

New York's SALT Solution

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PRACTICES Real Estate, Tax, Investment Management, Fund Formation and Management, Corporate Tax, Commercial Real Estate Leasing, Portfolio Companies and Investors, Real Estate Finance

Since 2018, state and local tax deductions have been limited to \$10,000 per individual taxpayer for federal income tax purposes, disproportionately burdening taxpayers residing in states with significant state income tax rates. States soon began enacting state tax deduction workarounds, which generally allow a partnership or S corporation to elect to pay state income tax in exchange for a state income tax credit allocable to its partners, members and shareholders. After an initial period of uncertainty regarding the deductibility of these elective taxes, the IRS issued Notice 2020-75, confirming the deductibility of these elective entity level taxes for federal income tax purposes.

On April 19, 2021, the State of New York enacted an elective passthrough entity tax (“**PTET**”) effective for tax years beginning January 1, 2021, that applies to partnerships (including limited liability companies taxed as partnerships) and S corporations (“**Eligible Entities**”). Eligible Entities must generally make this irrevocable election on an annual basis by March 15th of the applicable tax year, but may make this election until October 15, 2021, for the 2021 tax year. Single-member limited liability companies and individuals acting as sole proprietors are not eligible to make the PTET election.

The PTET is based on the income of an Eligible Entity from New York sources directly allocable to individual partners and, in the case of a partnership that is an Eligible Entity, also includes all other income allocable to New York individual resident partners. Although this legislation is generally beneficial to New York residents and non-residents with a New York business, there are a number of factors that should be considered prior to making this election.

- Credit for Other States Passthrough Taxes – The PTET provides a credit for Eligible Entities that pay other elective state income taxes which are substantially similar to the PTET. There is currently no authority as to the state income taxes that meet this criteria and there is therefore some risk that another state’s elective income taxes may not provide credit against the PTET. Ultimately, any excess payment of PTET should be refundable to the partners, members and shareholders of an electing Eligible Entity, but this could result in a temporary overpayment of taxes.
- Excess PTET Payments Could Offset Other Non-Passthrough Income – There are circumstances in which the PTET of an Eligible Entity may exceed the state income tax due from its partners, members and shareholders. However, taxpayers can offset New York income tax arising from other sources with excess PTET credits and effectively make the New York tax due from these other sources deductible for federal tax purposes (to the extent satisfied with excess PTET credits).
- Tiered Partnerships – The calculation of the PTET is generally based upon the income of an Eligible Entity that will be subject to New York income tax when allocated to its individual partners, members and shareholders. Accordingly, the PTET credit only passes through to those individual partners, members and shareholders and not partners or members that are partnerships or multi-member limited liability companies. Individuals who own their interests

indirectly through a tiered partnership structure will not benefit from a PTET election made for a lower tier entity and should ensure that an election is made for the Eligible Entity in which it directly holds its interest.

- Guaranteed Payments – The PTET legislation indicates that income tax credits can only be allocated to partners and members that receive a distributive share and not to partners or members that receive a guaranteed payment. However, there is some uncertainty whether this is the case, and such an interpretation would run counter to the policy behind this legislation.
- Joint and Several Liability – Each individual partner, shareholder or member of an Eligible Entity that (i) is a general, managing, or controlling partner or member of the electing Eligible Entity, (ii) owns greater than fifty percent of the interests or profits of the electing Eligible Entity, (iii) is under a duty to act for the electing Eligible Entity in complying with the PTET, or (iv) was the individual that made the election on behalf of the electing Eligible Entity, is jointly and severally liable for the PTET imposed on the Eligible Entity. Such individuals should ensure that they are contractually entitled to a full indemnification from the Eligible Entity and/or the other partners and members for the PTET taxes due as a result of this election.

Single-member limited liability companies and individuals acting as sole proprietors are not eligible to make the PTET election, effectively subjecting the owners of these businesses as well as employees to a higher level of federal taxation. Nevertheless, the PTET provides significant relief for many New York taxpayers and should be considered by any entity for which the PTET election is available.