REPORT #753

TAX SECTION

New York State Bar Association

Report on New York City

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TAX SECTION
New York State Bar Association

March 18, 1993

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

Dear Mr. Thomas:

I am pleased to inform you that at its meeting on Thursday, March 11, 1993, the Executive Committee of the Tax Section of the New York State Bar Association endorsed the proposed amendments to the Administrative Code relating to the unincorporated business tax that were distributed at your meeting on February 25, 1993, subject to certain understandings relating to two of the amendments that are set forth below.

We wish in particular to commend the Department of Finance for its proposal to replace the additional exemption with a credit, bringing to fruition the work of the Additional Exemption Working Group on which the Tax Section was represented by Robert J. Levinsohn, Co-chair of our Committee on New York City Tax Matters. We note with special satisfaction that the Department has adopted the position recommended by our Executive Committee at its meeting on April 16, 1992, that the credit should be available to corporate partners taxed on the alternative income-plus-compensation base, without any inference as to the propriety of allowing the existing additional exemption to corporate partners taxed on such method.

The Tax Section fully supports the proposed legislation to liberalize the exemption for holding, leasing or managing real estate by eliminating the requirement that such business be the partnership's sole activity, in the form presented at your meeting. As to the other two proposed amendments, our support is subject to the following understandings:

As to the credit replacing the additional exemption:

1. The legislative memorandum accompanying the bill will state expressly that no inference is intended regarding the application of the existing additional exemption as to partners taxed on the alternative income-plus-compensation method.

2. The statutory language will be revised to make the credit available to sole proprietorships.

3. An effort will be made to devise rules that ordinarily will preclude the possibility that a third tier New York taxpayer might be taxable on income from a second tier partnership not itself subject to UBT, without receiving credit for tax on income flowing through from a first tier partnership operating and taxable in the City.

4. The legislative memorandum will state that the application of the credit to third tier or more remote partners is not intended to reflect in any way on the proper treatment of remote partners under the current additional exemption.

As to the trading-for-own-account exemption:

5. The legislative language will be adjusted so that the availability of the exemption where the $25,000 maximum for non-trading income is exceeded will remain whatever it is under present law.

6. The Statement of Audit Procedure in SAP 93-1-GCT, 3/1/93, regarding attribution of noninterest expenses to investment capital, will be made applicable to the UBT when the amendments are adopted.

7. The word “tangible” will be stricken from §11-502(c)(2). I understand that the Department is prepared to strike the words “real or personal” from that subparagraph as well, restoring the existing “purchase and sale of property” language. We recommend that change to avoid any implication that the amendment is intended to narrow the scope of the word “property”-from its meaning under present law.

8. Language will be added that will include in the exemption income related to investment activity that is not covered by the express language in the existing draft.

Our Executive Committee did not adopt a position as to the precise manner in which the change described in paragraph 8 above should be accomplished. One alternative that has been suggested would be to add a new subparagraph to §11-502(c) with language adapted from §851(b)(2) of the Internal Revenue Code, which sets forth the types of receipts which must constitute at least 90 percent of the gross income of a regulated investment company to retain its qualification under Subchapter M. Such a provision would list as permissible receipts any other income derived with respect to the activity of investing in any of the types of property referred to in subparagraphs (1), (2) or (3) of §11-502(c).

Another alternative that we believe would be preferable (since it would clearly include all types of income that are commonly regarded as derived from investment-type activity) would be to adopt the pattern of the Internal Revenue Service regulations setting forth the types of investment income which are excluded in computing the unrelated business taxable income of certain tax-exempt organizations. See Regs. §1.512(b)-1(a)(1). Under this approach, §11-502(c)(1) of the draft would be amended to insert after “governmental,”

some such language as the following, adapted from that regulation and from §851(b)(2) as well:

> "notional principal contracts, foreign currency contracts, futures or forward contracts and other substantially similar ordinary and routine investments to the extent determined by the Commissioner,"

The rules of the Department could then give content to this provision, including a definition of "notional principal contracts" along the lines of that now appearing in some detail in proposed Treasury Regulations §1.446-3(c) and (d). The language suggested is flexible enough to permit the Department's rules to add in the future new types of investment instruments that may be devised over the years.

The Tax Section leaves to the Department the decision as to the optimum method of satisfying our final understanding set forth in paragraph 8 above.

Further background as to our positions is provided in Mr. Levinsohn's memoranda to our Executive Committee dated February 26 and March 10, 1993, copies of which are enclosed.

We remain available to-consult with you and other departmental personnel as the draft legislation is revised, and look forward to an opportunity to review the final version of the legislation when the bill is ready for introduction.

Very truly yours,

Peter C. Canellos
Chair

cc: Simon G. Salas, Esq.
Deputy Commissioner for Legal Affairs
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345 Adams Street, 3rd floor
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TAX SECTION
New York State Bar Association

March 10, 1993

TO: EXECUTIVE COMMITTEE

FROM: ROBERT J. LEVINSOHN

Re: New York City Unincorporated Business Tax

This will supplement my memorandum of February 26, 1993. Since the meeting on February 25, I have had a number of telephone discussions with personnel at the Department of Finance regarding various problems which have been raised in certain quarters as to aspects of the amendments that would substitute a credit for the additional exemption and that would modify the exemption for trading for one's own account. No problems have been brought to my attention in connection with the amendment that would liberalize the exemption for holding, leasing or managing real estate. The problems as to the other two amendments are discussed below.

Additional Exemption Replaced With a Credit

1. Sole proprietorships: As drafted, the amendment allowed a credit only to corporate or partnership partners in a partnership subject to the unincorporated business tax. An individual member of a partnership who also carries on a separate and independent unincorporated business is not required or permitted to include his or her distributive share of partnership income in computing the

unincorporated business gross income of the separate business. Rule income from the partnership. See, e.g. Matter of Richard Siegal (Hearings Bureau 9/13/91), 1991-1 N.Y. Tax Cases (Comeau-Rosen ed.) at C-593, where a partner who was paid fixed management fees by the partnership for the management of its property was held to be himself carrying on a business and subject to UBT on those fees. As a payment to a partner for services, the fees would not have been deductible by the partnership in computing its own UBT, Adm. Code §11-507(3), and it appears that the partnership would have been entitled to claim an additional exemption under present law for the amount included in the individual partner's unincorporated business taxable income. Accordingly, staff personnel of the Finance Department have drafted revisions to proposed §11-503(j) which would make the new credit available to any unincorporated partner, whether individual or partnership, that is required to include a distributive share of partnership items in computing its own unincorporated business taxable income. Although not yet approved at all levels of the Department, it appears reasonably certain that these changes will be included in the legislation when it is introduced.

2. Tiered partnerships: As drafted, the credit would be available to third tier and more remote partners provided that the preceding tier partnership was itself subject to UBT. Concern has been expressed that there could be cases where a middle tier partnership, which owns an interest in a partnership that is conducting an unincorporated business in New York and in turn has a third tier partner in New York, is itself wholly outside New York and not subject to UBT, so that the third tier partner would get no credit. Department personnel's response is that it is intended that regulations will be drafted providing nexus rules for partnerships, which may include provisions similar to those applicable to corporations in the New York City General Corporation Tax Rules adopted December 9, 1992. Under Rule §11-06, a corporation, not otherwise engaged in business in the City, will be considered to be doing business in the City by virtue of its ownership

of a limited partnership interest in a partnership doing business in the City unless it is a passive limited partner in a publicly-traded partnership, or in a portfolio investment partnership which meets the gross income requirement of §851(b)(2) of the Internal Revenue Code. Another possibility is that the partnership nexus rules will contain no exception, so that any ownership of an interest in a partnership doing business in the City will require the reporting of income for UBT purposes. If nexus rules of either type are adopted for UBT purposes, and if regulations also set forth the flow-through concept referred to in my prior memorandum as to the nature of a partnership's income and provide that it also applies in calculating allocation factors, it seems likely that in most cases any foreign partnership owning a limited interest in a New York partnership ineligible for exemption and subject to UBT will be required to file a UBT return on which its UBT as initially computed will be offset by the credit, and a third tier local partner (corporate or unincorporated) required to include a share of income from the middle tier partnership will in turn be able to offset its tax on such income with the credit provided by the existing draft of the statutory language. If there still is a rare case where the middle tier partner is not subject to UBT (e.g., if the portfolio investment partnership exception applies but 10% of the latter partnership's income is from an active business subject to the UBT), there are at least some Department personnel who seem prepared to accept the position that a third tier partner in the City would not be required to include income from the second tier partnership in its taxable income for either UBT or GCT purposes. Even if this position is not adopted, the number of cases where a third tier partner might have to include partnership income from a middle tier, ultimately derived from a New York City partnership, that did not give rise to a credit because the middle tier partnership was not required to report any income from the New York City partnership, would seem very few and far between. Accordingly, no change in the statutory draft on this point is contemplated.

As stated in the memorandum from the Director of the Tax Law Division dated April 6, 1992, that accompanied my memorandum to the Executive Committee dated April 9, 1992, the application of the credit to third tier or more remote partners is not intended to reflect in any way on the proper treatment of remote partners under the current additional exemption. It would be desirable for this statement to be included in the legislative memorandum. A contention by the City that no additional exemption is available under present law for second tier partners was rejected in Matter of M. L. Weiss & Company v. O'Cleireacain (Sup. Ct., N.Y., July l, 1992), appeal pending in the 1st Department.

3. Credit carryover: As drafted, no carryover or carryforward of unused credit would be allowed in cases when the partner's credit as computed under the first paragraph of the applicable statutory formula is reduced under the second paragraph because the partner's income from the partnership is offset by losses from other sources. Proposals to deal with this problem that were discussed in the Additional Exemption Working Group were not adopted because of the complexity of the statutory mechanism that would be necessary and the difficulty of making accurate revenue projections. Although ideally inclusion of a carryover feature in the credit provision would be desirable, and further efforts to arrive at a workable formula to this end would seem justified, it does not appear appropriate to hold up the legislative effort at this juncture because of failure to provide for this detail.

Trading for One's Own Account:

1. Effect of $25.000 de minimis rule on the exception: Under present law the rules provide that where the purchase and sale of property for one's own account is connected with an unincorporated business otherwise regularly carried on by the individual or entity, the profits and income from such purchases and sales will ordinarily be includible in the unincorporated business gross income of the

individual or other entity. Rule § 28-02(g)(i). The Department's position is that this provision must be read against Rule § 28-02(a)(4)(ii), which says that

> "An individual or other unincorporated entity carrying on a number of separate and distinct unincorporated businesses some located (in whole or in part) in the City and others located entirely outside the City, must treat all the New York businesses as a single business in computing its tax. The businesses carried on entirely outside the City are not taxable and, therefore, items of income, gain, loss or deduction from such businesses are not included in computing the unincorporated business taxable income of the City business."

Accordingly, the Department contends under present law that the only business that can be treated as not connected with the trading operations for purposes of the exemption for such operations is one that is geographically separated by virtue of being carried on entirely outside the City. On the other hand, taxpayers have contended that Rule § 28-02(g)(i) permits the application of the trading for one's own account exemption if it can be shown that an unincorporated business otherwise regularly carried on by the entity is wholly unconnected with the trading operation, even if the other business is conducted wholly or partly in the City. I am advised that this issue has never been resolved under current law because all cases raising the issue have been settled.

Concern has been expressed that the addition to the statute of a $25,000 maximum amount of income from other business that would not affect the trading for one's own account exemption, and the deletion of the "solely by reason of" language, might convey the negative inference that any other income above the $25,000 amount would clearly make the exemption unavailable. The response of Department personnel initially was that § 11-502(c)(4) of the amendment as drafted excludes from consideration gross receipts from "any activity

not otherwise subject to the tax imposed by this chapter". This does take care of the partnership with a non-trading business carried on wholly outside the City.* However, City personnel now agree that the existing version of the amendment may be so precisely worded as to eliminate any ambiguity that may exist under the present statute, and to make impossible the retention in the rules of the sentence in § 28-02(g)(1) which forms the basis for taxpayers' argument that an unconnected business can be directly carried on in the City without destroying the trading-for-own-account exemption. Department personnel have stated that the amendment to § 11-502(c) was not intended to change present law, whatever that may be, as to the availability of the exemption where income from an in-City operating business exceeds $25,000. However, a statement to that effect in the legislative memorandum may not be sufficient to preserve the issue given the wording of the amendment as presently drafted. Some further revision of the statutory amendment may therefore be necessary, although precise language to this end has not yet been formulated.

2. Discretionary authority in computing investment capital and investment income: Section 11-501(g) and (h) of the draft statute gives the Commissioner of Finance discretion in computing investment capital to deduct any liabilities which are directly or indirectly attributable to investment capital, and in computing investment income to subtract any deductions directly or indirectly

* It may also cover a trading and investment partnership which owns a limited partnership interest in an operating partnership subject to the UBT, since any tax on income from the latter partnership would be offset by the new credit, so that such income is arguably from an "activity not otherwise subject to" the UBT. It also takes care of a glitch in present law which might literally make neither exemption available where a partnership engages solely in real estate and trading activities which if conducted independently would be exempt but if conducted together would be disqualified for exemption as not the sole activity. The real estate activity will now be exempt because it need not be the sole activity, and the trading activity will be exempt because the real estate activity will be "not otherwise subject to" tax.

attributable to investment capital or investment income. One source has urged that this discretionary authority should be eliminated because it will create a significant compliance burden and that clear statutory guidelines for calculating investment income and capital should be substituted. However, the proposed language is in substance identical to that already applicable under the general corporation tax. The Department of Finance has now issued a Statement of Audit Procedure under the GCT (SAP 93-1-GCT) dated March 1, 1993, which sets forth detailed rules for attribution of non-interest expenses to investment income or capital, including illustrative examples. If the proposed UBT amendments are adopted, it is expected that similar audit procedures will be made applicable to the UBT. This should largely satisfy the concern that taxpayers will be at risk of an unbridled exercise of discretion by the Commissioner. Assuming that the new UBT provisions will be administered in the same manner as the corresponding GCT provisions, a change in the draft language on this point would not seem necessary.

3. Scope of activities within the purchase and sale for own account exception: Finance Administration personnel have advised me that the draft as previously distributed inadvertently narrowed the exemption by limiting it to gross receipts from securities, options, and the purchase and sale of real or tangible personal property for his or her own account. They have decided that the work “tangible” should be eliminated in the revised § 11-502(c)(2), so that the exemption will apply to receipts from the purchase and sale of intangible property other than securities, an example of which would be foreign currency hedge contracts entered into in connection with an investment in shares of stock of foreign corporations. It should be noted that with this clarification, the category of investments qualifying for the exemption is broader than those qualifying as investment capital eligible for allocation by issuers' allocation percentages under the new § 11-508(f) where the trading-for-own- account exemption does not apply.

There remains the problem that even as revised, the language may not be broad enough to cover under the exemption some items that are generally considered as investment income in today's world, such as income from interest rate swaps and similar instruments. One solution would be to add to § 11-502(c) a new subparagraph, adapted from the language in § 851(b)(2) of the Internal Revenue Code, which would include as permissible any other income derived from the activity of investing in any of the types of property referred to in subparagraphs (1), (2) or (3) of § 11-502(c). Regulations could give content to this language by spelling out the types of income that would be covered.

Summary and Recommendation

Based on the above discussion, I recommend that the Executive Committee endorse the proposed legislation, subject to the following understandings:

As to the credit replacing the additional exemption:

1. The legislative memorandum will state expressly that no inference is intended regarding the application of the existing additional exemption as to partners taxed on the alternative income-plus- compensation method.

2. The statutory language will be revised to make the credit available to sole proprietorships.

3. An effort will be made to devise rules that ordinarily will preclude the possibility that a third tier New York taxpayer might be taxable on income from a second tier partnership not itself subject to UBT, without credit for tax on income flowing through from a first tier partnership operating and taxable in the City.

4. The legislative memorandum will state that the application of the credit to third tier or more remote partners is not intended to reflect in any way on the proper treatment of remote partners under the current additional exemption.

As to the trading for own account exemption:

5. The legislative language will be adjusted so that the availability of the exemption where the $25,000 maximum for non-trading income is exceeded will remain whatever it is under present law.

6. The Statement of Audit Procedure in SAP-93-1—GCT will be made applicable to the UBT when the amendments are adopted.

7. The word “tangible” will be stricken from § 11-502(c)(2).

8. Language will be added that will include in the exemption income related to investment activity that is not covered by the express language in the existing draft.

RJL

TAX SECTION
New York State Bar Association

February 26, 1993

TO: Executive Committee (cc: Committee on New York City Tax Matters)

FROM: Robert J. Levinsohn

Re: New York City Unincorporated Business Tax

Yesterday I attended a meeting at the New York City Department of Finance at which the City unveiled its statutory drafts of amendments to the law governing three aspects of the unincorporated business tax: substituting a partner-level credit for the additional exemption at the partnership level; liberalizing the exemption for real estate income; and changing the basis for allocating investment income to the method used under the general corporation tax. The statutory drafts are enclosed, together with a brief summary of the changes distributed by the City. The following serves to supplement the summary based on the discussion at the meeting. All of the amendments are to be effective for taxable years beginning on or after January 1, 1993.

Additional Exemption Replaced with a Credit: This is the outcome of the work of the Additional Exemption Working Group of which I was a member since its inception two years ago. The enclosed statute is a revised version of the draft that was considered by the Executive

Committee at its meeting on April 16, 1992. See item 10 of the minutes of that meeting. The City has acceded to the position insisted upon by the Executive Committee at that meeting, and now provides that the new credit will be available prospectively to corporate partners taxed on the alternative income-plus-compensation method. The legislative memorandum accompanying the bill when it is introduced will state expressly that no inference is intended regarding the application of the existing additional exemption as to partners taxed on such method. The City's appeal from Supreme Court decisions holding that the exemption is available in such cases is now pending in the Appellate Division.

The draft statute provides that the application of the credit will not shift the basis on which a partner's tax is computed, even if the net tax after credit is less than what it would be under one of the alternative methods.

Holding, Leasing or Managing Real Estate: The exemption for income from the holding, leasing or managing of real estate would no longer be limited to taxpayers engaged solely in such activities. If a taxpayer is engaged in other business activities, only the income from the latter activities would be taxed.

Trading for One's Own Account: The exemption for taxpayers engaged solely in trading in stocks and securities for their own account would be clarified as applicable to investment income as well as trading income, and would be available even if the taxpayer has other business receipts provided they do not exceed $25,000 of gross receipts during the taxable year. Taxpayers with business gross receipts in excess of that amount would allocate their income from investment capital under the same method as applies to the general corporation tax.

As to both the real estate and trading exemptions, it is intended that the nature of a partnership's income would flow through to its partners, so that a partner that receives a share of the profits from a real estate or

investment partnership and is itself subject to the UBT would determine its eligibility for the exemptions on the basis of its proportionate share of the partnership's real estate or investment income. I am not clear whether it is intended that this be accomplished by regulation or by clarification of the statutory drafts.

The City has asked for technical comments on the draft language by next Friday, March 5, as they plan to have the amendatory bill introduced in the Legislature as promptly as possible. If any of you have any comments, please furnish them to me by that date.

The Tax Section's position as to the proposed legislation will be on the agenda of the Executive Committee meeting on March 11, 1993. The City has asked for a resolution endorsing the proposed legislation, and I recommend that we respond favorably.

RJL

UBT Reform Proposals

Replace Additional Exemption with a Credit. The additional exemption would be repealed. Instead, each corporate or partnership partner in a partnership UBT taxpayer would be entitled to a credit against its UBT or GCT tax liability equal to its share of the UBT liability reported by the partnership. The credit would be limited to the tax paid by the partner on its share of the partnership's income. This limit would be determined by comparing the partner's tax liability calculated with and without inclusion of the partner's share of the partnership's income, including gains and payments to the partner. A credit would be available to third tier and more remote partners with the limitation that the credit available to a third tier partner, for example, would not be greater than the credit allowed to the second tier partner. The credit could not be carried to future or prior years of the partners. The credit would be available to corporate partners taxed on the alternative income-plus-compensation base.

Holding, Leasing or Managing Real Estate. All income from the holding, leasing, or managing of real estate would be exempt from the UBT regardless of whether the taxpayer was engaged in other business activities. Only the income from any other business activities would be taxable. This would include income from garages, health clubs, laundries, etc. operated as businesses. Income from such facilities provided as an incidental service to tenants and not open to the public would be exempt as Income from real estate and not taxed as income from other business activities.

Trading for One's own Account. An individual or unincorporated entity solely engaged in trading stocks and securities (and other real or personal property) for its own account would continue to be exempt from the UBT. Persons engaged in trading for their own account who also derive any income from another nonexempt business activity would not be exempt from the UBT. However, Income from investments in stocks and securities would be allocated to the City using the same investment allocation method as is currently applied under the GCT.