PET presents a potential cash crunch—the State will effectively collect double tax on the entity's income before issuing a PIT refund to the pass-through owners. The entity would pay PET with its return and the owners would claim a credit and refund on their personal income tax returns; however, NY will have collected individual estimated tax from the pass-through owners in the meantime, which means they pay an extra level of tax out of pocket.
- Some aspects are unclear: for example, how will the State handle federal changes to income that arise from partnership audits? Do credits for out-of-state tax apply before applying credits for PET, in determining refundability? Will pass-through tax paid to NJ, CT and MD qualify for a PIT credit under the provision for similar taxes paid to other states? Will NYC join the State?

Additional Tax Items in the Budget

The budget sets a temporary top PIT rate of 10.9%;[24] increases the corporate tax rate from 6.5% to 7.25%[25] for corporations that have business income in excess of $5 million; adds-back gains that are excluded from federal gross income under the Qualified Opportunity Zone regime; extends the sales tax exemption for certain entities covered by the Dodd Frank Wall Street Reform and Consumer Protection Act; increases the gross receipts threshold for sales tax registration to $500k; excludes publicly traded entities, REITs, UPREITs and mutual funds from the beneficial owner disclosure requirements that apply to certain real estate transactions involving LLCs;[26] legalizes mobile sports gambling; and offers and extends numerous tax credits. Notable omissions include a new levy on mezzanine debt and a revival of the stock transaction tax.

Conclusion

Overall, and when compared to the originally proposed unincorporated business tax, the PET has the potential to provide a substantial benefit to State residents and nonresidents. The PET election will not be appropriate for all pass-through entities, however. The State understood that reality and therefore made the tax electable. New York businesses should take advantage of that electability and be open to re-organizing in ways that allow them to avoid making tough choices between the needs of resident and nonresident pass-through owners. The PET is designed to be personal.

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Endnotes

[1] On December 16, 2020, State Assembly Member Amy Paulin and State Senator James Skoufis submitted a bill to the State Legislature that would have created a statewide unincorporated business tax ("UBT"), which was never enacted. See our Legal Update on the December 2020 proposal for more information.

[2] From 2021 to 2027, the following additional rate brackets apply: (a) 9.65% for income over (i) $2,155,350 but not over $5 million, for married individuals filing jointly; (ii) $1,646,450 but not over $5 million, for resident heads of household; and (iii) $1,077,050 but not over $5 million, for unmarried individuals, married individuals filing separately, estates, and trusts; (b) 10.3% for income over $5 million but not over $25 million; and (c) 10.9% for income over $25 million. *See* N.Y. Tax Law § 601(a)(1)(B), (b)(1)(B), (c)(1)(B).

[3] The IRS recently blessed this approach by state legislatures in IRS Notice 2020-75, (11/09/2020).

[4] *See* N.Y. Tax Law §§ 860-863.

[5] The PET follows the failed UBT bill that in turn resuscitated a proposal that the governor's office and the State Department of Taxation and Finance prepared in 2018, as part of the State's initial response to the TCJA.

[6] N.Y. Tax Law § 860(h)(1).

[7] N.Y. Tax Law § 863; § 606(kkk).

[8] These are federal "S" corporations that elect similar New York status under Tax Law § 208(1-A).

[9] N.Y. Tax Law § 860(h)(2).

[10] The current design of New Jersey's pass-through entity tax suggests that the tax applies to New Jersey source income if the partnership has resident and nonresident partners but to all of the partnership's income if it only has resident partners.

[11] N.Y. Tax Law § 860(a), (b).

[12] N.Y. Tax Law § 861.

[13] N.Y. Tax Law § 862.

[14] Generally, any taxpayer eligible to claim a PET credit and that is a general, managing or controlling partner of the electing partnership or managing or controlling shareholder of the electing S corporation, owns greater than 50% of the interests or profits of the electing partnership or electing S corporation, is under a duty to act for the electing partnership or S corporation in complying with these provisions, or was the individual that made the election on behalf of the electing partnership or electing S corporation. *See* N.Y. Tax Law § 866(c)(3).

[15] N.Y. Tax Law § 866(c)(1)-(3).

[16] N.Y. Tax Law § 863; § 606(kkk).

[17] N.Y. Tax Law § 620(b).

[18] N.Y. Tax Law § 620(c).

[19] N.Y. Tax Law § 865(c)(2); § 606(kkk)(5).

[20] N.Y. Tax Law § 865(c), (d).

[21] N.Y. Tax Law § 865(e).

[22] N.Y. Tax Law § 864(b).

[23] N.Y. Tax Law § 865(f)(2).

[24] The new temporary rate brackets are discussed in Footnote 3.

[25] See Article 9A of the N.Y. Tax Law.

[26] *See* N.Y. Tax Law § 1409(a).