



NYS Pass-Through Entity Tax

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Overview

Entity level tax that is a deductible business expense to the entity which lowers the federal taxable income allocated to the partners

- “Work-around” to the \$10,000 individual federal deduction cap for state and local taxes following Notice 2020-75

Tax paid by the partnership with a *refundable* credit allocated to the partners

Applies to tax years beginning on or after January 1, 2021

Partnerships having an Article 22 partner (individuals, trusts and estates) are eligible

- Having a corporate or partnership partner does not disqualify
- No “doing business” requirement or state source income requirement

Applies to the partnership and thus binds all partners; cannot pick and choose which partners participate

Annual election generally by the due date of the first estimated payment (March 15)

- 2021 transition year election date is October 15

Estimated payments are made on the 15th of March, June, September and December (regardless if calendar or fiscal year)

- Not required for 2021 transition year

Entity pays tax using the individual rates on the sum of the tax base

Mechanics

Tax base

- NYS resident partners - entire distributive share (worldwide income) (including guaranteed payments?)
- NYS non-resident partners - NYS source distributive share
- S Corps use NYS source income for *both resident and non-resident shareholders*
- Partners that are themselves passthroughs are not considered in the calculation and must make the election at their own level



Cost vs Benefit

- Federal deduction is an addition modification to the NYS personal income tax base
- Amount of credit is also an addition modification to the NYS personal income tax base
- Result is that more NYS tax is paid than if the PTET election is not made because of this tax on the credit
- This is the “cost” of getting the federal deduction – roughly 120 bps for highest bracket taxpayers

Example: PTET calculation

Partnership income: \$50mm total income (pre-PTET)

NYS apportionment: 50%

Partner Makeup:

- Partner 1 – NYS Resident Individual: 50%
- Partner 2 – Non-NYS Individual: 25%
- Partner 3 – Corporation 12.5%
- Partner 4 – Partnership 12.5%



PTET Calculation:

| | |
|---|-------------------|
| Partnership Income | 50,000,000 |
| NYS Apportionment | 50% |
| NYS Source Income | 25,000,000 |
| Partner 1: (50% of total income) | 25,000,000 |
| Partner 2: (25% of NY source income) | 6,250,000 |
| Partner 3: (tax is inapplicable to corps) | 0 |
| Partner 4: (PS makes election at their own level) | 0 |
| PTET Base | 31,250,000 |
| Tax Rate (partnership income >\$25mm) | 10.9% |
| NYS PTET | 3,406,250 |

Federal taxable income:

| | |
|------------------------|------------|
| Partnership Income | 50,000,000 |
| NYS PTET | 3,406,250 |
| Federal Taxable Income | 46,593,750 |

Example: Credit calculation



Credit calculation:

| | | |
|--------------|--------------------|---|
| Partner 1: | \$2,725,000 | $(\$25\text{mm}/\$31,250,000) \times \$3,406,250$ |
| Partner 2: | \$681,250 | $(\$6,250,000/\$31,250,000) \times \$3,406,250$ |
| Partner 3: | 0 | |
| Partner 4: | 0 | |
| Total | \$3,406,250 | |

— Credit allocation is based on relative income inclusion into tax base

Example: NYS resident partner calculation



NYS Personal income tax

Partner 1: NYS Resident

| | | |
|--|-----------------------|--------------------------|
| Total Income from Partnership | 25,000,000 | |
| <u>Addback of NY PTET (10.9% x \$25,000,000)</u> | <u>2,725,000</u> | |
| NYS Taxable Income | 27,725,000 | |
| <u>NYS Individual Tax Rate</u> | <u>10.9%*</u> | |
| NYS Tax Liability | 3,022,025 | |
| <u>NYS PTET Credit</u> | <u>2,725,000</u> | |
| Additional Liability | 297,025 | (297,025 / 25mm = 1.19%) |
| <u>Federal Benefit (\$2,725,000 x 37%);</u> | <u>1,008,250</u> | |
| <u>Net Benefit</u> | <u>711,225</u> | |

- For Federal purposes, should the allocation of the state tax expense follow the allocation of the credit or is it allocated similarly to other expenses?

*The maximum rate, rather than the progressive rate, is being used for simplicity purposes..

Example: NYS non-resident partner calculation



NYS Personal income tax

Partner 2: NYS Non-resident

| | | |
|---|-----------------------|------------------------------|
| Total Income from Partnership | 6,250,000 | |
| Addback of NY PTET (10.9% x \$6,250,000) | 681,250 | |
| NYS Taxable Income | 6,931,250 | |
| <u>NYS Individual Tax Rate</u> | <u>10.3%*</u> | |
| NYS Tax Liability | 713,919 | |
| <u>NYS PTET Credit</u> | <u>681,250</u> | |
| <u>Additional Liability</u> | <u>32,669</u> | (32,669 / 6,250,000 = 0.52%) |
| <u>Federal Benefit (\$681,250 x 37%);</u> | <u>252,063</u> | |
| <u>Net Benefit</u> | <u>219,394</u> | |

*Note that while the PTET is calculated using the rate applicable to the partnership (over \$25mm bracket is 10.9%), the individual liability is calculated using the taxpayers individual rate (\$5mm-\$25mm bracket is 10.3%). The maximum rate, rather than the progressive rate, is being used for simplicity purposes.

Non-Resident partner issues

Issue: Does the partner's resident state provide a credit for state taxes paid if a PTET?

- State's that have PTET's generally provide a credit
- State's that do not have a PTET are silent or don't allow.
 - Still relatively new and needs to be determined.



Solution

- Create a feeder partnership for the NYS resident partners and any other partners who want to participate.
 - Since election applies to all partners, this allows for only those wishing to avail themselves of the election to participate.

Limitations?

— Is the federal deduction subject to limitation if the entity is not in a trade or business?

- Section 164 vs. 162/212
- Notice 2020-75 states intent to be deductible as a “nonseparately stated income or loss”

Specified Income Tax Payments not separately taken into account. Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year does not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately under section 702 or section 1366 in determining the partner’s or S corporation shareholder’s own Federal income tax liability for the taxable year. Instead, Specified Income Tax Payments will be reflected in a partner’s or an S corporation shareholder’s distributive or pro-rata share of nonseparately stated income or loss reported on a Schedule K-1 (or similar form).

- Investment partnerships generally do not have “nonseparately stated income or loss”
- Itemized deductions not associated with a section 162 business are generally separately stated under section 702
- How do you reconcile Notice 2020-75 with existing law?



Limitations? (continued)

- Will AMT cause the taxpayer to lose the federal benefits?
 - Individuals in investor funds would generally report as Schedule A – Line 6
- Could IRS challenge a special allocation of the partnership level tax deduction that is made in accordance with the state methodology for awarding the credit?
 - Could this allocation cause the tax to be viewed as akin to a composite or withholding
 - How does the partnership allocate other entity level taxes (e.g., NYC UBT)?



Other considerations

- Will new entity be subjected to additional taxes?
 - NYC Unincorporated Business Tax (UBT) on partnerships
 - NYC General Corporation Tax (GCT) on S corps
 - New York City does not recognize Federal or New York State “S Corporation” elections
- Cash flow issues – tax is paid by partnership entity
 - Reduces AUM/capital
 - May require additional capital calls
 - Effect on tax distributions
- Fund income may not be known until year end so income attributable to respective partners may be uncertain until then
- Considerations with respect to compensatory equity interests/profits interest
- Will new tax legislation eliminate the need?
 - Annual election takes some pressure off if SALT deduction is restored
 - SALT cap set to expire post – 2025





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