D.C. Tax Revision Commission Policy Options

Policy Option: Exempt Investment Funds from the Unincorporated Business Franchise Tax (UPDATE)

MEMORANDUM

Proposal: Exempt investment funds from the unincorporated business franchise tax
Tax Type: Business
Origin: Public
Commission Goal: Competition and business growth

Current Law

An unincorporated business, including a partnership or a sole proprietor with more than $12,000 in annual gross income, is subject to the unincorporated business franchise tax (UBFT). The tax rate for the UBFT is 9.975%; the same as the business franchise tax (BFT).

D.C. can only collect income tax from residents —while other states can collect income tax from nonresidents. However, D.C. collects a UBFT on businesses operating in the city (which may be owned by nonresidents). Notably, the UBFT exempts any trade or business in which more than 80% of gross income is derived from the personal services actually rendered by the individuals or partners, without capital as a material income-producing factor, such as professional firms, including doctors, lawyers, engineers and accountants.

The UBFT effectively precludes investment funds from operating a stock “trading” business in D.C., as such funds would likely be subject to the 9.975% tax on their capital gains, dividends, and interest (which would not be imposed on funds locating in other states).

New York City also collects an unincorporated business franchise tax, but exempts partnerships and other unincorporated entities that purchase, hold or sell property (including both intangible property, like stocks and bonds, and real property) for their own account (a “trading” safe harbor).

Proposed Change

Adopt a “trading” safe harbor similar to New York City’s so that investment funds are exempt from the UBFT—but only funds that invest in stocks, bonds, commodities and other intangible property, and not real property.

Reason for Change

The current UBFT effectively precludes investment funds from operating in D.C. As a result, the UBFT keeps a potentially vibrant industry from developing in D.C. Additionally, because none of these firms operate in the city, the UBFT collects little to possibly zero tax revenue from these firms.
Pros

- Reforming the UBFT could make D.C. more attractive to investment funds and their advisers.
- If provided an exemption, these firms would not pay the unincorporated business franchise tax. However, by locating and operating in the city, such firms could eventually contribute sales, property and possibly individual income taxes to D.C. For example, the fees received by the advisers would be taxed.

Cons

- There is a chance that some firms already located in D.C., and not the targeted beneficiaries of the exemption, could avoid UBFT payments as a result of the change.
- The proposal only exempts funds that invest in stocks, bonds, and commodities, and not real property, which raises horizontal equity issues.

Revenue Impact

The Office of Revenue Analysis has not completed an official estimate for this policy option. However, an earlier proposal to exempt portfolio investment funds from the UBFT was projected to cost about $1 million in revenue in its first full year. A new exemption may cost more or less depending on the drafting of the law.