

December 15, 1998

Re: Ruling Request

Unincorporated Business Tax
FLR- 984725- 005

Dear :

This letter is in response to your request dated for a ruling on the application of the New York City Unincorporated Business Tax ("UBT") to the cancellation of debt ("COD") income received by (the "Taxpayer")¹. Additional information was received by this office on , and and .

FACTS

The facts presented are:

The Taxpayer was a partnership for federal, state, and New York City tax purposes engaged in the practice of law within New York City. On , certain creditors filed an involuntary petition with respect to the Taxpayer in the United States Bankruptcy Court for the Southern District of New York. The Bankruptcy Court converted the claim from a case under Chapter 7 of the United States Bankruptcy Code, 11 U. S. C. §701 et. seq. ("Bankruptcy Code") to a voluntary case under Chapter 11 of the Bankruptcy Code. On , the Bankruptcy Court entered an order (the "Bankruptcy Order") confirming the Chapter 11 plan proposed by the Trustee for the Taxpayer, with certain amendments (the "Plan"). The Plan became effective on . Under the Plan, the

¹For purposes of this ruling, the term Taxpayer refers both to and the Trustee in Bankruptcy acting on its behalf.

assets of the Taxpayer were transferred to three trusts. The trusts are grantor trusts and the Taxpayer is deemed the owner of the trusts. The Taxpayer filed federal, state and UBT returns reporting the income and deductions from the trusts.

Under the Plan, a share of each liability or claim was allocated to each former partner of the Taxpayer. Most of these debts were recourse to the Taxpayer and the partners. Most of the partners agreed to make substantial capital contributions to the Taxpayer's estate in Bankruptcy in order to settle all claims against themselves. Partners who agreed to and made such contributions in accordance with the terms of the Plan and their individual agreements with the Trustee for the Taxpayer were protected from further liability to the creditors.

Assuming no default in payment, the excess of the amount of liabilities allocated to a former partner under the Plan over that former partner's capital contribution would be uncollectible, and therefore, represents COD income under Internal Revenue Code ("IRC") section 108.

Under the Plan, substantial amounts of debt were canceled or otherwise discharged or satisfied in . The partners were given the option, pursuant to a closing agreement entered into with the Internal Revenue Service, of recognizing the COD income in the year the Plan was accepted or in equal increments over the subsequent ten years. The Taxpayer reported the COD income in full in on its federal and state partnership returns.

The income was also reported on the Taxpayer's UBT return for and deducted with a disclosure citing section 346(j)(1) of the Bankruptcy Code. That section provides that, for state and local tax purposes, "income is not realized by the estate, the debtor or a successor to the debtor by reason of forgiveness or discharge of indebtedness in a case under this title." 11 U.S.C. §346(j)(1). The Trustee's Second Amended Disclosure Statement for the Taxpayer (the "Disclosure Statement") prepared in connection with the solicitation of votes on the Plan at page stated with respect to Bankruptcy Code section 346(j)(1), "while the application of this Bankruptcy Code section to partnerships is not clear, it appears that the [Taxpayer] and the Partners may not be required to recognize any income for state or local income tax purposes as the result of the cancellation of the [Taxpayer's] obligation."

Bankruptcy Code section 346(j)(2)-(7) provides for certain adjustments to the amount of a deduction allowed with respect to a liability, the debtor's net operating loss and the basis of a debtor's property. These adjustments are designed to prevent a debtor from reaping a double benefit as a result of retaining tax attributes that could be beneficial

in later years while avoiding the recognition of COD income under Bankruptcy Code section 346(j)(1). You have represented that adjustments pursuant to Bankruptcy Code section 346(j)(2)-(7) are not applicable to the Taxpayer.

In , the Internal Revenue Service requested that the Taxpayer amend the United States Partnership return to report the COD income ratably over the years so it could more easily match the recognition of the income by the partners who had participated in the closing agreement. According to the terms of the closing agreement, the K-1s of the partners who had agreed to recognize the income over a -year period were amended. Instead of reporting the entire amount of COD income, the K-1 would include only one- of the partner's COD income.

ISSUE

You have requested a ruling that the COD income is not includible in the Taxpayer's income for UBT purposes.

CONCLUSION

We have determined that, to the extent Bankruptcy Code section 346(j)(1) applies to a partnership, the Taxpayer's COD income should be excluded from the Taxpayer's unincorporated business taxable income. Because our authority is limited to legal rulings under the City taxes administered by the Department of Finance, we are unable to opine conclusively on the application of the Bankruptcy Code to the Taxpayer.

DISCUSSION

1. IRC Section 108

Under section 11-503 of the Administrative Code of the City of New York (the "Code"), the UBT is imposed on the unincorporated business taxable income of unincorporated entities doing business in the City. The starting point for calculating the unincorporated business taxable income is the entity's gross income from the business for federal income tax purposes, subject to certain modifications. Code §11-506. Under IRC section 61(a)(12), income from the discharge of indebtedness is included in gross income. Therefore, unless excluded by some other provision of the IRC or by some modification under the UBT, the Taxpayer's COD income would be included in the Taxpayer's unincorporated business taxable income.

IRC section 108(a)(1)(A) provides that for federal tax

purposes, COD income is excluded from gross income if the cancellation occurred in connection with a Title 11 bankruptcy. IRC section 108(a)(1)(B) excludes COD income from gross income if the discharge occurs when the taxpayer is insolvent. In the case of a partnership, these provisions are to be applied at the partner level. IRC §108(d)(6). Discharge of indebtedness income is thus not excludable by a partnership, but is an item of income that is allocated separately to each partner pursuant to IRC section 702(a), and each partner then applies the IRC section 108 rules with reference to his own circumstances. 1 William S. McKee, William F. Nelson & Robert L. Whitmore, Federal Taxation of Partnerships and Partners §9.02[2][a][ii] (1996). The starting point for calculating the UBT in the case of a partnership is the partnership's federal gross income. Code §11-506. Because IRC section 108 does not exclude the Taxpayer's COD income from gross income for federal tax purposes, the COD income is included in the Taxpayer's unincorporated business gross income for UBT purposes. None of the modifications under the UBT excludes that income. Id. Therefore, the COD income would be included in the Taxpayer's unincorporated business taxable income subject to the UBT.

2. Bankruptcy Code

Section 346(j)(1) of the Bankruptcy Code provides that with respect to any state or local law imposing a tax, "income is not realized by the estate, the debtor, or a successor to the debtor by reason of forgiveness or discharge of indebtedness in a case under [the Bankruptcy Code]". The power of Congress to establish uniform laws on the subject of bankruptcy throughout the United States is unrestricted and paramount, preventing states from passing or enforcing laws to interfere with the Bankruptcy Code. See International Shoe v. Pinkus, 49 S. Ct. 108, 278 U.S. 261, 73 L. Ed. 318 (1929). Because, as the Disclosure Statement indicates, application of Bankruptcy Code section 346(j)(1) to a partnership is unclear and because our authority is limited to legal rulings under the City taxes administered by the Department of Finance, we are unable to opine on that issue. However, we have determined that, to the extent Bankruptcy Code section 346(j)(1) applies to a partnership, the Taxpayer's COD income should be excluded from the Taxpayer's unincorporated business taxable income.

The Department reserves the right to verify the information submitted.

Very truly yours,

Devora B. Cohn
Assistant Commissioner,
Legal Affairs

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