NEW YORK STATE BAR ASSOCIATION
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Report No. 1451
May 24, 2021

The Honorable Amanda Hiller
Acting Commissioner of Taxation and Finance
W.A. Harriman Campus
Albany, NY 12227

Re: *Implementation of the Pass-Through Entity Tax*

Dear Acting Commissioner Hiller:

On April 19, 2021, the 2021-2022 New York State Executive Budget (the "Budget Act") was signed into law by Governor Cuomo. Part C of the Budget Act imposes a "pass-through entity tax" ("PTET") with respect to taxable years beginning on or after January 1, 2021 on partnerships and S corporations that are eligible to, and do, elect, on a year-by-year basis to be subject to it (hereinafter referred to as "electing entities"). Electing entities, whether partnerships or S corporations, are subject to PTET on their "pass-through entity taxable income" ("PTETI") and partners or shareholders, as applicable, in electing entities are allowed a corresponding refundable "pass-through entity tax credit" ("PTETC") against their New York personal income tax for their respective "direct shares" of the PTET.

This letter[1] focuses on selected matters likely to affect electing partnerships and S corporations for calendar year 2021 (hereinafter referred to simply as "2021"), particularly as regards their New York resident partners and shareholders, and with respect to which we believe urgent guidance is needed.[2]

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1 The principal drafter of this letter was Elliot Pisem, with the assistance of Bonnie Daniels. Helpful comments were received from Robert Cassanos, Michael Schler, Jonathan Talansky, Jack Trachtenberg and Gordon Warnke. This letter reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

2 This letter does not address all issues relating to resident partners and shareholders or any issues relating specifically to non-resident partners and shareholders. A listing of certain of the issues not addressed herein is contained at the end of this letter.

I. 2021 Transitional Issues

A. Background

For years after 2021, an eligible entity generally must make the election to be taxed under the PTET regime by March 15 of the calendar year to which the election relates, and any such electing entity must make quarterly estimated PTET payments on March 15, June 15, September 15 and December 15 of the election year. The amount of PTET paid by an electing entity, and the corresponding PTETC to be received by a partner or shareholder, as applicable, with respect to the PTET, can then be taken into account by the partner or shareholder in calculating its New York estimated tax payments due on April 15, June 15 and September 15 of the election year and January 15 of the following year.

As noted above, however, the PTET applies to taxable years beginning on or after January 1, 2021. An eligible entity may accordingly elect to be subject to the PTET for 2021, and the Budget Act contains rules under which the application of the PTET for 2021 differs from its application for later years summarized above. In particular:

- If an eligible entity wishes to be subject to the PTET for 2021, it must make an election to that effect by October 15, 2021.

- If an eligible entity makes an election to be subject to PTET for 2021, its PTET for 2021 will be due on March 15, 2022.

- An electing entity is not required to make quarterly estimated tax payments of PTET with respect to 2021.

- Partners and shareholders of an electing entity are required to continue making quarterly 2021 estimated tax payments, and any penalties for failure to make estimated tax payments for 2021 are calculated as if the partner or shareholder was not entitled to a PTETC.

B. Duplication of New York tax payments

As discussed above, the Budget Act provides that partners and shareholders of electing entities must compute their 2021 estimated New York personal income tax payments as if they will not receive any PTETC and, correspondingly, penalties for underpayment of such estimated taxes are computed as if the partner or shareholder was not entitled to a PTETC. This combination of PTET payments for 2021 by electing entities with the statutory rules for computing penalties for underpayment of individuals' estimated tax can result in an onerous and inequitable duplicative payment of taxes.

For example, suppose a cash basis partnership promptly elects into the PTET regime, and makes the full PTET payment on March 15, 2022. But the partners in the partnership were also

required to have made estimated tax payments for 2021 on April 15, June 15 and September 15 of 2021 and January 15 of 2022. Accordingly, the effect of the payments of PTET by the partnership and estimated tax payments by the partners will be a double payment of taxes from the date the partnership makes the PTET payment until such time as the partners are able to utilize the PTETC. Such utilization could occur either as a credit as of April 15, 2022 against unrelated state income taxes the partners might owe for 2021 or against first quarter estimated tax payments for 2022, or, more likely if the partners did not have much income aside from the partnership income, as a cash refund subsequent to the time of filing their 2021 personal income tax returns. For some partners, the filing of their 2021 personal income tax returns may occur as late as October 15, 2022.

C. Federal income tax considerations

We assume that the New York legislature intended to enable partners and S corporation shareholders to take advantage of Federal income tax benefits for 2021 to be derived from an electing entity's being subject to the PTET for 2021, since the new statutory provisions were made effective retroactively to January 1, 2021. The question of when an electing entity will be able to deduct 2021 PTET payments on its Federal income tax return will depend on that electing entity's method of accounting. All electing entities that use the cash receipts and disbursements method of accounting and some electing entities that use an accrual method of accounting[3] will not be able to deduct 2021 PTET on their 2021 Federal income tax returns unless they actually pay the PTET in 2021. Accordingly, in order to obtain the benefit of the PTET in 2021, many electing entities will want to pay their PTET by no later than December 31, 2021. This acceleration of PTET payments by an electing entity will further prolong the duration of the overpayment period discussed above.

D. Proposed solution

To ameliorate the foregoing double tax payment inequity, we recommend that partners and shareholders in electing entities be permitted to reduce their New York estimated tax payments for any quarter of 2021 with respect to payments of estimated 2021 PTET by their corresponding electing entities. Of course, partners and shareholders of electing entities should not be able to reduce their estimated tax payments for any quarter of 2021 with respect to payments of estimated PTET that are not made until after the applicable due date for estimated tax payments for that quarter. Accordingly, in computing the 2021 estimated tax penalty (if any) of a partner or shareholder in an electing entity, the penalty should be reduced to the same extent that it would have been reduced if the partner or shareholder had made estimated personal income tax payments *on the same dates and in the same amounts* as the partner's or shareholder's direct share of the payments made by the electing entity.

New York Tax Law ("Tax Law") Section 685(d)(4) grants authority to the Department of Taxation and Finance (the "Department") to waive penalties for underpayment of estimated

[3] Those that are not eligible to, or do not, apply the "recurring items exception" in accounting for their PTET payments.

personal income tax in "unusual circumstances" to the extent that the imposition of such penalties would be against "equity and good conscience." We believe that such a waiver is authorized and warranted to deal with the double tax payment problem outlined above, and that the Department should immediately announce its intention to grant such waivers in the case of electing entities that do make estimated tax payments during 2021, thereby enabling partners and shareholders to compute the correct amount of their individual estimated tax payments. If the Department, however, entertains doubts about its authority, we strongly recommend that the Department seek a prompt legislative amendment (either confirming the Department's authority to grant the waiver or addressing the double tax payment problem directly) that will enable proper functioning of the 2021 PTET.

In order to permit partners and shareholders to take advantage of the PTET regime for the second and third quarters of 2021, the Department should promptly (and, in any event, before June 15, 2021) issue guidance regarding how partnerships and S corporations can become electing entities and make estimated tax payments, including such mundane matters as forms to be used, address for mailing, etc. Such guidance should also confirm that, to the extent that an electing entity does make estimated tax payments, the Department will use its authority under Tax Law Section 685(d)(4) to compute underpayment penalties for individual estimated tax as though the partners' and shareholders' share of those payments had been made by the partners or shareholders of the electing entity. In the absence of such action, partners and shareholders may have to make duplicative payments of the same tax amounts, thereby driving the amount of tax paid out of synchronization with actual tax liabilities and, to the extent that electing entities fail to make their own tax payments by December 31, 2021, subverting the legislative intent that partners and shareholders obtain the intended Federal tax benefit of the PTET for 2021. Correspondingly, we also request immediate guidance on the items discussed in Sections II. through IV. below to facilitate the making of 2021 PTET elections and payments by electing entities.

II. Computation of PTETI

Tax Law Section 860(h)(1)(ii) defines PTETI, in the case of an electing partnership all of the partners in which are New York resident individuals, by reference to "all items of income, gain, loss, or deduction" of the electing partnership to the extent they are included in the taxable income of the partners. Where some partners are subject to tax under Article 22 (personal income tax) of the Tax Law and others are not, PTETI is computed solely with respect to the shares of those partners who are so subject to tax.[4]

[4] Generally, only individuals and certain trusts are subject to tax under Article 22. The definitions of PTETI with respect to non-resident partners and with respect to S corporation shareholders are somewhat different from the definition of PTETI with respect to resident partners, but issues discussed herein as regards PTETI arise under those definitions as well.

Guidance should be provided regarding the application of this definition. The following issues warrant immediate guidance, so that electing partnerships that wish to make second quarter estimated tax payments can compute the proper amount thereof:

- Provisions of the Internal Revenue Code (the "Code") incorporated by reference in the Tax Law impose limitations on the allowability to an individual of deductions for various sorts of losses. For example, Code Section 1211 generally prohibits an individual from claiming deductions for capital losses in excess of the individual's capital gains, and Code Section 469 generally prohibits an individual from claiming deductions for losses from activities that are "passive" with respect to the individual in excess of the individual's income from such activities. These limitations are computed at the individual level, by taking into account the individual's items from pass-through entities and from activities that the individual conducts directly. How does an electing entity compute PTETI if it has such losses?

- The statutory provisions governing the PTET changed over the course of the legislative process. A prior version would have limited the scope of the tax to items taken into account by the members of an electing entity under Code Section 702(a)(8), thereby excluding the broad range of items listed in Section 702(a)(1)-(7), including, for example, charitable contributions and capital gains and losses.[5] We note that, in accordance with the broadened statutory language, all such excluded items will now be taken into account in the computation of PTETI.

- A prior version of Tax Law Section 860(g) included a definition of "Pass-through Adjusted Net Income", now referred to as PTETI, that specifically excluded amounts "less than zero". The enacted version of Tax Law Section 860(h) defining "Pass-through Entity Taxable Income" does not include the "less than zero" clause. There will be instances where an electing entity may have Article 22 partners that are allocated overall income while other Article 22 partners are allocated overall loss. Is an electing entity expected to include Article 22 partners with losses when computing the electing entity's PTETI, or should an Article 22 partner with a loss be reflected as zero in computing the electing entity's PTETI?

- How, if at all, are depreciation deductions and items of gain or loss arising by reason of an adjustment, under Code Section 743(b), to the basis of partnership property with respect only to a transferee partner taken into account in computing PTETI?

[5] See our Report No. 1449 to Governor Cuomo, dated March 6, 2021, on the 2021-2022 New York State Executive Budget.

III. Coordination of PTET with PTETC

Under Tax Law Section 863 only a "direct" partner or shareholder subject to tax under Article 22 is eligible for the PTETC. Similarly, Tax Law Section 606(kkk) provides that the PTETC is equal to the partner's or shareholder's "direct share" of the PTET. In contrast, Tax Law Section 860(h) provides that the taxable base for the PTET is the electing entity's income to the extent it is included in the taxable income of Article 22 partners or shareholders (without any reference to "direct" partners or shareholders). As a result of this discrepancy, the PTET could arguably be imposed on an electing entity's income that is ***indirectly*** included in an Article 22 taxpayer's taxable income even though the Article 22 taxpayer would not be able to claim a corresponding PTETC with respect to such tax.

Suppose, for example, that A and B, two New York resident individuals, are equal partners in a holding partnership ("P1"). P1 and C, also a New York resident individual, are equal partners in an active partnership ("P2"). Both P1 and P2 elect into the PTET regime. The PTET should be imposed on all of P1's income (including its share of P2's income) since it is directly included in the income of A and B, each of whom will be able to claim a corresponding PTETC. The PTET should only be imposed on one-half of P2's income since only one-half is directly included in C's income - the other half is ***indirectly*** included in A and B's income, but they would not be able to claim corresponding credits for the tax.

Guidance should clarify that only income included in the taxable income of "direct" Article 22 partners or shareholders and eligible for the PTETC is included in PTETI.

IV. Coordination of PTET Add-Back with Deductible Income Tax Add-Back

Tax Law Section 612(b)(3) provides that income taxes that were deducted for Federal tax purposes are added back in determining a New York resident's taxable income. New Tax Law Section 612(b)(43) similarly provides that a New York resident's share of the PTET is added back in determining the resident's taxable income. If the PTET were treated as an income tax for Tax Law Section 612(b)(3) purposes, this would result in a double add-back of the PTET.

Guidance should clarify that there is no duplication of the PTET add-back (i.e., that in totality the PTET is only added back once to a New York resident's taxable income).[6]

[6] The same add-back duplication issue exists for nonresidents, but fixing the issue for residents should automatically fix it for nonresidents because the rule for addbacks for nonresidents is by cross reference to the addback rule for residents. See Tax Law Section 631.

V. Other Issues

There are a number of other issues raised by the PTET rules that are not addressed in this letter. Among those issues are:

- The treatment of guaranteed payments under the PTET.
- Whether retirement payments to nonresident partners that are protected from nonresident state taxation by 4 U.S.C. Section 114 are included in PTETI.
- Whether an electing entity that makes estimated PTET payments with respect to its nonresident partners is additionally required to make estimated withholding tax payments for such partners under Tax Law Section 658(c)(4).
- Whether PTETC can be claimed on a composite return.
- The treatment of electing entities that pay taxes similar to the PTET to another jurisdiction.

We expect to submit a further letter or report on these and other issues under the PTET in the future.

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We appreciate your consideration of our comments. If you have any questions regarding the matters discussed in this letter, please contact me.

Respectfully submitted,

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Chair

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