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## NYS is the Latest to Impose a Pass-through Entity Tax ... *and it Actually is a Good Thing*

By Wayne K. Berkowitz, CPA, J.D., LL.M. and Richard Goldstein, J.D.

Many law firm partners have felt the pain inflicted by the federal Tax Cuts and Jobs Act (TCJA) of 2017 and the \$10,000 limitation placed on the deductibility of state and local taxes for federal income tax purposes – the notorious SALT Cap. Encouraged by Internal Revenue Service Notice 2020-75, to date ten states have enacted some type of pass-through entity (PTE) tax and New York has joined the movement. Beginning on January 1, 2021, New York allows eligible PTEs to elect to be taxed at the entity level rather than the shareholder or partner level.

### Why is this a Big Deal for Law Firms?

#### **Background**

Starting with tax year 2018, the SALT Cap applied to the New York State and New York City personal income taxes and New York Property taxes. New York State already imposed one of the highest income tax burdens in the country. Starting in 2021, New York has the highest combined state and local tax rate in the country (the highest earning residents of New York City will pay a top combined rate of 14.776%). For more on these rates see our [April 12, 2021 Client Alert](#). Law firms which are typically organized as pass-through entities may use the PTE tax as a tool to mitigate the impact of the SALT Cap on their partners bottom lines.

#### **Some Nuts and Bolts**

Electing PTEs are taxed at the rate of 6.85% to 10.90%, depending on their PTE taxable income. In the case of an electing partnership, pass-through entity taxable income includes New York source income of a nonresident partner plus all income of a resident partner. In the case of an electing S corporation, taxable income includes income derived from or connected with New York sources.

### ***Making the Election***

The PTE tax election is made annually by the due date of the first estimated payment (i.e. March 15) and is irrevocable for the year elected. For 2021, the election is due by October 15, 2021 and partners must continue to make estimated income tax payments (the partnership does not make estimated PTE tax payments for 2021). The mechanism by which individuals' estimated tax payments for 2021 will be applied to the PTE tax for 2021 is not clear at this time and we will monitor for developments.

### ***How the PTE Tax Mitigates the Impact of the SALT Cap***

The PTE tax effectively converts individual state and local income tax (which is limited by the SALT Cap) into a business tax paid by the law firm. For federal purposes, when the entity computes its non-separately stated income, it deducts the PTE tax as business expense (instead of the partner, member or shareholder deducting state and local income taxes as an itemized deduction, thereby bypassing the SALT cap).

### ***Partners, Members, and Shareholders PTE Tax Credit***

If the PTE tax election is made, individual owners of the PTE will receive a corresponding New York State refundable personal income tax credit equal to the owner's direct share of the PTE tax. Notably, the legislation also allows residents of New York to take a credit against their personal income tax for PTE tax paid to other nonresident states, provided that the other state's PTE tax is substantially similar to the New York PTE tax. Prior to providing certainty to allow credit for nonresident PTE taxes paid, New York resident partners were hesitant to commit to another State's PTE tax fearing double taxation if the credit were ultimately denied.

### ***By the Numbers – A Simple Example of the PTE Benefit to Members***

Example assumes all NY resident partners:

- NY Law firm with two 50% NY resident partners earns \$1 million, all from NY sources
- Assuming NY tax rate for both the PTE tax and the personal income tax (PIT) of 10%
- **If no election is made:**
  - Each partner receives \$500,000 earnings

Each partner pays \$50,000 NY PIT

- For federal income tax purposes, each partner is limited to a \$10,000 deduction for state and local taxes (SALT), most likely already taken in the form of a property tax deduction.
- Assuming a 40% federal tax rate<sup>1</sup>, the tax liability of each partner would be:

$\$500,000 \times 40\% =$	$\$200,000$
$\$500,000 \times 10\% =$	$\$50,000$
Total tax per partner	$\$250,000$
Total tax for all partners	$\$500,000$

- **If the PTE election is made:**
  - Each partner receives \$450,000 earnings (\$1 million less \$100,000 of tax/ 2)

- For federal income tax purposes, the SALT limitation is no longer a concern as the \$50,000 of NY PTE tax reduced the pass-through entity income.
- Assuming a 40% federal tax rate, the tax liability of each partner would be:

\$450,000 x 40% =	\$180,000
Reduced earnings from PTE tax	\$50,000
NY PIT (\$500K x 10% - \$50 PTE tax credit)	\$0
Total tax per partner	\$230,000
Total tax for all partners	\$460,000

- Potential Savings: \$40,000.

As the example illustrates, the PTE liability of the Partners is now borne by the Partnership and accordingly adjustments to Partner distributions will need to reflect this.

Although the PTE tax can result in substantial tax saving to the partners, it is important to consider that there will often be a decrease to partner cash flow. This is because many firms will make estimated tax payments computed at the highest (10.9%) PTE tax rate while their partners in many instances will incur New York income tax at lower individual tax rates. The benefits to partners in electing PTE partnerships is realized when the partners file their returns to claim a refund.

Please contact your [Berdon advisors](#) for tailored advice.

**Questions:** Contact Wayne K. Berkowitz at 212.331.7465 | [wberkowitz@berdonllp.com](mailto:wberkowitz@berdonllp.com) or Richard Goldstein at 212.331.7557 | [rgoldstein@berdonllp.com](mailto:rgoldstein@berdonllp.com) or reach out to your Berdon advisor.

<sup>1</sup> Tax rate is used for illustrative purposes only.

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