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Memorandum

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subject: Refundable New York State Investment Tax Credit

This Chief Counsel Advice responds to an email request for assistance dated October 25, 2013. This advice may not be used or cited as precedent.

LEGEND

A =

X =

Year =

1

Year =

2

FACTS

The taxpayer, A, is an individual passive investor in X, an LLC that is treated as a partnership for federal tax purposes. Taxpayer has zero basis in his partnership

interest. In Year 1, the LLC purchased equipment that qualified for the refundable New York State Investment Tax Credit. The taxpayer claimed the credit on his Year 1 personal income tax return and received a “refund” in Year 2 because the credit exceeded his state income tax liability; this payment is not an actual refund of any amount previously paid by the taxpayer or the LLC.

The New York State Investment Tax Credit (New York Code § 210.12, hereinafter NYITC) is a credit that corporations may claim against the New York Franchise Tax (New York Code Article 9-A) and individuals who are business owners of partnerships and S corporations may claim against the New York Personal Income Tax. The credit is only allowed in the year the property is placed into service. In general, if a business (or a previously described individual business owner) cannot claim the NYITC because the NYITC is more than the New York State tax less other credits, it may carry over the unused amount to future tax years. A new business (or previously described individual business owner), however, may claim a refund of the unused credit rather than carrying over the unused amount to a future year.

Partners and partnerships file New York State Tax Form IT-212 relating to the NYITC. A partnership must file Form IT-212 to show the partnership’s total investment in qualified property with its Form IT-204, Partnership Return. Form IT-204 includes a section entitled “Partner Credit Information” which calculates the amount of the credit for each partner and refers the partner to Form IT-212. Partners also file Form IT-212 in order to claim the NYITC, including their refund, if applicable. The partnership has no right to the refund.

It is the taxpayer’s position that the refundable portion of the credit is not ordinary income. Examination’s email dated October 25, 2013 states that it believes the refunded portion of the NYITC is taxable as ordinary income and cannot be offset by flow through loss due to the fact that the taxpayer does not have basis to claim the loss.

The taxpayer argues that there are two possible scenarios under which the taxpayer can avoid ordinary income treatment as a result of receiving the NYITC refund. First, if receipt of the NYITC refund creates outside basis in the taxpayer’s interest in the LLC, then the taxpayer’s LLC losses are no longer limited by § 704(d), and the taxpayer argues he should be allowed to offset his income from the refundable portion of the NYITC with losses from the LLC. Second, the taxpayer asserts that the NYITC refund is a deemed distribution of money in excess of basis and therefore subject to capital gain rates under § 731.

ISSUE

Although the NYITC refund is not a distribution from the LLC to the taxpayer, the taxpayer would have no right to the NYITC refund but for his investment in the LLC and his interest in its underlying activities. Therefore, should the refundable portion of the

New York State Investment Tax Credit paid directly to the investor in an LLC be treated as an item that increases the taxpayer's outside basis or as a deemed distribution?

LAW

Section 702(a) provides that in determining his income tax, each partner shall take into account separately his distributive share of the partnership's--

- (1) gains and losses from sales or exchanges of capital assets held for not more than 1 year,
- (2) gains and losses from sales or exchanges of capital assets held for more than 1 year,
- (3) gains and losses from sales or exchanges of property described in § 1231 (relating to certain property used in a trade or business and involuntary conversions),
- (4) charitable contributions (as defined in § 170(c)),
- (5) dividends with respect to which § 1(h)(11) or part VIII of subchapter B applies,
- (6) taxes, described in § 901, paid or accrued to foreign countries and to possessions of the United States,
- (7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary, and
- (8) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

Section 704(a) provides that a partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

Section 704(b) provides that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if--(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Section 704(d) provides that a partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred. Any excess of such loss over such basis shall be allowed as a deduction at the end of the partnership year in which such excess is repaid to the partnership.

Section 705(a) provides that the adjusted basis of a partner's interest in a partnership shall, except as provided in subsection (b), be the basis of such interest determined

under § 722 (relating to contributions to a partnership) or § 742 (relating to transfers of partnership interests)--

(1) increased by the sum of his distributive share for the taxable year and prior taxable years of--

(A) taxable income of the partnership as determined under § 703(a),

(B) income of the partnership exempt from tax under this title, and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion;

(2) decreased (but not below zero) by distributions by the partnership as provided in section 733 and by the sum of his distributive share for the taxable year and prior taxable years of--

(A) losses of the partnership, and

(B) expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account.

Section 731(a)(1) provides that in the case of a distribution by a partnership to a partner gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution.

Section 1.731-1(a)(1)(i) provides that where money is distributed by a partnership to a partner, no gain shall be recognized to the partner except to the extent that the amount of money distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution. This rule is applicable both to current distributions (i.e., distributions other than in liquidation of an entire interest) and to distributions in liquidation of a partner's entire interest in a partnership.

Section 1.731-1(a)(3) provides that gain or loss recognized under section 731(a) on a distribution is considered gain or loss from the sale or exchange of the partnership interest of the distributee partner, that is, capital gain or loss.

ANALYSIS & CONCLUSION

Eligible businesses compute the NYITC based on the investment credit base. The investment credit base is the cost, or other basis when placed in service in New York State for federal income tax purposes, of qualified tangible property, including building and structural components of buildings, less the amount of nonqualified nonrecourse financing with respect to such property.

The taxpayer contends that there are two alternative theories under which the taxpayer may avoid ordinary income treatment for the NYITC refund. First, if the taxpayer's basis in his interest in the LLC increases, § 704(d) will no longer limit his ability to use losses arising from his interest in the LLC. Thus, the taxpayer can offset his passive losses from the LLC with his income from the NYITC refund.

Second, the taxpayer argues the income from the NYITC refund should be treated as a partnership distribution in excess of outside basis, which is capital gain pursuant to § 1.731-1(a)(3). Although the payment comes from the state, not the LLC, the taxpayer's right to receive the payment arises out of his interest in the LLC and he would not receive the payment but for the activities of the LLC.

Central to both of the taxpayer's arguments is that the NYITC refund should be considered a partnership item, or similar in nature to a partnership item. If the NYITC is a partnership item it may increase the taxpayer's outside basis in the partnership interest under § 705(a). In addition, since the refund arises from the trade or business activities of the partnership, the refund amount could be considered a deemed distribution of money to the taxpayer from the partnership under § 731(a)(1).

The NYITC refund is paid directly by New York State to the taxpayer, and the LLC neither receives the refund nor has a right to receive the refund. We do not believe that the partnership owns the NYITC refund and therefore it is not properly treated as a partnership item under § 702. Because the NYITC refund is not properly treated as a partnership item, the NYITC refund cannot affect the taxpayer's outside basis in the partnership under § 705(a).

Similarly, the NYITC refund should not be treated as partnership property for purposes of § 731(a)(1). Accordingly, if the NYITC refund is not properly treated as partnership property, it should not be treated as a deemed distribution in excess of basis from the partnership to the taxpayer.

Therefore, the refundable portion of NYITC should be treated as ordinary income to the taxpayer.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-6852 if you have any further questions.