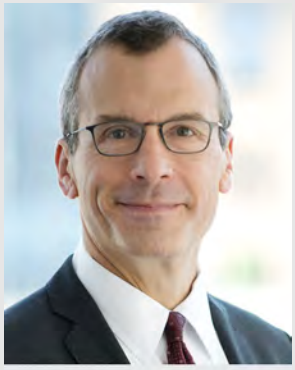
New York's Proposed 'SALT Workaround' Legislation — Observations

by Mark E. Berg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In this article, Berg describes and quantifies the effect on taxpayers of the 2017 limitation on the deductibility of state and local taxes for federal income tax purposes, discusses the resulting impetus for high-income taxpayers to move themselves and their businesses from high-tax states such as New York, and the dilemma that this poses for such states. Berg also examines and compares the features and likely impact of two recently proposed variations of an entity-level tax in New York that is designed as a "workaround" to ameliorate the effects of the SALT limitation on New York taxpayers.

The 'Residency Drain' and the Need for a Workaround

Being a resident of high-tax jurisdictions such as New York state and New York City can be expensive. In New York State, for example, a resident individual is generally subject to personal income tax at graduated rates up to a maximum of 8.82 percent on the individual's worldwide income,[1] whereas a nonresident is subject to personal income tax only on income from New York sources.[2] The contrast between residents and nonresidents is even more stark for NYC personal income tax purposes: An NYC resident individual is generally subject to the state personal income tax plus city personal income tax at graduated rates up to a maximum of 3.876 percent on his worldwide income — for a combined rate of as high as 12.696 percent[3] — whereas a city nonresident is not subject to NYC personal income tax.[4] And the cost may get even higher: A temporary high-income tax surcharge recently proposed by Gov. Andrew Cuomo (D) for 2021-2023 would increase the state personal income tax rate on individuals with taxable income of more than $5 million to 9.32-10.82 percent and the combined state and city personal income tax rate on city-resident individuals to 13.196-14.696 percent.[5]

Before 2018, when state and local taxes were fully deductible for federal income tax purposes (albeit not for federal alternative minimum tax purposes), the cost of being a resident of a high-tax state such as New York was often mitigated by the benefit of the federal deduction. Now that the

[1] N.Y. Tax Law section 601(a)-(d-1); *see* N.Y. Tax Law section 611(a). Some income of a New York resident that is not included in gross income for federal purposes, such as the non-U.S. source, non-effectively connected income of an individual who is a nonresident of the United States and treaty-exempt income, is not subject to state or city tax. *See* N.Y. Tax Law section 612(a); and TSB-A-10(7)I (Sept. 7, 2010).

[2] N.Y. Tax Law section 601(e); *see* N.Y. Tax Law section 631(a).

[3] N.Y.C. Admin. Code section 11-1701; *see* N.Y.C. Admin. Code section 11-1711(a).

[4] N.Y.C. Admin. Code section 11-1902(a), held unconstitutional in *City of New York v. State of New York*, 94 N.Y.2d 577 (2000).

[5] Fiscal 2022 New York State Executive Budget, Revenue, Article VII Legislation, Part A (Jan. 19, 2021) (Fiscal 2022 Budget). The top rates would apply to individuals having taxable income of more than $100 million.

deduction for state and local income taxes for federal income tax purposes has been all but eliminated by the Tax Cuts and Jobs Act (P.L. 115-97) — at least through 2025[6] — the after-tax cost of being a resident of a high-tax state has increased dramatically, as illustrated by the following simplified example:

Example 1. Individual A is a State X resident who is subject to State X personal income tax at a 9 percent rate and federal income tax at a 40 percent rate. A is a partner in partnership ABC, the only activity of which is to operate a business exclusively in State X. A has a one-third distributive share of each item of income and deduction of ABC. For 2021 ABC has $300,000 of net business income, A's distributive share of which is $100,000. A incurs local property taxes of $10,000 in 2021, with the result that none of the State X income taxes she incurs in 2021 are deductible for federal income tax purposes.

a. Were it not for the TCJA's limitation, A's after-tax income would have been $54,600, computed as follows:

Share of ABC's net income	$100,000
Less: State X personal income tax (9%)	(9,000)
Federal taxable income	$ 91,000
Less: federal income tax (40%)	(36,400)
After-tax income	$ 54,600

b. The TCJA eliminated the deduction for A's State X personal income tax, thus reducing A's after-tax income by $3,600 (that is, 40 percent of the $9,000 of State X tax) to $51,000:

Share of ABC's net income	$100,000
Less: State X personal income tax (9%)	(9,000)
Less: federal income tax (40%)	(40,000)
After-tax income	$ 51,000

Not surprisingly, the nondeductibility of state and local taxes has been a catalyst for taxpayers to become even more focused on their state and local tax burden, and in many cases to vote with their feet, as witnessed by the growing number of news reports of wealthy individuals (including at least one high-profile political figure) moving themselves and in some cases their businesses from New York or other high-tax states to jurisdictions such as Florida.[7] Realizing not only that they were headed toward a significant "residency drain" on revenues as high-income individuals and their businesses fled to low-tax states, but also that it could well be difficult to convince those who left to return, numerous high-tax states began looking for ways to ameliorate the effects on their taxpayers of the TCJA's limitation, which became known as "SALT workarounds."

SALT Workarounds — A Brief History

Some early SALT workarounds met with little success. This category includes those that would have effectively converted nondeductible local property tax payments into deductible charitable contributions by giving property owners a credit against their property taxes for donations they made to one or more designated charitable funds.[8] Treasury shut this workaround down in 2018 by first announcing and then issuing regulations denying the charitable deductions to the designated charitable funds.[9] Other workarounds convert employees' nondeductible state income tax payments into deductible payroll taxes

[6] IRC section 164(b)(6), added by section 11042(a) of the Tax Cuts and Jobs Act, 131 Stat. 2054 (Dec. 22, 2017) (limiting the annual deduction for state and local income, property, and sales taxes to $10,000 ($5,000 for married taxpayers filing separately)). The limitation applies to individuals for their tax years beginning after December 31, 2017, and before January 1, 2026. Although the limitation by its terms does not apply to state and local real property and personal property taxes paid or accrued in carrying on a trade or business or for the production or collection of income, it does apply to state and local income taxes imposed on an individual even if the taxes are paid or accrued in carrying on a trade or business or for the production or collection of income.

[7] *See, e.g.*, Lauren Thomas, "Retailers Trade Fifth Ave. for Worth Ave. as Palm Beach Scene Thrives With Americans Heading South," CNBC, Feb. 16, 2021; Darla Mercado, "COVID-19 Accelerated Retirement Moves as People Fled These High-Tax States During 2020," CNBC, Jan. 8, 2021; Katherine Burton and Hema Parmar, "Hedge Funds Head for Florida With Taxes on Rich Rising Elsewhere," Bloomberg, Sept. 23, 2020; Oshrat Carmiel, "NYC's Wealthiest Flocking to Florida Even While COVID Rages," Bloomberg, July 31, 2020; Juliet Chung and Joseph De Avila, "Florida's Sunshine and Tax Benefits Beckon Billionaires," *The Wall Street Journal*, Nov. 11, 2019; and Maggie Haberman, "Trump, Lifelong New Yorker, Declares Himself a Resident of Florida," *The New York Times*, Oct. 31, 2019.

[8] *See, e.g.*, N.Y. Tax Law section 606(iii) (credit against state personal income tax equal to 85 percent of donations to designated charitable funds); and N.Y. Real Property Tax Law section 980-a (authorizing localities to provide a credit against property tax in an amount up to 95 percent of contributions to designated charitable funds).

[9] Treas. reg. section 1.170A-1(h)(3) (reducing a taxpayer's charitable deduction by the amount of any state or local tax credit that the taxpayer receives or expects to receive in consideration for the taxpayer's payment or transfer), announced in Notice 2018-54, 2018-24 IRB 750.

imposed on their employers[10] — an idea that, at least in New York, has not really caught on.[11]

As time has passed since the TCJA limitation took effect and high-tax states have lost increasing numbers of high-income taxpayers, states have increasingly attempted to stop the residency drain by enacting workarounds that impose on passthrough entities (PTEs) (in some cases on an elective basis) an entity-level tax and relieve the PTE owners from state income taxation, in whole or in part, on their shares of the entity's income. These workarounds are limited — they do not solve the problem as it relates to those who earn their income as employees or those who pay property taxes — but they were explicitly endorsed by Congress in the TCJA's legislative history.[12] On the strength of this legislative history, several states have enacted or are considering PTE workaround legislation.[13] The goal of these workarounds is to convert what would otherwise be nondeductible state and local personal income taxes if paid or incurred directly by an individual into entity-level taxes that are in effect deductible by the individual owners of the entity through a reduction of the amount of income that flows through to them and is subject to federal income tax.

The basic features and impact of an entity-level tax workaround can be illustrated by the following example:

Example 2. The facts are the same as in Example 1. If State X were to enact an entity-level tax workaround, the extent to which the workaround would restore to A the $3,600 of lost after-tax income would depend on several factors, including how the rate of tax State X imposes on ABC compares with the rate of tax State X imposes on A and the extent to which the owners of ABC are relieved of State X taxation on their distributive shares of ABC's income.

a. For example, were State X to enact a workaround that imposed an entity-level tax on ABC's net business income at the full 9 percent State X personal income tax rate and allowed a credit to A for 100 percent of her distributive share of the entity-level tax, A's after-tax income would be fully restored to $54,600, thus restoring to A the entirety of the $3,600 of lost after-tax income[14]:

Share of ABC's pretax net income	$100,000
Less: share of State X entity-level tax (9%)	(9,000)
Federal taxable income	$ 91,000
Less: federal income tax (40%)	(36,400)
Subtotal	$ 54,600
State X personal income tax:	
Share of ABC's pretax net income	$100,000
State X tax before credit (9%)	$ 9,000
Less: credit for entity tax (100% of $9,000)	(9,000)
State X personal income tax after credit	- 0 -
After-tax income	$ 54,600

b. By contrast, were State X to enact a workaround that imposed an entity-level tax on ABC at a 6 percent rate and allowed A a credit for 90 percent of her distributive share of the entity-level tax, A's after-tax income would be $52,800, restoring $1,800[15] (or 50 percent) of the $3,600 of lost after-tax income:

[10] *See, e.g.*, N.Y. Tax Law sections 850-857 and 606(ccc); *see also* TSB-M-18(1)ECEP (July 3, 2018) (the "Employer Compensation Expense Tax," which established an elective tax payable by employers for employees earning over $40,000 annually and provides a credit to the employees for the tax paid by the employer).

[11] Perhaps because the state employee workaround is complex and presumably involves asking employees to accept lower pre-tax wages in return for a restoration of a portion of the after-tax wages that were lost because of the TCJA limitation, few employers have participated. *See* Office of the New York State Comptroller, "Report on the State Fiscal Year 2019-20 Executive Budget," at 29 (Feb. 2020) ("For the 2020 tax year, 311 businesses have chosen to pay this tax, an additional 49 businesses from 2019.").

[12] *See* H.R. Rep. No. 115-466, at 260 n.172 (2017) ("taxes imposed at the entity level, such as a business tax imposed on passthrough entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law").

[13] States that have enacted these measures include Connecticut (Conn. Gen Stat. section 12-699), Louisiana (La. Rev. Stat. section 42:287.732.2), Maryland (Md. Code Ann., Tax-Gen. section 10-102.1), New Jersey (N.J. Rev. Stat. section 54A:12-3), Oklahoma (Okla. Stat. tit. 68, section 2355.1P-1 et seq.), Rhode Island (R.I. Gen. Laws section 44-11-2.3), and Wisconsin (Wis. Stat. sections 71.05, 71.07, 71.21, 71.36, 71.365, and 71.775). All these entity-level taxes are elective except for Connecticut's mandatory tax. In some cases, entity owners are afforded a full or partial credit against their state income tax liability for their distributive shares of the entity-level tax and, in others, the owners' shares of the net income of the entity are excluded from the owner's taxable income. Numerous additional states, including California, are considering similar legislation.

[14] $54,600 (after-tax income with the workaround) - $51,000 (after-tax income absent the workaround) = $3,600 of restored after-tax income.

[15] $52,800 (after-tax income with the workaround) - $51,000 (after-tax income absent the workaround) = $1,800 of restored after-tax income.

Share of ABC's pretax net income	$100,000
Less: share of State X entity-level tax (6%)	(6,000)
Federal taxable income	$ 94,000
Less: federal income tax (40%)	(37,600)
Subtotal	$ 56,400
State X personal income tax:	
Share of ABC's pretax net income	$100,000
State X tax before credit (9%)	$ 9,000
Less: credit for entity tax (90% of $6,000)	(5,400)
State X personal income tax after credit	(3,600)
After-tax income	$ 52,800

In this case, State X would in effect receive $600 of the after-tax income that was lost to A — the 10 percent of the $6,000 entity-level tax that was not allowed to A as a credit.

Treasury Department Blesses Entity-Level Tax Workarounds

In Notice 2020-75,[16] issued in November 2020, Treasury gave these state efforts the green light. The notice stated that proposed regulations will be issued whereby amounts paid by a partnership or S corporation to a state, locality, or the District of Columbia to satisfy its liability for income taxes imposed by the jurisdiction on the partnership or S corporation will be deductible by the partnership or S corporation in computing its taxable income in the year the payment is made, and thus will reduce the net income flowing through to its individual partners or shareholders and in effect give them the benefit of a deduction for such taxes notwithstanding the TCJA limitation.

The notice says this favorable treatment will apply whether the entity-level tax is mandatory or imposed at the PTE's election, and regardless of 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 . . . and which reduces the partners' or shareholders' own individual income tax liabilities" under the applicable jurisdiction's tax law. The regulations will apply to tax payments made on or after November 9, 2020, and to tax payments made before that date under a law enacted before that date. Under these principles, the various types of entity-level taxes that have been enacted by the states will generally accomplish their intended objective, without regard to whether they allow a full or partial credit against the entity owners' state tax liability.

New York's Response to Notice 2020-75

In response to Notice 2020-75,[17] two workaround bills — S.3186 and A.4663 — were recently introduced in the New York State Legislature,[18] and Gov. Andrew Cuomo's budget for fiscal 2022 includes a third proposed workaround provision.[19] On February 16, 2021, A.4663 was revised to conform to the Cuomo proposal and redesignated A.4663A, and on February 24 A.4663A was revised again and redesignated A.4663B. Since each of these legislative proposals was modeled after a discussion draft of proposed legislation that was issued by the New York State Department of Taxation and Finance in January 2018, they are similar in some respects. For example, each proposal would impose an entity-level tax under new Tax Law article 24-A — in one case mandatorily and in the other on a year-by-year, elective basis — on some PTEs. In each case, the tax rate would be lower than the top state personal income tax rate and that rate would be applied to a tax base that differs somewhat from the tax base on which the state personal income tax is imposed. Under each proposal, the owners of the entity would be entitled to a partial credit for their distributive shares of the entity-level tax.[20] However, the proposals differ in other significant respects, as seen in the following table.

[16] 2020-49 IRB 1453 (Nov. 30, 2020).

[17] For suggestions regarding possible responses by New York to Notice 2020-75, see New York State Bar Association Tax Section, "Report on New York State's Potential Response to Internal Revenue Service Notice 2020-75 and the State's Resident Tax Credit (No. 1446)" (Jan. 20, 2021) (NYSBA Tax Section Report).

[18] 2021 N.Y. S.3186 (introduced Jan. 28, 2021); and 2021 N.Y. A.4663 (introduced Feb. 4, 2021, revised and redesignated as A.4663A on Feb. 16, 2021 and revised and redesignated as A.4663B on Feb. 24, 2021).

[19] Fiscal 2022 Budget, *supra* note 5 at Part C.

[20] NYC has for many years imposed its own unincorporated business tax on some partnerships and sole proprietorships doing business in the city and provided a limited credit to city residents that are subject to the tax (whether as sole proprietors or as partners in partnerships) against their personal income tax liability. This existing tax clearly qualifies for favorable treatment under Notice 2020-75. (NYC does not recognize S corporations as PTEs, and as a result imposes its general corporation tax rather than its unincorporated business tax on S corporations.)

Table 1. Comparison of Two Proposed New York PTE Workarounds

	S.3186	Cuomo Proposal/A.4663B
Tax rate	5%	6.85%
Imposition	Imposed on all partnerships (and LLCs treated as partnerships) doing business in the state; does not apply to S corporations	Imposed on electing partnerships (and LLCs treated as partnerships) and electing New York S corporations
Liability for tax	Entity only	The entity and its owners eligible to claim a credit (jointly and severally)
Effective date	Tax years beginning on or after January 1, 2021	Tax years beginning on or after January 1, 2021
Mandatory/elective	Mandatory	Annual election
Eligibility for election	N/A	All owners must be individuals. In the case of an S corporation, a New York S election must be in effect and the corporation must be subject to tax under the Article 9-A corporation franchise tax
Deadline for election	N/A	The first day of the last month of the immediately preceding year (December 1 for calendar-year taxpayers)*
Termination/revocation of election	N/A	Election terminates when the partnership or S corporation becomes ineligible
Tax base	Net non-separately stated income plus the state entity tax plus guaranteed payments; does not include separately stated Schedule K items	Net non-separately stated income plus the state entity tax plus similar taxes imposed by other states plus (in the case of a partnership) guaranteed payments; does not include separately stated Schedule K items
Method of apportionment to New York	Using a three-factor formula (property, payroll and gross income)	For electing partnerships, using the personal income tax source rules; for electing S corporations, using the single-factor (receipts) apportionment method that is applicable for general corporation tax purposes
Credit to entity owners for their share of state entity-level tax	93% of the entity owner's distributive share of the state entity tax	92% of the entity owner's distributive share of the state entity tax
Treatment of credits exceeding the entity owner's state personal income tax liability	Not refundable; carry excess credit over to subsequent years	Fully refundable (without interest)

Table 1. Comparison of Two Proposed New York PTE Workarounds *(Continued)*

	S.3186	Cuomo Proposal/A.4663B
Credit to entity owners who are New York residents for their share of an entity-level tax imposed by another state, a political subdivision of another state, or the District of Columbia on a partnership or New York S corporation	No provision	92% of state resident owner's distributive share of the other entity-level tax if (i) the other entity-level tax is substantially similar to the New York entity-level tax, (ii) the other entity-level tax is imposed on income both derived from the jurisdiction imposing the entity-level tax and subject to New York State personal income tax in the hands of the resident owner and (iii) the jurisdiction imposing the entity-level tax imposes an income tax that is substantially similar to the New York State personal income tax

*While the initial Cuomo proposal and A.4663A would have applied for tax years beginning on or after January 1, 2022, the revised version that was redesignated as A.4663B would apply for tax years beginning on or after January 1, 2021. Because the current version of this legislation sets a deadline for the election of the first day of the 12th month of the immediately preceding year (December 1 for a calendar-year entity), it is not clear how and by when a partnership would make the election for 2021 (December 1, 2020 having passed). Presumably, there will be a further revision of the legislation providing a later deadline for the election for 2021.

Preliminary Observations

How Much of the Lost After-Tax Income Would The Proposed Workarounds Restore?

While neither of the proposed workarounds would solve the entire problem for PTE owners by restoring 100 percent of their lost after-tax income, both proposals would partially bridge the gap while providing New York with additional revenue. Generally, the higher entity-level tax under the Cuomo proposal would restore more of the lost after-tax income and would generally yield more revenue to the state than would S.3186, as shown by the following example:

Example 3. The facts are the same as in Example 1 except that State X is New York and A is a New York (but not NYC) resident.

a. S.3186 would restore to A $1,650[21] (or roughly 46 percent) of her $3,600 of lost after-tax income, increasing her after-tax income to $52,650:

Share of ABC's pretax net income	$100,000
Less: share of New York entity-level tax (5%)	(5,000)
Federal taxable income	$ 95,000
Less: federal income tax (40%)	(38,000)
Subtotal	$ 57,000
New York personal income tax:	
Share of ABC's pretax net income	$100,000
New York tax before credit (9%)	$ 9,000
Less: credit for entity tax (93% of $5,000)	(4,650)
New York personal income tax after credit	(4,350)
After-tax income	$ 52,650

Of the balance of A's lost after-tax income, New York would recover $350 — the 7 percent of the $5,000 entity-level tax that is not credited to A.

b. By contrast, the Cuomo proposal, because it would impose a higher entity-level tax, would restore to A $2,192[22] (roughly 61 percent) of her $3,600 of lost after-tax income, increasing A's after-tax income to $53,192:

Share of ABC's pretax net income	$100,000
Less: share of New York entity-level tax (6.85%)	(6,850)
Federal taxable income	$ 93,150
Less: federal income tax (40%)	(37,260)
Subtotal	$ 55,890

[21] $52,650 (after-tax income with the workaround) - $51,000 (after-tax income absent the workaround) = $1,650 of restored after-tax income.

[22] $53,192 (after-tax income with the workaround) - $51,000 (after-tax income absent the workaround) = $2,192 of restored after-tax income.

New York personal income tax:	
Share of ABC's pretax net income	$100,000
New York tax before credit (9%)	$ 9,000
Less: credit for entity tax (92% of $6,850)	(6,302)
New York personal income tax after credit	(2,698)
After-tax income	$ 53,192

Of the balance of A's lost after-tax income, New York would recover $548 — the 8 percent of the $6,850 entity-level tax that is not credited to A.

Treatment of New York Residents and Nonresidents — Sourcing and Apportionment

Under both proposals, the credit would apparently be available to offset the state personal income tax liability of New York residents and nonresidents alike.

New York Residents

In the case of a New York resident, who is generally taxed on income from New York and non-New York sources, the limitation of the entity-level tax base to income sourced or apportioned to the state would diminish the benefit of the workaround. This is because the entity-level tax would be imposed only on the net income of the entity that is sourced or apportioned to New York whereas the resident owner will be subject to state personal income tax on both the New York and non-New York income of the entity.

Example 4. The facts are the same as in Example 3 except that under the relevant sourcing or apportionment method (discussed below), only 60 percent of A's distributive share of ABC's net income is considered income from the operation of a business in New York.

a. S.3186 would restore to A only $990[23] (or 27.5 percent) of her $3,600 of lost after-tax income, leaving A with after-tax income of $51,990:

Share of ABC's pretax net income	$100,000
Less: share of New York entity-level tax (5% of 60%)	(3,000)
Federal taxable income	$ 97,000
Less: federal income tax (40%)	(38,800)
Subtotal	$ 58,200
New York personal income tax:	
Share of ABC's pretax net income	$100,000
New York tax before credit (9%)	$ 9,000
Less: credit for entity tax (93% of $3,000)	(2,790)
New York personal income tax after credit	(6,210)
After-tax income	$ 51,990

b. The Cuomo proposal, because it would impose a higher entity-level tax, would restore to A $1,315[24] (or roughly 36.5 percent) of her $3,600 of lost after-tax income, leaving A with after-tax income of $52,315:

Share of ABC's pretax net income	$100,000
Less: share of New York entity-level tax (6.85% of 60%)	(4,110)
Federal taxable income	$ 95,890
Less: federal income tax (40%)	(38,356)
Subtotal	$ 57,534
New York personal income tax:	
Share of ABC's pretax net income	$100,000
New York tax before credit (9%)	$ 9,000
Less: credit for entity tax (92% of $4,110)	(3,781)
New York personal income tax after credit	(5,219)
After-tax income	$ 52,315

New York Nonresidents

In the case of a nonresident of New York, who is taxed only on income from New York sources, the limitation of the entity-level tax base to income sourced or apportioned to New York would tend to align the entity's tax base with the tax base on which state personal income tax is imposed on the nonresident owner, thus maximizing the benefit of the workaround. In this connection, the alignment would be closer under the Cuomo proposal than

[23] $51,990 (after-tax income with the workaround) - $51,000 (after-tax income absent the workaround) = $990 of restored after-tax income.

[24] $52,315 (after-tax income with the workaround) - $51,000 (after-tax income absent the workaround) = $1,315 of restored after-tax income.

under S.3186 because the Cuomo proposal would apply to the entity the same source or apportionment rules that apply to the entity's individual owners. In the case of a partnership, the source rules applicable to individual partners for personal income tax purposes under Tax Law section 632(a)(1) would apply to both the partnership and the owners. In the case of an S corporation, the apportionment rules applicable to S corporation shareholders under Tax Law section 632(a)(2) would apply to both the S corporation and its shareholders.[25]

By contrast, S.3186 would apply a three-factor apportionment formula (averaging the New York percentages of property, payroll, and gross income) to the partnership's income that is like the formula that previously applied for general corporation tax purposes. That will in many cases result in a different apportionment (and thus a different tax base) at the entity level than the basis on which the nonresident individuals are taxed.

Example 5. The facts are the same as in Example 4 except that (i) A is a nonresident of New York (and a resident of a state such as Florida that does not impose an income tax); (ii) under the three-factor formula applicable under S.3186, 45 percent of the net income of ABC would be apportioned to New York; and (iii) under the sourcing rules applicable to New York nonresident individuals, 60 percent of A's distributive share of ABC's net income is considered income from New York sources.

a. Were it not for the TCJA limitation, A's after-tax income would have been $56,760, computed as follows:

Share of ABC's net income	$100,000
Less: New York personal income tax (9% of 60%)	(5,400)
Federal taxable income	$ 94,600
Less: federal income tax (40%)	(37,840)
After-tax income	$ 56,760

b. The TCJA eliminated the deduction for A's New York personal income tax, thus reducing A's after-tax income by $2,160 (that is, 40 percent of the state tax of $5,400) to $54,600:

Share of ABC's net income	$100,000
Less: New York personal income tax (9% of 60%)	(5,400)
Less: federal income tax (40%)	(40,000)
After-tax income	$ 54,600

c. S.3186 would restore to A $743[26] (or roughly a third) of her $2,160 of lost after-tax income, leaving A with after-tax income of $55,343:

Share of ABC's pretax net income		$100,000
Less: share of New York entity-level tax (5% of 45%)		(2,250)
Federal taxable income		$ 97,750
Less: federal income tax (40%)		(39,100)
Subtotal		$ 58,650
New York personal income tax:		
Share of ABC's pretax net income	$100,000	
New York tax before credit (9% of 60%)	$ 5,400	
Less: credit for entity tax (93% of $2,250)	(2,093)	
New York personal income tax after credit		(3,307)
After-tax income		$ 55,343

[25]Mirroring the strikingly different source/apportionment rules that apply in the case of partnerships and S corporations, the Cuomo proposal as applied to a partnership or S corporation such as a law firm or accounting firm, the income of which is derived from the performance of services, would source a partnership's service income on the basis of where the services are performed (proposed N.Y. Tax Law section 860(h); see N.Y. Tax Law sections 632(a)(1) and 631) and would apportion an S corporation's service income on the basis of the generally applicable apportionment rules under the general corporation tax, which would look to the location of the customer; i.e., generally where the benefit is received (proposed N.Y. Tax Law sections 860(i) and 862(c); see N.Y. Tax Law sections 632(a)(2) and 210-A(10)). By contrast, S.3186 would include in the numerator of the gross income factor gross income from services performed "by or through" an office, branch, or agency located in the state, including charges for services performed by employees, agents and independent contractors "chiefly situated at, connected by contract or otherwise with, or sent out from" offices, branches, or agencies located in New York.

[26]$55,343 (after-tax income with the workaround) - $54,600 (after-tax income absent the workaround) = $743 of restored after-tax income.

d. The Cuomo proposal would restore to A $1,315[27] (or roughly 61 percent) of her $2,160 of lost after-tax income, leaving A with after-tax income of $55,915:

Share of ABC's pretax net income	$100,000
Less: share of New York entity-level tax (6.85% of 60%)	(4,110)
Federal taxable income	$ 95,890
Less: federal income tax (40%)	(38,356)
Subtotal	$ 57,534
New York personal income tax:	
Share of ABC's pretax net income	$100,000
New York tax before credit (9% of 60%)	$ 5,400
Less: credit for entity tax (92% of $4,110)	(3,781)
New York personal income tax after credit	(1,619)
After-tax income	$ 55,915

Tax Base Considerations — The Exclusion of Separately Stated Items

Each of the proposals would apply the tax rate to a tax base that is essentially equal to the non-separately stated net income of the entity as increased by the entity-level tax and guaranteed payments to partners. Because a partnership's or S corporation's non-separately stated net income is computed without regard to items whose separate statements could affect the taxation of the partner or shareholder,[28] the entity-level tax would be computed without regard to separately stated Schedule K items such as interest income, dividend income, net rental income, royalty income, capital gains, charitable deductions, and IRC section 179 deductions even though a New York resident owner of the entity would be subject to state personal income tax on those items. In many (but not all) cases, this would cause a further diminution of the amount of the lost after-tax income that is restored to the owner.

Example 6. The facts are the same as in Example 3 except that A's $100,000 distributive share of ABC's taxable income in 2021 comprises $80,000 of net business income, $10,000 of interest and dividend income, and $15,000 of net rental income, less a $5,000 distributive share of ABC's qualified charitable contributions.

a. S.3186 would restore to A $1,320[29] (or roughly 37 percent), rather than the $1,650 restored in Example 3, of her $3,600 of lost after-tax income, leaving A with after-tax income of $52,320:

Share of ABC's pretax net income	$100,000
Less: share of New York entity-level tax (5% of $80,000)	(4,000)
Federal taxable income	$ 96,000
Less: federal income tax (40%)	(38,400)
Subtotal	$ 57,600
New York personal income tax:	
Share of ABC's pretax net income	$100,000
New York tax before credit (9%)	$ 9,000
Less: credit for entity tax (93% of $4,000)	(3,720)
New York personal income tax after credit	(5,280)
After-tax income	$ 52,320

Of the balance of the lost after-tax income, New York would recover $280 — the 7 percent of the $4,000 entity-level tax that is not credited to A.

b. By contrast, the Cuomo proposal, because it would impose a higher entity-level tax, would restore to A $1,754[30] (or roughly 49 percent), rather than the $2,192 restored in Example 3, of her $3,600 of lost after-tax income, increasing A's after-tax income to $52,754:

Share of ABC's pretax net income	$100,000
Less: share of New York entity-level tax (6.85% of $80,000)	(5,480)
Federal taxable income	$ 4,520
Less: federal income tax (40%)	(37,808)
Subtotal	$ 56,712

[27] $55,915 (after-tax income with the workaround) - $54,600 (after-tax income absent the workaround) = $1,315 of restored after-tax income.

[28] *See* IRC sections 702(a)(1)-(8) and 1366(a)(1)(A); and Treas. reg. section 1.702-1(a)(8)(ii) and (9).

[29] $52,320 (after-tax income with the workaround) - $51,000 (after-tax income absent the workaround) = $1,320 of restored after-tax income.

[30] $52,754 (after-tax income with the workaround) - $51,000 (after-tax income absent the workaround) = $1,754 of restored after-tax income.

New York personal income tax:	
Share of ABC's pretax net income	$100,000
New York tax before credit (9%)	$ 9,000
Less: credit for entity tax (92% of $5,480)	(5,042)
New York personal income tax after credit	(3,958)
After-tax income	$ 52,754

Of the balance of the lost after-tax income, New York would recover $438 — the 8 percent of the $5,480 entity-level tax that is not credited to A.

The exclusion of investment income from the entity-level tax base seems unnecessary as a matter of maximizing the federal deduction given that Notice 2020-75 does not distinguish between state taxes on business income and state taxes on investment income. The reason for the exclusion might be to avoid a situation in which nonresident partners in an investment partnership (or, in the case of the Cuomo proposal, nonresident shareholders in an S corporation whose only activity is investment), who in many cases would not be subject to New York tax on their shares of the entity's investment income,[31] would in effect become subject to state tax to the extent of their shares of the entity's tax.

The Cuomo proposal at least partially addresses this concern both by giving entities having nonresident partners or shareholders the option each year not to have the entity-level tax apply to them and by providing the owners of electing entities with a refundable credit equal to 92 percent of their shares of the tax. But even so, were the legislation to impose the entity-level tax on investment income, a partnership or S corporation with resident and nonresident owners would be forced to choose between subjecting its nonresident owners' distributive shares of investment income to the entity-level tax or depriving its resident owners of the ability to maximize the federal deduction for the state entity-level taxes afforded by Notice 2020-75. A more complete, albeit potentially problematic,[32] solution that would maximize the federal deduction allowed to each owner under Notice 2020-75 would bifurcate the entity's investment income into amounts allocable to resident owners and amounts allocable to nonresident owners and apply the entity-level tax and the owner credit only to the portion of the investment income that is allocable either to resident owners or to nonresident owners to the extent they are subject to New York tax on these amounts (or instead make the entity-level tax elective at the owner level).

Sole Proprietorships

The TCJA's legislative history states that "taxes imposed at the entity level, *such as* a business tax imposed on passthrough entities, that are reflected in a partner's or S corporation shareholder's distributive or pro-rata share of income or loss on a Schedule K-1 (or similar form), will continue to reduce such partner's or shareholder's distributive or pro-rata share of income as under present law."[33] Although this legislative history mentions state and local taxes imposed on PTEs and does not mention state and local taxes imposed on a sole proprietorship, such as NYC's unincorporated business tax (which is imposed on partnerships and sole proprietorships alike), the words "such as" suggest that taxes imposed on PTEs such as partnerships and S corporations are merely examples, rather than an exhaustive list, of the business taxes "imposed at the entity level" for which favorable treatment was intended.

Indeed, were state and local taxes imposed on sole proprietorships to be treated less favorably than state and local taxes imposed on partnerships and S corporations, a sole proprietor could relatively easily obtain the benefits by forming an S corporation or creating a partnership with one or more individuals. As a result, it is difficult to justify the exclusion of sole proprietorships as a policy matter. Nonetheless,

[31] For nonresident partners, see N.Y. Tax Law sections 632(a)(1) and 631(b)(2). For nonresident S corporation shareholders, see N.Y. Tax Law sections 632(a)(2), 631(b)(1), and 210-A(5); and TSB-M-15(7)C, (6)I (Dec. 1, 2015).

[32] *See* NYSBA Tax Section Report, *supra* note 17, at 9 (in addition to complexity, a statute affording partial electivity may not be eligible for favorable treatment under Notice 2020-75 and may raise one-class-of-stock issues for S corporations).

[33] H.R. Rep. No. 115-466, at 260 n.172 (2017) (emphasis added).

since Notice 2020-75 did not extend its blessing of state and local business taxes to sole proprietorships, it is understandable that the authors of the New York legislative proposals were hesitant to apply them to sole proprietorships.

S Corporations

Even more so than in the case of sole proprietorships, since S corporations are both explicitly mentioned in the TCJA legislative history and explicitly approved in Notice 2020-75, the exclusion of S corporations from S.3186 seems unnecessary and questionable as a policy matter.[34] As noted, the Cuomo proposal would apply to both partnerships and S corporations.

Excess Credits

Under each of the proposals, an entity owner would be entitled to a credit against his or her New York personal income tax liability for the owner's distributive share of the entity-level tax. Under these proposals, there would be situations in which the credit exceeds the entity owner's total state personal income tax liability — for example, the entity-level tax rate exceeds the owner's effective New York personal income tax rate, the owner has other losses or deductions that reduce his or her taxable income, or a combination of the two. When the credit for the entity-level tax exceeds the entity owner's New York tax liability, the entity owner would be entitled to a refund of the excess under the Cuomo proposal, whereas under S.3186 the excess would be carried over to later years (apparently indefinitely) and applied to reduce the owner's New York personal income tax in later years. The difference in approach may be a function of the higher entity-level tax rate under the Cuomo proposal — a rate equal to the highest applicable rate apart from the temporary tax surcharges in effect for some high-income taxpayers — which makes it more likely that there would be an excess.

Conclusion

While it is possible that Congress will repeal or ameliorate the TCJA limitation on the deductibility of state and local taxes, there can be no assurance that this will occur, or even that the limitation will expire as scheduled after 2025. With this in mind, and particularly now that Treasury has removed whatever doubt there was that a PTE tax with a corresponding full or partial credit to the entity's owners will be an effective workaround to the TCJA limitation, it seems extremely likely that New York and other states will enact some version of a PTE tax.

Of the provisions that have been introduced or proposed in New York, the Cuomo proposal appears to be the most helpful in that it would maximize the benefit to taxpayers by:

- imposing the entity-level tax on an elective basis each year and at a rate that is relatively high via-à-vis the highest New York personal income tax rate;
- apportioning an entity's income to New York for purposes of the entity-level tax on the same basis that income is apportioned at the owner level;
- providing that any excess credits would be fully refundable; and
- applying the tax to S corporations as well as partnerships.

Revisions to this legislation that would improve the situation for taxpayers further include applying the entity-level tax to investment income and other separately stated income, as would appear to be authorized by Notice 2020-75; providing a post-enactment date in 2021 by which the election to apply the PTE tax for 2021 may be made; and applying the tax to sole proprietors.

Even with these revisions, however, the critical question for high-tax states such as New York is whether whatever workaround is enacted will be too little and too late to stop the residency drain and its attendant revenue loss: Too little because it covers only PTE owners and not employees and those who pay property taxes and does not restore 100 percent of the lost after-tax income even to those it does cover; too late because once people have relocated themselves and perhaps their businesses to sunnier, lower-tax

[34] *See* NYSBA Tax Section Report, *supra* note 17, at 8 ("Failure to apply a New York entity-level tax to S corporations would create an artificial inequity in treatment as between partnerships and S corporations and would likely incentivize individuals to form partnerships that may be questionable as a matter of substance.").

destinations — particularly now that COVID-19 has made it clear to many that it is possible to work productively from a remote location — it may be impossible to lure them back even if 100 percent of the benefit of the deduction for state and local taxes were restored. This is especially so if states also increase their tax rates, as New York is proposing to do. While a workaround along the lines of the Cuomo proposal would help those who cannot or will not leave, the larger issue for high-tax states may well be much more difficult to solve. ■