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NY Unincorporated Biz Tax Proposal Overshoots Its Mark

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The New York State Department of Taxation and Finance just released for comment a draft bill to enact a new unincorporated business tax, or UBT. The department's stated purpose for the new UBT is to provide relief to individual New York state taxpayers who would be subject to the new federal $10,000 state tax deduction limitation, part of the federal Tax Cuts and Jobs Act of 2017. While that is a laudable goal, the proposal as currently drafted appears to generate substantially more revenue for the state — at the expense of partnerships doing business in New York — than the benefit to individual partners would seem to justify. In other words, enactment of the proposed UBT appears to be a revenue raiser and a substantial one at that. If the goal of the state's UBT proposal is to provide the same type of relief as it provided to wage earners via its recently enacted voluntary employer payroll tax, then the state's UBT should likewise allow companies to opt in rather than be mandatory.

We applaud the department for releasing a draft of the UBT proposal and seeking comments from interested parties. This is consistent with the open, collaborative relationship between the department, taxpayers and practitioners that existed during New York state's 2014 tax reform.[1]

Current Regime

Currently, the state does not directly impose tax on partnerships and multimember limited liability companies doing business in the state.[2] However, New York state previously had a UBT. The state's original UBT was enacted in 1935 as a "temporary" tax, made permanent in 1960 as Article 23 of the tax law. The state's stated goal in enacting the original UBT was to impose a tax on noncorporate enterprises that competed with corporations subject to the state's franchise tax. The state's UBT was repealed in 1978 effective for taxable years beginning after Dec. 31, 1981, and was phased out via rate reductions during the interim period. New York City also enacted its own UBT in 1966, which was patterned after the state's original UBT. The city UBT is imposed on partnerships and multimember limited liability companies doing business in New York City, with longstanding exemptions for certain self-trading and real estate management activities.

After our overview of the current proposal, we consider how the proposed state UBT would handle some of the issues that we regularly encounter in city UBT audits.

Overview of the State's UBT Proposal

The proposed UBT would apply to entities treated as partnerships for federal purposes. As currently drafted, that includes partnerships and multimember limited liability companies but not single-member limited liability companies, which would continue to be disregarded into their members.

A 5 percent tax would be imposed on those partnerships "doing business" in New York state. The term "doing business" is not defined, but as proposed, the personal income tax provisions in Article 22 would apply. New York state's Article 9-A was recently changed to an economic nexus standard from a physical presence nexus standard, but that change was not made for insurance companies, utilities nor — most importantly — Article 22's personal income tax. Coupled with the apportionment provision — which assigns gross income in connection with activities occurring in New York state — a physical presence would likely be required before a partnership would have apportionable income.

The city UBT excludes companies engaged in self-trading activities and those whose activities are limited to managing real estate from the tax. The state UBT proposal does not explicitly carve out those activities from "doing business" or eliminate the resulting income from the tax base. However, as discussed in the next paragraph, such income may not be included in the state UBT tax base at all. In addition, there is a possibility the state's UBT will be voluntary — which would create an opportunity for those entities not to opt in. If self-trading and real estate partnerships are taxable under the proposed regime, this would be a major shift in policy and one that could cause New York City to reconsider its exemptions as it continues its efforts to reform the city UBT.

The department is expressly seeking comments on what should be treated as unincorporated taxable income. As currently proposed, the tax base would be federal ordinary business income with an addback for unincorporated business tax and an addback for guaranteed payments to partners. The reference to federal ordinary business income includes a reference to federal code Section 702(a)(8), which describes taxable income that is not separately stated under other provisions of Section 702(a). Rental income and portfolio income may fall outside of Section (a)(8) because they may require separate computation in (a)(1) through (7). This suggests that self-trading and real estate managing partnerships would not include such income in their state unincorporated business tax base. We look forward to clarification on this point and hope that any clarification offered recognizes the longstanding nontaxability of partnerships engaged in those activities and the ease of moving investment activities out of state.

The tax base portion of the proposed UBT is notably silent on some of the more contentious income-affecting provisions found in federal tax reform, including the Section 163(j) interest expense deduction limitation, Section 951A GILTI inclusion and Section 965 repatriation toll charge. Given that the stated purpose for the proposed UBT is to help New York taxpayers address unfavorable aspects of federal tax reform, we would urge the department to address these aspects of the federal reform similarly (i.e., by providing relief).

Under Article 9-A, prior to apportionment, corporate income is divided into several buckets, some of which are exempt; under the city UBT, income is divided into investment income and business income, and each is apportioned separately. Here, with the state UBT, a lump sum of income would be apportioned by a single formula. If the reference to federal ordinary business income excludes investment income, then the regime would be consistent with New York's "headquarters-favorable" regime. Otherwise, this would be a departure from New York's historic approach to treating certain types of income more favorably than other income.

The proposal includes equally weighted three-factor apportionment, comprising property, payroll and gross income percentages. The proposal is short on details as to how each would be computed and we assume regulations would flesh that out at a later date. The gross income factor, interestingly, could be read to include only sales of services and assigns those services to the office where the sales are negotiated, consummated or performed. However, the proposed statutory language is identical to the Article 22 regulation on "gross income percentage,"[3] which the department views as including receipts from all sales and not just those related to sales of services.

Partnerships will compute their tax on an entity-level basis, adding the already apportioned income of lower-tier partnerships to their own already apportioned income and receiving credits for the state UBT paid by lower-tier entities.

The proposed state UBT contains a credit for partners filing other New York returns. Recall that the purpose for restoring the state UBT is to generate a credit that can be applied against a partner's New York personal income tax liability. For partnerships whose partners are not New York taxpayers (e.g., where a partnership is doing business in New York but its corporate or individual partners are not themselves New York taxpayers), the credit is of little to no value. For corporate and individual partners in an overall loss position, the credit is not refundable, but it can be carried forward indefinitely.

Two preliminary items should be explained before getting to the credit computations. First, for purposes of the credits, a partner's "ownership percentage" is not its technical actual ownership percentage. Rather, it is the partner's relative portion of distributed income, gain, loss and deductions, and guaranteed payments. This means that special allocations and other income distribution agreements could result in a 50-50 partnership — based on capital ownership — having a different "ownership percentage" for UBT purposes. Because the economics of many partnerships were designed without a state UBT in mind, perhaps the New York State Legislature should consider allowing partners to elect to allocate the credit consistent with the overall economics of the partnership rather than just based on proportionate distributions.

Second, a partnership that is itself a partner in a lower-tier partnership must compute its own unincorporated business credit, or UBC, before its partners compute their credits. A partnership's UBC is the partnership's ownership percentage (i.e., relative distribution percentage) multiplied by the greater of the lower-tier partnership's UBT or the lower-tier partnership's UBC. In computing the UBC for determining various upstream entities' credits, there is no limitation applied to the UBC. However, when determining the UBC that a particular partner can actually take, the limitation discussed below is applied.

For partners who are partnerships, the UBC will be the taxpayer-partnership's ownership percentage multiplied by the greater of the UBT of the partnership or the partnership's UBC. For this computation, the limitation in proposed Section 862(a)(3), which prevents the partnership from reducing tax below zero and prevents any carry-forward of unused credit, applies.

For partners who are individuals, a credit against New York state personal income tax is available. The credit would be the taxpayer-partner's ownership percentage in the partnership multiplied by 93 percent multiplied by the greater of the partnership's UBT or its UBC. Credit from multiple partnerships can be added together. If the credit exceeds the taxpayer-partner's tax, the excess can be carried indefinitely. For New York state residents, the value of the credit seems readily identifiable. But for nonresidents, receiving a credit against New York state tax may not provide any relief in the nonresident individual's home state resident tax return. For example, depending on how the state of residence determines what counts toward that state's credit for taxes paid to other jurisdictions, the nonresident may not receive any economic benefit at all. If that is the case, then the entire state UBT regime's purported benefit — to provide relief to those taxpayers impacted by the federal SALT deduction limitation — would be meaningless to nonresident partners.

For partners that are corporations, the credit would be the taxpayer's ownership percentage in the partnership multiplied by 93 percent multiplied by the greater of the partnership's UBT or its UBC. Credit from multiple partnerships can be added together. If the credit exceeds the taxpayer's tax in excess of the taxpayer's fixed dollar minimum tax, such excess can be carried forward indefinitely.

Finally, something that will likely be a relief to partners, but may be less of a relief to some partnerships: Under the proposal, the department will have the authority to share partnership returns and "information" with the partners. A lack of partnership data was a significant concern for some corporate partners attempting to determine whether partnerships — the actions of which were not visible to those partners — had done certain things that are required under Article 9-A for income to qualify as investment income.

Does the Proposed State UBT Resolve the Murky Issues that Partners and Partnerships Regularly Face Under the City UBT?

Yes, no and maybe.

Some of the issues we see regularly are addressed here. For example, expense attribution takes a leading role in some city UBT audits; however, that would not appear to be an issue here as only a limited set of expenses would be disallowed — UBT tax and guaranteed payments. Questions regularly arise regarding apportionment of flow-through income, particularly if the lower-tier entity has a full or partial exemption from the city UBT. Here, the entity-level apportionment is black and white — though we think the city's rules are clear on this point. Similarly, the state's UBT proposal addresses the implications of a change in accounting method (under federal code Section 481) more cleanly than do the city UBT's provisions.

However, the state UBT's silence on whether self-trading and real estate management are exempt may cause some consternation (though the reference to federal ordinary business income and Internal Revenue Code Section 702(a)(8) should alleviate that concern). Similarly, the rather limited apportionment guidance will be a problem. Then again, we expect that both of these issues will be addressed prior to enactment. The question, of course, is how they will be addressed. Deductibility of certain payments to partners is a common audit issue in the city; here it is clear that whatever payments are treated as guaranteed payments are not deductible, whereas other payments to partners would not be added back.

Comments Requested

As mentioned earlier, the department has asked for comments on its draft proposal. Our hope is that commentary will aid the department in honing the UBT proposal to better address its stated purpose of swatting the federal SALT deduction limitation for New York taxpayers.

The deadline for submitting comments to the department is July 16, 2018. The resulting UBT may be as game-changing as another event on that day in history, the July 16, 1969, launch of Apollo 11, carrying the first men to land on the moon.

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[1] To that end, Mayer Brown will be submitting comments on its own behalf and for clients and would be happy to discuss possible additional comments or submissions.

[2] Although nonpayment can result in the partnership having liability, any "withholding tax" payments made by the partnership on behalf of nonresident partners is not considered a tax imposed on the partnership for this discussion.

[3] 20 NYCRR 132.15(f)