

New York SALT Workaround

New Guidance, Affected Industries, and What to Know Before the
October 15 Election Deadline

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Presentation Outline

1. The SALT Cap Problem
2. A Partial SALT Cap Solution: Pass-Through Entity Taxes (PTET)
3. New York's PTET:
 - A. The Mechanics
 - B. Planning Considerations for Fund Managers
 - C. Planning Considerations for Entertainment Industry Talent
 - D. Comparison with Other States
4. Pre-Submitted Questions
5. Legislative Update

The SALT Cap Problem

Very quickly, we promise

A SALT Cap Problem

- Federal income taxes went up for many individuals residing or working in high tax states after 2017 because the Tax Cuts and Jobs Act (the TCJA) limited an individual's ability to deduct state and local taxes (SALT) to **\$10,000**.
- For people in high tax states, capping this deduction can be material.
- **Simple Example:**
 - \$1,500,000 taxable income.
 - NYS income tax @ 6.85% = \$102,750.
 - Westchester real estate taxes = \$40,000.
 - **Tax increase = \$49,118** (i.e., $(\$142,750 - \$10,000) \times 37\%$ marginal rate).*

**Assumes taxpayer was paying regular tax pre-TCJA and not AMT.*

The SALT Cap Problem

- **Question:** Because of AMT, weren't many people not getting the benefit of the SALT deduction before 2017 anyway?
- **Answer:** Yes. Individuals who were subject to AMT before 2017 were not receiving the full benefit of the SALT deduction anyway because SALT was an add-back for AMT purposes. However, a significant number of taxpayers (especially those with very high incomes) were not subject to AMT – and thus were receiving the full benefit of the SALT deduction before 2017. These taxpayers were hit the hardest by the SALT Cap.

Note: Repeal of the SALT cap is estimated to reduce revenues by approximately \$95 billion per year through 2025.

A Partial SALT Cap Solution

Pass-Through Entity Taxes

A Partial SALT Cap Solution

- **“Workarounds” Emerge.**
 - After 2017, many states began looking for ways to alleviate the increased tax burden on their residents due to the SALT Cap by enacting new taxes/collection mechanisms that would allow their state tax payments to be federally deductible. Some ideas included:
 - ❖ State Charitable Contributions.
 - ❖ New Payroll Taxes.
 -  ❖ Shifting to an Entity-Level Tax (PTET).
- **Why Have PTETs Proliferated?**
 - IRS Notice 2020-75 issued November 10, 2020, indicated IRS willingness to allow a federal deduction for PTEs, even if elective.
 - In response, many states started enacting pass-through entity taxes.

A Partial SALT Cap Solution

- **Section 3.01 of Notice 2020-75:**

“For this purpose, a Specified Income Tax Payment includes any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or S corporation, without regard to whether the imposition of and liability for the income tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction’s tax law and which reduces the partners’ or shareholders’ own individual income tax liabilities under the Domestic Jurisdiction’s tax law.”

New York's PTE Regime

The Mechanics

New York's PTE Regime: The Mechanics

- **Applies to:**

- Partnerships (e.g., multi-member LLCs, LPs)
 - S Corporations
- 
- PTEs**

- **How It Works:**

- The PTE pays an entity level-tax at the same New York personal income rates on that income which would have been subject to New York personal income tax by its owners on a flow-through basis. Meaning:
 1. New York Source Income
 2. Income Allocable to New York Resident Partners/Shareholders
- Credit is then allocated among the owners in the same percentages in which the income taxable in New York would have been allocated to those owners.

New York's PTE Regime: The Mechanics

- The PTE tax is elective on an annual basis. Once made, the election is irrevocable for that tax year.
- For 2021, the deadline for a partnership or S corporation to make the election to be subject to the PTE tax is October 15, 2021.
- To receive a federal tax deduction for 2021, an electing entity must make payments of the PTE tax before the end of the year.
- Partners and shareholders of an electing entity must continue to make NYS estimated tax payments for 2021 without regard to the PTE tax credit.
- Effectively, this means that for 2021, individual partners and shareholders pay their NYS income tax liability twice. The taxpayer can get a refund of the excess 2021 tax paid after filing a 2021 return in 2022.
- Beginning in 2022, partners and shareholders of an electing entity can take the amount of any potential PTE tax credit into account when calculating estimated tax payments.

New York's PTE Regime: The Mechanics

- **Important S Corp vs. Partnership Distinction:**
 - PTE Taxable Income:
 - For Partnerships: NY Source Income + Income Allocated to Residents.
 - For S Corporations: NY Source Income Only.
- **Why the Distinction?**
 - It appears NYS was concerned about a creating a potential second class of stock issue for S Corporations.
 - For the program to work, the deduction for the entity level tax paid by the PTE must be allocated to those partners receiving the credit.
 - Thus, if only some S corporation shareholders are NY residents, the deduction cannot be specially allocated to those NY residents while still treating all shareholders pro rata.

New York's PTE Regime: The Mechanics

- **Example:** Bills Mafia LLC has four individual members and one corporate member. In 2021, it has \$14 million of New York source income from the sale of folding tables from its operations in Orchard Park, NY.

Partner	Residency	% Interest	Federal Taxable Income (Before PTET)	Share of PTET	Federal Taxable Income (After PTET)
Jim	NY	15%	\$2,100,000	?	?
Bruce	NY	25%	\$3,500,000	?	?
Andre	FL	20%	\$2,800,000	?	?
Thurman	FL	30%	\$4,200,000	?	?
Zubaz Inc.	DE	10%	\$1,400,000	?	?
Totals		100%	\$14,000,000	?	?

- **PTE Taxable Income** = _____.
- **PTE Tax** = _____.

New York's PTE Regime: The Mechanics

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Jim	NY	15%	\$2,100,000	?	?
Bruce	NY	25%	\$3,500,000	?	?
Andre	FL	20%	\$2,800,000	?	?
Thurman	FL	30%	\$4,200,000	?	?
Zubaz Inc.	DE	10%	\$1,400,000	\$0	?
Totals		100%	\$14,000,000	\$1,209,300	\$12,790,700

- **PTE Taxable Income = \$12,600,000 (i.e., \$14,000,000 – \$1,400,000).**
- **PTE Tax = \$1,209,300 (see rate tables).**

New York's PTE Regime: The Mechanics

- **Credit Allocation:**
 - Resident Pool: Jim and Bruce
 - Resident PTE Taxable Income: **\$5,600,000**
 - Resident PTE Taxable Income / Total PTE Taxable Income: **44.4%**
 - Resident Pool Share of Credit (44.4% of total credit): **\$537,413**

Resident Members	Resident PTE Taxable Income	Resident Pool %	Share of Credit
Jim	\$2,100,000	37.5%	201,530
Bruce	\$3,500,000	62.5%	355,883
Total	\$5,600,000	100%	\$537,413

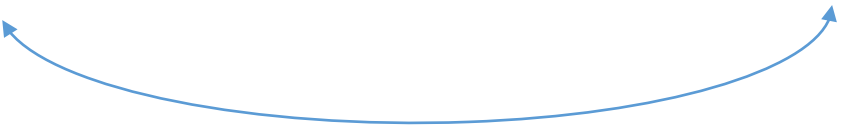
New York's PTE Regime: The Mechanics

- **Credit Allocation:**
 - NR Pool: Andre and Thurman
 - NR PTE Taxable Income: **\$7,000,000**
 - NR PTE Taxable Income / Total PTE Taxable Income: **55.6%**
 - NR Pool Share of Credit (55.6% of total credit): **\$671,833**

NR Members	NR PTE Taxable Income	NR Pool %	Share of Credit
Andre	\$2,800,000	40%	\$201,530
Thurman	\$4,200,000	60%	\$403,100
Total	\$7,000,000	100%	\$671,833

New York's PTE Regime: The Mechanics

Partner	% Interest	Federal Taxable Income (No Election)	Share of PTET Credit	Federal Taxable Income (After PTET)	Reduction in Federal Taxable Income
Jim (R)	15%	\$2,100,000	\$201,550	\$1,918,605	\$181,395
Bruce (R)	25%	\$3,500,000	\$335,917	\$3,197,675	\$302,325
Andre (NR)	20%	\$2,800,000	\$268,733	\$2,558,100	\$241,860
Thurman (NR)	30%	\$4,200,000	\$403,100	\$3,837,210	\$362,790
Zubaz Inc.	10%	\$1,400,000	\$0	\$1,279,070	\$120,930
Totals	100%	\$14,000,000	\$1,209,300	\$12,790,700	\$1,209,300



Wait. . . Shouldn't these columns match?

New York's PTE Regime: The Mechanics

Partner	Federal Taxable Income (No Election)	Share of PTET Credit	Federal Taxable Income (Without Special Allocation of PTET Deduction)	Federal Taxable Income (With Special Allocation of PTET Deduction)	Reduction in Federal Taxable Income
Jim (R)	\$2,100,000	\$201,550	\$1,918,605	\$1,898,450	\$201,550
Bruce (R)	\$3,500,000	\$335,917	\$3,197,675	\$3,164,083	\$335,917
Andre (NR)	\$2,800,000	\$268,733	\$2,558,10	\$2,531,267	\$268,733
Thurman (NR)	\$4,200,000	\$403,100	\$3,837,210	\$3,796,900	\$403,100
Zubaz Inc.	\$1,400,000	\$0	\$1,279,070	\$1,400,000	\$0
Totals	\$14,000,000	\$1,209,300	\$12,790,700	\$12,790,700	\$1,209,300

Much better.

New York's PTE Regime: The Mechanics

- **Allocations/Distributions Work?**
 - **Allocations:** Need to review LLC Agreement to make sure that the appropriate partners are receiving the deduction for the PTE. May need to add language to LLCA that the PTE deduction is to be specially allocated to those members receiving the benefit.
 - **Distributions:** Need to review LLC Agreement to make sure PTET payment does not change the deal economics (otherwise could become a priority distribution to the partner on whose benefit the PTE was paid). Consider adding specific language that PTET payments are added back to determine Net Cash Flow and treated as actually distributed to such member.

New York's PTE Regime

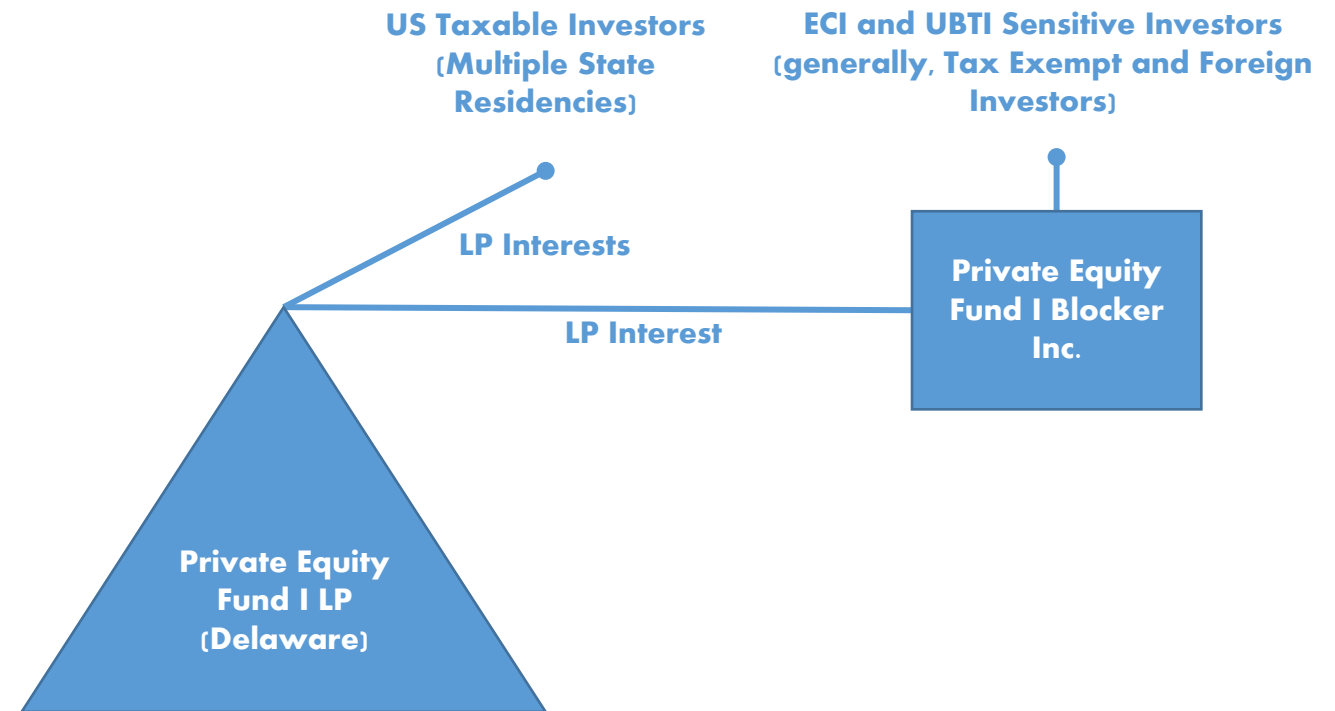
Planning Considerations for Fund Managers



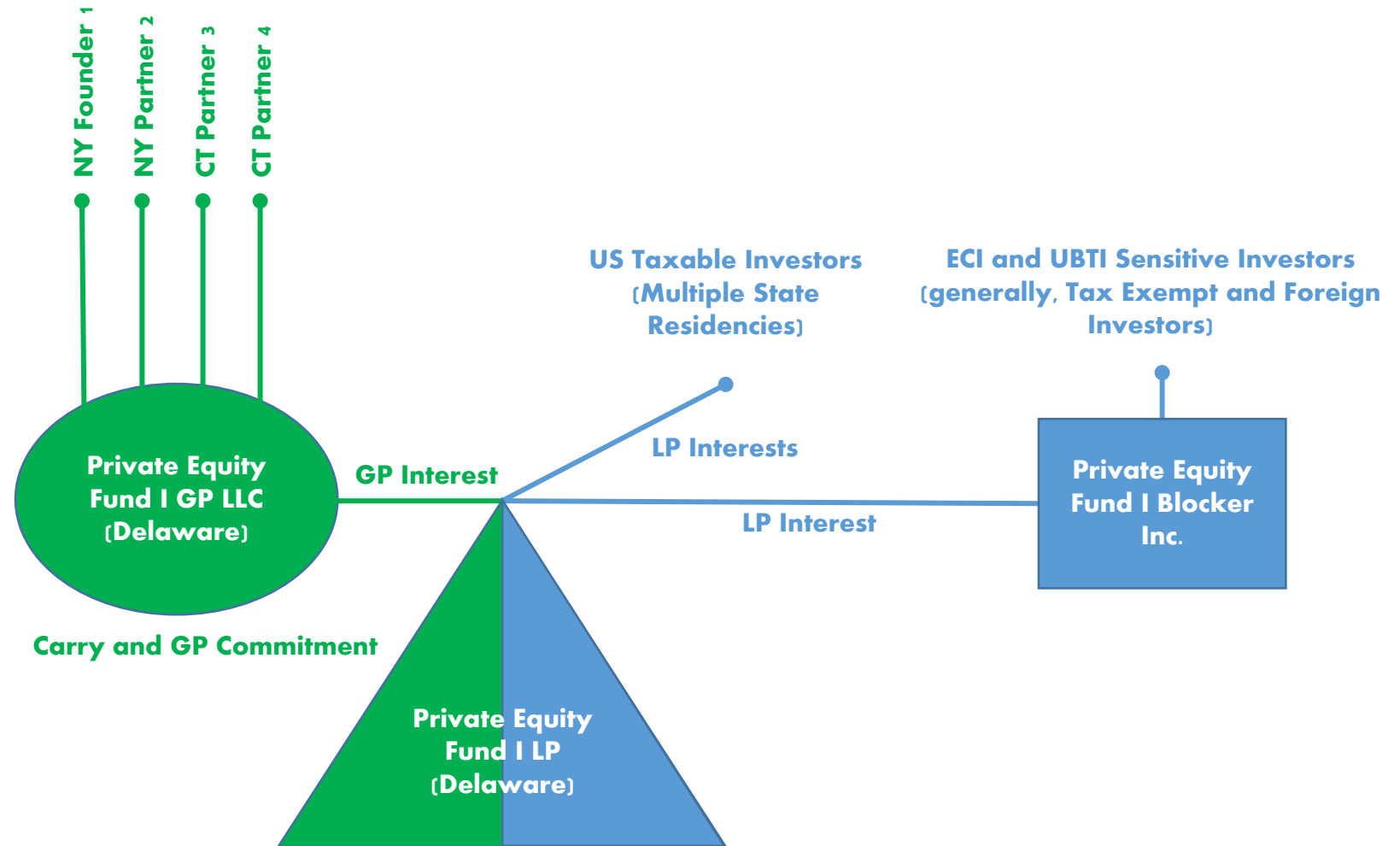
New York's PTE Regime: Planning Considerations for Funds

Basic Fund Structure (Following Slides)

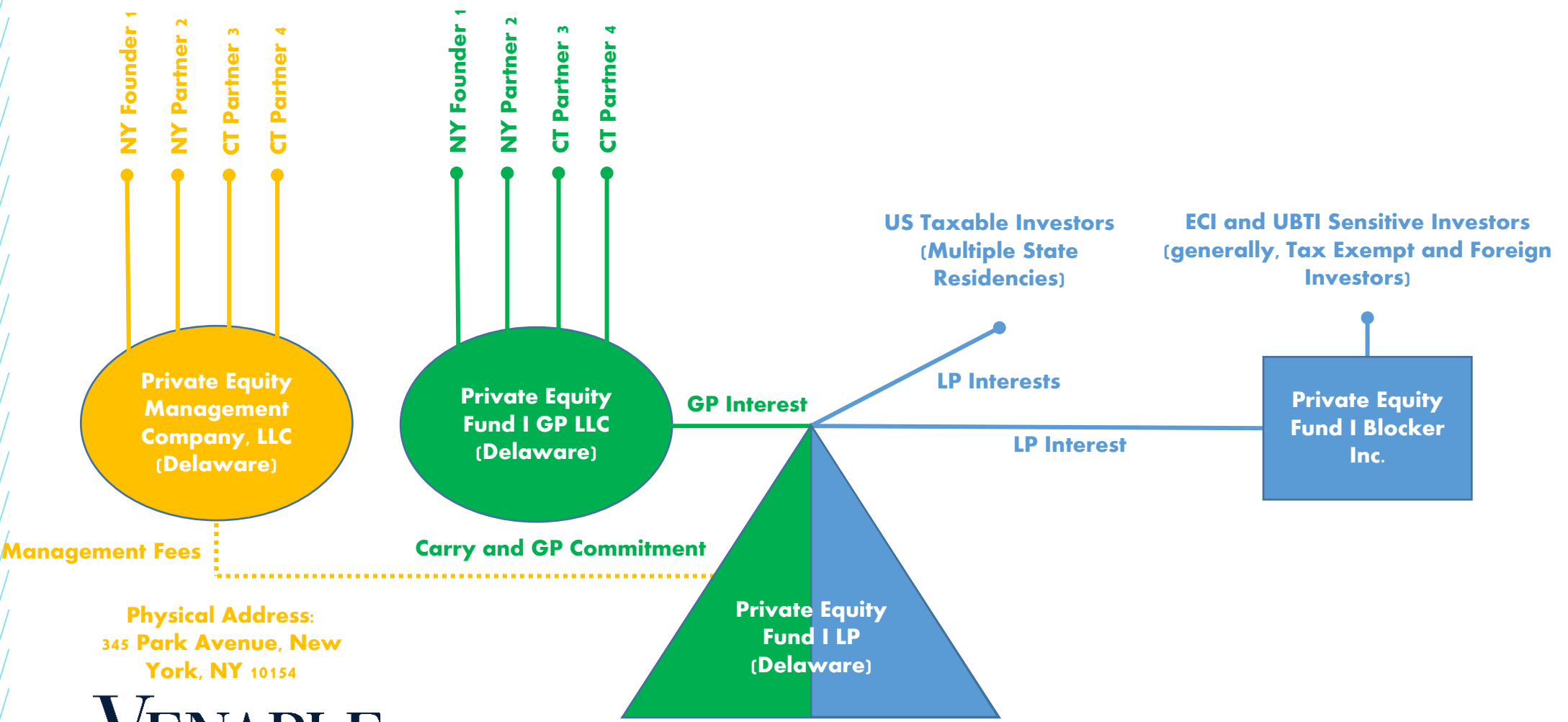
New York's PTE Regime: Planning Considerations for Funds



New York's PTE Regime: Planning Considerations for Funds



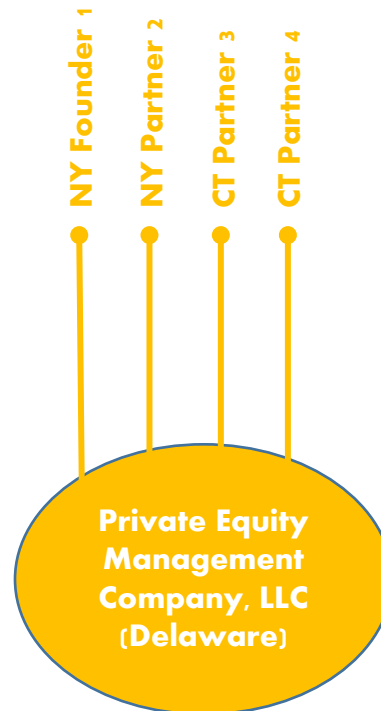
New York's PTE Regime: Planning Considerations for Funds



New York's PTE Regime: Planning Considerations for Fund Managers

Management Co:

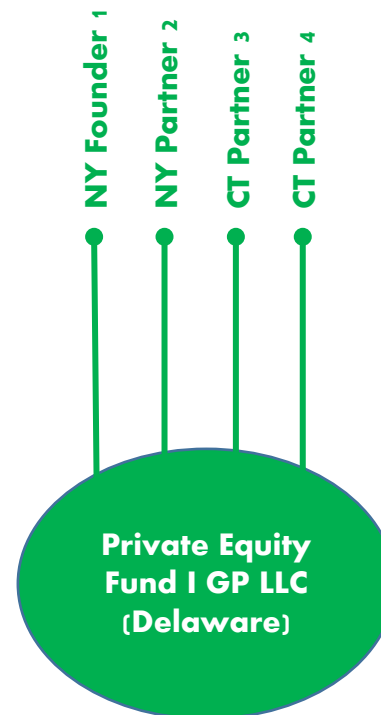
- Making the NY PTET election at the management company level would seemingly be beneficial for both the NY and CT partners because the management fee income is NY-source income and CT credits the NY PTET against the CT partner's CT resident return.



New York's PTE Regime: Planning Considerations for Fund Managers

GP Entity:

- Making the NY PTET election for the GP entity would seemingly benefit the NY resident partners only because, in most cases, income earned by the GP entity (e.g., carry gains) is not NY-source and therefore not taxable in NY to the CT resident partners.

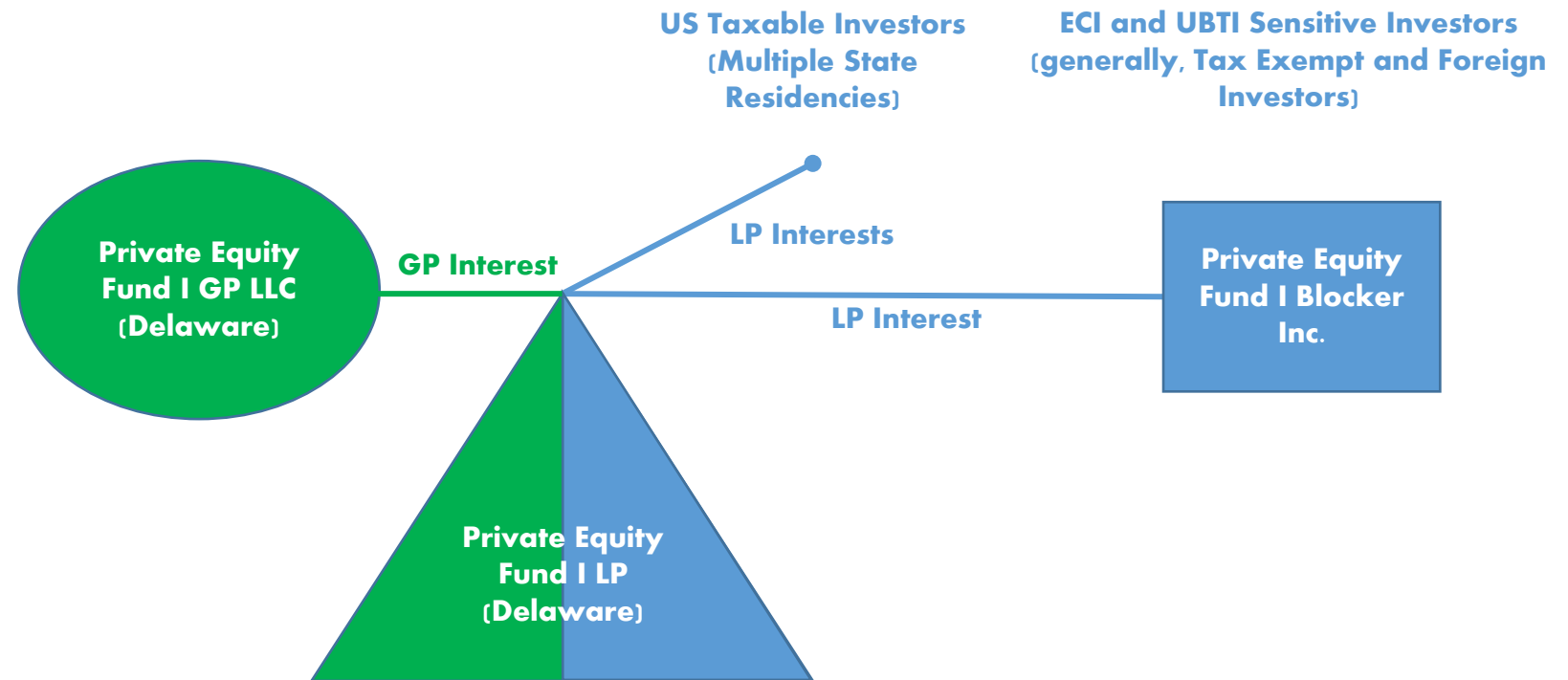


Carry and GP Commitment

New York's PTE Regime: Planning Considerations for Fund Managers

The Fund:

- Making the PTE election at the fund level presents concerns with credit issues, as the fund will likely have investors residing in many jurisdictions, some of which may not offer a credit for the PTE tax paid.



New York's PTE Regime: Planning Considerations for Fund Managers

- An individual partner could seek to drop the partner's interest into a partnership with the partner's spouse or domestic partner, but it is unclear whether PTE taxes paid by this partnership would be deductible. Dropping the interest into an LLC presents other non-tax concerns.
- The partner might need to obtain consents from the partnership to drop the interest into an LLC.

New York's PTE Regime

Planning Considerations for Entertainment Industry Talent

New York's PTE Regime: Planning Considerations for Entertainment Industry Talent

- Many individuals in the entertainment industry work through S corporation loanouts.
- S corporation loanout are eligible to make the PTET election.
- Many have traditionally bonused out their net profits at the end of the year without taking S corporation distributions.
- **Should they leave those earnings in the pass-through entity to benefit from the PTET?**

New York's PTE Regime: Planning Considerations for Entertainment Industry Talent

- **Each situation must be evaluated separately.**
- **Some key considerations:**
 - For S corporations, only NY source income is eligible for the credit.
 - NYS uses market-based sourcing for S corporations (incl. PTET purposes).
 - NYC does not recognize S corporations and subjects earnings to 8.85% GCT using cost of performance sourcing.
- **Other Ventures?**
 - Many celebrities also own LLC interests received for services in sweat-equity deals.
 - If celebrity is a NY income tax resident, may want to consider having venture make PTET election because — unlike S corporations — all income allocable to the NY resident celebrity is eligible for the credit
 - E.g., West Coast fashion label founded by a New York resident celebrity.

New York's PTE Regime

Comparison with Other States

New York's PTE Regime: Comparison with Other States

Considerations When Comparing PTE Tax Regimes

1. Mandatory or Elective

- IRS Notice 2020-75 allows for PTE taxes to be elective.
- Is the state's PTE mandatory? If elective, must it be elected for all members?

2. Tax Deduction Addback

- States don't allow a deduction for state income tax when determining state taxable income.
- How is this avoidance of the deduction implemented? An addback at the owner level? A reduction in the amount of the credit for the PTE tax?

3. Applicable Owners

- Ideally a PTE tax applies only to entity level taxable income of owners who will benefit from a SALT deduction that they do not otherwise get the benefit of.
- What owners have their shares of taxable income included as subject to the tax?

New York's PTE Regime: Comparison with Other States

Considerations When Comparing PTE Tax Regimes (continued)

4. Apportionment

- State taxes applicable to business entities generally apply only to taxable income apportioned to the state. But resident individuals are subject to state income tax from all sources.
- Does the state's PTE tax apply only to apportioned income?
- Does the tax apply to all income allocable to residents and only to apportioned income allocable to nonresidents? Does this regime apply to S corporations?

5. Other State Tax Credit

- When considering the benefits of the PTE tax for an entity with nonresident owners a vital consideration is whether the owner's resident state will allow a credit for the tax.
- Does the state's law enacting a PTE tax have a reciprocity provision under which the state will allow its resident taxpayers a credit for "similar" PTE level taxes paid to other states under nonresident status?

Pre-Submitted Questions

What about...?

Pre-Submitted Questions

1. If the election is made and PTET is paid by 12/31, can individuals pass on making 4th quarter estimates without penalty or interest assessment?
2. Can a CPA firm set up a business account and pay the PTET on behalf of the client?
3. Does the form E-ZRep provide any authorization to make the election on behalf of clients?

Legislative Update

Where are we going?

Legislative Update

- Without any legislative action, the SALT cap is scheduled to expire on December 31, 2025.
- The text of the legislation proposed by the House Ways and Means Committee does not repeal or expand the SALT cap.
- Repeal of the SALT cap is estimated to cost approximately \$95 billion per year.
- A small but vocal group of Democrats from high tax states have pushed for a repeal of the SALT cap and threatened to withhold support for the reconciliation bill if it does not include SALT relief.
- Last week, a temporary, two-year repeal of the SALT cap was proposed.



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