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INSIGHTS FROM THE BDO ASSET MANAGEMENT PRACTICE

NEW YORK PASS-THROUGH ENTITY TAX IMPLICATIONS FOR ASSET MANAGEMENT BUSINESSES

By Jonathan Schmeltz, Joe Pacello, and Ozair Minty

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The New York state budget signed by the governor on April 19, 2021 includes provisions to allow pass-through entities (PTEs) to [elect to pay New York state income tax](#) at the entity level, rather than the owners of the PTE paying New York tax on their distributable shares of PTE income. The New York PTE tax election is effective for tax years beginning on or after January 1, 2021.

The purpose of the PTE tax election is to mitigate the impact of the Tax Cuts and Jobs Act's SALT deduction "cap" of \$10,000 for individuals. The election effectively shifts the state tax liability from the individual partner or shareholder to the PTE, generating a state tax expense deduction at the PTE level that reduces each individual owner's distributable share of taxable income. The IRS issued [Notice 2020-75](#) on November 9, 2020, indicating that a PTE can deduct state income taxes paid by the PTE pursuant to a state PTE tax election, as long as the state income tax is directly imposed on and a tax liability of the PTE. Since Notice 2020-75 was issued, a number of states including New York have enacted their own PTE tax election statutes.

Asset management businesses have unique circumstances, and the following information and issues with respect to the New York PTE tax election have been of interest to these taxpayers.

OVERVIEW

New York S corporations, general and limited partnerships, and limited liability companies (LLCs) taxed as partnerships for federal tax purposes are eligible to make the New York PTE tax election. It is important to note that a corporation that has made the election at the federal level to be treated as an S corporation is not automatically treated as an S corporation for New York tax purposes. Instead, a corporation is generally required to make a separate New York S corporation election. In addition, disregarded entities (i.e., certain single member LLCs, etc.) are not eligible PTEs for New York state purposes. Further, while the electing PTE is taxable, the distributable share of income still flows through to the owners and is reported on their New York income tax returns. As further explained below, direct owners whose distributable shares are included in the PTE's tax base are then entitled to a refundable credit on their New York return for their share of the PTE tax.

MAKING THE ELECTION

The PTE tax election must be made annually by the first estimated quarterly payment due date, which is March 15th.

However, for the 2021 tax year, the election may be made by October 15, 2021. In addition, New York has indicated that it expects partners and shareholders to continue to make their individual estimated tax payments for the 2021 tax year.

For partnerships, the PTE tax election may be made by any partner, member, owner or other individual with authority to bind the PTE or sign tax returns. For S corporations, the election may be made by any officer, manager or shareholder that is authorized to make the election and represents to having such authorization under penalty of perjury. Once made, the election is binding for that year and may not be revoked.

The New York PTE tax election does not require unanimous approval from its owners and, therefore, could lead to negative tax consequences if a nonresident minority owner is forced to participate in New York's elective PTE regime by majority resident owners (for example, if a nonresident owner resides in a state that does not provide a credit for taxes paid by the PTE but did provide a credit when the owner paid the tax directly).

PTE TAX RATE AND TAXABLE INCOME

The 2021 tax rate for electing PTEs is a graduated rate ranging from 6.65% on the first \$2 million of a PTE's taxable income up to a maximum of 10.9% on the PTE's taxable income in excess of \$25 million.

The PTE's taxable income is the sum of the income the resident and nonresident individual, estate and trust partners would include from the PTE when calculating their respective New York State taxable income. Income allocated to corporations or other types of PTE partners is not included in the PTE tax base.

The calculation of PTE taxable income is dependent on the types of owners of the PTE making the election. For both electing partnerships and electing S corporations, the tax base includes all types of income (including but not limited to interest and dividends), gains (including capital gains), losses and deductions.

For electing partnerships, PTE taxable income is the sum of New York source income to the extent it is includable in the New York taxable income of a nonresident partner and all items of income to the extent includable in the taxable income of New York resident partners.

For electing New York S corporations, PTE taxable income is the sum of all items of income derived from or connected with New York sources, to the extent it would be included for nonresident shareholders. In other words, the tax base is calculated for all shareholders, including resident shareholders, as if they were nonresidents. The S corporation, therefore, would not include the total share of distributable income of its New York resident shareholders in the PTE tax base.

Due to differences in tax rates, a PTE doing business in New York may pay more entity-level tax as compared to the aggregate New York tax of the individual owners. Because the credit for the PTE tax is refundable, owners of the PTE could receive a refund where their share of the PTE tax credit exceeds their tax liability.

WHAT DOES THIS MEAN FOR THE PTE?

Management Companies and General Partner Entities

A management company that is a PTE could benefit from making the PTE tax election if it has predominantly individual partners that are residents of New York or another state whose PTE tax regime allows a credit for PTE taxes paid to New York.



General partner entities often receive only a carried interest from the investment funds and are separate vehicles from the management companies. General partner entities may make the PTE election in New York and may benefit from the election depending on their partners' profiles.

Investment Funds

PTE tax elections can pose unique challenges for PTEs that are investment funds. Investment funds may have more diverse types of partners than other PTEs, including tax-exempt entities, corporations and foreign investors. Some of these partners may not benefit from a PTE election because they do not have a New York state tax liability. Further, a PTE electing into the PTE tax regime would lower its overall income and rate of return because the state tax would be an expense of the PTE.

Qualified Investment Partnerships

Hedge funds and other investment partnerships (including a "portfolio investment partnership," which is a limited partnership that meets the gross income requirement of Section 851(b)(2) of the Internal Revenue Code) generally do not generate New York source taxable income for their nonresident partners. However, such partnerships are not precluded from electing into the PTE tax system. If the PTE has New York resident partners, all portfolio income distributable to those partners would be includable in the PTE tax base. Further, trader partnerships may benefit from the election since the state and local tax may be considered a deductible expense based on trade or business status. The PTE tax election may not be impactful, however, if the partnership is not able to deduct state and local taxes due to limitations as an investor fund.

Multi-Tiered Partnerships

New York's PTE tax election is made at the entity level, i.e., each partnership or S corporation in a multi-tiered structure is responsible for making its own election. The PTE tax is calculated on the partnership's or S corporation's distributable income of its direct partners or shareholders that are individuals, trusts or estates.

Upper-tier PTEs with New York state filing requirements may want to elect into the PTE tax if they have individual, trust or estate partners or shareholders. However, since an electing PTE's tax base does not include the income of other types of partners (including other PTEs), an upper-tier PTE would not receive a credit for its share of the PTE tax of a lower-tier PTE.

CREDIT FOR TAX PAID BY THE PTE

Individuals, estates and trusts that are partners or shareholders in an electing PTE will receive a credit for their share of the PTE's New York tax on their New York state income tax returns. The credit is refundable to the partner or shareholder to the extent the credit creates an overpayment. As such, the PTE tax credit may offset the partner's or shareholder's tax liability on income from sources other than the PTE. The partner or shareholder must add back the PTE tax credit to their income for New York state purposes such that the PTE tax mechanism is revenue neutral to the state.

Other states may or may not allow a credit to partners or shareholders of a PTE that elects to pay New York tax. Similar to New York's rules, some states provide a credit for taxes paid to another state only if the other state has a similar PTE tax regime. However, many states do not have such a regime. Further, it is not clear whether states without a substantially similar PTE regime will allow a credit to their resident partners for tax paid at the entity level by a PTE in New York.

EXAMPLE 1: All New York Resident Partners

Partnership X has \$30 million of taxable income. The partnership is made up of 30 New York state resident individual partners, all owning an equal amount of Partnership X. Partnership X's income is 100% New York source.

Partnership X's total New York PTE Tax is \$3,031,500 (\$30 million * graduated rates up to 10.9% over \$25 million). Therefore, each partner's share of the PTE tax is \$101,050.

Each partner's New York individual tax calculated on their share of PTE income is \$67,033 (\$1 million * graduated rates up to 6.85% on income up to \$1,077,550 assuming single filer status), and each partner may claim a PTE tax credit on their individual return for \$101,050 (their share of the PTE tax). Assuming no other income or deductions, each partner would therefore receive a refund of \$34,017.

Note that for federal income tax purposes this refund could be taxable to the individual partner in the following year, because state tax deducted in a prior year normally results in additional income subject to tax if it is refunded by the state.



EXAMPLE 2: Resident and Nonresident Partners

Partnership Y has \$3 million of taxable income. The partnership is made up of a New York state resident individual partner, a New York nonresident individual partner that is a resident of State A and a New York nonresident individual partner that is a resident of State B. State A offers a credit for the full amount of New York PTE tax paid, whereas State B does not offer a credit for New York PTE tax. All three partners own an equal amount of Partnership Y, and Partnership Y's income is 100% New York source.

Partnership Y's total New York PTE tax is \$233,500 (\$3 million * graduated rates up to 9.65% on income over \$2 million), or \$77,833 per partner. The New York individual partner's tax calculated on their share of PTE income is \$67,033 (\$1 million * graduated rates up to 6.85% on income up to \$1,077,550), and the New York individual partner will receive a New York tax credit of \$77,833.

With respect to the nonresident partners, the State A individual partner will receive a credit in State A for its \$77,833 share of New York PTE tax paid. However, the State B individual partner will not receive a credit for the New York PTE tax in State B.

Based on this example, the State B resident individual partner could be negatively impacted by a New York PTE election as compared to the other partners, especially if State B would have allowed a credit had the New York tax been paid by the partner instead of the PTE.

IMPACT TO CORPORATE AND OTHER PTE PARTNERS

If the PTE tax is a deductible trade or business expense for federal income tax purposes, the tax reduces the taxable income of all partners or shareholders in the electing PTE. However, only individual, trust or estate partners would receive a New York state tax credit for PTE taxes paid. Corporate and other PTE partners would still be subject to New York state tax on their distributions but would not receive a credit.

DETERMINING WHETHER TO MAKE THE NEW YORK PTE TAX ELECTION

An election into New York's PTE tax regime should be made only after a careful analysis of a number of factors, including:

- ▶ The types of partners;
- ▶ Whether the partners are resident or nonresident;
- ▶ Whether other states allow a credit for the partner's share of the New York PTE tax; and
- ▶ The deductibility of state and local taxes at the PTE level for federal income tax purposes.

An election into the PTE tax regime may not always be advantageous and may, in fact, negatively impact certain partners even when others may receive a benefit. PTE's considering a PTE tax election should review a financial model of the impact of an election on all partners and the PTE before making a decision.



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CONTACT:

JOE PACELLO

Tax Partner

212-885-7375 / jpacello@bdo.com

JONATHAN SCHMELTZ

Tax Partner, New York Asset Management Practice

212-885-8170 / jschmeltz@bdo.com

OZAIR MINTY

SALT Managing Director

212-885-7224 / ominty@bdo.com

ANTHONY MOSCATO

Tax Partner, Asset Management Practice

212-885-7361 / amoscato@bdo.com

STEVE WINTER

Tax Partner

212-885-7270 / swinter@bdo.com

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