

# Navigating the New York Pass-Through Entity Tax – A Handy FAQ Guide

BERDON Tax Team

## PTE TAX BASICS

- Question:** What is the New York Pass-Through Entity (PTE) tax?  
**Answer:** It is an optional tax imposed on the net income of electing eligible PTEs (i.e., Subchapter S corporations and entities taxed as partnerships).
- Question:** Why did New York State enact the PTE tax?  
**Answer:** The PTE tax was enacted as a workaround to the \$10,000 federal cap on state and local tax deductions for individuals and non-grantor trusts.
- Question:** When does the PTE tax take effect?  
**Answer:** The PTE tax is effective for tax years beginning on or after January 1, 2021.
- Question:** Is the PTE tax mandatory?  
**Answer:** No, the tax is optional. The election to pay the PTE tax is made at the entity level.
- Question:** Is the NYS PTE tax deductible for federal income tax purposes?  
**Answer:** Based on existing federal guidance, it is clear that the NYS PTE tax should be deductible federally, to the extent it is applicable to business income of the PTE, which likely encompasses both income from carrying on a trade or business and income from rental real estate. However, it is unclear whether NYS PTE attributable to non-business income of a PTE will be eligible for a federal income tax deduction at the PTE level.

Non-business income would include items such as interest, dividends, and capital gains from investments. The treatment of income earned on investment of business working capital is uncertain.

For partnerships, the NYS PTE tax applies to business and non-business income of resident partners and to NYS source business and non-business income of non-resident partners. For S corporations, the NYS PTE tax applies to NYS source business and non-business income of resident and non-resident shareholders.

Federal regulations governing deductibility of State PTE taxes are initially expected to be issued in proposed form. However, regulatory projects proposed by the Trump administration have been put on hold by the Biden administration, so the status of the regulatory project is uncertain.

**Firm Guidance:** It is the firm's view that PTE taxes on non-business income will ultimately be non-deductible for federal income tax purposes. However, until further guidance is promulgated clarifying that issue, we feel it is reasonable to take the position that such PTE taxes may be deducted federally in most circumstances. Proposed federal regulations are usually effective once finalized and published in the federal register. Thus, for 2021, if final federal regulations narrowing the scope of the federal PTE

deduction to PTE taxes on business income are not finalized by the end of the year, the position may remain available for PTE taxes paid on non-business income in 2021.

## ELECTION

- Question:** When is the due date for the PTE tax election?  
**Answer:** For 2021, the election is due by October 15th. For subsequent tax years, the election must be made annually by March 15th.
- Question:** Can the election be revoked once made?  
**Answer:** No, it is an annual irrevocable election.
- Question:** Can a single-member LLC (SMLLC) disregarded for federal income tax purposes and sole proprietors elect into the PTE tax?  
**Answer:** No, SMLLCs that are disregarded entities and sole proprietorships are not eligible.
- Question:** Can a federal S corporation that is taxed as a C corporation for New York income tax purposes elect to pay the PTE tax?  
**Answer:** No.
- Question:** Can some partners, shareholders or members of the PTE (the “PTE Owner”) elect to be included in the PTE tax?  
**Answer:** No. All PTE Owners are required to be included once the PTE is elected.

## COMPUTATION OF TAX

- Question:** How does an entity that is taxed as a partnership compute PTE taxable income?  
**Answer:** An electing partnership’s taxable income includes only the New York source income of a nonresident partners plus all of the income of a resident partners. Note, the distributive shares of income attributable to partners who are not individuals or trusts (e.g., corporations, upper-tier partnerships) are not included in the PTE tax base.
- Question:** How does an S corporation compute its PTE taxable income?  
**Answer:** An electing S corporation’s taxable income only includes income derived from or connected with New York sources.
- Question:** What is the applicable tax rate?  
**Answer:** The tax is imposed at the following tax rates:

Pass-through entity taxable income	Rate
Not over \$2 million	6.85%
Over \$2 million but not over \$5 million	\$137,000 plus 9.65% of the excess over \$2 million
Over \$5 million but not over \$25 million	\$426,500 plus 10.30% of the excess over \$5 million
Over \$25 million	\$2,486,500 plus 10.90% of the excess over \$25 million

*continued*

4. **Question:** How does a multi-tiered partnership structure affect the calculation of PTE taxable income?  
**Answer:** The PTE tax base only includes the share of items includable in the taxable income of partners subject to New York personal income tax. Therefore, the items of income attributable to upper-tier partnerships are excluded from a lower-tier partnership's PTE tax base.
5. **Question:** If a PTE owner is a disregarded entity (e.g., a grantor trust or a single member LLC), how does the disregarded entity's share of income from the PTE affect the calculation of PTE taxable income?  
**Answer:** If the owner of the disregarded entity is an individual or trust, the share of income attributable to the disregarded entity is included in PTE taxable income, subject to the rules outlined in Answer #1 above. Note, the PTE tax return must disclose the identity of the owners of the disregarded entities.

#### PTE TAX CREDIT

1. **Question:** Will a New York nonresident PTE Owner receive a credit on their New York nonresident tax return for the PTE tax paid?  
**Answer:** Yes, the nonresident PTE Owner will receive a dollar-for-dollar refundable personal income credit for their direct share of PTE tax paid.
2. **Question:** How is the New York PTE tax credit calculated for an owner of multiple PTEs that pay the PTE tax?  
**Answer:** The credits are calculated separately for each entity
3. **Question:** Is the PTE Owner permitted to use the PTE tax credit to offset income tax related to non-PTE income?  
**Answer:** Yes.
4. **Question:** Must the PTE Owner add back the amount of the PTE tax credit to New York taxable income reported on their New York income tax return?  
**Answer:** Yes.
5. **Question:** Is there a New York resident income tax credit for PTE taxes paid to other states?  
**Answer:** Yes. There is a New York resident tax credit for PTE taxes paid to other states if the other state's PTE tax is "substantially similar" to New York's PTE tax.
6. **Question:** Does New York tax law provide a resident income tax credit to the PTE Owner for their direct share of the New Jersey business alternative income tax (BAIT) paid by the PTE?  
**Answer:** Probably yes. We think that the New Jersey BAIT is substantially similar to the New York PTE tax.
7. **Question:** Can a New York resident PTE Owner claim a resident tax credit on their New York resident income tax return for New Jersey BAIT paid by a PTE that does not pay New York PTE tax?  
**Answer:** Probably yes.
8. **Question:** If a PTE's taxable income bracket is higher than the PTE Owner's New York taxable income bracket, will the PTE Owner pay a higher effective rate of tax than they would if the PTE did not elect to pay the PTE tax?  
**Answer:** No. If the PTE Owner pays tax at a lower marginal rate than the PTE, the unused PTE credits are treated as an overpayment and may be refunded or carried forward.

## PAYMENT OF PTE TAX

- Question:** When are PTE estimated tax payments due?

**Answer:** Estimated taxes are due in four equal installments on March 15th, June 15th, September 15th, and December 15th in the calendar year prior to the year in which the due date of the return falls. Fiscal-year filers have the same estimated tax payments due dates as the calendar-year filers.
- Question:** Does the PTE make estimated tax payments for the 2021 tax year?

**Answer:** No, however, see the answer to Question 4 below.
- Question:** Should the PTE Owner adjust their New York estimated tax payments for 2021 in anticipation of the PTE electing to pay the PTE tax in 2021?

**Answer:** No, the PTE Owner must continue to make estimated income tax payments as if the PTE election will not be made.
- Question:** How will an electing PTE pay the tax in 2021?

**Answer:** Although there is no guidance at this time, one possibility is that a portion of the PTE owner's estimated payments will be transferred to cover payment of 2021 PTE tax. Additionally, it has come to our attention that the New York State Department of Taxation & Finance might provide a voluntary online PTE tax payment mechanism before the end of 2021. It is possible that this voluntary payment mechanism may be the sole method for facilitating payment of the PTE tax during the 2021 tax year (i.e., crediting a portion of the PTE owners' 2021 estimated income tax payments to the PTE to cover payment of the 2021 PTE tax may not be an option). Voluntary PTE payments that are made in 2021 will satisfy the requirement of federal Notice 2020-75 that the PTE tax payment should be made by the PTE in the year for which the PTE takes the related deduction (see question 6 below).
- Question:** For tax years beginning on or after January 1, 2022, what is the required annual estimated tax payment?

**Answer:** It is the lesser of (i) 90% of the tax for the taxable year, or (ii) 100% of the tax of the preceding tax year.
- Question:** Does the PTE tax need to be paid during the taxable year for the federal deduction to be allowed?

**Answer:** IRS Notice 2020-75 provides that payment is required "during a taxable year" for the federal deduction. For taxpayers on the cash method of accounting, amounts representing allowable deductions should be paid within the taxable year. For taxpayers on the accrual method of accounting, however, the application of the payment rule is not as clear. To ensure a tax deduction, the conservative approach would be to pay the PTE during the taxable year, but there may be a position for accrual method taxpayers to claim the federal deduction if the PTE is paid under the "recurring item exception" as explained further below.

Since the IRS Notice 2020-75 is not law making and is interpreting existing rules, it is the firm's view for accrual method taxpayers that the normal all events and the economic performance rules should apply. Specifically, for accrual method taxpayers, a deduction is allowed in the year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. If all the events have occurred to fix the liability and economic performance has occurred in a taxable year, the fact that the exact amount of the liability is not known generally does not prevent a taxpayer from taking the deduction in that year as long as the amount can be determined with reasonable accuracy.

Under the economic performance rules, when the liability is for state income taxes, economic performance occurs when the tax is paid to the governmental authority that imposed the tax. In general, estimated tax payments are included as payments for this purpose. If taxes are not paid during the taxable year, the recurring item exception can allow a deduction for state income if paid within 8 ½ months after the end of the taxable year to which they relate, if the liabilities are generally recurring in nature and the taxpayer can reasonably expect that the liability will be incurred on a recurring basis in the future.

**Firm Guidance:** It is clear that Notice 2020-75 is interpretive only, and cites federal statutes, Congressional material, and IRS precedent for its authority. Notwithstanding that, it seems to be the IRS position that it will require payment within the tax year for PTE tax deductions. Thus, in the absence of further guidance, we feel it is prudent to make payment to secure the deduction. However, with a full understanding of the risk, it is reasonable to take the position that such PTE taxes may be deducted federally for accrual method taxpayers under the recurring item exception. Note that for tax year 2021, securing a federal deduction may require payment of the PTE tax before the end of the year or relying on the attribution of partner estimated payments to the entity.

### FILING THE PTE TAX RETURN

- Question:** When is the PTE tax return due?

**Answer:** On or before March 15th following the close of the PTE's taxable year. For 2021, the return is due by March 15, 2022. For fiscal-year filers, the return is due on or before March 15th following the close of the calendar year that contains the final day of the entity's taxable year.
- Question:** Can the deadline be extended?

**Answer:** Yes, the Commissioner may grant an extension of up to 6 months (note, at this time, it appears that the extension is discretionary and, not as of right. We believe it is likely that the tax commissioner will clarify the nature of the extension through informal guidance, instructions and or regulations.
- Question:** Can the return be amended once filed?

**Answer:** Only with the consent of or otherwise as authorized by the tax commissioner.

### PLANNING CONSIDERATIONS

- Question:** Should taxpayers be forming partnerships and contributing their investments now to make their prospective investment income eligible for the NYS PTE deduction?

**Answer:** Anti-abuse regulations (Treas. Reg. §1.701-2) empower the IRS to disregard a partnership if it is formed with the primary purpose of reducing the partners' aggregate federal tax liability. Moreover, there is a substantial body of case law that provides guidance for determining whether a partnership was formed and/or operated for bona fide purpose and should be respected for tax purposes. Formation of an investment partnership for the primary purpose of qualifying for a PTE tax deduction likely fails this standard.

**Firm Guidance:** The firm does not support formation of an investment partnership for the primary purpose of qualifying for the NYS PTE tax deduction on investment income. If, however, the primary purpose is for investment planning, management, or for other legal reasons as a business purpose, the arrangement may be respected, but taxpayers should be aware that this broad interpretation of the scope of the federal deduction may be circumscribed by future guidance. In general, whether a partnership was formed with a principal purpose to reduce the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of the Internal Revenue Code is determined based on all the facts and circumstances, including consideration of

the purported business purpose. If the IRS ultimately disallows the deduction of the NYS PTE tax for investment income, despite not having taken a deduction for federal purposes, as written it appears that the New York State statute would still require the add-back of any PTE in computing income for New York State purposes.

2. **Question:** Should taxpayers convert SMLLCs (treated as disregarded entities), sole proprietorships, and directly owned rental properties into tax partnerships (or S corporations) for the purpose of benefiting from the PTE?

**Answer:** It depends. If the SMLLC only holds a partnership interest, then it is not necessary to convert the SMLLC because the PTE tax law permits the underlying partnership to disregard the SMLLC and pay the PTE on behalf of the ultimate individual or trust taxpayer. If, on the other hand, the SMLLC is itself conducting a business or rental activity, the owner may want to consider converting to a tax partnership to take advantage of the PTE deduction. In some cases, partnership anti-abuse rules may need to be considered to support a bona-fide partnership and business purpose. One way to create a tax partnership is to include a 1% S corporation member. Doing this avoids the issue of converting to a S corporation entirely, which would subject all the income to NYC tax.

If it is impractical for a SMLLC to add another member to achieve partnership tax status, another approach could be to check the box for corporate status and make an S election for the SMLLC. However, SMLLCs operating in NYC will likely not choose this option because of the NYC corporate tax burden, which is about two times the UBT rate and applies to rental real estate income which is exempt from UBT. Also note that for 2021, only the portion of the year following conversion to partnership or S corporation status will qualify for the PTE tax deduction.

**Firm Guidance:** Certain taxpayers with SMLLCs, sole proprietorships, and directly owned rental properties should consider converting to a partnership, or in certain circumstances S corporation tax status for the purpose of benefiting from the PTE.

**Questions:** Please reach out to your [Berdon advisor](#).

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