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Help Is On the Way: New York Enacts Pass-Through Entity Tax

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Prior to 2018, a taxpayer could generally deduct his state and local taxes for purposes of determining his federal taxable income. Beginning in 2018, the Tax Cuts and Jobs Act (P.L. 97-115) significantly changed these rules by generally limiting an individual's state and local tax deduction to $10,000 per year. Since the enactment of this rule, states with high income tax rates have been considering various ways to work around this limitation. With regard to taxpayers that are partners in a partnership or shareholders in an S corporation, many states had considered allowing partnerships and S corporations to elect to be taxed at the entity level, with the partners or shareholders being allowed a credit for these entity-level taxes, such that the total state taxes paid would generally be the same as if the election had not been made.

It was hoped that these entity-level taxes would be deductible at the entity level for federal income tax purposes and that the partners or shareholders would be subject to federal tax only on the entity's after-tax income, thus avoiding the $10,000 limitation with respect to the state or local taxes imposed on the partnership or S corporation.

On November 9, 2020, the IRS issued Notice 2020-75, which provides a framework under which these arrangements may comply. The notice states that the Treasury Department intends to issue proposed regulations that will provide that, if a state or local government imposes taxes on a partnership or S corporation, those taxes will be fully deductible by the partnership or S corporation, without regard to the $10,000 limitation of its partners or shareholders. The notice provides that this will be the case even if the jurisdiction allows an offsetting partner-or shareholder-level tax benefit, such as a credit, deduction, or exclusion.

Since the IRS issued this notice, several states have enacted some form of pass-through entity tax. Most recently, on April 19, 2021, New York State enacted an elective pass-through entity tax regime as part of its budget legislation. This new regime has the potential to provide a significant federal income tax benefit to owners of pass-through entities, which are typically used for real estate and other closely held businesses.

Under the New York law, any partnership (including an LLC that is taxed as a partnership) that has any New York-source income or any New York resident partner can make an election to pay a New York pass-through entity tax. In addition, any entity that is treated as a New York S corporation is eligible to make the election. The election is made annually for each taxable year of the partnership or S corporation, and must generally be made by March 15 of such year. A special rule allows elections for 2021 to be made by October 15, 2021.

If a pass-through entity elects to be subject to the tax, the entity will be taxed at rates ranging from 6.85% to 10.9% (generally corresponding to the rates that apply to individuals) on its "pass-through entity income." Pass-through entity income is defined, in the case of a partnership, as the sum of (1) all partnership items to the extent they are included in taxable income of resident partners and (2) all New York-source items of the partnership to the extent included in taxable income of nonresident partners. In the case of an S corporation, pass-through entity income includes all New York-source items of the S corporation to the extent they are included in its shareholders' taxable income.

A direct partner or shareholder of an entity that has elected to pay the pass-through entity tax must still include in New York taxable income his share of the entity's income (determined without any deduction for the pass-through entity tax paid). However, the partner or shareholder is allowed a refundable credit equal to his share of the tax paid by the pass-through entity. From a New York tax perspective, this will generally place the partners or shareholders in the same position as they would have been had the partnership or S corporation not elected to pay the pass-through entity tax. However, because the New York law directly imposes an income tax on a pass-through entity, it complies with IRS Notice 2020-75 and therefore effectively allows the New York tax to be deductible for federal purposes.

There are a number of uncertainties and complexities regarding the application of the New York law. For example, complications may arise when a partner or shareholder is not a resident of New York State. Some states will allow a partner a credit for a partnership's New York pass-through entity tax paid, but other states will not allow such a credit. If the partner's home state does not allow such a credit, then the partner will be subject to two levels of state tax on the partnership's New York-source income: New York tax imposed at the partnership level, and a partner-level tax in the partner's home state on the same income. This is obviously a very bad result, and the additional state tax paid could easily outweigh any federal income tax benefit from making the election.

It is also important to note that New York's pass-through entity tax regime applies only to entities that are treated as partnerships or S corporations for income tax purposes; it does not apply to sole proprietorships or entities that are disregarded for income tax purposes (such as single-member LLCs). Taxpayers with these types of businesses should consider restructuring their ownership as soon as possible in order to permit them to qualify for this election.

In sum, New York's new pass-through entity tax regime can provide a significant federal tax benefit to businesses owned through pass-through entities, such as real estate and other closely held businesses. However, taxpayers need to ensure that their businesses are owned through partnerships or S corporations in order to take advantage of these provisions, and should be mindful of the tax consequences that may arise when partners or shareholders are residents of other states.

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