REPORT #878

TAX SECTION

New York State Bar Association

Proposed Reforms to the New York City
Unincorporated Business Tax

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TAX SECTION
New York State Bar Association

May 16, 1996

Hon. Sheldon Silver
Speaker
New York State Assembly
Room 932, Legislative Office Building
Albany, NY 12248

Re: A. 8170-A, S.3424-C— Proposed Reforms to the New York City Unincorporated Business Tax

Dear Speaker Silver:

On behalf of the Tax Section of the New York State Bar Association, we write to reiterate our support for the bill to reform the New York City Unincorporated Business Tax ("UBT") originally introduced in the 1995 Session, which we endorsed in our letters of May 26, 1995 and June 28, 1995, copies of which are attached. The bill, in amended form, passed the State Senate on April 29, 1996, and was reported out of the Assembly Ways & Means Committee on May 14, 1996.

As set forth in our May 26, 1995 letter, this bill deals with a number of problems left unresolved by Chapter 455 of the Laws of 1994, which enacted significant reforms in the UBT. That legislation mandated the convening by the New York City Commissioner of Finance of a working group consisting of representatives of the Department of Finance and the private sector to study and report on several specified aspects of the UBT as it stood under the 1994 amendments. The Tax Section and other business and professional groups were represented on that working group.

The pending bill is largely the product of the deliberations of the working group. It would expand the reforms in the UBT enacted in 1994 by providing solutions to most of the problems outlined as requiring further study in the 1994 legislation.

Since its original introduction in 1995 in the form commented on in our 1995 letters, the UBT reform bill has been amended to add certain special provisions which were not considered by the working group. The addition of these provisions does not change our previous support for the bill.

Enactment of the bill before you would go a long way toward completing the job of reforming the UBT that was begun by the 1994 legislation. The bill's provisions would generally simplify and improve the law, and would foster an improved economic climate for unincorporated entities operating in the City, all at a relatively minor cost to the City.

We strongly urge the prompt enactment of the bill.

Very truly yours,

Richard Lt Reinhold
Chair, Tax Section

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TAX SECTION
New York State Bar Association

June 28, 1995

Hon. Sheldon Silver Speaker
New York State Assembly
Room 932, Legislative Office Building
Albany, NY 12248

Re: A. 8170, S.3424-B -- Proposed Reforms to the New York City Unincorporated Business Tax

Dear Speaker Silver:

On behalf of the Tax Section of the New York State Bar Association I am writing to urge that the Assembly pass the proposed legislation reforming the City unincorporated business tax ("UBT"). As set forth in detail in our letter of May 26, 1995, this bill reflects a year's effort by the City, the Bar and various private sector groups to respond to the legislature's 1994 directive to address certain problems in the existing UBT statute. The bill would simplify and improve the law and foster an improved economic climate for unincorporated entities doing business in the City. We believe this bill is important, and we urge that it be promptly enacted. Thank you.

Very truly yours,

Carolyn Joy Lee
Chair

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TAX SECTION
New York State Bar Association

May 26, 1995

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Chair, Investigations, Taxation
& Government Operations Committee
New York State Senate
Room 913, Legislative Office Building
Albany, NY 12247

Re: New York City Unincorporated Business Tax Reform

Gentlemen:

We write to express our support for the bill to reform the New York City Unincorporated Business Tax ("UBT") that has been forwarded to the Legislature by the City. The bill is accompanied by a Memorandum in Support expressing the Mayor's

desire for the earliest possible favorable consideration of the bill by the Legislature. A copy of the Memorandum in support accompanies this letter.

The bill would expand the reforms in the UBT enacted by Chapter 485 of the Laws of 1994 by providing solutions to most of the problems outlined as requiring further study in our letter to the legislative leaders dated June 30, 1994, in which we recommended approval of last year's UBT legislation. The bill is the product of the deliberations of the working group established by the Commissioner of Finance under the mandate of § 11-503(j)(6) of the Administrative Code, as added by the 1994 law. The Tax Section and other business and professional groups were represented on that working group.

The bill would make changes in three major areas: the exemption for taxpayers engaged solely in trading in property for their own account (the "self-trading exemption"); the exemption for real estate activities; and the credit for UBT paid by another entity in which the taxpayer owns an interest. The substantive changes in the bill are generally effective for taxable years beginning on or after January 1, 1996.

1. Self-Trading Exemption: The bill would make the following significant improvements in the self-trading exemption:

a. The types of property within the exemption would be expanded to include a much broader range of property, intended, among other things, to cover expressly all categories of property in which investment firms commonly deal.

b. The activities exempted would include not only the purchase and sale of property but specified dealings in positions in property.

c. The exemption would be clarified to include expressly income from "holding" property --i.e., investment income, and to include the ownership of an interest in another unincorporated entity that itself qualifies for the self-trading exemption.

d. The bill adds a definition of "dealers," who continue not to be eligible for the exemption.

e. The bill provides a new partially exempt category for taxpayers ineligible for the existing exemption because they are not "solely" engaged in qualifying self-trading activities, provided that they are "primarily" engaged in such activities or in holding or disposing of interests as an "investor" in

unincorporated entities doing business in the City. The test for being “primarily” so engaged is having at least 90% of a taxpayer's total assets consist of qualifying property, as defined. An interest in another entity is held as an “investor” if (i) the other entity qualifies under the 90% asset test and the taxpayer's share of income, gain, loss, deduction, credit and basis attributable to the entity's in-City business is not materially greater than its share of other items of such entity, or (ii) the taxpayer is not a general partner in the entity and is neither authorized to manage or participate in its day-to-day business operations nor actually doing so. A taxpayer qualifying for the partial exemption is not taxable on its self-trading income, as defined, or on its share of such income of another entity that qualifies for the full or partial exemption, nor is it taxable on that part of its gain on the disposition of its interest in such an entity that is attributable to that entity's exempt activities.

f. The bill adds express coverage of the treatment of so-called “carried interests” in other entities (i.e., disproportionate to the taxpayer's capital contribution), by providing in general that income from such interests retains the same character as it had in the originating entity regardless of how the taxpayer's interest in that entity was acquired. Guaranteed or other payments that are treated under the Internal Revenue Code as not being made to a partner are excepted from this rule.

g. The bill includes express provisions governing the application of the UBT to taxpayers owning interests in other unincorporated entities, reflecting the “flow through” nature of partnerships.

The structure of the self-trading exemption as it would operate under the provisions of the bill is set forth in more detail in the outline which is attached to the letter.

2. Real Estate Exemption; The exemption for the operation of real estate, as revised in 1994, applied to income from a garage only if it was operated solely for the benefit of tenants and was not open or available to the general public. The bill would expand the exemption so that, in the case of a garage open to both tenants and the general public, the exemption would apply to that part of the income from tenants that is derived from parking, garaging or storing of motor vehicles on a monthly or longer term basis. Eligibility for the exemption is conditioned on the inclusion with the UBT return of prescribed information on the garage and its tenants. Failure, in any material respect, to include such information with the original or an amended return would render all income from the garage taxable.

3. UBT Credit: As enacted in 1994, the credit' available to a partner against its own UBT or corporate tax for its share of UBT paid by the partnership from which it receives a distributive share of income was so structured that, in certain situations where the partner has its own operating loss, a net operating loss carryover, or a distributive share of loss from another partnership, part or all of the credit would not serve to reduce the taxpayer's UBT or corporate tax and would accordingly be wasted.

Under the bill, the calculation of the credit would be restructured to create an unused credit in such situations; this unused credit could be carried forward for a maximum of 7 years. In the case of a partnership subject to the UBT, the availability of the carryover would be subject to restrictions, where there are changes in ownership in that partnership, identical to those that apply in the context of net operating loss carryovers.

The operation of the credit carryover is described in more detail in the accompanying Memorandum in Support.

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As noted above, we endorse the enactment of the bill. Our endorsement of the bill is, however, subject to our understanding that the following interpretations of the self-trading exemption set forth in the Memorandum in Support will be incorporated in regulations to be promulgated by the Department of Finance:

1. The elaboration that the “income from ordinary and routine trading or investment activity” eligible for the partial self-trading exemption will include commitment fees, standby fees, breakup fees and similar fees incident to investment activity, as set forth at page 5 of the Memorandum in Support.

2. The elaboration on the activities that an investor can engage in with respect to an investment in an operating partnership (i.e., a partnership not itself eligible for such exemption), and that will not be classified as the type of management activities that preclude application of the partial self-trading exemption. See page 6 of the Memorandum in Support.

The bill specifies that an individual or an entity will not be considered a dealer solely because of its ownership by, or of, a dealer. Consistent with this language, we understand that the intent of the bill is that persons may own multiple entities that regularly deal with one another, with one entity carrying on dealer activities (which would not be exempt) and the other entity carrying on exempt activities, and that the exempt activities of one entity would not be rendered taxable by the dealer activities of the related entity. The

provision thus appropriately permits business interests to isolate taxable activities from nontaxable activities by conducting such activities in separate entities.

As indicated in the accompanying outline, in applying the 90% of assets test for qualification as being primarily engaged in activities permitted under the self-trading exemption, marketable securities and real estate are valued at fair market value and other assets are valued at accounting book value, all based on average monthly gross values. The provision requiring fair market value for real property and marketable securities and accounting value for other assets was modeled on the general corporation tax provisions for valuation of subsidiary, investment and business capital in Administrative Code § 11-604.2. The requirement for using average monthly gross values was inserted in the bill having in mind primarily its application to marketable securities. Average monthly gross values for real estate are generally not readily ascertainable. Monthly appraisals, while theoretically possible, would be prohibitively expensive. Therefore, we assume that regulations will provide for a reasonable interpretation of this provision in its application to the determination of the fair market value of real estate, such as permitting the use of beginning and end-of-year values, which we believe will be a reasonable approximation of monthly values.

We also assume that regulations on the provision barring application of the real estate exemption to garaging for tenants if information required to accompany the return is omitted “in any material respect” will provide that inadvertent omission of information on a small number of tenants or minor inadvertent factual errors will not destroy the exemption.

Enactment of the bill would largely complete the job of reforming the UBT that was begun by the 1994 legislation. As more fully set forth at page 11 of the Memorandum in Support, the bill's provisions would simplify and improve the law, and would foster an improved economic climate for unincorporated entities operating in the City, all at a relatively minor cost to the City.

The drafting of this bill by the working group represented an outstanding example of cooperation between City officials and representatives of the private sector. The legislative mandate for study of specified areas was fully and promptly responded to by the Department of Finance and by numerous private sector representatives, and the resulting bill stands as an excellent example of public/private cooperation in resolving difficult tax issues. We were pleased to be part of this process.

We strongly urge the prompt enactment of the bill.

Very truly yours,

Carolyn Joy Lee
Chair, Tax Section

Robert J. Levinsohn
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MEMORANDUM IN SUPPORT

TITLE

AN ACT to amend the administrative code of the city of New York in relation to the applicability of the city unincorporated business tax to certain investment activities and certain activities incidental to the holding, leasing or managing of real property, and in relation to the carryforward of a credit allowed against such tax and the city general and banking corporation taxes for certain unincorporated business tax payments

PURPOSE

The purpose of this bill is to promote a more favorable tax environment for unincorporated entities in New York City by continuing the effort, begun with legislation enacted in 1994, to reform the City unincorporated business tax as it affects investment activities and certain activities incidental to the ownership and operation of real estate, and to minimize multiple taxation of partnership income that is includable in the taxable income of partners that are themselves subject to City business income taxes. Passage of this bill should help to attract new businesses to the City and keep existing businesses here at a very modest cost in foregone tax revenue.

BACKGROUND—THE 1994 LEGISLATION

Chapter 485 of the Laws of 1994 made substantial changes to the New York City unincorporated business tax (UBT) affecting

the treatment of investment and real estate activities and income, and also enacted a credit that partners subject to City business income taxes can claim for their shares of the unincorporated business taxes paid by partnerships of which they are members.

Investment Activities. Subdivision (c) of section 11-502 of the New York City Administrative Code provides that individuals and unincorporated entities, other than dealers holding property primarily for sale to customers in the ordinary course of business, are not subject to the UBT solely by reason of the purchase and sale of property or the purchase, writing or sale of stock options for their own account (the “self-trading exemption”). If a person is purchasing and selling property for that person's own account and is also engaged in business activities, those business activities may “taint” the trading activity, causing the income from the purchase and sale of property to be subject to the UBT.

The 1994 legislation added to section 11-502(c) a provision stating that the UBT will not apply if a person who purchases and sells property for that person's own account does not receive more than $25,000 of gross receipts during the taxable year from the conduct of an unincorporated business in the City. The amendment made it clear that if a taxpayer's receipts from an unincorporated business carried on in the City exceed the threshold, the taxpayer is not eligible for the self-trading exemption.

The 1994 legislation also revised the rules under which taxable income from certain stocks and securities is allocated to the City for purposes of the UBT. The legislation prescribed a new set of rules for allocating income from “investment capital,”

the definition of which was patterned after the definition of “investment capital” for purposes of the New York City General Corporation Tax. The allocation of income from investment capital under the revised rules generally results in a lower allocation of such income to the City for many taxpayers than under the allocation rules applicable to business income under the UBT.

Real Estate Activities. Subdivision (d) of section 11-502 of the Administrative Code exempts from UBT an -owner, lessee or fiduciary engaged exclusively in holding, leasing or managing real property. Prior to the 1994 legislation, if an owner, lessee or fiduciary engaged in any business activity in addition to holding, leasing or managing real property, both the business activity and the real estate activity were subject to the UBT. The 1994 legislation amended section 11-502(d) to preserve the existing exemption for real estate activities even if other business activities are also carried on. The amendments to subdivision (d) further provided that if the owner, lessee or fiduciary carries on any business at the real property, including, for example, a garage, restaurant, laundry or health club, that business will be considered incidental to holding, leasing or managing real property and not an unincorporated business, provided the business is conducted solely for the benefit of tenants as an incidental service to the tenants, and is not open or available to the general public.

Credit For UBT Paid. The 1994 legislation enacted a credit provision under which a partner that receives a distributive share of income from a partnership subject to the UBT can claim a credit against its liability for the UBT, City general corporation tax (GCT) or City banking corporation tax (BCT) for its share of the UBT paid by the partnership. (Before the enactment of this credit, a partnership could claim a limited

exemption from its UBT base for amounts included in the income of partners subject to the City business income taxes.)

The amount of this new credit is equal to the lesser of the amounts calculated under two different measures. The first measure is the partner's pro rata share of the tax paid and credit claimed by the partnership in which it is a direct partner. The second measure limits the amount of the credit by reference to the incremental effect of the distributive share on the partner's tax liability. If a partner is subject to the UBT, the credit cannot exceed the amount by which the partner's tax liability (before all credits) exceeds the tax it would owe (before all credits) if it did not have a distributive share from the partnership. If a UBT- paying partner is a member of more than one partnership, the sum of such partner's credits with respect to all of the partnerships cannot exceed its total tax liability (before all credits). Similar limitations are provided for partners subject to the GCT and BC7, with additional calculations required to reflect tax rate differentials among the UBT, GCT and BCT.

Tax paid by a remote partnership in a multi-tiered partnership structure does not enter directly into the calculation of a partner's credit. However, it is reflected indirectly by the inclusion of the “credit claimed” in the calculation mechanism, which serves to pass the credit through tiers. Thus, even though the partner only looks to partnerships in which it is a direct partner to calculate its credit, because the credit takes into account credits taken by those partnerships, it minimizes the possibility of a double tax on a distributive share that flows through tiers from a more remote partnership.

Mandate to Form Working Group.

While commentators on the 1994 legislation welcomed the relief it provided, they had additional concerns not addressed by the 1994 bill. As a result, the 1994 legislation added section 11- 503(j)(6) to the Code, which required the New York City Commissioner of Finance to convene a working group of representatives of the New York City Department of Finance, affected industries and other interested persons to study the UBT treatment of investment activities and garages open or available to the public that also provide space to building tenants, to study the impact of the new credit in circumstances where the existence of losses and loss carryovers may affect a partner's ability to fully utilize the credit to which it would otherwise be entitled, and to prepare a report based on the deliberations of the group. Specifically, the group was to take into account economic development, tax administration and other goals of tax policy, and to consider alternatives to existing law that would reduce disincentives to investment in corporations and other entities doing business in the City, including exempting income from investment activities from the UBT. That working group was convened in October, 1994 and several subcommittees were formed to consider these issues.

SUMMARY OF PROPOSED AMENDMENTS TO 1994 LAW

Expansion of Self-Trading Exemption

The memorandum in support of the 1994 legislation states in connection with the self-trading exemption that the 1994 bill did not address the question of under what circumstances receipts from activities other than those specifically exempted by Code section 11-502(c), i.e., the purchase and sale of property and

the purchase, writing and sale of stock options, would be considered receipts from an unincorporated business conducted in whole or in part in the City. Moreover, the statute does not contain a definition of property that may be purchased or sold in an exempt transaction.[1]

To better reflect the types of investment vehicles that are the subject of routine investment activity of investors in today's markets, section 3 of the bill adds a definition of property for purposes of the self-trading exemption that includes stocks and securities as well as notional principal contracts, foreign currencies, publicly-traded commodities and derivative financial instruments (including options, forward or future contracts, and other instruments) in property, as defined. Certain securities not qualifying as investment capital, as defined in the rules governing the definition of investment capital for purposes of the GCT, are excluded, as are all interests in unincorporated entities. Property and positions in property held by dealers in such property or positions in property, respectively, are also excluded.

In addition, to better reflect the types of transactions commonly engaged in by investors, section 3 of the bill amends the self-trading exemption to include the entry into, assumption, offset, assignment or other termination of a position in, as well as the purchase and sale of, property in the categories of exempt trading activity.

Finally, bill section 3 amends the self-trading exemption to make it clear that the ownership of an interest in

[1] The amendment of Code section 11-502(c) in 1977 to exempt the purchase, sale and writing of stock options implies that such options were not included in the definition of property prior to that amendment.

an unincorporated entity that itself qualifies for the self-trading exemption will not disqualify the owner of that interest from the exemption.

Partial Exemption for Investors

In considering the economic development aspects of investment activities, the investment subcommittee of the UBT working group focussed on the effect on investment decisions of the "tainting" of investment income by the receipt of more than $25,000 of gross receipts from the conduct of an unincorporated business in the City. The concern was that unincorporated entities engaged in activities that would otherwise qualify for the self-trading exemption would not risk subjecting the income from those activities to tax by investing in businesses in the City or by expanding into the City businesses in which they had previously invested.

Section 3 of the bill amends section 1 1-502 of the Code to exempt from the UBT income from self-trading activities for unincorporated entities that are primarily engaged in trading for their own account or in the ownership, as an investor, of interests in unincorporated entities engaged in unincorporated business activities in the City. This provision is in addition to the self-trading exemption, which is retained and clarified by the bill, as described above. Specifically, bill section 3 adds to section 11- 502(c) of the Code a new paragraph (4), which provides that if an unincorporated entity is "primarily engaged" in activities qualifying for the self-trading exemption and/or the acquisition, holding or disposition of interests, as an investor, in unincorporated entities carrying on any unincorporated business in the City, the self-trading activities of the taxpayer (including those of a "primarily engaged" entity

in which the taxpayer owns an interest that are attributed to the taxpayer), will not be subject to the UBT.

An unincorporated entity qualifying for the partial exemption will be allowed to exclude from its unincorporated business gross income any income and gains from activity qualifying for the self-trading exemption, including income with respect to securities loans, and other substantially similar income and gains from ordinary and routine trading and investment activity to the extent determined by the Commissioner of Finance (see bill section 3). It is expected that rules will be adopted under this provision that will exempt, for example, commitment fees, standby fees, breakup fees and similar fees commonly received by investors who receive such fees as an incident to their investment activity. Correspondingly, such taxpayers will not be allowed any deduction for losses and expenses directly or indirectly attributable to such exempt activity (see bill sections 6 and 10).

90 Percent Asset Test. For purposes of this partial exemption, an unincorporated entity will be considered to be "primarily engaged" in the designated activities if at least 90 percent of the gross value of its assets is represented by assets qualifying for the self-trading exemption, interests in unincorporated entities not carrying on any unincorporated business in the City, or investments in unincorporated entities carrying on any unincorporated business in the City held by the taxpayer as an investor. In determining whether a taxpayer meets the above test, the average gross value of the assets over the year will be taken into account under rules patterned after those applicable to the New York City General Corporation Tax. The Commissioner of Finance is, however, given discretion to use net values or to exclude assets if he or she deems it necessary to

properly reflect the primary activities of the taxpayer. For example, office furniture and fixtures of a taxpayer may be apportioned between qualifying and nonqualifying assets or excluded. In addition, if a taxpayer holds securities purchased on margin or securities hedged by offsetting positions, the Commissioner may use net values in applying the 90 percent test.

“Investor” Defined. For purposes of the partial exemption, a taxpayer will be treated as owning an interest in an unincorporated entity as an investor if the taxpayer is not a general partner, is not authorized by the entity's governing instrument to manage or participate in the day-to-day business of the entity, and is not actually managing or participating in such day-to-day business. A taxpayer can also qualify as an investor in an unincorporated entity, regardless of the taxpayer's involvement in management or status as a general partner, if the unincorporated entity itself qualifies as primarily engaged in the designated activities (i.e., the entity meets the 90 percent test), provided the taxpayer receives substantially the same share of each item of income, gain, loss and deduction of the entity. This latter proviso is designed to preclude taxpayers from abusing the partial exemption through special allocations. Activities performed by a taxpayer that are customarily performed by investors to preserve their investments will not be considered managing or participating in the day-to-day business of an unincorporated entity. For example, a taxpayer who invests in an entity may be entitled to representation on the entity's oversight body. Mere representation of the taxpayer as an investor on a body whose sole responsibility is oversight of the entity will not be considered managing or participating in the day-to- day business of the entity. Similarly, if an investor, to protect its investment, is entitled to review and/or veto the monthly budget and/or certain major decisions of the entity's

management, such review and/or the exercise of such veto will not be considered managing or participating in the day-to-day business of the entity. If an investor is authorized to manage or participate in the day-to-day business only upon the occurrence of certain unanticipated events, then such investor will not be deemed to be managing or participating in the day—to-day business until the event occurs and, where necessary, the investor elects to manage or participate in the day-to-day business. For example, the right of an investor to manage the business if there is a default on payments to the investor will not be deemed to be managing the day-to-day business until the payments are not made and the investor declares the default. For purposes of determining whether a taxpayer will be considered to be managing or participating in the day-to-day business, activities performed by employees, officers or partners of a taxpayer will be imputed to the taxpayer but only to the extent that the employee, officer or partner is performing the activity as an employee, officer or partner of the taxpayer.

Dealers

Both this bill and the current UBT law use the term “dealer.” Since the term is not currently defined, section 1 of the bill amends Code section 1 1—502(a) to add a definition for purposes of the UBT law. The term “dealer/' as defined, includes a person that (i) holds or disposes of property that is stock in trade of the taxpayer or is otherwise held for sale to customers in the ordinary course of the taxpayer's business or (ii) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in property with customers in the ordinary course of a trade or business. An entity will not be considered a dealer based solely on its ownership of an interest

in another entity that is a dealer or based solely on the ownership by a dealer of an interest in it.

“Carried Interests”

The current UBT law provides no guidance regarding the treatment of a partner's distributive share of income from a partnership if a partner acquires a partnership interest under circumstances in which the partnership interest might be viewed as having been acquired for services.[2] Section 5 of the bill amends Code section 11-506(a) to make it clear that the character of the partner's distributive share of income, gains, losses or deductions from the partnership is to be determined as if those items were realized directly by the partner, regardless of how the interest in the partnership was acquired or whether the distributive share received is disproportionate to the interest of the partner in the partnership's capital. This provision will not apply to payments to a partner treated under Internal Revenue Code section 707 as occurring between a partnership and a nonpartner. This provision is not intended to affect the treatment of a taxpayer's distributive share of income, gains, losses or deductions from a partnership as qualifying for the self-trading exemption or as taxable income, gain, loss or deduction from an unincorporated business in the taxpayer's hands. However, under this provision, a partner's disproportionate share of a partnership's investment income would retain its character as investment income in the partner's hands even if the partner also is receiving a fee for managing the

[2] The memorandum in support of the 1994 legislation indicated that the Department of Finance would promulgate rules under that legislation to provide that a partner's distributive share of income of a partnership qualifying as investment income would retain that character to the partner regardless of how the partnership interest was acquired and regardless of whether the partner was a general or limited partner.

partnership's business, which fee is subject to the UBT as compensation income. If the partner does not qualify for the partial exemption, its share of the investment income from the partnership would be subject to the UBT but would continue to be treated as investment income allocated using the investment allocation rules enacted by the 1994 legislation.

Flow-Through Issues

The bill also clarifies certain issues regarding the application of the UBT to persons owning interests in other unincorporated entities, reflecting the flow-through nature of partnerships. Section 2 of the bill amends Code section 11-502(a), which defines the term “unincorporated business,” to provide that if an individual or unincorporated entity carries on in whole or in part in the City two or more unincorporated businesses, all the businesses will be treated as a single business.

In addition, that Code section is amended to provide that an unincorporated entity is to be treated as carrying on any business activity carried on in whole or in part in the City by any other unincorporated entity in which the first entity owns an interest, and, conversely, that the ownership by an unincorporated entity of an interest in another unincorporated entity not carrying on any business activity in whole or in part in the City will not be considered the conduct of an unincorporated business in the City.

This latter provision is not intended to preclude the taxation, where appropriate, of an entity that provides services in whole or in part in the City to another unincorporated entity located outside the City, nor is it intended to preclude an

unincorporated entity from being treated as engaged in an unincorporated business in whole or in part in the City, where appropriate, by reason of activities carried on in the City on its behalf by a partner.

Finally, section 5 of the bill amends Code section I1-506(a) to clarify that the unincorporated business gross income of an unincorporated entity includes the income or gain from the sale of an interest in another unincorporated entity attributable to an unincorporated business conducted in whole or in part in the City by that other unincorporated entity.

Real Estate Activities

Section 4 of the bill amends subdivision (d) of section 11-502 with respect to the UBT treatment of garages open to the public that also provide space to tenants in the building that houses the carage.

Under subdivision (d), as amended, if an owner, lessee or fiduciary that holds, leases or manages real property also operates at such real property a garage, parking lot or other similar facility that is open or available to the general public, the operation of that garage, parking lot or other facility will be considered an unincorporated business subject to the UBT. However, the provision by any such owner, lessee or fiduciary of parking, garaging or motor vehicle storage service on a monthly or longer term basis at such a facility to tenants in the building as an incidental service to such tenants will not be deemed an unincorporated business even if the garage is open or available to the public. As a result, the income from such tenants received for monthly or longer term parking, garaging or storage service will not be subject to the UBT while the income

received from monthly or longer term parking service for nontenants and from all other parking, garaging or storage service provided to tenants and nontenants will be subject to UBT (see bill section 8). Losses and expenses of the garage or parking operation will not be deductible for UBT purposes to the extent directly or indirectly attributable to the building tenants that are monthly or longer-term parkers (see bill sections 6 and 10).

Due to the difficulty of verifying on audit the identity of persons receiving transient parking services at a facility, the partial exemption for parking, garaging or storage services provided for building tenants is limited to income received for monthly or longer term parking services. As an additional measure to facilitate verification, taxpayers claiming the partial exemption for parking income from tenants must attach to their UBT return such information with regard to the provision of monthly or longer term parking, garaging, or storage services to tenants as the Commissioner of Finance may require. It is anticipated that the Commissioner will require a schedule to be included with the return showing, among other things, the name of each tenant receiving such services and the amount received from each such tenant for such services. Section 4 of the bill amends subdivision (d) of section 11-502 to provide that if a taxpayer's UBT return omits in any material respect the required information relating to parking services provided to tenants at a garage, parking lot or similar facility, the provision of all parking, garaging and storage services to tenants at that facility will be taxable as an unincorporated business.

Technical Corrections. Sections 7 and 9 of the bill amend certain provisions of sections 11-506 and 11-507 added by the 1994 legislation to make it clear that the exclusion from

unincorporated business income for income and deductions from the holding, leasing or managing of real property that is not deemed an unincorporated business applies to all persons receiving a distributive share of such income or deductions, not just to the owner, lessee or fiduciary holding the property. Section 6 of the bill adds a new paragraph 14 to subdivision b of section 11-506 to clarify that under the 1994 legislative amendments, losses from the disposition of real property qualifying for the exemption for holding, leasing or managing of real property are not deductible for UBT purposes.

UBT Credit Carryforward

In various contexts where a partner receiving a distributive share of income from a partnership also has losses or loss carryovers, the effect of the losses or loss carryovers may be to nullify the value of the new credit for UBT paid. The reason for this is that one of the measures of the allowable credit is the incremental tax effect on the partner of its distributive share. If the partner has its own operating loss, a net operating loss carryover, or a distributive share of a loss from another partnership, the partner's income without the distributive share that generates the credit may be less than zero. As a result, its tax without that distributive share will be zero. To the extent that the distributive share raises the taxable income from a number less than zero to zero, the distributive share has no incremental effect on the tax owed (i.e., the tax remains at zero). Therefore, the distributive share does not generate a credit. However, the distributive share may nullify the loss and therefore prevent the taxpayer from carrying the loss to another taxable year.

In order to help minimize loss of the credit in these situations, sections 11, 12 and 13 of the bill amend the relevant UBT, GCT, and BCT sections to change the” way in which the incremental tax-effect of a distributive share is calculated. Under current law, the partner's tax is calculated with and without the distributive share in question. Under the bill, these calculations are modified so that various types of losses are added back before the “with and without” calculations of tax liability are made. The result of this is that a taxpayer may be “allowed” a credit that exceeds the amount that the taxpayer can take in a given year. In such case, the excess can be carried forward and taken against a tax liability in one of the succeeding seven taxable years.

For GCT and BCT taxpayers, the calculation is similar to the UBT calculation, with modifications to equalize the effective tax rates. In addition, for GCT and BCT taxpayers, the bill provides that the credit allowed is always calculated as if the taxpayer were on the respective entire net income bases. This is a change from current law, under which the credit is calculated with reference to the base on which the partner would pay tax in the absence of the credit.

Although for GCT taxpayers the credit is always calculated as if the taxpayer were subject to tax on the entire net income base, the credit may also be taken against the alternative tax measured by entire net income plus compensation paid to officers and certain shareholders (the “income plus compensation base”). In such case, there is again a rate equalization provision under which one dollar of credit reduces the tax by sixty-six and thirty-eight one hundredths cents. Similarly for BCT taxpayers, the credit is calculated as if the taxpayer were subject to the basic tax measured by entire net

income; however, the credit may also be taken against the alternative tax measured by alternative entire net income. In such case, there is a rate equalization provision under which one dollar of credit reduces the tax by seventy-five cents. (In a taxable year in which a GCT or BCT taxpayer is liable for tax on any of the other tax bases, a credit may be “allowed,” but in order to be actually “taken,” it must be carried over to a year in which the taxpayer is liable for tax under one of the above specified income bases.)

Effective Date

The amendments made by the bill are generally effective January 1, 1996 and applicable to taxable years beginning on or after that date. However, the technical amendments described in a previous section of this memorandum, which are designed to clarify certain provisions of the 1994 legislation, are made effective as of the July 1, 1994 effective date of the 1994 legislation and applicable to taxable years beginning on or after that date.

REASONS FOR SUPPORT

This bill represents a continuation of the effort begun last year to reduce the burden of the City unincorporated business tax and thus foster an improved economic climate for unincorporated entities operating in the City. The bill is the product of a cooperative undertaking by the City and representatives of affected industries and professional groups to make the tax more equitable and to help encourage additional investment in the City. The bill addresses favorably each issue that the working group was directed to consider.

As more fully discussed in the preceding sections of this memorandum, the bill will enable investment firms to carry on a broad range of investment activities without the risk that those activities will be subjected to the UBT, and will also afford tax relief to real property owners who provide certain parking or garaging services to building tenants. Partners subject to City business income taxes will also be able to more fully utilize the credit enacted last year for their shares of unincorporated business taxes paid by partnerships of which they are members.

These important improvements in the unincorporated business tax can be implemented at a relatively minor cost to the City. In FY96, there will be no revenue loss as a result of these chances. The revenue cost is estimated to be $1 million in FY97, $4 million in FY98 enc $5 million in FY99.

Accordingly, the Mayor urges the earliest possible favorable consideration of this bill by the Legislature.

OUTLINE OP LEGISLATIVE PROPOSAL ON
U.B.T. INVESTMENT ACTIVITIES
May 15/ 1995

I. If an individual or unincorporated entity, other than a dealer, is engaged solely in trading for its own account, in the ownership, or disposition not in the ordinary course of trade or business, of unincorporated entities that qualify for the self-trading exemption, or, in addition, in activities not otherwise constituting the conduct of a business in the City, it is not subject to the tax. § 11-502 (c)(2).

A. Trading for its own account means the purchase, holding, or sale of property generally, or the entry into, assumption, offset, assignment, or other termination of a position in property.

1. Property generally eligible for the self-trading exemption includes, without limitation:

a. real and personal property;

b. property qualifying as investment capital and stocks, notes, bonds, debentures, and other evidences of indebtedness;

c. interest rate, currency, or equity notional principal contracts;

d. foreign currencies;

e. interests in, or derivative financial interests (including options, forward or futures contracts, short positions, and similar financial instruments) in any asset described above; and

f. any publicly traded commodity. § 11-502(c)(1)(A).

2. Property the trading of which does not qualify for the self-trading exemption includes:

a. debt instruments issued by the taxpayer;

b. accounts receivable held by a factor;

c. property held for sale to customers in the ordinary course of trade or business;

d. debt instruments acquired in the ordinary course of trade or business for funds loaned, services rendered, or property sold, rented or otherwise transferred;

e. interests in unincorporated entities; and -

f. positions in property described in 1 or 2 above entered into, assumed, offset, assigned or terminated by a dealer therein. § 11-502(c)(1)(A).

B. Definition of “dealers” that are not protected by the self-trading exemption. § 11-501 (1).

1. A dealer generally is a taxpayer that in the ordinary course of trade or business:
   a. holds or disposes of property that is held for sale to customers; or

   b. regularly offers to enter into, assume, offset, assign, or terminate positions in property

   with customers.

2. An individual or entity will not be a dealer solely because he or it owns an interest in a dealer or because a dealer owns an interest in the entity.

C. The receipt of $25,000 or less of gross receipts during the year from an unincorporated business conducted wholly or partly in the City will not result in a loss of the self-trading exemption. § 11-502(c)(3).

II. If an unincorporated entity is “primarily” engaged in activities qualifying for the self-trading exemption and/or in the acquisition, holding or disposition, other than in the ordinary course of trade or business, of interests as an investor in unincorporated entities doing business in the City, it will be taxed on its income from an unincorporated business conducted in the City but income from self-trading activities (as defined in I above) conducted by it or by an unincorporated entity (in which it owns an interest) that qualifies for the full or partial exemption will be exempt from tax and will not be “tainted” by the taxpayer's business activities. § 11-502(c)(4)(A).

A. A taxpayer is “primarily” engaged in these activities if at least 90 percent of its total assets consist of qualifying property, based on value. § 11¬502 (c)(4)(B).

B. Qualifying property. § 11-502(c)(4)(C).

1. Property that qualifies for the self-trading exemption. (See I.A.I. above.)

2. An interest in an unincorporated entity that does not do any business in the City.

3. An interest in an unincorporated entity that does business in the City that is held as an investor. An interest is held as an investor if:

a. the taxpayer is not a general partner in the entity and is neither authorized under the entity's governing instrument to manage or participate in, nor manages or participates in, its day-to-day, business operations, or

b. the entity qualifies under the 90 percent rule as being primarily engaged in the activities qualifying for this partial exemption, and the taxpayer does not receive a distributive share from such entity's in-city business that is materially greater than its share of any other items of such entity. § 11-502(c)(1)(B).

C. Valuation of property.

1. Marketable securities and real estate are valued at fair market value. Other assets are valued at accounting book value.

2. The value is average monthly gross value.

3. Commissioner of Finance has discretion to reduce gross value by liabilities or eliminate assets so as to properly and accurately reflect the taxpayer's primary activities. § 11-502 (c)(4)(D).

D. Income that is exempt from the tax if the taxpayer qualifies includes:

1. dividends, interest, and payments with respect to securities loans;

2. income from notional principal contracts;

3. other income, gains, and losses (other than asa dealer) from positions in property that qualifies for the self-trading exemption.

4. income, gains, and losses from the dispositionof interests in unincorporated entities that are primarily engaged in activities that give riseto the partial exemption from tax discussed in this Section II, to the extent that such items are attributable to self-trading activities of the owned entity.

5. other income from investment and trading-related activities (commitment fees, etc.). § 11- 506(c)(9) and (10)

III. A taxpayer that does not qualify for the self-trading exemption and is not primarily engaged in the activities described in Section II that qualify it for a partial exemption from tax is taxable on all of its income from City sources if it engages in a business in the City. Income qualifying as income from investment capital will be allocated within and outside the City under the investment allocation percentage.

IV. Flow-through principles.

A. If a taxpayer owns an interest in an unincorporated entity, the entity's business activities will be attributed to the taxpayer. § 11-502(a).

B. The mere passive ownership of an interest in an entity that is not conducting business in the City will not be treated as the conduct of a business in the City by the owner. § 11-502(a). If the taxpayer performs services in the City on behalf of such an entity, the performance of services may constitute a business and fees received for such services may be taxable (and the activities could cause the entity to be treated as doing business in the City).

C. Investment income from a “carried interest” in an entity (i.e., where the taxpayer's interest is disproportionate to its capital contribution) does not lose its character and is not treated as business income regardless of how

the interest was acquired (i.e., even if acquired in exchange for the performance of services). This will not apply with respect to guaranteed payments or other payments that are treated under section 707 of the Internal Revenue Code as not being made to a partner. § 11-506(a)(2).