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Report No. 1452
July 30, 2021

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

Re: *Further Comments on Implementation of the Pass-Through Entity Tax*[1]

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, and elect on a year-by-year basis, to be subject to the tax (hereinafter referred to as "electing entities"). On May 24, 2021, we submitted NYSBATS Report No. 1451, in which we focused on selected matters likely to affect electing partnerships and S corporations for calendar year 2021 that required immediate attention.

We are now submitting this follow-up letter, focused on a number of additional issues highlighted in Section V of NYSBATS Report No. 1451

[1] The principal drafters of this letter were Pamela Lawrence Endreny, Alyssa Keim, Elliot Pisem, Jack Trachtenberg, and Jennifer S. White. Helpful comments were received from Yaron Reich, Michael Schler, Eric Sloan, and Gordon Warnke. This letter reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBATS") and not those of its individual members, the New York State Bar Association's Executive Committee or House of Delegates, or any other party.

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that we believe require further guidance and/or clarification from the Department of Taxation and Finance (the "Department").[2]

I. Issues for Consideration

A. Are guaranteed payments paid to nonresident foreign partners for services performed outside the United States included in the PTET?

For purposes of the PTET, New York Tax Law ("Tax Law") Section 860(h)(1)(i) defines "pass-through entity taxable income" ("PTETI"), in relation to nonresident partners, as the sum of all items of income, gain, loss or deduction derived from or connected with New York sources to the extent they are included in the taxable income of a nonresident partner subject to personal income tax on nonresident partners. Thus, to determine whether guaranteed payments paid to a nonresident foreign partner for services performed outside the United States are included in PTETI it is necessary to look at the sourcing rules found in New York's Article 22 personal income tax ("PIT").[3]

Section 632(a)(1) of the Tax Law provides, in pertinent part, that

> [i]n determining New York source income of a nonresident partner of any partnership, there shall be included only the portion derived from or connected with New York sources of such partner's distributive share of items of partnership income, gain, loss or deduction entering into his federal adjusted gross income…

Further, Section 632(b) of the Tax Law states that "[i]n determining the sources of a nonresident partner's income, no effect shall be given to a provision in the partnership agreement which (1) characterizes payments to the partner as being for services or for the use of capital…" Rather, the character of partnership items for a nonresident partner is to be determined under Section 617(b) of the Tax Law, which states that the character for New York purposes shall be the same as for federal income tax purposes. *See* Tax Law Section 632(e)(2).

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[2] In addition to the issues outlined in detail in the text of this letter, we note that the PTET provisions, as currently drafted, could result in double taxation at the entity level for entities that do business in multiple jurisdictions and elect to pay the PTET, as well as a similar tax in another jurisdiction. For example, assume a partnership does business in both New York and State A, which has a tax substantially similar to the PTET, and that all partners are resident individuals of New York. The partnership has $50 of income allocable to New York and $50 of income allocable to State A. The PTET is imposed on $100 of partnership income (since all of the partnership's partners are New York residents), and State A will impose tax on $50 of partnership income (since the New York resident partners will owe tax to State A on $50 of income allocable to State A). As a result, the partnership is subject to double taxation on $50 of its income. This double taxation is ultimately remedied at the *partner level* because the partners will receive a pass-through entity tax credit ("PTETC") based on income of $100, and a New York resident credit for State A taxes based on $50 of income subject to State A tax at the entity level. We presume that this treatment was intended by the legislature. However, if the intention is to avoid double tax at the *entity level,* a legislative fix should be made to provide a partnership level tax credit (against taxes owed with respect to income allocated to New York residents) for partnership level taxes paid to other states, although we recognize that would make the calculation of the tax at the entity level more complex.

[3] This issue assumes that, based on Tax Law § 860(h)(1)(i), guaranteed payments are included in PTETI. If the Department has a different view, we request additional guidance on that point.

Finally, the Tax Law and corresponding regulations assert that a nonresident partner's New York source income includes only the portion of income, gain, loss, and deduction sourced to New York. *See* Tax Law Section 632(a)(1); 20 NYCRR Section 132.15. Gross income is attributed to New York if the "sales or charges for services [are] performed by or through an office, branch of agency of the business located within New York." *See* 20 NYCRR Section 132.15(f). Accordingly, for partnerships, an origination-based apportionment formula is applied to nonresident partners with respect to the gross income factor.

Applying this guidance to the issue at hand, we begin by concluding that guaranteed payments are to be treated the same as distributive shares of income for PIT purposes. Next, a nonresident partner will generally be subject to PIT on guaranteed payments received based upon the location at which the sales or charges for services of the *partnership* are performed. For example, assume that a nonresident partner receives a guaranteed payment of $100, and the partnership has a 90 percent New York allocation. The partner will be subject to PIT on $90, or 90 percent of its guaranteed payment. The result may not, however, be the same for a nonresident foreign partner. Because a nonresident partner's items of partnership income, gain, loss or deduction must enter into the partner's federal adjusted gross income in order to be subject to PIT, guaranteed payments paid to a foreign partner will not be subject to tax in New York (notwithstanding the origination-based allocation method for partnerships), if his or her income is not subject to federal income tax. This conclusion is consistent with TSB-A-93(2) I, issued by the Department on April 2, 1993.

Accordingly, guaranteed payments paid to nonresident foreign partners for services performed outside the United States are *only* included in PTETI if the guaranteed payments are includable in the foreign partner's federal adjusted gross income. If any portion of the guaranteed payment is includable in the partner's federal adjusted gross income, that portion is sourced to New York using the partnership's apportionment formula. We request confirmation and clarification from the Department to confirm that our understanding and application of the PIT sourcing rules to the definition of PTETI is correct.

B. Are retirement payments to nonresident partners that are protected from nonresident state taxation by Section 114 of Title 4 of the United States Code included in the PTET base?

Title 4 U.S.C. Section 114(a) bars any state from imposing an income tax on any retirement income of an individual who is not a resident or domiciliary of such state. "Retirement income," is defined to include, under Section 114, only amounts received from certain retirement plans, defined under the Internal Revenue Code and any plan, program or arrangement defined under Section 114 pursuant to the amendments made by Public Law 109-264. Because retirement income is not included in the personal income tax base of a nonresident, we read it to follow under the PTET statute that retirement income, as so defined, paid to a nonresident partner is also not included in the PTET tax base. Consistent with this interpretation, a retired, nonresident partner will be allocated no credit associated with the PTET, and will not be required to file a New York personal income tax return (assuming it has no other New York sourced income). If the Department has a differing view, additional guidance should be issued.

C. Can the PTET be claimed on a composite return?

20 NYCRR Section 151.17(a) provides that limited liability partnerships, limited liability investment companies, limited liability trust companies, and limited liability companies that are treated as a partnership for federal income tax purposes may file a New York Group Return for Nonresident Partners (Form IT-203-GR) ("Group Return") on behalf of nonresident partners. The PTET provisions of the Tax Law, however, do not provide any guidance regarding the use, or disallowance, of a Group Return for PTET purposes.

We request the issuance of guidance to make clear that qualifying electing entities can also file a Group Return for PTET purposes. Assuming that qualifying electing entities are permitted to file a Group Return, we urge that an electing entity be permitted to claim a PTETC for PTET allocated to those included on a Group Return when determining the group tax liability.

D. When is the PTET election due for partnerships that did not exist on the annual due date currently included in the Tax Law?

The PTET election for calendar year 2021 is due by October 15, 2021. *See* Tax Law Section 861(c), updated in Section 8(a). However, Article 24-A of the Tax Law does not provide guidance on the PTET election deadline for pass-through entities that did not exist when the election was due for calendar year 2021 (i.e., pass-through entities that did not exist as of October 15, 2021 but did exist prior to January 1, 2022). Guidance should be released providing the PTET election due date for calendar year 2021 specific to pass-through entities that were not in existence on October 15, 2021.

Tax Law Section 861(c) also indicates that, beginning with tax year 2022, the annual PTET election is due by March 15 of each taxable year (i.e., the due date of the first estimated PTET payment as prescribed by Tax Law Section 864). Article 24-A, again, is silent regarding the PTET election due date for pass-through entities that are formed after the annual PTET election deadline (i.e., March 15). In addition, calendar year, pass-through entities formed after January 1 are deemed to have a short taxable year. Tax Law Section 864(c) specifies that Tax Law Section 864 applies to short taxable years in accordance with procedures established by the Commissioner.

Accordingly, additional guidance is requested outlining the PTET election due date for pass-through entities that fall into the below fact patterns:

- Short taxable, calendar year that begins after March 15 (or, in the case of 2021, October 15); and
- Short taxable, calendar year that begins after January 1 but before March 15 (or, in the case of 2021, October 15). For example, we recommend that a threshold is included for entities formed just prior to the March 15 (or, in the case of 2021, October 15) deadline.

Similarly, it would be helpful for the Department to clarify the due date for estimated tax payments in the context of short taxable years.

E. Does the PTET, and corresponding PTETC, have an impact on nonresident partner withholding?

Pass-through entities are required to withhold estimated tax on nonresident partners, members, and shareholders (specifically individuals and C corporations) under Tax Law Section 658(c)(4) ("estimated tax withholding"). Based on the statute as currently drafted, the PTET does not appear to relieve an electing entity of the obligation to withhold on nonresident individual partners, members, and shareholders (referred to as "nonresident individuals"). Further, Tax Law Section 658 provides that estimated tax shall be "reduced by the distributive share or pro-rata share of any credits determined under [Tax Law Sections 187, 187(a), 606, and 1511]" from the pass-through entity. As currently written, however, the statute does not appear to allow for PTETC to offset nonresident individual withholding.

We request guidance on whether electing entities are required to withhold on nonresident individuals, and, in particular, whether (as we would urge) an electing entity can reduce its estimated withholding liability with respect to a nonresident individual by the amount of PTETC allocated to that individual. We note that there could be instances where the tax rate of the electing entity's PTET is less than the nonresident individual withholding rate for that respective tax year. Thus, we urge the Department to consider additional guidance regarding the impact of the election to pay the PTET on estimated tax withholding in order to prevent aggregate withholding that is not reflective of the estimated PIT liability owed.

F. Certain estate and non-grantor trust issues

The PTET regime is intended to provide benefits to all Article 22 taxpayers subject to PIT, a class that includes estates and non-grantor trusts, as well as individuals. However, there are possible technical flaws in the regime as applied to trusts and/or estates that may result in the benefits of Article 22 not being available to income earned through estates and non-grantor trusts that are partners in partnerships in certain circumstances, as illustrated below.

For purposes of simplicity, we provide an example involving a non-grantor trust that is subject to PIT on 100 percent of its income. The trust has a sole beneficiary who is an individual resident of New York subject to PIT. Assume that:

- The New York State ("NYS") tax rate is 10 percent for both the PTET and PIT;
- The federal income tax rate is 40 percent (rate brackets being ignored);
- The trust's distributive share of the income of a partnership is $100 (before PTET), all of which enters into the computation of the trust's distributable net income ("DNI");
- The trust has no other items that enter into the computation of DNI, other than its NYS tax expense;
- The trust has sufficient cash available for use to pay NYS taxes and/or to make distributions to its sole beneficiary; and

- The taxable year is 2022, and the partnership pays its 2022 PTET during that year on an estimated tax basis.

Prior to the Tax Cuts and Job Act of 2017 (the "2017 Act"), to determine the federal income tax and PIT payable by the trust the first question was whether the trust had distributed at least $100 of income (whether during the year or within 65 days thereafter). If it did, the trust would have no taxable income and thus owe no income tax for New York State or federal purposes. On the beneficiary's income of $100 derived from the trust, the beneficiary would pay PIT of $10 and, after taking into account the deduction under Section 164 of the Internal Revenue Code for that tax, $36 of federal income tax (ignoring alternative minimum tax effects). If the trust did not make a distribution, the same amount of PIT and federal income tax would be payable by it, and no further tax would be payable by the beneficiary upon receiving distributions from the trust more than 65 days after the end of the taxable year. The total tax in either event would be $10 + $36 = $46.

Consider the same scenario, but after the enactment of the 2017 Act, and before giving effect to the PTET. If the trust had distributed $100 of income there will again be a distribution deduction of $100, which is sufficient to reduce the trust's taxable income to zero. The beneficiary has $100 of income derived from the trust, on which the beneficiary pays $10 of PIT and $40 of federal income tax. If the trust did not make a distribution, the same amount of PIT and federal income tax would be payable by it, and no further tax would be payable by the beneficiary upon receiving distributions from the trust more than 65 days after the end of the taxable year. The total tax paid, by the trust or the beneficiary, is $50 ($10 + $40 = $50).

Lastly, assume the same scenario, but after the enactment of the 2017 Act *and* giving effect to the PTET. After making a valid election to pay the PTET, the partnership pays $10 of PTET on the trust's distributive share of the income of the partnership. For purposes of an "apples to apples" comparison, let's treat this as funded to the partnership by the trust. The trust's income before the distribution deduction is $90 for federal income tax purposes and $100 for PIT purposes (for now we ignore the possibility of a double counting that would increase the beneficiary's NYS income to $110; *see* NYSBATS Report No. 1451, Section IV). Because of the New York "fiduciary adjustment," the trust's distribution deduction is effectively $100 for PIT purposes, even though limited to $90 for federal purposes. Accordingly, the trust will have no 2022 taxable income for federal income tax or PIT purposes. When the trust files its 2022 PIT return, it will claim a refundable credit of $10, which, when refunded to it, will be subject to $4 of federal income tax. Although PTET may be deductible for federal income tax purposes, there is no provision in the federal tax law that makes refunds paid to a taxpayer, like the trust, that has no PIT liability excludible from federal gross income. Since the trust reduced its federal taxable income by the $10 of PTET paid by the partnership, a refund of the PTET will now be included in its federal taxable income. At the beneficiary level, there would be $90 of federal taxable income and $100 of state taxable income, resulting in a total beneficiary-level tax of $46 (($90 * 40 percent) + ($100 * $10) = $46). The total tax paid by the trust and the beneficiary is $50 (($10 + ($10) + $4 + $36 + $10 = $50), and there would be no net federal benefit from participation in the PTET regime. This negates the precise benefit that the PTET statute was intended to confer on the ultimate taxpayer (in this example, the beneficiary of the trust). If, on the other hand, the trust does not make any distributions to the beneficiary until more than 65 days after the end of the taxable year, the trust will pay $36 of

federal income tax ($90 * 40 percent) and no net PIT tax since the trust's $10 PIT liability will be offset by a $10 PTETC. The beneficiary will not owe any tax upon receiving subsequent distributions from the trust of the trust's 2022 income. The total tax paid is thus $46 ($36 federal income tax + $10 PTET), such that the trust receives the intended benefit of the PTET statute.

To remedy this problem, we suggest that the Department issue guidance clarifying that the PTETC can be apportioned between an estate or trust and its beneficiaries. We note that the Department has provided such guidance (by means of the construction of forms and return instructions) with respect to the permissibility of apportioning other credits between an estate or trust and its beneficiaries, notwithstanding the statute being silent on the issue. For example, the Department's forms allocate the investment credit (Form IT-212), the alternative fuels credit (Form IT-253), and the brownfield redevelopment tax credit (Form IT-611) between the beneficiaries and the trust or estate, even though the Tax Law does not discuss this treatment explicitly. Providing a similar pass-through of the PTETC would be entirely consistent with this approach.

We recommend that the guidance issued make clear that, in cases where amounts are distributed to beneficiaries within 65 days of the trust's year end, the PTETC should be allocated in such a manner that the PTETC follows the income that is taxed to either the trust (for income not distributed) or the beneficiary (for income distributed) in the same manner it would have been allocated had the income instead been earned by the income includer from holding a direct interest in the partnership.

G. *Are special allocations of PTET expenses permitted between resident and nonresident partners?*

A partnership with New York resident and non-resident partners may wish to specially allocate the liability for the PTET expense among its partners to appropriately align the PTET liability with the partners whose residency status gives rise to the tax. Otherwise, there may be a mismatch between the economic burden of the PTET as between New York residents and non-residents, with nonresidents receiving too much of the PTETC and residents receiving too little.

We believe that, consistent with the Tax Law and corresponding regulations, as well as the policy of the PTET, such a special allocation is permissible. For federal income tax purposes, we expect a special allocation of the tax liability would have substantial economic effect. *See* IRS Notice 2020-75.

Tax Law Section 617(c) and NYCRR 117.5(b) contain an anti-abuse rule under which an allocation of an item, amount or activity, even if recognized for federal income tax purposes, will not be recognized where it has as a principal purpose the avoidance or evasion of PIT. Where an allocation is not recognized, the partner's distributive share will be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances).

The determination of whether a principal purpose of an allocation is the avoidance or evasion of PIT depends on the surrounding facts and circumstances. *See* 20 NYCRR Section 117.5. Among

the relevant circumstances to be considered are (i) whether the partnership or a partner individually has a business purpose for the allocation; (ii) whether the allocation has substantial economic effect, that is, whether the allocation may actually affect the dollar amount of the partner's shares of the total partnership income or loss independently of the PIT consequences; (iii) whether the related items of partnership income, gain, loss or deduction from the same source are subject to the same allocation; (iv) whether the allocation was made without recognition of normal business factors and only after the amount of the allocated item could reasonably be estimated; (v) the duration of the allocation; and (vi) the overall PIT consequences of the partners.

A special allocation of the PTET expense among resident and nonresident partners in a manner that aligns the economic burden of the tax expense with the status of the partners should satisfy the majority, if not all, of these factors and thus should be respected. Advisory Opinion TSB-A-09(7)C (Corporation Tax) and TSB-A-09(4)I (Income Tax) (May 13, 2009) reinforces this conclusion, stating that "if a partnership expenditure is the sole component in the calculation of the New York tax credit and the New York tax credit is allocated in the same way as that *expenditure* is allocated among the partners, the allocation of the New York tax credit is valid if it does not have as a principal purpose the avoidance or evasion of any tax imposed on the taxpayer, and the allocation of the *expenditure* has substantial economic effect." (Emphasis in original.)[4]

We request guidance from the Department to expressly confirm that a special allocation of the PTET expenditure among resident and nonresident partners in a manner that aligns the economic burden of the tax expense with the status of the partners, or is otherwise in accordance with the partners' interest in the partnership, will be respected. In fact, we have difficulty imaging any other allocation that would yield an acceptable result, and thus be respected. Notwithstanding such, if the Department disagrees with our interpretation, the Department should instead grant explicit permission under Tax Law Section 632(d) for the allocation of the PTET expense to match the allocation of the PTETC.

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[4] Although an Advisory Opinion is only binding with respect to the taxpayer to whom it is issued, it provides useful guidance as to the Department's views of the issues involved.

II. Conclusion

We appreciate your consideration of our comments and look forward to working with you to resolve these issues. If you have any questions regarding the matters discussed in this letter, please contact me.

Respectfully submitted,

Gordon E. Warnke
Chair

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