REPORT #569

TAX SECTION

New York State Bar Association

Committee on New York City Tax Matters

Report on the NYC Unincorporated Business Tax

August 21, 1987

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TAX SECTION
New York State Bar Association

September 14, 1987

<u>BY HAND</u>

Commissioner Abraham Biderman
New York City Department of Finance
500 Municipal Building
New York, New York 10004

Dear Commissioner Biderman:

I enclose a Report on the New York City Unincorporated Business Tax prepared by the Committee on New York City Tax Matters of the Tax Section of the New York State Bar Association, which has been approved by the Executive Committee of the Tax Section.

The Report recommends that the Department of Finance amend its regulations to provide that the exemption from unincorporated business tax for the shares in partnership income of incorporated partners that pay New York City general corporation tax on the “salary add-back” alternative should be based on the corporate taxable income after the salary add-back, rather than the allocated net income before the add back, as under the regulations. The recommended change would restore the position taken by the City prior to the promulgation of the regulations in 1985, as set forth in New York City Department of Finance Bulletin, Val. 11, No. 2, October 1980, at page 4. It would also be consistent with the decision of the State Tax Commission in <u>M.L. Weiss & Company</u>, 3 N.Y. Tax Reports (CCH) ¶ 251-663 (November 14, 1986). We believe that the recommended change represents the proper interpretation of the statute, and can be effectuated without any need for legislative action.

The Report is consistent with the recommendations in a report by a Special Committee of the Tax Section on the unincorporated business tax that was submitted to you on August 13, 1986. That report (a copy of which is enclosed)endorsed a proposal by the Department of Finance under which earnings subject to unincorporated business tax would be deductible from income for purposes of personal income and nonresident earnings taxes. That proposal of the Department contemplated that compensation of individual recipients that has been added back to corporate income under the salary add-back method would also be deductible from income for purposes of personal income and non-resident earnings tax. The Department's proposal also would have changed the salary add-back alternative in the general corporation tax to a 4% tax on 100% (rather than 30%) of net income after the salary add-back. In supporting these proposals, our 1986 report also recommended that the unincorporated business tax exemption for partnerships with corporate partners be changed so that it equals the corporate partner's full share of the partnership net income multiplied by the corporate partner's New York allocation ratio, unreduced by losses from other sources, whether the corporation computes its tax under the regular or the salary add-back method.

The Tax Section adheres to the recommendations in the 1986 report of the Special Committee, which would require amendments to the statute. Even if those changes are not made, however, the Tax Section supports the proposal for regulatory amendment in the enclosed Report, which was suggested in the alternative in the 1986 report of the Special Committee.

Sincerely,

Donald Schapiro

cc: Honorable Alair Ane Townsend
Deputy Mayor for Finance and
Economic Development
City of New York
City Hall
New York, New York 10007

TAX SECTION

New York State Bar Association

September 14, 1987

BY HAND

Edward Sadowsky, Esq., Chairman
City of New York Tax Study Commission
405 Lexington Avenue - 15th Floor
New York, New York 10174

Dear Mr. Sadowsky:

I enclose a Report on the New York City Unincorporated Business Tax prepared by the Committee on New York City Tax Matters of the Tax Section of the New York State Bar Association, which has been approved by the Executive Committee of the Tax Section.

The Report recommends that the Department of Finance amend its regulations to provide that the exemption from unincorporated business tax for the shares in partnership income of incorporated partners that pay New York City general corporation tax on the "salary add-back" alternative should be based on the corporate taxable income after the salary add-back, rather than the allocated net income before the add back, as under the regulations. The recommended change would restore the position taken by the City prior to the promulgation of the regulations in 1985, as set forth in New York City Department of Finance Bulletin, Val. 11, No. 2, October 1980, at page 4. It would also be consistent with the decision of the State Tax Commission in M.L. Weiss & Company, 3 N.Y. Tax Reports (CCH) ¶ 251-663 (November 14, 1986). We believe that the recommended change represents the proper interpretation of the statute, and can be effectuated without any need for legislative action.

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The Tax Section adheres to the recommendations in the 1986 report of the Special Committee, which would require amendments to the statute. Even if those changes are not made, however, the Tax Section supports the proposal for regulatory amendment in the enclosed Report, which was suggested in the alternative in the 1986 report of the Special Committee.

Sincerely,

Donald Schapiro

cc: Mr. John Fava, Executive Director
City of New York Tax Study Commission
52 Chambers Street - Room 356
New York, NY 10007

REPORT #569

August 21, 1987

Tax Section, New York State Bar Association

Committee on New York City Tax Matters

Report on the NYC Unincorporated Business Tax[1]

INTRODUCTION

The New York City unincorporated business tax law[2] contains a provision that allows an exemption from unincorporated business taxable income for the shares in partnership income of partners that are themselves subject to an entity level tax, to prevent the double taxation of the shares of entity partners. The New York City Department of Finance has, however, issued regulations (the “Regulations”)[3] that have the effect of causing the very double inclusion in income that the exemption provision is meant to prevent.

The purpose of the UBT exemption is to prevent the inclusion of more than 100% of an unincorporated entity's

[1] This report was prepared by Hugh T. McCormick and Robert J. Levinsohn. Helpful comments were made by Gordon D. Henderson, Anshel E. David and Donald Schapiro.

[2] Ch. 5, Title 11 of the N.Y.C. Adm. Code, referred to hereinafter as the “UBT.” Section references herein pertain to the N.Y.C. Adm. Code unless otherwise noted.

[3] New York City Unincorporated Business Tax Regulations Section 9-2. New York City Unincorporated Business Tax Regulations are hereafter cited as “Reg. section.”

income on an entity level tax return.[4] Under the Regulations, however, amounts that are reflected in a corporate partner's tax base under the “net income plus salaries” alternative, and are thus subject to corporate tax, are also subject to UBT. Consequently, as much as 130% of each dollar earned by a partnership with corporate partners taxed on the “net income and salaries” base will be subject to an entity level tax. The Committee believes that this result is inconsistent with the purpose of the statute.

SUMMARY OF POSITION

The New York City UBT in principle provides an exclusion from the UBT tax base for any amount of income that is subject to corporate tax in the case of a corporate partner. Under existing law and regulations, disregarding the $5,000 UBT exemption, the operation of the New York UBT with respect to income distributed to a corporate partner can be illustrated as follows:[5]

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4 See Richmond Constructors v. Tishelman, 61 N.Y.2d 1, 7 (1V83), reh. den., 61 N.Y.2d 905 (1984), in which the Court of Appeals stated that “The apparent object of the exemption provision is to avoid double taxation of the distributed share of net income earned by an unincorporated business in New York City ....”

5 There is an equivalent exemption for a distributive share of partnership income which, in turn, is subject to UBT at a different level, but this exemption is not relevant to the matter under discussion in this report.

Assume that a New York partnership is composed of two partners, an individual and a corporation. The partnership has taxable income before exemptions, all from New York City sources, of $200,000 which is divided equally among the two partners. Assume the corporate partner, which includes $100,000 of partnership income, pays corporate tax on $100,000 because the corporation has no other deductions and no allocation percentage outside New York City. On these facts, the $100,000 subject to corporate tax is eliminated from the UBT base. In technical terms, there is $100,000 exemption from UBT. If the facts are varied so that the corporate partner has expenses which reduce its taxable income subject to corporate tax to $40,000, the UBT exemption is only $40,000 so that the partnership would be subject to UBT on $160,000 (apart from the $5,000 exemption). Varying the facts further, if the corporate partner had an allocation percentage outside New York City of 70%, so that only 30% of its $40,000 net income was allocated to New York City, then only $12,000 would be subject to New York City corporate tax, the UBT exemption would be reduced to $12,000, and the UBT would be payable on $188,000. In each of these situations, the total amount subject to entity level taxes never exceeds $200,000.

The results illustrated by the example above stem from the law itself, as interpreted by two seminal cases.[6] The issue here under consideration arises where the corporate partner on the facts assumed in the example has deductions for salaries of officers and over-5% stockholders which reduce its taxable income to zero, and, under the alternative tax method, the general corporation tax is calculated by adding back 30% of such salaries. On this basis, and assuming that 100% of the corporate partner's income is allocated to New York City, the corporate partner's tax base (ignoring the $15,000 offset) would be $30,000. The Regulations take the position that the $30,000 representing the salary add-back is not to be treated in the same fashion as $30,000 of other taxable income in the hands of the corporate partner. Thus, there is a zero UBT exemption where the corporation has zero net income before the add-back. On the facts stated in the original example, the business enterprise consisting of the partnership and its partners would be subject to tax on $230,000, representing UBT on $200,000 and a corporate tax on $30,000.

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6 Fischbach and Moore v. State Tax Commission, 36 N.Y.2d 605 (1975), reversing 43 A.D. 2d 81 (3d Dep't 1973); Richmond Constructors v. Tishelman, supra note 4.

The legislative history of the alternative taxing provisions on corporations shows that it was intended to deal with what otherwise might be termed as "excessive salaries."[7] The add-back is an economic substitute for partial disallowance of salaries. Thus, for example, if, in lieu of utilizing the salary add-back formula, the agent auditing the corporate return disallowed $30,000 of salaries as unreasonable compensation, the corporate tax would be the same -- that is to say, a corporate tax on $30,000 -- and the $30,000 would be allowable as an

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[7] The salary add-back alternative in N.Y.C. Adm. Code §11-604.1.E(3), as authorized by §4.1(a)(3) of the Model Local Law in the enabling act, Laws 1966, Chapter 772, §1, as amended, was modelled after the corresponding provision of the New York State franchise tax formerly in Tax Law §210.1(a)(3), repealed by Laws 1987, Chapter 817, §23. The precursor of the salary add-back alternative in the franchise tax was first added to the Tax Law by Laws 1929, Chapter 384, §2. The legislative history of that provision indicated that it was enacted in an effort to correct a situation described as follows:

> The practice in the past of certain closely held business corporations has been to deduct excessive salaries paid to officers and large stockholders from the net income of the corporation which is the basis of the tax. Much time and effort has been expended in the past by the Tax Commission to forestall such evasion.

Annual Report of the State Tax Commission for 1929, Legislative Document (1930) No. 11 at p. 11.

exemption from UBT. The fact that the alternative salary add-back method is employed to reach the--same result should not change the amount of the UBT exempt ion.

In response to the Fischbach and Moore case the State administration initially adopted the same position as the City Regulations in denying UBT exemption for the salary add-back in administering the former State UBT; however, the State has had its position reversed in M.L. Weiss & Company, 3 N.Y. Tax Reports (CCH) ¶ 251-663 (State Tax Commission, November 14, 1986). The Regulations represent a change in the City's view of the UBT exemption provision, as prior to promulgation of the Regulations in 1985 the City did take the add-back into account in computing the exemption.

In the view of this Committee, the position taken in the Regulations, which would deny a UBT exemption for the salary add-back in a corporate partner's taxes, is unjustified under the statute, case law and policy of the law, and we thus suggest that the Regulations be retroactively amended so as to take into account any amount of a corporate partner's income that is actually subject to the general corporation tax.[8]

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[8] On August 13, 1986, the Tax Section submitted a Report by a Special Committee, dated August 4, 1986, on proposed changes in both the UBT and general corporation tax provisions of the City Administrative Code. To the extent here relevant, that Report dealt with a proposal by the New York City Department of Finance to change the "net income plus salaries" alternative (which now in general applies the regular corporate rate to 30% of net income after the salary add-back) to a tax in general at the 4% rate used for UBT, applied to 100% of net income after the salary add-back. The Department's proposal also contemplated a deduction for personal income tax and nonresident earnings tax purposes for compensation of individual recipients that has been added back to and taxed as corporate income under the salary add-back method. In discussing these proposals, that Report basically recommended that the unincorporated business tax exemption for partnerships with corporate partners be changed so that it equals the corporate partner's full share of the partnership net income multiplied by the corporate partner's New York allocation ratio, unreduced by losses from other sources, whether the corporation computes its tax under the regular or the salary add-back method. That Report also recommended that, even if this change were not accepted, the City in implementing its proposal eliminate the regulatory interpretation that a corporate partner's exemption is limited to the corporation's allocable net income under the regular method, even though the corporation is paying tax on a higher amount under the alternative method by reason of the salary add-back. This Report's recommendation is essentially the same as the latter, and is of immediacy so long as the "net income plus salaries" alternative is retained for corporation tax purposes, whether or not changes such as those in the Department's 1986 proposals are made.

DISCUSSION

A. The Law

New York City imposes a 4% tax on the unincorporated business taxable income of partnerships, unincorporated proprietorships and professional practices. Section 11-501, et seq. Unincorporated business taxable income is determined by subtracting certain deductions and exemptions from unincorporated business gross income. Section 11-505. Entities subject to UBT are allowed an unallocated deduction of $5,000 for compensation paid to each proprietor or partner who provides services to the entity and is actively engaged in the business (subject to certain limitations), and a single unallocated exemption of $5,000. Sections 11-509, 11-510. Partnerships that include as members corporations or other partnerships subject to the UBT are also provided an exemption for the distributive shares of such members, as described immediately below.

Under section 11-510(2) a partnership is allowed an additional exemption for the distributive share in partnership net income of a partner that is itself subject to UBT, or of a corporate partner subject to the New York City general corporation tax ("GCT").[9] The exemption is limited, however, to the amount that is "included in a non-corporate partner's unincorporated business taxable income allocable to the city," or "included in a corporate partner's net income allocated to the city" for GCT purposes. As previously noted, this report is concerned with the UBT exemption for the distributive shares of corporate partners when such partners are subject to tax on the "net income and salaries" alternative tax base, under which thirty percent of salaries paid to officers and owners are "added back" to net corporate income for purposes of determining the amount of taxable income allocable to the City.[10]

Until relatively recently, the City took the position that when a corporate partner was under the GCT "net

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[9] Ch. 6, Title 11 of the N.Y.C. Adm. Code. The GCT tax rate is 9%, and is applied to "entire net income." If, however, one of three alternative tax bases (business and investment capital, net income plus salaries or a minimum tax) produces a greater tax liability, the alternative base that produces the highest tax will be used.

[10] Under section 11-604.1.E(a)(3) a corporation is taxed at the rate of 9% on "thirty per centum of the taxpayer's entire net income plus salaries and other compensation paid to the taxpayer's elected or appointed officers and to every stockholder owning in excess of five per centum of its issued capital stock minus fifteen thousand dollars ... and any net loss for the reported year. ..." This amount is then subject to allocation.

income and salaries" tax base, its "net income" included the amount "added-back."[11] Without change in the governing statute the city has changed its position, however, and no longer takes the "add-back" amount into consideration. On August 15, 1985, the New York City Commissioner of Finance promulgated the Regulations, which express the City's "net income" interpretation of the UBT exemption limitation. Reg. section 9-2(b) provides as follows:

> (b) Limitation on amount of additional exemption. The additional exemption allowable under subdivision (a) of this section is limited to the amount which is included in the partner's or member's unincorporated business taxable income allocable to New York City, or included in a corporate partner's or corporate member's net income allocable to New York City, under the provisions of Title S or Title R of Chapter 46 of the Administrative Code. Thus, the additional exemption attributable to a partner cannot exceed that partner's unincorporated business taxable income allocable to New York City in the case of an unincorporated partner <u>or that partner's net income allocable to New York City in the case of a corporate partner.</u> (Emphasis added)
>
> Reg. section 9-2(c)(4) further provides:
>
> (4) The additional exemption allowed an unincorporated business with respect

[11] <u>See</u> <u>New York City Department of Finance Bulletin,</u> vol. 11, No. 2, October 1980. <u>Compare</u>, Vol. 10, No. 1, March 1979; Vol. 10., No. 2, July 1979.

> to a corporate partner is limited to the corporate partner's net income allocable to the City even though the corporate partner does not pay a New York City general corporation tax measured by allocated net income because one of the alternative measures of the general corporation tax produces a higher tax.[12]

We believe that the above provisions, which fail to take account of the amount “added-back” for GCT purposes under the alternative method in determining the UBT exemption, are inconsistent with the statute and with the original purpose of the exemption provision, as discussed below, and produce an inequitable result.

B. History and Purpose of Exemption Provision

The UBT statute has contained an exemption for the distributive shares of entity partners since the law's inception. However, the exemption limitation provision currently in effect was first enacted in 1949 under the New York State

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[12] Reg. section 9-2(c)(4) Example 7 provides that current losses or loss carryovers utilized reduce a corporation's net income for purposes of computing the Reg. section 9-2(b) exemption limitation. Example 7 also demonstrates that the compensation “add-back” to the GCT income and salaries tax base is not included in a corporation's net income in computing the exemption limitation. Despite the contrary ruling cited in footnote 11, supra, we understand that the City is administratively applying the Regulations retroactively.

UBT statute.[13] Under the State UBT rules interpreting that provision in effect prior to 1975, the entire partnership distributive share of a corporate or other entity partner was multiplied by the entity's New York GCT or UBT allocation ratio, and the result was carried back to the partnership as the exemption amount. See section 209.2(c) of the New York State UBT Regulations, which were apparently followed by the City. Thus, under prior procedure the UBT exemption limitation was computed by reference to the amount of the partnership distributive share that was allocated to New York, and included in determining the partner's net income for purposes of determining the partner's franchise tax, GCT or UBT liability, even if that amount was ultimately offset by losses at the entity level. For example, if a partnership apportioned $10,000 to a corporate partner with a 50% GCT allocation ratio, the exemption amount would be $5,000,

[13] N.Y. Tax Law § 386-f, now N.Y. Tax Law § 709(2)(McKinney 1983 Supp.). The State's UBT has been eliminated. L. 1978, ch. 69, § 7. The City's UBT statute was enacted pursuant to an enabling act of the New York State legislature granting the City the power to impose such tax. L. 1966, ch. 722, § 2, as amended. Under the terms of the enabling act, if the City decided to impose this tax it was required to adopt in all important respects a model UBT law (which was part of the enabling act) that was drawn directly from the State UBT statute.

even though the corporate partner might have losses sufficient to reduce corporate taxable income to zero. Under this approach, the result was the same whether a corporate partner's income was taxed under the regular or the alternative method.

This approach was entirely consistent with the legislative history of the limitation provision. Until 1949 the State's statute, N.Y. Tax Law § 386-f, used in the exemption limitation provision the words “included in computing the net income...” (emphasis supplied). Although the word “computing” was deleted in 1949 (L. 1949, ch. 387), the pre-1949 language clearly shows the context and manner in which the phrase “included in net income” was used, and was intended to be interpreted.[14] Moreover, the official explanation of the 1949 amendment makes it clear

[14] The deletion of the word “computing” was related to the then new requirement that only corporate income included in the income of a corporation subject to the New York State franchise tax, and allocated to New York, could enter into the UBT exemption. As income from sources other than New York could be said to be used in computing net income allocable to the State, even though it was then allocated away from New York, it was felt that the word “computing” had to be eliminated in order to properly convey the meaning of the amendment. However, its deletion had a limited and discrete purpose, having to do with entities with a New York allocation ratio of less than 100%; and was not intended to alter the meaning of the statute, or the impact of the tax, for purposes of an entity with a 100% New York tax allocation ratio.

through both text and example that the amendment addressed only the situation in which corporate income is allocated outside of New York. The explanation discussed a situation in which, under the law in effect prior to 1949, a joint venture share was derived from New York sources, but was only partially taxed because of the operation of the full UBT exemption, combined with the franchise tax allocation formula, as follows:

> [I]f the net income of a joint venture, amounting to $100,000 is allocable wholly to New York, a corporate partner having a 50% interest would in its corporate franchise tax report filed under Article 9-A include its distributive share of $50,000 in its entire net income and the joint venture would be allowed an exemption for the $50,000. However, if the corporate partner's other activities within and without the State result in allocating only 10 per cent of its income to New York, only $5,000 of its distributive share would be subject to tax computed on income under Article 9A. Thus, under the present law the joint venture obtains the benefit of the $50,000 exemption even though only $5,000 is actually subjected to tax in New York. In such circumstances the exemption allowed the joint venture should be limited to $5,000.

The 1949 amendment attempted to remedy that situation "by limiting the exemption allowed the joint venture to that portion of a partner's distributive share allocable to New York... ."

N.Y.S. Legislative Annual: 1949 at p. 301. (Emphasis supplied).[15]

The above example shows the proper computation of the exemption before the 1949 amendment (the limitation was based on the entire share of partnership income, $50,000, regardless of the corporation's allocation ratio). It further shows that in the case of the partner with a 10% allocation ratio the amount included on the corporate return as income ($5,000 in the example) is the amount “included in net income” after the 1949 amendment; in the case of the corporate partner with the 100% allocation ratio, however, the exemption amount before and after the 1949 amendment is the entire partnership distributive share. Thus, it is clear from the example that the 1949 amendment contemplated that if a partnership distributive share was included in income by a corporate or entity partner, double taxation would result unless the partnership was given a UBT exemption for the amount of the distributive share that was allocable to New York for franchise tax, UBT or GCT purposes, regardless of which alternative measure

[15] The memorandum quoted in the Legislative Annual was prepared by the New York State Department of Taxation & Finance.

of tax was applicable to a corporate partner. The example thus recognizes that when income is reported on a return it has a tax effect, whether or not that income is offset by losses, and that the exemption should reflect that effect.

This result was changed by the Court of Appeals in Fischbach and Moore v. State Tax Commission, *supra* note 6, where, despite “the clear legislative intent”, 43 A.D. 2d at 83, quoted at page 14 above, that the limit on the UBT exemption should be the amount of the corporate partner's proportionate interest in the partnership net income which is included in the corporate partner's net income allocable to New York, the Court held, contrary to the State Tax Commission's contention, that the limit was the amount of the corporate partner's total net income from all sources allocable to New York.[16] Following Fischbach & Moore the State applied as an audit position a new interpretation of the exemption provision, under which the exemption limitation is computed by reference to the amount of net income shown on the UBT or GCT return; *i.e.*, income after all entity deductions,

[16] Thus, in the example quoted on page 14 above, if the corporate partner's net income allocated to New York was $30,000 because it had income from sources other than the joint venture, the limit on the UBT exemption would be $30,000, rather than $5,000 as indicated in the example.

exemptions and allocations are taken into account.[17] Under this approach, “net income” includes income and is reduced by losses that arose in activities unrelated or related to the partner's participation in the partnership; i.e., if a corporate partner has unrelated losses, the partnership's exemption for the distributive share of that partner will be reduced by those losses, even though that share was included in computing the corporation's net income. The State's audit position did not allow a UBT exemption for the amount included in the corporate partner's tax base under the state's “net income plus salaries” franchise tax base.[18] This position was recently rejected by the New York State Tax Commission. In M.L. Weiss & Company, supra, p. 6, the Commission concluded that the State's refusal to take the “salary add-back” amount into account in computing the UBT exemption resulted in impermissible double taxation.

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17 The State's Regulations, which were held invalid on this point by Fischbach and Moore, were not amended. The State UBT was repealed, effective for 1981 and thereafter.

18 The former “net income plus salaries” alternative tax base for New York State franchise tax purposes did not apply to professional corporations. Former N.Y. Tax Law S 210.1-b, repealed by L. 1987, ch. 817, § 24.

The City followed the State's post-Fischbach and Moore "net income" interpretation as to corporations taxed under the regular method in the Bulletins referred to in footnote 11, supra, and successfully defended this interpretation in Richmond Constructors v. Tishelman, supra, note 4, in which the Court of Appeals concluded that the City's "net income" interpretation of the exemption limitation, taking account of losses and deductions from sources other than the partnership, was based on a permissible reading of the statute. Although the computation of the limitation for a partnership the corporate members of which were under a GCT alternative tax base was not at issue in those cases, the City has based the Regulations generally on the conclusions reached by the Court of Appeals in Fischbach and Moore and Richmond Constructors, and specifically on the State's recently rejected audit position.

C. The Double Tax Problem

The two Court of Appeals cases provide support for the Regulations, insofar as they state that where a corporate partner's losses or expenses reduce net income to less than the distributive share of that partner, the UBT exemption is thereby reduced. These cases do not, however, support the Regulations as they are applied to a corporate partner under the GCT “net income plus salaries” alternative income base. Indeed, to the extent they are relevant, they would lead to an opposite conclusion, since they would suggest that, to the extent a partner's distributive share is taxed at the corporate partner level, there is a UBT exemption.

The purpose of the exemption is to mitigate double taxation of any item of income that appears on both a UBT and a GCT return, or on two UBT returns. The purpose of the exemption limitation is to insure that no item of income attributable to New York City escapes taxation under both of the entity level taxes. See New York State Legislative Annual: 1949, at 300; see also Richmond Constructors v. Tishelman, 61 N.Y.2d at 7.[19] The exemption limitation provision should cause l00%,

[19] The operation of the exemption limitation can again be illustrated as follows: Assume that Corporations A and B form a partnership. The net income of Partnership AB is $200,000, which is divided equally between A, who has a 100% New York City allocation ratio, and B, whose New York City ratio is 90% (and neither has net income or loss from other activities). Without the exemption limitation provision (as was the case under the pre- 1949 State UBT provisions), Partnership AB has a UBT exemption for the entire $200,000 of distributive shares, and thus none of its income is subject to UBT. However, only $190,000 is reported on GCT returns, and thus less than 100% of the total partnership distributive shares is subject to entity level tax. With the exemption limitation in place, however, the UBT exemption is $190,000, rather than $200,000, and the $10,000 of partner B's income that was allocated away from New York City for GCT purposes is taxed at the partnership level.

but not more than l00%, of a partnership distributive share allocable to New York City under the partnership's allocation ratio to be included in a tax computation at one entity level or another. The statute should not be construed so that more than 100% of the distributive share is reported in income at the applicable entity levels. If the “add-back” to the GCT net income and salaries tax base is not reflected in “net income” for purposes of computing the exemption limitation, however, 130% of each dollar will be directly subject to an entity level tax. This result is not warranted by the statute.

D. Effect of the Regulations

As previously noted, the maximum effective rate of tax on an entity subject to the UBT is 4%. The maximum effective rate of tax for a corporation under the “net income plus salaries” base is 2.7% (9% GCT rate x 30% “add-back”). Following the Richmond Constructors decision, the effective rate of tax on a partnership of corporations subject to the net income plus salaries base (but following the City's prior ruling position, as well as the holding of the State Tax Commission in M.L. Weiss) is approximately 53, as the following examples demonstrate:

> Example 1. Assume Partnership AB has a New York City allocation ratio of 100% and has net income of $200,000 divided equally between its two corporate partners. If A and B are each PCs with a 100% GCT allocation ratio, the total GCT and UBT liability if, contrary to the Regulations, the "add-back" is taken into account is as follows: Each PC has gross income of $100,000, which it distributes through a salary payment to its owner/employee. Under the net income plus officers' compensation formula, however, each PC must "add-back" 30% of officer's salaries, minus $15,000 (i.e., $100,000 minus $15,000, or $85,000, x 30%). Thus, each PC's taxable income is $25,500, and its GCT is $2,295, for a total of $4,590. Partnership AB would reduce its $200,000 UBT income by a $51,000 exemption amount (reflecting the combined "add-back"), a $5,000 entity exemption, and the $10,000 services deduction. Total UBT income is $134,000, against which AB applies the 4% tax rate, for a total UBT liability of $5,360. The total combined UBT and GCT liability is $9,950, yielding an effective tax rate of 4.98%.[20]

In contrast, under the Regulations, the effective rate of tax on such partnership is nearly 6%, as the following example demonstrates:

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[20] If the "add-back" is reflected in the exemption limitation, the maximum tax rate is 5.5% (9% GCT rate x the "add-back," plus 4% UBT rate x the remaining 70%).

Example 2. If A and B are PCs, and pursuant to the Regulations the add-back is not reflected in the exemption limitation, the total GCT and UBT tax liability is as follows: Each PC partner's GCT is $2,295, as above. Partnership AB reduces its $200,000 UBT income by the $5,000 entity exemption, and the $10,000 services deductions, but it has no exemption for the add-back included in A's and B's GCT tax base, and thus has total UBT income of $185,000, against which a 4% tax rate is applied, for a total UBT liability of $7,400. The total combined UBT and GCT liability is $11,720, yielding an effective tax rate of approximately 5.9%.[21]

Thus, as is shown in these examples, the effect of the difference between the City's prior interpretation of the exemption provision (and the State Tax Commission's current interpretation) and its present position, as measured by effective tax rates, is approximately a 1% increase in the effective rate. The Committee suggests that this 1% differential reflects the unwarranted double inclusion of the 30% “add-back.”[22]

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[21] If the “add-back” is not reflected in the exemption limitation, the maximum tax rate is 6.7% (9% GCT rate x the “add-back,” plus 4% UBT rate x the entire distributive share).

[22] It should be noted that this discrepancy in effective rates cannot simply be dismissed as a cost of doing business in the corporate form. As the following example shows, the corporate form of organization can easily be used to significantly reduce the overall City tax liability. Assume that partnership ABC has 25 equal partners, each receiving a $100,000 distributive share. If ABC's partners are unincorporated, ABC pays the 4% tax on $2,500,000 minus the single $5,000 exemption and the $125,000 compensation deduction (25 x $5,000) for a total UBT liability of $94,800, and an effective tax rate of approximately 3.8%. If ABC has 25 PC partners, however, the total GCT liability for those partners (assuming no other income or deductions and a 100% New York City allocation ratio) is $2,295 x 25, or $57,375. Assuming that the “add-back” is reflected in the exemption, ABC's UBT liability is $69,300 14% x $1,732,500 ($2,500,000 - $637,500 - $130,000)1, for a total combined UBT and GCT tax liability of $126,675, and an effective tax rate of approximately 5.1%. If no credit is given in the UBT exemption for the GCT “add-back,” the UBT will be $94,800 (as in the partnership above with unincorporated partners), and the effective rate of tax will be approximately 6%. In contrast, if ABC is a single PC with 25 equal shareholders, its GCT should be negligible, because the “add-back” covers only 5% shareholders and officers. Assuming 4 officers, ABC, PC's GCT liability is approximately $10,400, or less than 1/2 of 1%.

<u>CONCLUSION</u>

In essence, the Regulations appear to take the position that since the salaries' “add-back” is an “addition to” net income, and thus is not, as a purely technical matter, “included in” net income, no reflection of that amount should be included in the calculation of the UBT exemption. We believe, however, that this position does violence to the statutory language and the overall structure of the UBT, and thus should be reversed. As shown above, partnership distributive shares are first included in computing the partners' net income, and the amount of salary that is paid by a corporate partner out of such distributive share is then statutorily <u>re-included</u> in the corporation's net income.

It should again be observed that the statute does not equate the exemption with “net income”; rather, it refers to an amount that is “included in net income.” Had the legislature intended that the limit on the exemption must <u>equal</u> net income it would have so stated, and the City's Regulations might be correct. Such is not the case, however. By using the phrase “included in net income,” the legislature left open the possibility that in proper circumstances the exemption could be more or less than “net income,” so as to provide for a proper and fair measure of income to be subject to tax. <u>See M.L. Weiss</u>, 3 N.Y. Tax Reports (CCH) at 17,365, in which the State Tax Commission states with respect to this question as it arose under the State UBT, “The standards for measuring the extent of double taxation vary with the different methods of computing tax . . . .” In this context the UBT exemption must necessarily include the amount that is required to be added back under the alternative method. The result should be no different than if an amount of salaries equivalent to the add-back were disallowed as deductions because excessive, thereby increasing net income under the regular method.

We thus believe that, in light of both the legislative history of the exemption provision, and the State Tax Commission's view of the effect of the provision, as a technical matter the Regulations must interpret the term “included in net income” so as to give proper UBT credit for amounts of corporate income that are subject to corporate tax under either the regular or alternative methods. We thus strongly advocate that the City retroactively amend the Regulations so that they provide credit in the UBT exemption for the salary “add-back,” by interpreting the limitation on the exemption in section 11-510(2) as the amount to which the corporate partner's 9% general corporation tax rate is applied, whether under the regular method in section 11-604.1E(a)(1), or under the “net income and salaries” method in section 11-604.1E(a)(3), thus including in the latter case 30% times (allocated entire net income plus specified salaries minus $15,000 and minus any net loss). By recommending this change, we simply suggest that the City return to its prior position, which constitutes a fairer reading of the meaning of the statute and the overall purpose of the exemption.