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Alert | State & Local Tax (SALT)

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Proposed New York State Unincorporated Business Tax Provides SALT Limitation Workaround

On Dec. 16, 2020, New York legislation was submitted to impose an unincorporated business tax (UBT) on partnerships and limited liability companies that are treated as partnerships for federal tax purposes. The legislation is intended to provide a workaround for the $10,000 limitation on deductions of state and local taxes (SALT) put in place in the Tax Cuts and Jobs Act of 2017 and was recently given the green light in IRS Notice 2020-75. Several states including Connecticut and New Jersey have enacted taxes on unincorporated entities as workarounds; this prompted the IRS to issue Notice 2020-75.

The proposed legislation imposes a tax at the rate of 5% on partnerships and LLCs doing business in New York and is separate and distinct from the New York City unincorporated business tax that applies to partnerships and LLCs, as well as sole proprietorships that are not covered by the state proposal. The proposed UBT imposes tax on "the partnership's federal ordinary business income under IRC 702(a)(8) applied to partnerships pursuant to IRC 703" plus taxes paid to the extent deducted on its federal tax return and requires the add-back of guaranteed payments as described in IRC 707(c). This would mean that the tax is imposed on the amount shown on line 22 of the 2019 IRS form 1065 and imposed on add-back taxes shown on line 14 and guaranteed payments from line 10 of the return. Then the income is allocated to New York. That allocation to New York uses a three-factor formula consisting of property, payroll, and sales in New York divided by total property, payroll, and sales.

The proposed state UBT is to be paid by the unincorporated entity. The partners of that entity will be entitled to claim a credit against their New York personal income tax for 93% of the tax paid by the entity. (The state is giving this opportunity to save on federal tax but is keeping the difference between the UBT paid and the 93% credit – the house always gets its cut.) The proposed UBT would reduce the NY personal income tax paid by the partners and reduce the impact of the $10,000 SALT limitation. For example, a partnership with five equal partners which has $500,000 of allocated income to NY (after the add-back of taxes and guaranteed payments) would pay a UBT of $25,000. Each of the five partners would be able to claim 93% ($4,650) of their $5,000 proportional share of the UBT on their NY personal income tax returns.

The proposed state UBT would not provide similar treatment for S corporations or sole proprietors who have income shown on Schedule C of their federal tax return. In addition, some states that have imposed a tax on unincorporated businesses as a workaround have made the tax voluntary so that partnerships can avail themselves of the option to pay the UBT and get the credit on the income tax or choose not to (*see* for example, New Jersey's Pass-Through Business Alternative Income Tax Act or "BAIT" Act).

The sponsors of the legislation have urged that it be enacted before the end of 2020 so that the tax can be paid in 2020 and the credit taken in 2020. That is optimistic in that the Department of Taxation & Finance would have to publish tax returns; set up a system to process those returns; and inform taxpayers and practitioners of the new tax days before the end of the tax year.

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