Top Secret: How to Apply D.C. Combined Reporting To Unincorporated Businesses

by Brian Strahle

Get out your magnifying glass, metal detector, stud finder, GPS, and any other detecting equipment. Figuring out how to keep an unincorporated business in compliance with the combined reporting regime in the District of Columbia may take all of those and more. The D.C. Council and the Office of Tax and Revenue (OTR) have provided guidance through statutes and regulations, schedules, articles, and notices, yet taxpayers and tax practitioners are still struggling to apply the rules.

Taxpayers are concerned about taking positions on current returns that the OTR may later disagree with on audit. Taxpayers are used to interpreting and applying state tax laws that may not be clear, but in this case, the level of certainty when trying to apply the rules is closer to 50 percent. Because the D.C. combined reporting regime is only two years old, there is no precedent or standard to help taxpayers interpret vague rules to meet a more likely than not standard.

The D.C. combined reporting regime took effect September 14, 2011, under the Fiscal Year 2012 Budget Support Act of 2011.[1] It applies to tax years beginning after December 31, 2010.

Several iterations of regulations were proposed in 2012, with final combined reporting regulations issued September 14, 2012.[2] Temporary and permanent legislation affecting combined reporting has been passed in the last few years, but the most recent is the Fiscal Year 2014 Budget Support Emergency Act of 2013, signed by Mayor Vincent Gray (D) on July 30.[3] Section 7101 or subtitle J of the act may be cited as the Combined Reporting Clarification Congressional Review Emergency Act of 2013. As its name implies, the act was designed to provide more clarification and certainty regarding the application and implementation of combined reporting.

What's the Problem?

The D.C. combined reporting regulations have created confusion for taxpayers and tax practitioners when applying the regulations to unincorporated businesses and the real estate development industry. Why?

There are several reasons, but the overriding one is that the district, unlike many states, imposes an entity-level tax on partnerships (unincorporated businesses) and is attempting to apply corporate income tax rules to them. Hence, the normal application of combined rules — that is, nexus, unitary rules, apportionment, and elimination of intercompany transactions — causes confusion and unintended consequences.

1. Are unincorporated businesses included in a D.C. combined return?

The D.C. combined reporting regulations define includable persons as:

> All persons of the kind that are subject to tax or would be subject to tax if doing business in the District, under chapter 18 of the title 47 of the DC Code, even if those persons do not have nexus. The persons to be included in a combined group include, but are not limited to, any unincorporated business, S corporation, etc.[4]

The fiscal 2014 act amended the definition of person to include unincorporated businesses and exclude qualified high-technology companies.[5] Hence, the provision leads a taxpayer to conclude that unincorporated businesses are included in a combined return if they meet the ownership and unitary tests, regardless of whether they have nexus in the district. As a result, some practitioners believe

[1]D.C. Law 19-0021; 58 DCR 6226.
[2]59 DCR 37; final rulemaking Sept. 14, 2012.
[3]Act 20-130 (D.C.B. 20-337), Laws 2013, effective July 30 for a 90-day period that will expire October 28.

[4]9 DCMR section 157.2.
[5]D.C. Code section 47-1801.04(39).

out-of-state partnerships that meet the requirements to be included in a D.C. combined return would have their own column (report all their activity) on the return, even if they do not have nexus.

Other practitioners believe an out-of-state partnership cannot be an unincorporated business and thus, is not included and does not have its own column on the return. In that case, the owner or member/partner that is part of the combined return would simply report in its tax base its distributive share of income from the out-of-state partnership.

Generally, partnerships that are not engaged in a trade or business are not unincorporated businesses. However, out-of-state partnerships that are engaged in a trade or business but do not have nexus in the district are still unincorporated businesses. Therefore, section 157.2 of the regulations provides the basis for practitioners to conclude those out-of-state partnerships should be included on a combined return if they meet the ownership and unitary tests.

2. Can unincorporated businesses be unitary with their owners?

The D.C. combined reporting regulations define a unitary business as a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide mutual benefit that produces a flow of value to the separate parts.[6]

The fiscal 2014 act amended the definition of unitary business by eliminating the paragraph stating that "any business conducted by a partnership shall be treated as conducted by its partners, whether directly held or indirectly held through a series of partnerships, to the extent of the partner's distributive share of the partnership's income."[7] Does the elimination of that provision mean the unincorporated businesses (partnerships) cannot be considered unitary with their owners? Or is the this simply an elimination of a unitary presumption? In other words, a unitary relationship can still be found between a partnership and its owner, but is not presumed to be unitary.

The D.C. combined reporting regulations state that a unitary business may consist of a single entity or of a group of two or more related entities.[8] They also state that a commonly controlled group may include at least two entities, including unincorporated businesses or partnerships if a common owner directly or indirectly owns more than 50 percent of the interest in the entities, regardless of whether that owner is a corporate entity.[9] Therefore, unless the regulations are changed, unincorporated businesses that meet the 50 percent ownership test can also meet the unitary test and be included in a combined return with their owners.

3. How does the unitary test apply to the real estate development industry?

Applying the D.C. combined reporting rules to the real estate development industry has been challenging for tax practitioners. Real estate development ownership structures usually include multiple investors, and possibly multiple-tiered partnerships. If one of those partnerships holds real estate in the district, it is considered an unincorporated business subject to tax. Once that partnership creates a filing obligation, the question whether to file a combined return arises.

If the unincorporated business meets the ownership test with its partners/owners, does it also meet the unitary test? As stated earlier, the D.C. combined reporting regulations describe the unitary test as "sufficiently interdependent, integrated and interrelated."[10] Unitary is further described as a "sharing, exchange and flow of value" between segments of a commonly controlled economic enterprise. In addition to those factors, there is a presumption of unitary if the segments of the enterprise are in the same type of business, comprise of different steps in a vertically structured business, and have strong centralized management. Applying those tests to a real estate development ownership structure can be difficult.

First, the entities will meet the same type of business requirement and could meet the strong centralized management requirement. However, they generally won't satisfy the vertically structured requirement or other tests of flow of value or functional integration.[11] Each real estate project (partnership) generally stands on its own economically and operationally. Each partnership may even have different minority partners. It could be argued that those real estate partnerships, despite having common ownership and sharing the same type of business, are not unitary with the common owner or with each other. After initial setup, most real estate partnerships do not contribute to each other's profitability, rely on each other to achieve objectives, provide economies of scale, or have substantial intercompany transactions.

A 1983 D.C. Superior Court case, *McLean Gardens Corporation v. D.C.*, Tax Dkt. No. 3158.82 (Superior Court of D.C., 1983) provides hope that a non-unitary argument could be made today. The

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[6]9 DCMR section 158.1 and D.C. Code section 47-1801.04(55)(A).

[7]Former D.C. Code section 47-1801.04(55)(B).

[8]9 DCMR section 158.2.

[9]9 DCMR section 158.2(c)(3).

[10]9 DCMR section 158.7-158.11.

[11]9 DCMR section 158.7-158.10.

court held that separate apartment complexes operated in the district and Virginia were not unitary, and it approved separate accounting for the D.C. complex. The court found that the businesses lacked functional integration, centralized management, and economies of scale.

4. Do the passive holding company and passive parent holding company provisions apply to unincorporated businesses?

The D.C. combined reporting regulations state that a "passive holding company that is in a commonly controlled economic enterprise and holds intangible assets that are used by the enterprise in a unitary business shall be deemed to be engaged in the unitary business, even if the holding company's activities are primarily passive."[12] They also state that "a passive parent holding company that directly or indirectly controls one or more operating company subsidiaries engaged in a unitary business shall be deemed to be engaged in a unitary business with the subsidiary or subsidiaries, even if the holding company's activities are primarily passive."[13]

Those provisions are common in states with combined reporting, but most states with combined reporting do not also impose tax on unincorporated businesses. Those are corporate tax concepts, so when attempting to apply them to combined returns that include unincorporated businesses, the question becomes whether they apply to owners, partners, or investors in unincorporated businesses.

Tax practitioners who have attempted to address the issue have taken opposite positions. Unfortunately, the D.C. Code and regulations provide little clarification. If the provisions do apply, when groups contain multiple levels of passive holding companies, at what level does the deemed unitary provision stop? Is a real estate fund/holding company deemed unitary with the underlying real estate partnerships?

Assuming the ownership test is met, the effect of concluding that the rules apply to unincorporated businesses will result in an unincorporated business being included in a combined return with the holding company.

If the deemed unitary provision applies to the holding company and the underlying unincorporated business, it does not necessarily mean that each brother/sister unincorporated businesses owned by the same holding company are unitary with each other. Thus, if the sibling unincorporated businesses don't meet the regular unitary test, a holding company could be in multiple (separate) unitary groups with each sibling unincorporated business. That could result in complex compliance obligations, but it could also provide combined groups with the ability to exclude out-of-state unincorporated businesses if they don't meet the unitary test.

5. Can unincorporated businesses included in a D.C. return still take the section 117.13 gain exclusion?

Section 117.13 provides that "gain (other than ordinary gain resulting from the recapture of depreciation referred to in section 117.14) or loss from the sale or other disposition of property that results in the termination of an unincorporated business subject to the tax imposed under Title 8 of the Act shall be recognized and reported by the owners of the business rather than by the business entity."[14]

This presents one of the biggest challenges for real estate partnerships. If real estate partnerships are included in a combined return with their owner, then even if the partnership is allowed to take the gain exclusion, the gain would flow to the holding company and be taxed in the combined return. That is why the deemed unitary provision for passive holding companies is so important.

Most practitioners believe the regulation still applies and that real estate partnerships are allowed to take the exclusion. However, they are unsure whether the deemed unitary provision applies. Thus, it is unclear whether the gain would get trapped at the holding company level and be taxed in a combined return.

6. How are unincorporated businesses included in a D.C. combined return?

Section 170 of the D.C. Municipal Regulations describes how unincorporated businesses should be included in a D.C. combined return. However, each version of the regulations,[15] including the most recent, has caused confusion.

The regulations state that if a combined group includes an unincorporated business, that business should report all its income and apportionment factors on the combined return in its own column. The combined group member/partner includes its distributive share of the unincorporated business's income in its tax base and its apportionment factors. However, if the unincorporated business does not exclude the income from its tax base on the return, the combined group member/partner would deduct the distributive share from its tax base as income already taxed and not include it in its apportionment factor. The combined group member/partner

[12]9 DCMR section 159.1.

[13]9 DCMR section 159.2.

[14]9 DCMR section 117.13.

[15]Proposed rulemaking Jan. 20 and Aug. 31, 2012; final rulemaking Sept. 14, 2012.

does not include its share of the unincorporated business's apportionment factors in its apportionment factor.[16]

The fiscal 2014 act deleted some provisions from the D.C. Code that support the regulations, such as the provision stating the combined group member/owner would include its share of the unincorporated business's apportionment factors in its apportionment factor.[17] The act also deleted the provision regarding how a combined group member would include its share of income from a partnership that is not an unincorporated business. That provision was not in accordance with the regulations.[18]

The act replaced a provision with language that may now require the regulations to be rewritten or revised to provide further clarification. It deleted the provision that provides a deduction for a group member/partner's distributive share from an unincorporated business that was already taxed[19] and replaced it with the following provision:

> In the case of any person entitled to the distributive share of a trade or business net income, the Chief Financial Officer shall adopt regulations as necessary to determine the methodology of including the distributive share but provide an exclusion for the portion of the distributive share that is reported by and taxed against any person under the provisions of this chapter to prevent double taxation or double deduction.[20]

That provision implies that more guidance may be coming.

Conclusion

Taxpayers and practitioners normally review new legislation and new tax regimes to correctly apply them and to help taxpayers plan effectively. When tax rules like the D.C. combined reporting regulations are unclear, taxpayers are not only unable to plan, but also unable to comply. It becomes a guessing game of trying to determine what the OTR will conclude or apply when the taxpayer gets audited in a few years. It's like trying to pass a multiple-choice test when each of the answers could be correct.

Until further guidance is provided, taxpayers and practitioners should review each situation carefully and seek clarification from the OTR and other practitioners, especially when the result will have a material effect. Taxpayers, practitioners, and state tax industry organizations should also continue to work with the OTR to remove uncertainty and clear the path to compliance and reliability. ✰

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[16] 9 DCMR section 170.6 and 170.7.

[17] D.C. Code section 47-1810.04(c)(2).

[18] *Id.*

[19] D.C. Code section 47-1810.05(a)(3).

[20] D.C. Code section 47-1805(a)(3) as amended by the Fiscal Year 2014 Budget Support Emergency Act of 2013.