

State and Local Tax



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New York State Enacts Pass-Through Entity Tax as SALT Limitation Workaround

On April 19, 2021, New York Governor Andrew Cuomo signed into law legislation that creates a New York Pass-Through Entity Tax, effective for tax years beginning on or after January 1, 2021. This consequential tax legislation, available to electing pass-through entities, provides a mechanism for New York State individual taxpayers to limit the impact of the federal \$10,000 limitation on state and local tax deductions under the Tax Cuts and Jobs Act of 2017. The tax takes on added significance in mitigating the effect of the newly-imposed New York State personal income tax rate increases on high earners.

BACKGROUND

For tax years beginning after 2017, for federal income tax purposes an individual taxpayer (including married joint filers) is limited to an annual aggregate \$10,000 itemized state and local tax deduction (“SALT limitation”). For many individuals, particularly those in high-tax states such as New York, this limitation has often resulted in a significant increase in their federal income tax liabilities. Several states (such as Maryland, New Jersey, and Connecticut) have previously enacted entity-level income taxes on pass-through entities as workarounds to the SALT limitation. Those state taxes—both elective and mandatory—generally shifted state and local income tax deductions from individual

owners to their pass-through business entities, where the deductions are not subject to the SALT limitation at the entity level. In November 2020, the Internal Revenue Service issued Notice 2020-75, explicitly sanctioning the availability of state entity-level taxes on partnerships and S corporations, whether mandatory or elective, as a workaround to the SALT limitation.

WHAT THE NEW YORK STATE PASS-THROUGH ENTITY TAX DOES

The Pass-Through Entity Tax is an elective tax available to eligible partnerships (including limited liability companies taxable as partnerships) and New York S corporations. Qualifying pass-through entities will afford their owners a legal means to fully deduct their New York State income taxes and avoid the SALT limitation. Since its purpose is to provide a SALT limitation workaround to New York State taxpayer individuals, the tax is imposed at rates equivalent to the current (and recently increased) New York State personal income tax rates—that is, at 6.85 percent of pass-through entity taxable income of up to two million dollars, with excess income taxed at rates of between 9.65 percent and 10.90 percent. It does not, however, extend to the New York City resident income tax. The tax is elective for tax years beginning on or after January 1, 2021.

Eligibility. An “eligible partnership” is a partnership (or an LLC taxable as a partnership) with a New York tax return filing obligation as a result of having (i) income from New York sources or (ii) one or more New York resident partners. As a result, not only may a New York business operating in partnership form be eligible, but a partnership having no New York source income can also qualify as long as it has a New York resident partner who includes his or her share of income in the partner’s own New York State taxable income. New York S corporations (*i.e.*, federal S corporations that make a New York S corporation election) are also eligible.

The Election. The pass-through entity election is made annually, by the due date of the first estimated tax payment, and is irrevocable for the year. The law authorizes the Commissioner to extend the deadline for making the election for up to six months. Since under the new law the first estimated payment was due March 15, 2021, we expect in the coming weeks that the election deadline for 2021 will be administratively extended.

Pass-Through Entity Tax. For pass-through entities that are treated as partnerships for tax purposes, the tax is imposed on “pass-through entity taxable income,” which consists of two parts: (i) in the case of the entity’s *nonresident* individual partners, the entity’s income, gain, loss, or deduction from New York sources (“New York source income”) to the extent included in the nonresident partners’ own New York State taxable income, and (ii) in the case of the entity’s *resident* individual partners, the entity’s income, gain, loss, or deduction to the extent included in the resident partners’ own New York State taxable income, regardless of whether derived from New York sources.

This broad definition maximizes the tax that can be paid and, importantly, fully deducted by the electing partnership for income that is subject to New York State personal income tax, even income earned outside the State that is distributed to resident partners. The pass-through entity taxable income of an S corporation is its New York source income subject to State income tax on the entity’s nonresidentshareholders.

Pass-Through Entity Tax Credit. A direct partner, member, or shareholder is entitled to a tax credit against the individual owner’s State personal income tax liability for the owner’s direct share of the pass-through entity tax. Note that the credit is only available to direct partners, members, or shareholders of the electing pass-through entity, which in the case of a tiered ownership structure will likely determine which pass-through entity in the ownership chain makes the election. Any pass-through entity tax credit in excess of the owner’s New York State income tax may be taken as a credit or refund on the owner’s New York State personal income tax return.

The New York Pass-Through Entity Tax can provide significant tax benefits by allowing full deductibility of New York State personal income taxes and avoiding the onerous effect of the SALT limitation. The election should be considered by owners of pass-through entities that derive New York source income, but also by partnerships (and LLCs taxable as partnerships) conducting business outside New York but having New York resident partners. This includes private equity firms, real estate companies, and professional firms such as law firms and accounting firms. Questions concerning the scope and application of the tax will need to be considered in deciding whether to make the election. Particularly for 2021, it will be critical to monitor the anticipated extended deadline for making the pass-through entity election.

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