



S.2509 / A.3009, Part C

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BILL S.2509 / A.3009, Part C
SUBJECT Pass Thru Entity Tax/Federal Cap on Deduction of State Taxes
DATE February 19, 2021
SUPPORT WITH AMENDMENTS

The Business Council strongly supports this component of the Executive Budget; however, our support comes with several recommended amendments, as detailed below.

We support the overall intent of this legislation, which is to restore the full federal deductibility of New York State income taxes imposed on unincorporated businesses such and partnerships and limited liability companies, as well as certain S-Corporations.

Importantly, this is achieved with no loss of tax revenues to New York State (actually, this bill would likely generate a modest increase in state tax receipts).

Unlike C-corporations that are subject to the net income-based corporate franchise tax, unincorporated businesses and S-corporations do not pay entity-level income tax in New York State. Instead, their business income is taxed under the personal income tax (PIT), as their business' income is attributed to the business' owners/shareholders/partners. However, since this business income is taxed under the state's PIT, that state tax levy is subject to the federal \$10,000 cap on deduction of state and local taxes, adopted as part of federal tax reform in 2017. Under this legislation, an eligible partnership or S-corporation (including LLCs) can opt into payment of a newly created "pass through entity tax," or PTET, of 6.85%. The owners of the business would be eligible for a countervailing personal income tax credit calculated as a function of the owner's share of the profits of the pass through entity (PTE) times 92% times the PTET amount paid by the business. The owner's aggregate tax liability to the state remains approximately the same (higher income owners will see a modest increase in their state tax liability), but this mechanism produces a lower aggregate federal tax liability, as the full amount of the state PTET is federally deductible.

Importantly, rather than apply the PTET across the board, a business is allowed to opt into this new PTET, which allows taxpayers to avoid unintended adverse impacts (e.g., increased tax liability for entities with non-New York resident

shareholders or partners, an outcome that is counter to the purpose of this proposal).

Similar legislation has been adopted in seven states, including Connecticut, New Jersey, Maryland, Wisconsin, Rhode Island, Oklahoma and Louisiana, and has been introduced in California, Michigan, Minnesota and other states.

The IRS has, in effect, endorsed this approach in its **Notice 2020-75**, issued on November 9, 2020, which clarified that state income taxes paid by a partnership or an S-corporation would be federally deductible, regardless of whether the imposition of the tax was the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, credit, or other tax benefit at the state level.

While we support the intent and basic structure of this proposal, we have several recommended amendments.

- The bill currently limits the PTET election to S corporations and partnerships that consist solely of shareholders or partners that are individuals. We recommend that this limitation be dropped from the bill. This change would allow S-corps and partnerships with more complex ownership structures to elect to participate as well.
- The bill currently applies the pass thru entity tax to a limited share of an S-corporation or partnership's income (i.e., IRC sections 1366(a)(2) and 702(a)(8), respectively). For example, this limited approach would exclude several categories of partnership income, including gains from sales or exchanges of capital assets, gains from the sale of property, dividends, and other income items allowed by IRS regulation. We believe the bill's narrow definition of eligible income was based on earlier concerns about possible IRS rulings limiting the scope of such mechanisms. As the IRS has given broad support, we recommend that the PTET be applied to all income categories defined in IRC sections 1366 and 702.
- The bill currently requires an election to be made a full month before the commencement of the tax year to which the election would apply, meaning that the election is required up fifteen months prior to the date an entity's tax returns are due. We recommend that the state take the approach applied in other states, which allows the election to be made on the entity's tax return.

We recognize and appreciate that several legislators have introduced similar bills, and are supporting this important tax reform measure. These include S.2915 (Brooks), S.3186 (Skoufis), A.4663 (Paulin) and S.4318 (Mattera)/A.4642 (Stern). Both S.3186 and A.4663 are based on the Executive Budget language,

and S.3186 already reflects several of the amendments discussed above. The other proposals apply a somewhat different structure and approach, but produce the same beneficial outcome.

This legislation will support New York State's small and mid-sized business community at no cost to the state. It restores deductibility of state taxes limited under federal tax reform. And, to date, it is already receiving significant bipartisan support.

The Business Council strongly supports adoption of this legislation, with amendments, as part of the final state budget for FY 2022.