

# The Nuts and Bolts of NYC's New Passthrough Entity Tax

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In this installment of Noonan's Notes, Noonan and Banks offer background on New York City's new passthrough entity tax and answer potential questions regarding its mechanics.

Another legislative session and another new passthrough entity (PTE) tax bring another nuts-and-bolts article on the topic. A few years ago, we covered the first-of-its-kind PTE tax in Connecticut.<sup>1</sup> Last year, we did the same after New York enacted a similar tax.<sup>2</sup> And in April, New York's budget legislation created a new entity tax for New York City, so we won't disappoint our loyal followers: Here, we answer your questions on the mechanics of the city's PTE tax.

<sup>1</sup>Timothy P. Noonan and Elizabeth Pascal, "The Nuts and Bolts of Connecticut's New Passthrough Entity Tax," *State Tax Notes*, Nov. 12, 2018, p. 601.

<sup>2</sup>Noonan, Pascal, and Christopher L. Doyle, "The Nuts and Bolts of New York's New Passthrough Entity Tax," *Tax Notes State*, June 7, 2021, p. 997.

### NYC PTE Tax

Before the Q&A, some basic background is in order. As readers know, dozens of states have put PTE tax regimes in place as a workaround to the federal Tax Cuts and Jobs Act's \$10,000 state and local tax deduction cap that took effect in 2018.<sup>3</sup> The idea is that instead of having the PTE owners pay the state-level tax on income that flows through to them, the PTE pays the tax at the entity level. The PTE can deduct the tax (since the SALT cap does not apply at the entity level), thus reducing the amount of income that flows through to the owners. And that's the point: to reduce the PTE owner's flow-through income, and thereby reduce the owner's federal tax liability. The owner then gets a corresponding state tax credit for the entity's PTE payment that offsets their state tax liability, and everyone is happy. The owner's state taxes stay more or less the same, yet they still get the economic benefit of a SALT deduction at the federal level.

But this new PTE tax is the first workaround targeting a local tax. And it makes a lot of sense, since the loss of the SALT deduction for NYC residents was especially painful; at almost 4 percent, the local tax on NYC residents is high. Also interesting is that a PTE already pays a NYC tax on its income: Partnerships pay the unincorporated business tax (UBT), and S corporations pay the general corporation tax (GCT). Those taxes remained deductible by the entity at the federal level even after the SALT cap took effect, but for the entities' owners there is no credit mechanism for GCT paid, and only a limited credit mechanism for UBT paid. Of course, as we will outline, there will be such a credit mechanism for the city's PTE tax, but there

<sup>3</sup>Steven N.J. Wlodychak, "They're All Different and That's the Problem: State PTEs," *Tax Notes State*, Aug. 2, 2021, p. 455.

remains an oddity with these entities having to pay two separate taxes to NYC under this new regime.

### The Basics

**Question:** What is the New York City PTE tax?

**Answer:** New York's fiscal 2023 budget legislation enacted a new elective tax applicable to PTEs (partnerships, limited liability companies, and S corporations) as a workaround to the SALT cap that applies to individuals. The city's PTE tax is not to be confused with the New York state PTE tax, which first applied in 2021.<sup>4</sup>

**Question:** When does the PTE tax take effect?

**Answer:** The PTE tax is effective for tax years beginning on or after January 1, 2023.

**Question:** Is the PTE tax mandatory?

**Answer:** No. Eligible PTEs must elect to pay the tax at the entity level.

### The NYC PTE Tax Election

**Question:** When must the PTE tax election be made?

**Answer:** By March 15 of the applicable tax year, when the first estimated payment is due.

**Question:** Can my partnership elect into the city's PTE tax if it has not elected into the state PTE tax?

**Answer:** No. To be eligible to make the city's PTE tax election, a partnership must also make the annual election to be taxed under the state PTE tax.

**Question:** Can my partnership that has both NYC resident and nonresident partners elect into the city's PTE tax if it has elected into the state PTE tax?

**Answer:** Yes. Per below, the tax would only be computed on amounts flowing through to the resident partners.

**Question:** Can my S corporation that has both NYC resident and nonresident shareholders elect into the city's PTE tax if it has elected into the state PTE tax?

**Answer:** No. The city's PTE tax is limited to S corporations that have only NYC resident shareholders and that have made the annual

election to be taxed under the state PTE tax. An S corporation with any nonresident shareholders cannot make the NYC PTE tax election even though it can make a state PTE tax election. We understand this limitation exists because the State Department of Taxation and Finance believed that — for federal tax purposes — treating resident and nonresident shareholders of the same S corporation differently could violate the federal requirement that S corporations must have only one class of stock. Of course residents and nonresidents are always taxed on different bases (and in NYC nonresidents are not subject to tax at all), so the solution to the perceived problem is to limit the city PTE tax to resident-owned S corporations only.<sup>5</sup> With this limitation, the deduction for PTE tax paid will necessarily be allocated equally to all S corporation shareholders.<sup>6</sup>

**Question:** My partnership timely made the election, but our accountant told us that it wasn't a good idea to elect into the NYC PTE tax. Can we revoke our election?

**Answer:** It depends. For any year, the election becomes irrevocable as of its due date, which is also when the first estimated payment is due. This means an early election is revocable, but the election becomes irrevocable on the last day for making it.

**Question:** I have a single-member LLC that is a disregarded entity for income tax purposes. Can I elect into the NYC PTE tax?

**Answer:** No. Single-member LLCs that are disregarded entities and sole proprietorships are not eligible to elect into the tax. But it may be a good time to look for a 1 percent partner or consider whether it makes sense to elect to be taxed as an S corporation.

<sup>5</sup>The same 2023 budget legislation took a different approach to S corporations and the state-level PTE tax by creating two classes of S corporations: (1) electing standard S corporations, which are S corporations that make the PTE election but do not certify that all of their shareholders are residents of New York and (2) electing resident S corporations that certify that all of their shareholders are residents of New York. The tax base for electing standard S corporations is limited to New York source income. The tax base for resident S corporations is expanded to include all items of income, gain, loss, or deduction to the extent they are included in the taxable income of the shareholder subject to New York's personal income tax.

<sup>6</sup>There's interesting history on this for the state PTE tax that we will cover in next month's installment of Noonan's Notes!

<sup>4</sup>Noonan, Pascal, and Doyle, *supra* note 2.

**Question:** I am the owner of a federal S corporation that has not made the New York S election. Can my corporation still elect into the city's PTE tax?

**Answer:** It does not appear so. This issue is a little odd in the New York City context, since at least for NYC corporate tax purposes, S corporations are treated as separate taxable entities that are subject to the GCT. For purposes of the city's PTE tax, the definition of an eligible S corporation cross-references section 208(1-A) of the New York State Tax Law.<sup>7</sup> And section 208(1-A) defines a New York S corporation as one "for which an election is in effect" in accordance with subsection (a) of section 660. Section 660(a) is the provision that permits shareholders to make the New York S election. That's a lot of cross-references, but what is notable is that subsection (i) of section 660 is not expressly referenced in the NYC PTE tax definition of an eligible S corporation. Section 660(i) is the provision permitting New York state to require some corporations that have not made the New York S election to nonetheless be treated as if that election has been made. So it's questionable whether one of these deemed S corporations under section 660(i) could elect into the NYC PTE tax.

### NYC PTE Tax Payments and Returns

**Question:** When are PTE taxes due?

**Answer:** Estimated taxes are due in four equal installments on March 15, June 15, September 15, and December 15 of the tax year for which the entity has elected to file an NYC PTE tax return, regardless of whether the PTE is a calendar-year or fiscal-year filer.

**Question:** When is the NYC PTE return due?

**Answer:** On March 15 following the close of the PTE's tax year.

### NYC PTE Taxable Income

**Question:** How is the PTE's taxable income calculated for partnerships?

**Answer:** A partnership includes all items of income, gain, loss, and deduction to the extent

included in the taxable income of resident partners. The idea here is to capture all city taxes that the NYC resident individual partners would otherwise have to pay. Taxable income does not include any amounts attributed to nonresident partners not subject to NYC personal income taxation (such as corporations, upper-tier partnerships, and nonresident individuals).

**Question:** How is the PTE's taxable income calculated for S corporations?

**Answer:** An S corporation includes all items of income, gain, loss, and deduction to the extent included in the taxable income of NYC resident shareholders.

**Question:** Why is the benefit of the city's PTE tax limited to the income of resident partners and resident shareholders?

**Answer:** New York City's personal income tax only applies to residents. Nonresident partners and nonresident shareholders do not pay any personal income tax to the city. PTE taxes are premised on the notion of shifting the owner's personal income tax liability to an entity-level return and providing the owner with a credit for taxes paid by the entity. For a nonresident of the city, there is no personal liability to shift to an entity.

**Question:** My partnership has corporate partners. How does that affect the calculation of NYC PTE taxable income?

**Answer:** Like the state PTE tax, the only income that is taxed at the entity level is the income directly affected by the SALT cap — income that flows to individual taxpayers. So the share of items attributable to partners not subject to personal income tax (for example, corporate or exempt entities) is not included in the tax base.

**Question:** How does it work with a multitiered partnership structure?

**Answer:** This is complicated, but again very sensible. The PTE tax base only includes the share of items includable in the taxable income of partners subject to personal income tax. The tax credit available to individuals for NYC PTE taxes paid (see below) is only available on the partner's direct share of NYC PTE tax. We interpret these two provisions together to mean that a lower-tier partnership could not include the items of income attributable to corporate shareholders or upper-tier partnerships — even if they are ultimately

<sup>7</sup> N.Y. Tax Law section 867(j).

owned by individuals. Presumably, the upper-tier partnership would be able to include its share of the lower-tier partnership's income in its NYC PTE tax base.

**Question:** What about a partnership owned by disregarded entities?

**Answer:** A partnership will still include in its NYC PTE tax base the share of income attributable to an entity disregarded for tax purposes if that entity is owned by a resident individual. Note that the law explicitly requires that the PTE tax return disclose the identity of a disregarded entity's ultimate owner to include their shares in the PTE tax base.

**Question:** I am a part-year resident partner. How does the partnership calculate my share of the city's PTE tax base?

**Answer:** The law does not explicitly answer this question, so it remains to be seen if the tax department will give the same guidance that it gave for the state PTE tax. At the state level, the department has advised that if an individual is a New York resident for more than half the year, she will be treated as a full-year resident for state PTE tax purposes.<sup>8</sup> Likewise, if the individual is a resident for less than half the year, she will be treated as a nonresident for state PTE tax purposes. The answer may not necessarily be the same for NYC PTE tax purposes.

**Question:** Our partnership filed an NYC PTE tax return, and we miscalculated the tax base. Can we amend the return?

**Answer:** Like New York state, the city's PTE tax says no to amended returns, unless the tax department has consented to an amendment. It is not yet clear under what circumstances that consent would be granted or denied or how that process would work.

### Mechanics of the NYC PTE Tax

**Question:** Can the partnership or S corporation claim a deduction for state PTE taxes paid?

**Answer:** Yes, of course — that's the whole point. In Notice 2020-75, the IRS indicated that it will allow a deduction for partnerships and S corporations that pay PTE taxes — even if that tax

is elective. But the IRS has not yet issued regulations, so there could be nuances.

**Question:** What is the tax rate applicable to PTEs?

**Answer:** The city's PTE tax rate is 3.876 percent — the top rate for NYC personal income taxpayers.

**Question:** How does the credit on my personal income tax return work?

**Answer:** A partner or shareholder will get a dollar-for-dollar credit for their direct share of NYC PTE taxes paid, and excess credits will be fully refundable.

**Question:** Do I need to add back my NYC PTE tax credit to my state and municipal taxable income on my personal income tax return?

**Answer:** Yes. To make the city's PTE tax regime "revenue neutral," taxpayers are required to add back to their income the NYC PTE tax credit.

**Question:** I am a New York City resident and partner of an electing partnership. What if my share of the NYC PTE taxes paid exceeds my distributive share of partnership items under the partnership agreement?

**Answer:** Partnerships will need to review their agreements to determine whether the allocation of credits under the New York law is consistent with the existing agreement.

### Interplay With Preexisting NYC Entity-Level Taxes

**Question:** I am a shareholder of an S corporation that already pays NYC GCT. Does that tax still apply to S corporations?

**Answer:** Yes. The enactment of the NYC elective PTE tax does not change the imposition of the NYC corporate tax on S corporations. Under the new law, if an S corporation pays NYC PTE tax, it must add those payments back to the NYC corporate tax base.

**Question:** I am a partner in a partnership that already pays the NYC UBT. Does that tax continue to apply to partnerships?

**Answer:** Yes. The UBT is still imposed on partnerships. A partnership's payment of NYC PTE tax will be added back to the UBT base under the UBT's preexisting addition modification for income taxes.

<sup>8</sup> TSB-M-21(1)C, (1)I (Aug. 25, 2021).

## NYC PTE Tax: Should I Stay or Should I Go?

**Question:** What types of entities should definitely opt into this tax?

**Answer:** Any passthrough entity with resident owners should be a viable candidate. So that includes any partnership with at least one New York City resident partner and any S corporation with all resident owners. The problem, of course, is that an entity can only elect into the city's PTE tax if it also elects into the state PTE tax.

**Question:** Does it matter whether the entity itself has multistate operations?

**Answer:** No. While answering this question can be more complicated for purposes of the state PTE tax, the NYC analysis is way easier. New York City residents pay municipal tax on all their income regardless of its source. The NYC PTE is designed to simply shift that burden to the PTE.

**Question:** Can investment partnerships or other entities that just hold investment assets elect in?

**Answer:** Yes. If an investment partnership has New York resident partners, then it definitely can elect into the PTE tax regime and pay the tax, with the PTE tax credit flowing to the resident partners. But consult your (federal) tax adviser. There's been a lot of debate over the past year in connection with the state PTE tax as to whether the IRS will allow the deduction by a partnership that pays New York tax only on portfolio income.<sup>9</sup> We think it should, based on language in the IRC and Notice 2020-75. But draft Treasury regulations regarding business deductions for PTE taxes still haven't been issued, and we don't have a crystal ball, so we can't give you a clear answer on whether it makes sense to elect into the regime in this situation.

**Question:** Is it not a good idea to elect into this tax if my partnership has a lot of nonresident partners?

**Answer:** It is still a good idea. The stumbling block again, however, relates to the state PTE tax, since an entity can only elect into the NYC PTE tax if it elects into the state PTE tax regime. And for state PTE tax purposes, the problem isn't with

New York; it's with the other states where the nonresidents live. If those states have an income tax, then it may not be clear whether they would provide their residents with a credit for the New York state PTE tax. Some states limit their resident credits to taxes paid by the actual taxpayer. But under the PTE tax regime, the partners don't pay the New York taxes anymore. So there's a risk that nonresidents could get whipsawed and lose the resident credit for the New York taxes paid in their home states. Thus, those entities would not elect into the state PTE tax — and therefore could not elect into the NYC PTE tax, either. ■

<sup>9</sup> Lee A. Sheppard, "News Analysis: SALT Deductions for Investor Entities," *Tax Notes State*, Oct. 4, 2021, p. 49.