



July 11, 2018

New York State Department of Taxation and Finance
Building 9, W. A. Harriman Campus
Albany, NY 12227

Via Email: federal.tax.response.comments@tax.ny.gov

Re: Discussion Draft of an Unincorporated Business Tax

The S Corporation Association appreciates the opportunity to comment on the draft Unincorporated Business Tax (UBT) put forward by the New York State Department of Taxation and Finance.

The Association strongly supports restoring the ability of New York pass-through businesses to deduct their business-related income taxes, but only with two critical adjustments to the current draft plan. New York should 1) expand the proposed UBT to include S corporations and 2) make the new entity level tax an annual *election* where partnerships and S corporations are given the option of retaining their current pass-through treatment.

This election approach is essential to ensuring that the legislation does not cause serious hardship for certain pass-through businesses and is consistent with the model legislation (attached) published by the Parity for Main Street Employers coalition.

Background

The Tax Cuts and Jobs Act penalizes S corporations and partnerships by limiting their ability to deduct state and local income taxes from their business income, while leaving that benefit intact for C corporations.

This policy of denying legitimate business deductions to pass-through businesses was never fully articulated during consideration of the legislation. Indeed, there was significant confusion as to the actual policy being debated – would S corporations be able to deduct their business income taxes or not? Official summaries of the legislation conflicted with the legislative text.

To address the confusion, the Chairman of the House Ways and Means Committee released a [letter](#) making clear that the Tax Cuts and Jobs Act would limit the deduction for State and local taxes paid at the shareholder level.

In summary, taxes imposed on and paid by a pass-through business, such as sales and certain property taxes, would continue to be deductible by the business, to the extent related to business property. State and local income taxes paid by an individual owner of such a business would not be deductible on the individual's tax return.

The Chairman's explanation addressed business income taxes paid by individuals. But what about those taxes paid at the entity level? Several states tax S corporations and partnerships at the entity rather



than the shareholder and partner level. Would those “entity level” taxes be deductible against federal income?

The Conference Report states: “[T]axes imposed at the entity level, such as a business tax imposed on pass-through 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.”

So, taxes paid by the entity are deductible, while those paid by the owner are not.

This new policy puts many S corporations and partnerships at a competitive disadvantage. Most states, including New York, impose pass-through income taxes at the individual owner level. Of the 4.8 million S Corporations, we estimate that 3.5 million of them reside in states where their income taxes are paid at the shareholder level. The remaining 1.3 million S corporations are also at risk of losing these business deductions if they have out-of-state operations.

Just how adversely they are affected depends on the state and the applicable tax rate. States utilizing pass-through taxation have top income tax rates averaging 5.9 percent, resulting in marginal rate hikes of between 1.8 to 2.2 percentage points.

S Corporation Association’s Response

The Tax Cuts and Jobs Act’s disparate treatment of pass-through income presents states like New York with an opportunity. If taxes directly paid by pass-through businesses are deductible while those paid by the owners are not, then New York should give its pass-through businesses the option of paying New York state income taxes at the entity level. Doing so would reduce the tax burden on New York’s pass-through businesses and make the state a much more attractive place to invest and create jobs, all while costing New York nothing.

To help states take advantage of this opportunity, the Parity for Main Street Employers coalition released a model [legislation](#) that would restore the deductibility of state and local income taxes for pass-through businesses. Drafted with states like New York in mind, the model bill would provide for an annual election for pass-through businesses to be subject to an entity level tax. For businesses making the election, the bill:

- Imposes an entity level tax equal to the state’s individual tax rate;
- Provides business owners with a tax credit against their pass-through taxable income;
- Allows losses in elective years to be carried forward to elective years only;
- Allows income and losses in non-elective years to be fully reportable at the member level; and
- Allows residents a credit for income taxes paid to another state on the affected business entity income.



A key to this reform is to ensure that taxes on pass-through business owners remain level – that the new entity-level tax imposed on pass through businesses is fully offset by the tax credits granted to pass-through business owners. The goal of the reform should be to restore the deductibility of State and local income taxes for pass-through businesses, not to increase state revenues.

Connecticut was the first state to adopt a PMSE-type law. Enacted on May 31st, the Connecticut reform is effective beginning January 1, 2018 and generally mirrors the PMSE legislation with one significant difference – the Connecticut law is not an election. Connecticut pass-through businesses are required to pay the new, entity level tax. The S Corporation Association strongly recommended that the Connecticut Assembly make its reform elective and continues to press legislators to revisit this decision in their next legislative session.

Comments on New York’s Draft

New York’s top individual income tax rate of 8.97 percent is among the highest in the country, so there is a strong incentive for New York to adopt a reform along the lines of our model legislation. The loss of the SALT deduction results in a marginal tax increase for New York pass-through businesses of between 2.7 to 3.2 percentage points.

| Draft New York UBT | | | | | |
|---------------------------|--------------------------------|----------------|------------------|--------------------|----------------|
| | Tax Cuts & Jobs Act | | Draft UBT | | |
| | Pass-Through Owner | | S-Corp or | Pass-Through Owner | |
| | Taxed at 37% | Taxed at 29.6% | Partnership | Taxed at 37% | Taxed at 29.6% |
| Taxable Income | 100.00 | 100.00 | 100.00 | 91.03 | 91.03 |
| NY Tax Rate | 8.97% | 8.97% | 8.97% | 8.97% | 8.97% |
| NY Tax | 8.97 | 8.97 | 8.97 | 8.17 | 8.17 |
| Less Credit (93%) | 0 | 0 | | 8.34 | 8.34 |
| State Tax Due | 8.97 | 8.97 | 8.97 | 0.00 | 0.00 |
| Fed Taxable Income | 100 | 100 | | 91.03 | 91.03 |
| Federal Tax | 37.00 | 29.60 | | 33.68 | 26.94 |
| Effective Fed Tax Rate | 40.6% | 32.5% | | 37.0% | 29.6% |
| Tax Savings | NA | NA | | 3.32 | 2.66 |

As you can see from the table, shifting the incidence of tax from the owner to the entity has the potential to save New York pass-through businesses between \$2.66 and \$3.32 for every \$100 dollars of income.

Having reviewed the draft put forward by the New York Department of Taxation and Finance, our advisors recommend the proposal:

- Expand the UBT to include S corporations as well as partnerships. There are 410,000 S corporations in New York State, employing more than two million people. These S corporations



face the same challenges with the new policy as partnerships and they should be included in the reform.

- Allow for S corporations and other pass-through businesses to elect out of the UBT on an annual basis. There are several reasons why a pass-through business may choose not to be taxed at the entity level. They should be given that flexibility. Making the UBT an election is essential to avoiding unintended and unnecessary hardships.
- Maintain current levels of revenue. The purpose of this reform should be to restore legitimate business deductions to New York's Main Street community, not to raise new revenues.

As noted above, there are many reasons why a business may prefer not to pay an entity-level tax. For businesses with multiple pass-through entities, multiple tiers of ownership, corporate partners, employee ownership, and out-of-state owners, a new entity-level tax could result in higher tax burdens and additional complexity. While each of these issues could be addressed with a specific legislative solution, it is much easier to simply allow for businesses to opt out, on an annual basis, from the new UBT. The purpose of this reform should be to help businesses, not harm them. An annual election allows businesses that might be harmed to self-select and choose to retain their current tax treatment. Since the UBT is designed to collect the same amount of tax as the current pass-through treatment, there should be no revenue impact to making the UBT an election.

Encouraging New York and other states to shift to entity-level taxes is not S-Corp's preferred policy. The correct policy is for the Federal Tax Code to allow pass-through owners to continue to deduct these taxes as a legitimate business expense. We will continue to press for this change at the Federal level. In the meantime, however, New York has it within its power to address this disparity and make its tax code more attractive to Main Street businesses without any cost to the New York treasury. New York should exert this authority and take advantage of this opportunity.

Sincerely,

Brian Reardon
President, S Corporation Association