ADDENDUM TO INSTRUCTIONS TO FORMS NYC-4S, NYC-3L, NYC-202, NYC-204

Federal "Check the Box" Rules
New York City Tax Implications

On December 17, 1996, the Internal Revenue Service issued the final version of Treasury Regulation sections 301.7701-2 and 301.7701-3, the so-called "check the box" rules. The "check the box" rules provide for a system whereby "eligible entities" may elect to be treated as a corporation or partnership or, in some cases, to be disregarded altogether for federal income tax purposes. These rules replace for the most part, the subjective case by case analysis required under the prior rules.

Only eligible entities may make the election. Trusts (not business trusts), certain special entities (e.g. REITs, REMICs, etc.) and corporations formed as such under state law, including joint stock associations and joint stock companies, are not eligible entities and cannot make the election. Thus, entities incorporated under state law cannot elect to be treated as partnerships for federal tax purposes. Various other entities are also ineligible to make the election.

For domestic eligible entities, i.e., entities formed in the United States, if there are at least two owners, the entity is treated as a partnership unless it elects to be treated as an association taxable as a corporation for federal purposes. If there is only one owner, unless corporate status is elected, the entity is disregarded and is treated as a branch if the owner is a corporation, or as a sole proprietorship if the owner is an individual.

Similar rules apply to entities formed under the laws of a foreign country with an added consideration of whether any owner has unlimited liability for the debts of the entity. Certain foreign entities are classified as per se corporations and are not eligible to elect corporate or partnership treatment for federal tax purposes. These entities are taxable as corporations. Foreign eligible entities can elect to be treated as corporations for federal tax purposes. In the absence of an election, foreign eligible entities with two or more owners will be treated as partnerships if at least one owner has unlimited liability, or as corporations if all owners have limited liability. Single owner foreign eligible entities will be disregarded if the owner has unlimited liability unless it elects to be treated as a corporation. If the single owner of a foreign eligible entity has limited liability, the entity will be taxable as a corporation unless it elects to be disregarded.

New York City Law. As amended by Ch. 625 of the Laws of New York, 1996, section 11-126 of the Administrative Code of the City of New York (the "Code") defines a "partnership" as including a subchapter K limited liability company. A Subchapter K limited liability company under that section is a domestic or foreign limited liability company ("LLC") as defined in section 102 of the New York Limited Liability Company Law or an LLC formed under section 507 of the New York Banking Law that is classified as a partnership for federal income tax purposes. As amended, Code section 11-602.1 defines a "corporation" for purposes of the New York City General Corporation Tax ("GCT") as including joint stock companies, joint stock associations, certain business trusts, and publicly-traded partnerships and associations treated as corporations

for federal income tax purposes under Internal Revenue Code ("IRC") sections 7704 and 7701(a)(3), respectively. Those amendments are effective for taxable years beginning on or after January 1, 1996. As a result of those changes, entities treated as associations taxable as corporations for federal income tax purposes will be considered corporations for purposes of the GCT and an LLC treated as a partnership for federal income tax purposes will be treated as a partnership for New York City tax purposes.

New York City Tax Impact of "Check the Box". Because classification of an entity as a corporation for GCT purposes generally follows federal income tax classification, an eligible entity that is treated as a corporation for federal income tax purposes under the "check the box" rules will be treated as a corporation for GCT purposes, including but not limited to, the provisions of the GCT governing the filing of combined returns. Entities treated as corporations, per se or in the absence of an election to be treated as a partnership under the "check the box" rules, also will be treated as corporations for purposes of the GCT. (See, however, the one-time election to continue to be subject to the New York City Unincorporated Business Tax ("UBT") discussed below.) Entities treated as partnerships, per se or in the absence of an election to be treated as a corporation under the "check the box" rules, will not be treated as corporations for GCT purposes. Those entities will be considered unincorporated entities for purposes of the UBT. For example, if two or more corporations form an LLC and elect to have it treated as a partnership for federal tax purposes, it will be treated as a partnership for City tax purposes. As a result, if the LLC is doing business in the City, the corporate members will be treated as doing business in the City, subject to the applicable exceptions, under section 11-06 of the Rules of the City of New York Relating to the General Corporation Tax.

Single Owner Eligible Entities. Eligible entities having a single owner that elect under the "check the box" rules, either affirmatively or by default, to be disregarded and treated as a branch or sole proprietorship will be similarly treated for New York City tax purposes. The activities of such a single owner eligible entity in New York City will be considered activities of the owner for purposes of determining whether the owner is subject to the GCT, Banking Corporation Tax, Utility Tax or UBT. For example, if an individual is the sole owner of an LLC and the individual operates a grocery store in New York City through the LLC, if the individual owner does not elect to treat the LLC as a corporation for federal income tax purposes, the LLC will be disregarded and the individual will be considered to be operating the store as a sole proprietor. As a result, the individual is subject to the UBT. As an additional example, assume a corporation formed under the laws of another state is not doing business, employing capital, owning or leasing property or maintaining an office in New York City but forms a wholly-owned LLC that is engaged in business in the City. If the LLC is disregarded for federal income tax purposes and treated as a branch of the owner, the activities of the LLC will be considered activities in the City of the owner. In that event, the owner will be considered to be doing business in the City and all of its net income from all activities within and outside the City will be subject to tax subject to applicable allocation rules.

One-Time UBT Election. Ch. 625 of the Laws of New York, which changed the definition of a corporation for GCT
purposes as described above, also added Code section 11-602.1(b). Under that subdivision, if an

entity was subject to chapter five of title 11 of the Code, governing the UBT, in its taxable year beginning in 1995, and if that entity will be treated as a corporation for GCT purposes under the new definition, the entity is permitted to make a one-time election on its UBT return for the taxable year beginning in 1996 to continue to be subject to the provisions of the UBT law for taxable years beginning in 1996 and thereafter, unless the election is revoked. That election must be made on a timely filed return for the entity's taxable year beginning in 1996. The election cannot be made on a late or amended return and cannot be reinstated once revoked.

Therefore, if an eligible entity that was subject to the provisions of the UBT law for its taxable year beginning in 1995 will be a corporation for purposes of the GCT for its taxable year beginning in 1996 because it will be treated as a corporation for federal income tax purposes under IRC section 7701 and the rules thereunder applicable to 1996, it may elect on its return for its taxable year beginning in 1996 to continue to be subject to the UBT law. Moreover, if an eligible entity that was subject to the UBT law for its taxable year beginning in 1995 expects to be treated as a corporation for federal income tax purposes under the "check the box" rules for its taxable year beginning in 1997, it also may make an election on its return for its taxable year beginning in 1996 to continue to be subject to the UBT law.

An entity is eligible to make the one-time election if it was subject to the provisions of the UBT law for its taxable year beginning in 1995. For this purpose, an unincorporated entity that was in existence in 1995 and was engaged in activities in the City in its taxable year beginning in 1995 and that was not subject to an income or gross receipts tax under another chapter of the Code[1], is considered to be subject to the provisions of the UBT law even though it was not liable for the UBT because its activities were within the exemptions from the definition of an unincorporated business or because its net income was too low to generate a tax liability. Thus, an unincorporated entity that is exempt from the UBT for 1995 and prior years because it is engaged in activities that are not treated as an unincorporated business, e.g., trading for its own account, or because it is exempt from federal income tax under IRC subtitle A, subchapter F, can make the one-time City election to continue to be subject to the UBT.

Entities formed after 1995 may not make the election.

Inquiries may be directed to the Department of Finance Taxpayer Assistance Division at (718) 935-6000.

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[1] Other than the Utility Tax as a vendor of utility services.