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Pass-through entity taxes and new planning strategies

CAURIE PUTNAM

What are pass-through entity taxes, how have they changed, and why is planning in this space important for some types of businesses? We checked in with three local attorneys to find out.

"Generally speaking, pass-through entity taxes [PTET] are state income taxes paid by pass-through entities instead of the owners of those entities," said Kelly E. Marks, a partner at Phillips Lytle LLP and leader of the firm's tax practice group. "Pass-through entities for these purposes are generally partnerships, limited liability companies taxed as partnerships, and S corporations."


Kelly E. Marks

Marks explains that typically, pass-through entities are not subject to income taxes, either at the Federal or state level, and instead their partners, members, or shareholders pay income taxes on the entity's income at the owner level.

Early House versions of the One Big Beautiful Bill Act (OBBBA) contemplated denying PTETs as a workaround for the Federal limitation on deductibility of state and local taxes for certain types of businesses, Marks said; however, OBBBA, as passed and signed into law, did not contain this denial.

PTETs were introduced by a number of higher taxed states, including New York, Marks said, following the 2017 Federal tax law changes which limited the amount of state and local income taxes that individual taxpayers could deduct on their personal Federal income tax returns to $10,000 (or $5,000 for taxpayers who are married but file separate tax returns).

"With the most recent tax law changes, the limit has been temporarily increased to $40,000 (subject to a phase down)," Marks said. "Federal tax law allows the owners of pass-through entities to get the tax benefit of full deductibility of the state income taxes attributable to the pass-through entity's income, regardless of the Federal limitation."

When New York first introduced its PTET, Marks said she saw more existing businesses that operate as single member limited liability companies elect to be treated as S corporations so that they could take advantage of the PTET benefit.

"But most of the planning for existing business has been done as we are now a few years into these PTET regimes," she said. "Certainly, when we form new business entities, the availability of PTET is something we take into account when advising clients on choice of entity."

Marks says that states are regularly evaluating changes to their PTET regimes, which makes it important for tax advisors to stay on top of potential changes and how they impact their clients.

Samantha L. Gozlan, a senior associate at Lippes Mathias LLP, explains OBBBA also permanently instated IRC § 199A, the 20% Qualified Business Income deduction (the 199A deduction), which is important for pass-through entities to be aware of in that it effectively allows them to deduct up to 20% of qualified business income. Before the passage of the OBBBA, the 199A deduction was set to expire at the end of 2025.


Samantha L. Gozlan

"The looming expiration of the provision created uncertainty for business owners who relied on the deduction as a core element of their tax planning strategy," Gozlan said. "By making the deduction permanent, the legislation provides clarity and stability for small and mid-sized business owners, who can now structure their operations and take into account this substantial tax benefit."

Gozlan and colleague Robert B. Rowe, also a senior associate at Lippes Mathias, LLP, note that tax professionals are observing a strategic uptick in businesses adjusting their structures to leverage PTET and other pass-through planning opportunities.

"As a reminder (and perhaps a gross oversimplification), the TCJA [Tax Cuts and Jobs Act of 2017] imposed a $10,000 cap on the state and local tax deduction for individual taxpayers," Rowe said. "In response, many states enacted PTET as a workaround, allowing taxes to be paid at the entity level and shifting the deduction away from separate owners, bypassing the federal cap."

With the new law raising the federal SALT deduction cap from $10,000 to $40,000 (temporarily, through 2029), while phasing down for high-income filers, Rowe says, businesses in high-tax states are still able to take advantage of the PTET.

"Tax professionals are seeing that professional services firms (law, accounting, consulting, healthcare) are particularly interested in this PTET planning," he said. "When considered with some of the other favorable tax provisions in the new law, like the 199A deduction, the bonus depreciation extension, and the Qualified Small Business Stock rules (to name a few), there is a great deal of opportunity for taxpayers to plan and target their tax reduction goals at this time."


Robert B. Rowe

Gozlan and Rowe say they'd be remiss not to discuss developments at the IRS relevant to pass-through taxation, such as the ongoing focus on the Centralized Partnership Audit regime enacted by the Bipartisan Budget Act of 2015.

"The IRS continues emphasizing required actions under the Centralized Partnership Audit regime, like designation of a partnership representative, election options, and adherence to post-audit procedures, including modification requests or 'push out' elections," Rowe said. "Variation remains in how adjustments made under BBA are reported and recaptured, despite efforts like the Multistate Tax Commission's model statute aimed at uniformity."

Rowe says it's also important to mention that budget cuts and personnel changes have strained IRS capabilities across the board.

"While the prior administration was focused on complex partnership audit and oversight as part of the IRS's Strategic Operating Plan, we are seeing a shift with the new administration, such as the introduction of proposed regulations softening partnership compliance requirements," he said. "Further, the reduction in force will likely result in fewer audits, slower response times, and diminished enforcement of partnership-related issues."