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**by Timothy P. Noonan, Elizabeth Pascal, and Christopher L.
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workarounds permitting partnerships and S corporations to pay state taxes on distributive share income at the entity level. The theory around these workarounds is that because the SALT cap applies only to individuals, state and local income taxes applied at the entity level should be fully deductible for federal tax purposes without regard to the individual SALT cap. And in November 2020 the IRS gave a boost to many of these state-level workarounds by issuing a notice approving the workarounds as viable tax-planning arrangements.¹ Since that time, many more states have jumped on the bandwagon and either passed or proposed legislation creating these types of entity-level taxes.

The first state to pass this type of tax was Connecticut, which in early 2018 enacted its mandatory PTE tax. In response, our article for this publication summarized the different types of questions we were getting from our contacts and colleagues — as well as our responses — to provide some of the nuts and bolts of how we expected the new tax to work.² We thought the same type of Q&A format would make sense for New York’s new tax. So here goes.

The Basics

Question: What is the New York PTE tax?

Answer: The fiscal 2021-2022 budget legislation enacted a new elective tax applicable to passthrough entities (partnerships, limited liability companies, and S corporations) as a workaround to the federal cap on state and local tax deductions (that is, the SALT deduction limitation) for individuals.

New York has finally joined the passthrough workaround party! Since Gov. Andrew Cuomo (D) signed legislation creating the state’s version of a passthrough entity (PTE) tax in April, tax practitioners have been scrambling to figure out how it works and whether their clients should elect into the program.

Most readers are likely aware of the background around these types of taxes. Specifically, to combat the negative effect of the highly politicized federal tax cap on state and local tax deductions established by the Tax Cuts and Jobs Act of 2017, many states enacted

¹ IRS Notice 2020-75, 2020-49 IRB 1453.

² 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.

Question: When does the PTE tax take effect?

Answer: The PTE tax is effective for tax years beginning on or after January 1, 2021.

Question: Is the PTE tax mandatory?

Answer: No. Eligible PTEs must elect to pay the tax at the entity level. The election must be made each year by March 15, when the first estimated payment is due. In 2021, however, the election must be made by October 15.

The PTE Tax Election

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

Answer: No. Once the election is made, it is irrevocable for that year.

Question: I have a single-member LLC that is an income-tax-disregarded entity. Can I elect into the 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.

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

Answer: No, unless the corporation is a "deemed New York S corporation."³ The corporation must be a New York S corporation to elect to pay the PTE tax. Note that not every federal S corporation is eligible to be a New York S corporation.

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 a PTE tax return, regardless of whether the PTE is a calendar-year or fiscal-year filer.

Question: But it's already June 2021. What do I do about this year?

Answer: For the 2021 tax year only, no PTE estimated taxes will be due, which is good since the estimated tax payment forms for PTEs have not been released yet.

Question: So when does the 2021 PTE tax need to be paid?

Answer: Payments for 2021 are not due until March 2022.

Question: But to get the federal tax deduction for 2021, doesn't my cash-basis entity have to pay the tax in 2021?

Answer: Absolutely it does. Thus, even though the legislation allows the tax to be paid by March 2022, any cash basis taxpayer will be required to pay the PTE tax by December 31, 2021, in order for the workaround to be effective in 2021. This, of course, only further exacerbates the "double payment" situation arising in 2021, discussed immediately below, with partners continuing to have to make estimated tax payments even for entities that will ultimately elect into the program.

Question: I'm a partner in a partnership that intends to elect into the PTE tax for 2021. Do I need to make estimated tax payments for the taxes that will be paid by the partnership on its PTE tax return?

Answer: Yes! New York wants to get its money, and since it may not be getting the tax payments from the PTE until the return (or extension) is filed in 2022, it is requiring partner- and shareholder-level estimated payments for now.

Question: When is the PTE return due?

Answer: On March 15 following the close of the PTE's taxable year. Thus, a 2021 calendar-year filer would file the PTE return by March 15, 2022, or request a six-month extension by that date.

PTE Taxable Income

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

Answer: Partnerships and S corporations calculate their PTE taxable income differently. A partnership includes the New York-source income, loss, gain, or deductions for its nonresident partners *and* all items of income, gain, loss, and deduction (not just New York-source items) to the extent included in the taxable income

³ See N.Y. Tax Law section 660(i).

of resident partners. The idea here is to capture all New York taxes that the individual partners would otherwise have to pay. But be aware that the distributive shares of income attributable to partners who are not individuals or trusts (for example, corporations, upper-tier partnerships) are not included in the tax base. More on this below.

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

Answer: S corporations use only the *New York-source* income, loss, gain, or deduction includable in the taxable income of a shareholder who is subject to personal income tax (that is, an individual or trust). And under New York's rules, S corporations use market-based sourcing rules to compute New York-source income.

Question: Why would the state limit the S corporation tax base to sourced income only?

Answer: We're scratching our heads on that, too. Apparently, the state tax policy people were concerned that S corporation shareholders with different residency statuses could be treated differently by the electing taxpayer (since the residents would get a higher share of the deduction), and that this special allocation could create a second class of stock warranting the IRS to revoke the taxpayer's S election. But even with that concern, it's odd that other states with these entity taxes made no such distinction. And whatever the case, it seems like the State Legislature used a hammer when a scalpel would've done just fine. Many S corporations are wholly owned by a single New York resident or are owned by all New York residents, so the issue the tax department was so concerned about would never affect them. Ideally, the Legislature will be amenable to taking another look at this next year; it would seem easy enough to allow S corporations with all resident owners to compute the tax differently. Such legislation could provide that the tax base reverts to New York-source income in any year in which one or more shareholders is a nonresident or part-year resident.

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

Answer: Here, we think lawmakers did a nice job at structuring the workaround. Basically, the

only income that gets taxed at the entity level is the income that was 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 (that is, corporate or exempt entities) is not included in the tax base.

Question: How does it work with a multi-tiered 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 (that is, an individual or trust). The tax credit available to individuals and trusts for PTE taxes paid (see below) is only available on the partner's direct share of PTE tax. We interpret these two provisions together to mean that a lower-tier partnership could not include the items of income, etc., attributable to corporate shareholders or upper-tier partnerships — even if they are ultimately owned by individuals. Presumably, the upper-tier partnership would be able to include its share of the lower-tier partnership's income in its PTE tax base.

Question: What about a partnership owned by disregarded entities?

Answer: A partnership will still include in its PTE tax base the share of income attributable to an entity disregarded for tax purposes if the disregarded entity is owned by an individual or trust. Only the New York-source items will be included in the PTE tax base if the owner of the disregarded entity is a nonresident. Note that the law explicitly requires that the PTE tax return disclose the identity of disregarded entities' ultimate owners 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 PTE tax base?

Answer: The law does not explicitly answer this question, but we assume that the PTE would include only the share of New York-source income attributable to the nonresident period and the partner's entire share of income attributable to the resident period. It's not clear how that might be determined for partnership gains and losses that, for example, could be either prorated or accrued by the partner under N.Y. Tax Law section 639(f).

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

Answer: The law requires the tax department's consent for any amendments. It is not yet clear under what circumstances that consent would be granted or denied or how that process would work.

Credit for PTE Taxes Paid

Question: Can the partnership or S corporation claim a deduction for New York 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 state 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: PTEs will use the new personal income tax rates in the 2021-2022 budget legislation — ranging from 6.85 percent for PTE taxable income less than \$2 million up to a rate of 10.9 percent on taxable income over \$25 million.

Question: How does the PTE determine what rate to pay for its estimated taxes?

Answer: It uses this same rate table brackets. So if the entity as a whole has taxable income over \$25 million, estimated taxes are due at the 10.9 percent tax rate, even if the individual partner or shareholder will actually pay personal income tax at a different rate.

Question: How does the credit on my New York nonresident tax return work?

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

Question: My PTE's taxable income is over \$25 million, but my share of the firm's income is less than \$1 million. Does that mean I pay a higher effective rate of tax?

Answer: No. If a partner pays tax to New York at a lower marginal rate — which will likely happen in many large partnerships — they'll still get to claim a full tax credit for their share of the higher 10.9 percent estimated tax payment by the

PTE; the unused balance will be treated as an overpayment to be refunded or applied to future tax years.

Question: Can I use the PTE tax credit to offset New York tax due on other income?

Answer: We don't see why not. The issue here could come up with the example outlined in the previous question. Partner A pays New York taxes on all his income at the 6.85 percent rate, and perhaps Partner A's spouse earns \$200,000 of W-2 wages working as an accountant. If the PTE tax credit gets applied against Partner A's New York taxes shown on his and his spouse's joint tax return, the excess tax credit arising from the difference between Partner A's tax rate and the 10.9 percent rate the partnership used to pay PTE tax should be usable against Partner A's (and his spouse's) other New York taxes due.

Question: Do I need to add back my tax credit to my New York taxable income on my personal income tax return?

Answer: Yes. To make the PTE tax regime "revenue neutral," taxpayers are required to add back to their income the PTE tax credit. Some other states obtain the same result by lowering the rate of their PTE tax credits, rather than allowing dollar-for-dollar credits.

Question: I am a New York resident partner of an electing PTE. What if my share of the 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.

PTE Taxes Paid to Other Jurisdictions

Question: I am a New York resident partner of a partnership that will now elect to pay both New Jersey business alternative income tax (BAIT) and New York PTE tax. Can I take a credit on my New York personal income tax return for my share of New Jersey BAIT paid by the partnership?

Answer: Yes. The law explicitly allows for a credit for PTE taxes paid to other states that are "substantially similar" to New York's PTE tax. We assume that this provision was meant to cover the New Jersey BAIT.

Question: I am a New York resident partner of a partnership that elected to pay New Jersey BAIT

but did not elect into New York's PTE tax. Can I claim a credit on my New York personal income tax return for my share of New Jersey BAIT paid by the partnership?

Answer: Yes. The law does not require that the partnership paying BAIT also elect into New York's PTE tax regime for the individual to be eligible for the resident credit.

Question: I am a New York resident shareholder of a federal S corporation that only does business in New Jersey and pays the New Jersey BAIT. Will I now be eligible for a New York resident credit for New Jersey BAIT paid?

Answer: Probably not. The law explicitly requires that for an S corporation shareholder to claim the credit, the corporation must have been treated as a New York S corporation. For that to happen, it is presumed that the corporation must first have a filing requirement in New York. It's not clear whether a resident shareholder of a corporation that would be deemed a mandatory S corporation under N.Y. Tax Law section 660(i) but does not have nexus in New York would be eligible for the credit.

Question: How do I calculate the credit for New York PTE taxes paid by multiple PTEs of which I am a member or shareholder?

Answer: The credit is calculated as the sum of all allowable credits from the individual's or trust's direct ownership in the PTEs.

PTE Tax: Should I Stay or Should I Go?

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

Answer: Every situation is different, but entities with all resident partners and mostly all New York-sourced income are prime candidates. Think of a local law firm in Buffalo, a dentist with a practice in Albany, or a roofing contractor in Brooklyn. On the other hand, a large national law firm with partners in every state may not be as viable a candidate, since partners in states like California may not be able to offset their California taxes with a credit for the New York PTE tax paid.

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

Answer: If the tax department behaves itself, then it should not. The issue here is whether the resident New York partner will still be able to

claim a resident tax credit against their New York personal income taxes for taxes paid to other states. Normally, resident credits work to reduce the amount of New York tax the partner pays on their resident tax returns. But now, the partner has no New York tax liability. That said, since the income still flows through to the partner, and since that income is still subject to tax in the other state, the resident partner should get credit for the other state taxes under a fair reading of N.Y. Tax Law section 620, New York's resident credit statute. Assuming the tax department agrees to apply the resident credit first, this will result in the resident owners enjoying the largest possible PTE credit.

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 system and pay the tax, with the PTE tax credit flowing to the resident partners. But consult your (federal) tax adviser! It is unclear if the IRS would allow the deduction by a partnership that pays New York tax only on portfolio income. 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: See earlier answer; it very well might not be. The problem isn't with New York; it's with other states where the nonresidents live. If those other states have an income tax, then it is not clear whether they would provide their residents with a credit for the New York PTE tax. Some states limit their resident credits to taxes paid by the actual taxpayer. But under the PTE 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. ■