REPORT #756

TAX SECTION

New York State Bar Association

Letter on Unincorporated Business

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New York State Bar Association

April 14, 1993

Mr. William Thomas
Deputy Commissioner for Policy
Department of Finance
Room 509, Municipal Building
1 Center Street
New York, New York 10007

Dear Mr. Thomas:

On March 18, 1993, I wrote to inform you that the Executive Committee of the Tax Section of the New York State Bar Association, at its March 11, 1993, meeting, endorsed the proposed amendments to the Administrative Code relating to the unincorporated business tax (the UBT), subject to certain understandings. After that meeting, we identified an additional issue, implicating the credit that is to replace the additional exemption, which we believe should also be addressed.

The Issue

A taxpayer subject to the UBT generally calculates its income by reference to amounts of gross income and deductions reported for Federal income tax purposes. Adm. Code §§ 11-506, 11-507. Under the Federal Internal Revenue Code, partnerships are not allowed any net operating loss deduction. I.R.C. § 703(a)(2)(D). Among other adjustments, a UBT taxpayer is permitted a deduction for its own net operating loss carryovers, subject to certain limitations. Adm.

Code § 11-507(2). Under this structure, a UBT taxpayer (the Partner) that is a partner in another taxpayer (the Partnership) is required to include its share of the Partnership's income as reported on the Partnership's Federal income tax return, thus without reflecting any deduction for the Partnership's net operating loss carryovers as reported on its UBT return.[1]

The effect of this rule under present law, which is not ameliorated by the proposed credit provisions, is that related taxpayers can be subject to UBT at rates well in excess of 4% on aggregate net income. Consider first (example 1) the case where Partnership P is a partner in Partnerships S and T with a 100% share of income and loss[2], P has no income or loss in years 1 or 2, S has $100x of loss in year 1 and $100x of income in year 2, and T earned $100x in year 1 and had no income or loss in year 2. Under the proposed legislation as under present law, the result in year 1 would be that T would owe $4x of tax, S would owe $0 tax, and P would owe $0 tax because its $100x share of income from T would be offset by its $100x share of loss from S. In year 2, S would pay no tax because of its net operating loss carryover, T would owe no tax, but P would owe another $4x of tax based on its share of S's income in that year unreduced by S's net operating loss carryover. A total of $100x of net income has resulted in $8x of tax.
The reason is that while P has net income in year 1 against which to use S's loss, it has no tax against which to use the year 1 tax credit from T under the proposed legislation. That credit cannot be carried over and the result is extra tax of $4x.

Note that this phenomenon does not arise under both current and proposed law if P directly earns $100x in year 1 than receiving

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[1] For example, if the Partner has an 80% interest in a Partnership that has $400x of income and a $250x net operating loss carryover, the Partner would report $320x of income from the Partnership notwithstanding that the Partnership reports only $150x of income on its own UBT return.

[2] For simplicity we have assumed that all of Partnership S's and Partnership T's income and loss is allocated to Partnership P in the examples. We also, assume that the income or loss of each of the partnerships in the examples is derived from a trade or business of the partnership for purposes of § 172(d)(4) of the Internal Revenue Code.

it from another partnership. The reason is that the $100x income is reflected on the return of only one entity, Partnership P, and P's current benefit from S's loss of $100x in year 1 reduces its income to $0, so that no tax is paid on the $100x in that year. For example (example 2), if the facts are the same as in example 1 except that there is no Partnership T and P itself earns $100x in year 1, S pays no tax in either year and P pays no tax in year 1 and $4x in year 2 on its share of S's income unreduced by the loss carryover, exactly right for $100x of overall economic income for the two years.[3]

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[3] We assume that, if Partnership S's net loss in year 1 produced a net loss on Partnership P's own UBT return, as would be the case if P had no income or loss of its own from any source, the S loss could give rise to a net operating loss for P which it could itself carry over under the rules of Adm. Code § 11-507(2). Under that section, an unincorporated business is allowed a net operating loss deduction "in an amount computed in the same manner as the net operating loss deduction which would be allowed for the taxable year for federal income tax purposes if the unincorporated business were an individual taxpayer". The relevant restriction in I.R.C. §172(d)(4) in computing the net operating loss of an individual is that deductions not attributable to a taxpayer's trade or business are not taken into account to the extent they exceed the gross income not derived from such trade or business. Under the Internal Revenue Code an individual taxpayer's distributive shares of partnership trade or business losses are not treated as subject to this restriction, but as business losses which enter into the net operating loss calculation. See Treasury Reg. § 1.702-2; John L. Harrell. Jr., T.C. Memo 1978-211, 37 TCM 911, 915-17. Partnership P in the examples is subject to UBT only because it is presumed not to be eligible for the exemption for trading or investing for its own account. If the partnership interests, whether general or limited (P's only activity in example 1), are treated as an unincorporated business regularly carried on by the entity, precluding application of the exemption by reason of the last sentence before the example in Rule § 28-02(g)(1), it would be inconsistent to treat the distributive share of losses from such partnership interests as not attributable to Partnership P's trade or business so as to precipitate the restriction in I.R.C. § 172(d)(4).

The distortion illustrated by example l will also not occur if Partnership P's net income in a given year without including its distributive share of income from other partnerships is at least equal to P's distributive share of losses in that year incurred by other partnerships subject to the UBT. For example (example 3), if we combine the facts of examples 1 and 2 (P's own income is $100x in year 1 and $0 in year 2; S has $100x loss in year 1 and $100x income in year 2; and T's income is $100x in year 1 and $0 in year 2) then S would pay no tax in either year by reason of the loss carryover from year 1 to year 2? T would pay $4x tax in year 1 on its $100x income and P's net income in year 1 would be $100x, on which the $4x tax would be offset by a credit under the proposed legislation for the $4x tax paid by T, while P would owe $4x tax in year 2 on its $100x share of income from S. A total of $8x tax would be owed on a total of $200x of income, coming out to exactly 4%.

The problem illustrated by example 1 would also exist under both present and proposed law if P did not pick up a distributive share of loss from S but generated a loss from its own operations. Assume (example 4) that P had a $100x loss of its own in year 1 and no income or loss in year 2, and T earned $100x in year 1 and had no income or loss in year 2. T would owe $4x tax in year 1 the credit for which under the legislation as proposed would be wasted since P had no income. Thus, there would be $4x tax on $0 economic income. P would not have any net operating loss carryover because its loss would be offset by the distributive share of income from T. Thus, any future income of either P or T would be taxable without offset for P's year 1 loss and without credit for T's year 1 tax.

Possible Solutions

We have considered a number of solutions to this problem, some of which we find inadequate.

1. Permitting combined reporting under rules similar to those applicable under the general corporation tax is one possibility, but (1) that is a much bigger policy issue that goes beyond the narrow issue addressed here, (2) it does not deal with the case where P owns less than 80% of S and (3) it would not protect the situation where P and S could not file combined reports under the traditional tests, such as the requirement of a unitary business, even though the nature of partnerships is such that, we believe, offsetting of losses should generally be allowed.

2. Another possibility is to allow carryovers of UBT credits that are unused as a result of the limitations contained in proposed §§ 11-503(j)(2) and 11-203(j)(3) (or in the corresponding provisions in the general corporation or bank tax). This would solve the problem in both examples 1 and 4. We recognize that inclusion of a credit carryover was rejected in the legislation as proposed because of the complexity of the statutory mechanism that would be necessary and the difficulty of making accurate revenue projections.

3. As another alternative, an election could be allowed to a partner either (i) to include its share of a partnership's net operating loss or its own net loss in calculating the partner's income for purposes of the UBT in the year in which the partnership or the partner incurs the net operating loss or (ii) to disregard the net operating loss in calculating the partner's income in the year in which the net operating loss is incurred but to claim its distributive share of the partnership's net operating loss carryover, subject to the same limitations as now apply to carryovers at the first tier level under Rule § 28-06(c)(3), in the year in which the partnership claims a deduction for the net operating loss carryover on its own UBT return, or to carry over the net loss of its own which it has elected to disregard, subject to the generally applicable limitations. The partner's net loss subject to the election would include any net operating loss carried over from other years.

In example 1 above, partnership P would elect to disregard Partnership S's net operating loss in year 1, therefore reporting income of $100x from partnership T. Assuming no change in ownership, P would then report income of $0 in year 2 by claiming its 100% share of S's $100x carryover. In year 1, P would not pay any UBT on its income because it would be allowed a credit of $4x from Partnership T, and in year 2 P would not pay any UBT because its income from S would be fully offset by the loss carryover. The aggregate UBT paid with respect to the group's net income of $100x would be $4x, for an effective rate of 4%.

In example 4, Partnership P would elect to disregard its own loss in year 1, thereby reporting $100x of income from T, but P would pay no UBT by reason of the $4x credit from T. P would then be able to carry over its $l00x loss, assuming constant ownership, as an offset to $l00x of future income which it might earn directly. In a year when P's only income was a distributive share from T, P could be expected to further defer the use of its loss within the maximum 15-year carry-forward limit as set forth in Rule §28-06(c)(2)(ii)(A)(b), since its tax on the share of T's income would be offset by the credit. In the long run, again assuming constant ownership, the election should insure that the overall tax of the two entities will never exceed 4%.

In examples 2 and 3 above where P has other income in year 1, P would elect to include its share of Partnership S's loss in calculating its UBT income in year 1, and the figures would be the same as in examples 2 and 3 above.

This elective solution has its complications. Given that net operating losses of the partnership incurring the loss can be carried back 3 years[4] and forward 15 years, the parent partnership will know which election to make in the carry-back situation, but in the carry-forward situation, its choice of election may not be fully informed unless it is permitted to defer a final decision on the election until future results are known, which may be administratively unworkable. If a binding election is required on the return for the year in which the parent or subsidiary initially incurs a loss which it is to carry forward, the elective solution will not be adequate unless the election as to a given subsidiary partnership's loss can be partially one way and partially the other as to stated dollar amounts of the loss.[5] In such event, P will

[4] Beginning with losses sustained in taxable years ending after June 30, 1989, only the first $10,000 of loss sustained in each year may be carried back; the balance must be carried forward. Adm. Code § 11-507(2)(a).

[5] It would be equitable to allow changes in the election in the event of audit adjustments to the return for the initial loss year.

make the election to disregard the loss in year 1 in favor of carrying it forward only to the extent the loss cannot be offset in year 1 against directly-earned income or income from another partnership (e.g., a nonresident) not subject to UBT. The election would be appropriate to the extent the loss, if included by P in year 1, would only offset P's share of income from another partnership subject to UBT on which the tax can be fully offset by a credit from that other subsidiary partnership. If a split election is allowed, one condition would be that the portion of the subsidiary partnership's loss which P elects not to use currently, whether S carries it back or forward, must be used by P only in the first year in which the loss carryover is utilized on S's UBT return and to the same extent.

We hope that the amendments can be modified to incorporate one of the solutions we have suggested to address the issue described above. Failure to do so may have the undesirable effect of discouraging partnerships that carry on much of their activities through subsidiary partnerships from locating in New York. The members of the Tax Section are ready to work with you and your staff in drafting appropriate legislative language. Please call me if we can be of assistance.

Very truly yours,

Peter C. Canellos
Chair

cc: Simon 6. Salas, Esq.
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