SUPERIOR COURT OF THE DISTRICT OF COLUMBIA

TAX DIVISION

SCHOOL STREET ASSOCIATES LIMITED PARTNERSHIP, et al., Petitioners	*	
	*	Tax Docket No. 6345-95
v.	*	
DISTRICT OF COLUMBIA Respondent	*	

MEMORANDUM OPINION AND ORDER

School Street Associates Limited Partnership, Petitioner, incurred net operating losses (NOL) during the years 1982 through 1991 and attempted to carryforward these losses as a deduction on its 1992 District of Columbia unincorporated business franchise tax return. The District of Columbia, Respondent, disallowed the NOL deduction. Thereafter, Petitioner filed a petition and motion for summary judgment, challenging Respondent's NOL deduction statute, D.C. Code §47-1803.3(a)(14), and its application. Respondent opposed Petitioner's motion and filed a cross-motion for summary judgment, contending that the NOL deduction was properly disallowed.

Noting that the primary issues in this case are purely

legal and likely to be resolved by the Court's determination of the summary judgment motions, the parties submitted a joint motion requesting that the trial date be postponed indefinitely until, if ever, it is deemed necessary. Therefore, this case comes to the Court for a ruling on Petitioner's and Respondent's motion for summary judgment and cross-motion for summary judgment, respectively.

The three primary issues in this case are: (1) whether D.C. Code §47-1803.3(a)(14) allows a net operating loss (NOL) deduction for unincorporated businesses residing in the District of Columbia ("District") with owners residing outside the District; (2) whether D.C. Code §47-1803.3(a)(14) violates the Commerce Clause, the Due Process Clause, or the Equal Protection Clause of the Constitution and is as consequence, unconstitutional; and (3) whether D.C. Code §47-1803.3(a)(14) violates the Home Rule Act by, in effect, imposing a tax on the incomes of individuals not residing in the District.

BRIEF ANSWER

With respect to the first issue, this Court recognizes that D.C. Code §47-1803.3(a)(14) NOL deductions are required to be taken in the same manner as allowed by §172 of the Internal Revenue Code (IRC or Code). Section 172 of the code

allows such deductions to corporations or other entities specifically given corporate status for federal purposes. Since the unincorporated business in this case does not satisfy the requirements of IRC §172, it is not permitted to claim a NOL deduction under D.C. Code §47-1803.3(a)(14).

With regards to the second issue, this Court finds that D.C. Code §47-1803.3(a)(14) is not unconstitutional for the following reasons. First, the statute does not violate the Commerce Clause because it does not direct a commercial advantage to a local business. Second, the statute does not violate the Due Process Clause because there is a connection between the state and the transaction it seeks to tax. Third, the statute does not violate the Equal Protection Clause because it bears a relationship to a legitimate government purpose. Furthermore, D.C. Code §47-1803.3(a)(14) is not unconstitutionally discriminatory because, under the statute, those unincorporated businesses that wish to take a NOL deduction at the entity level may incorporate and subsequently qualify for such a deduction.

With respect to the third issue, this Court finds that deductions, unlike taxes, are a matter of legislative grace. Accordingly, the District has the authority and discretion to grant deductions. Thus, by selectively permitting a NOL

deduction only to those entities eligible under IRC §172 of the federal structure, the District is not in effect taxing the income of nonresident individuals. Therefore, the District is not violating the Home Rule Act.

I. FINDINGS OF FACT

Petitioner, School Street Associates Limited Partnership, is a limited partnership organized and operated in the District, but owned in substantial part by individuals and entities not residing in the District. It consists of four tiers of entities: a) School Street Associates Limited Partnership; b) School Street's general partners, First City Properties - E Street, Inc. and Boston School Associates Limited Partnership; c) Boston School General Associates, general partner of Boston School Associates Limited Partnership; and d) general partners of Boston School General Associates, Mortimer B. Zuckerman and Edward H. Linde.

Petitioner School Street L.P. is an unincorporated business which is subject to the District's unincorporated business franchise tax. As a real estate investment business, School Street's income is generated by a revenue-producing office building that it owns in the District. Petitioners Mortimer B. Zuckerman and Edward H. Linde are

residents of other states and neither filed District individual income tax returns for 1992. During the years 1982 through 1992, School Street L.P. apportioned 100 percent of its income to the District. On its 1992 Unincorporated Business Franchise Tax Return, School Street deducted a net operating loss deduction incurred from 1982 through 1992, claiming to follow IRC §172. These losses were reported as ordinary losses on its District unincorporated business franchise tax returns and on its federal partnership informational return, Form 1065.

In April 1994, Respondent issued a Notice of Tax Deficiency, which disallowed School Street's NOL deduction in its entirety. Later, in August 1994, Respondent issued a final determination assessing School Street's deficiency as $31,168.37. Respondent noted that included in this amount was a deficiency from another disallowed deduction (unrelated to the deduction at issue).

School Street responded to the District's disallowance by filing a petition, and subsequently a motion for summary judgment which challenged the application and constitutionality of D.C. Code §47-1803.3(a)(14). Respondent opposed Petitioner's motion and filed a cross-motion for summary judgment, contending that the NOL deduction was

properly disallowed.

School Street claims that Respondent disallowed the NOL deduction on the grounds that School Street had passed its prior operating losses through to its partners. Furthermore, School Street claims to have already covered the alleged deficiency through payments made in its 1992 estimated franchise tax payments.

II. CONTROLLING LAW AND CONCLUSIONS

A party that moves for summary judgment has the burden of submitting a statement of material facts as to which it contends there is no genuine issue. Sup. Ct. Civ. R. 12-I(k). A motion for summary judgment may only be granted when there is "no genuine issue as to any material fact and ... the moving party is entitled to a judgment as a matter of law." Sup. Ct. Civ. R. 56(c). In the present case, both parties moved for summary judgment. Having considered all the facts and applicable law, this Court concludes that there are no material facts at issue. The Court will, therefore, consider the merits of Petitioners' motion for summary judgment and Respondent's cross-motion for summary judgment.

A. D.C. Code §47-1803.3(a)(14) Does Not Allow a NOL Deduction for Unincorporated Businesses Residing in the District of Columbia.

In order to obtain a deduction, a taxpayer must be able to point to an applicable statute and show that he or she comes within its terms. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440. In this case, the statute in question states:

> (14) Net operating losses. -- In computing the net income of a corporation, an unincorporated business, or a financial institution, there shall be allowed a deduction for net operating losses, in the same manner as allowed under §172 of the Internal Revenue Code of 1986 and as reported on any federal tax return for the same taxable period, except that no net operating losses may be carried back to any year ending before January 1, 1988.

D.C. Code. Ann. §47-1803.3(a)(14). Petitioner contends that it comes within the statute's terms, stating that: (1) the statute's plain meaning entitles Petitioner to a NOL deduction against its income; (2) Respondent's regulations confirm that the statute permits an unincorporated business to execute a NOL deduction against its income; and (3) the statute's legislative history confirms the intent that an unincorporated business deduct at the entity level.

1. The plain meaning of D.C. Code §47-1803.3(a)(14) does not entitle Petitioner to a NOL deduction.

Petitioner reads the plain meaning of D.C. Code §47-1803.3(a)(14) as allowing a NOL deduction from the gross income of an unincorporated business in determining net, taxable income. Furthermore, Petitioner contends that the statute affords unincorporated businesses an entity-level NOL deduction because the statute and the D.C. Tax Code treat unincorporated businesses as if they were corporations. Consequently, Petitioner claims that the NOL deduction is available to unincorporated businesses "in the same manner" as is available to corporations, and thus Respondent impermissibly rewrites the statute with its interpretation.

It is important to note that the District does not always treat unincorporated businesses as corporations. In the instant case, the District treats an unincorporated business like a corporation only for franchise tax purposes.[1] The fact that the District treats both corporations and unincorporated businesses the same in this particular situation, however, does not require it to treat them equally in all situations.

Generalizations as to the treatment of entities is

[1] The General Instructions to the 1992 Form D-30, the District of Columbia Unincorporated Business Franchise Tax, states: "For *franchise tax purposes*, an unincorporated trade or business is treated as an entity, *comparable* to a corporation..." (emphasis added).

particularly dangerous when dealing with tax related issues. Notably, statutes dealing with tax deductions are interpreted strictly, only allowing deductions when "plainly authorized." Helvering v. Inter-Mountain Life Insurance Co., 294 U.S. 686, 689 (1935).

When a conflict exists between the general and specific terms in a tax statute, the more specific provision typically prevails. Howard v. Riggs National Bank, 432 A.2d 701, 709 (D.C. 1981). Statutes should not, however, be "construed in such a way as to render certain provisions superfluous or insignificant." Tuten v. United States, 440 A.2d 1008, 1010 (D.C. 1982). This is important to remember when dealing with ambiguity because in such situations the rule favoring taxpayers does not apply. Inter-Mountain Life Insurance Co., 294 at 689.

a. The more specific provision usually prevails.

The specific language of the statute at issue states that "in computing the net income of a corporation, an unincorporated business, *or* a financial institution, there shall be allowed a deduction for net operating losses,..." (emphasis added). D.C. Code §47-1803.3(a)(14) employs the word "or" instead of "and," which may imply that there is

some selectivity in determining which entities are permitted to take NOL deductions. The general terms would lead to an interpretation where all three entities are allowed a NOL deduction. The more specific provision, however, requires a narrower reading of the statute and may be interpreted to allow NOL deductions only to those businesses that can fulfill the requirements of the statute. Since the more specific provision usually prevails in situations of conflict, the statute can reasonably be interpreted to allow NOL deductions to entities that are also eligible to do so under §172 of the Code.

With respect to §172, the statute at issue approves of NOL deductions "[i]n the same manner as allowed under §172 of the Internal Revenue Code of 1986...." §172 of the Code allows NOL deductions to corporations, but not partnerships (partnerships are explicitly prohibited from taking a NOL deduction, IRC §7039(a)(2)(D)). Further, the federal government does not recognize an entity known as an "unincorporated business". Thus, Petitioner would fall under the IRC's definition of a partnership. IRC §761. The statute specifically prefaces that the NOL deduction is only allowed "in the same manner as allowed under §172." Petitioner is unable to fulfill this necessary requirement since

partnerships are not allowed to take a NOL deduction and Petitioner is a partnership within the definitions of the IRC.

D.C. Code §47-1803.3(a)(14) states that a NOL deduction will be allowed "as reported on any federal tax return for the same taxable period." Partnerships, unlike corporations, are only required to file a federal informational return and not a federal income tax return. The inclusion of this clause supports the above requirement, which in effect only allows corporations to take a NOL deduction and harmonizes the clause as a whole.

b. Statutes should not be construed in such a way as to render certain provisions superfluous or insignificant.

Petitioner's view that Respondent's interpretation renders the term "unincorporated business" superfluous and contradictory to the rules of statutory interpretation is incorrect. One example is that publicly-held partnerships are treated like corporations for federal tax purposes. IRC §7704. As such, they are taxed like a corporation and are entitled to a NOL deduction as allowed to corporations. Thus, publicly-held partnerships may be an "unincorporated business" under the District's definition, yet are still able

to deduct a NOL "in the same manner as allowed under §172 of the Code." An interpretation any other way would be contrary to the entire federal taxing structure and the part of the District's structure that has conformed to the federal.

2. The Agency's interpretation is entitled to controlling weight.

School Street claims that the District's regulations interpreting D.C. Code §47-1803.3(a)(14), specifically Regulations 117 and 119, contradict the District's arguments and confirm that School Street is entitled to deduct its NOL at the entity level. Agency interpretation is entitled to controlling weight unless it conflicts with the statute or is inconsistent with the regulation. Freeman v. District of Columbia Dep't of Employment Servs., 568 A.2d 1091, 1093 (D.C. 1990). In this case, however, the agency's interpretation does not conflict with the statute and is not inconsistent with the regulations.

Regulation 117, "Tax on Unincorporated Businesses," provides, at Section 117.1, that "the design of the unincorporated business tax ... is to impose a tax upon all business income ... without regard to whether the business is carried on by an individual, a partnership, or some other

unincorporated entity." This regulation is inapplicable to the situation at hand because it addresses the purpose of the tax, but mentions nothing with respect to deductions.

Regulation 119, "Tax Computation for Unincorporated Businesses," provides, at section 119.2, that "the net income of an unincorporated business is computed in practically the same manner as the net income of a corporation" and is "generally entitled to allowable deductions from gross income to the same extent that would be allowable if the business were incorporated." Regulation 119.2 further states that an unincorporated business' net income is computed in "practically" the same manner as a corporation and is "generally" entitled to the same deductions as a corporation. Nowhere, however, does Regulation 119.2 claim to always conform to this method.

Neither Regulation 117 nor Regulation 119 are conclusive. Even when combined, these regulations do not necessarily lead to Petitioner's outcome.

3. The legislative history indicates that unincorporated businesses are not entitled to a NOL deduction.

"A statue should be read and construed as a whole within the context of the entire legislative scheme." Howard v.

Riggs Nat'l Bank, 432 A.2d 701, 709 (D.C. 1981). The legislative history of D.C. Code §47-1803.(a)(14) supports the reading of the statute, that unincorporated businesses are not entitled to NOL deductions. Thus, School Street is incorrect in claiming that the statute's legislative history supports NOL deductions for unincorporated businesses.

When the Internal Revenue Code was revised in 1986, the District, as required, responded to the change by proposing and enacting the District of Columbia Income and Franchise Tax Conformity and Reform Act of 1987 ("the Act"). The Act asserts an overall desire to maintain its limited conformity with the Internal Revenue Code in light of the 1986 Federal Tax Reform Act.

The Act's use of the word "conformity," and the immediate action that was required with respect to the federal revisions, infers that the District wished to adhere to the federal structure to the greatest extent possible. The bill, as initially proposed, lists as a purpose, inter alia, "to provide for greater conformity with federal income tax laws in the reporting of net operating loss deductions for *corporations*." Despite the use of more general language in the final enacted statute, the intent of the legislature seems to point to the fact that the NOL was intended for

those entities eligible under §172 of the Code.

B. D.C. Code §47-1803.3(a)(14) is Constitutional.

D.C. Code §47-1803.3(a)(14) does not violate the Commerce Clause, the Equal Protection Clause, or the Due Process Clause of the Constitution. "Deductions ... from otherwise taxable income are a matter of legislative grace." B.F. Goodrich Co. v. Dubno, 490 A.2d 991, 995 (Conn. 1985). If an unincorporated business wishes to be able to take a NOL deduction at the entity level, it can incorporate and qualify for a NOL deduction under the statute. However, an unincorporated business cannot choose to operate as such and yet expect to be given corporate status. By remaining an unincorporated business, it retains the advantages of such status, but must accept the disadvantages as well.

1. The statute does not violate the Commerce Clause.

The Commerce Clause of the Constitution is a grant on congressional power as well as a limit on state power. With respect to taxation, "the clause does not shield interstate...commerce from its fair share of the state tax burden." Barclays Bank PLC v. Franchise Tax Board of California, 512 U.S. 298 (1994). However, "no state

consistent with the Commerce Clause, may 'impose a tax which discriminates against interstate commerce ... by providing a direct commercial advantage to local business.'" Sprint Communications Company v. Kelly, 642 A.2d 106, 114 (1994), quoting Boston Stock Exchange v. State Tax Commission, 429 U.S. 318, 329 (1977).

The test to determine whether a state tax violates the Commerce Clause is whether the tax is applied to an activity with a substantial relation to the taxing state and is fairly apportioned. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977). Furthermore, the test requires that the tax not discriminate against interstate commerce and is fairly related to the services the State provides. Id. Assuming that this test applies in the case at hand, the statute would still be upheld. The point at issue in the case at hand is not a tax, but a deduction. Unlike a tax, deductions are a matter of legislative grace and are thus strictly construed. B.F. Goodrich, 490 A.2d at 995.

The test in Complete Auto is used to determine whether a *tax* is unconstitutional. When applied to this case, the following facts become evident. First, School Street L.P. receives its income from the rental activity of an office building that it owns in the District and hence has a

substantial nexus with the taxing state. Second, the franchise tax is fairly apportioned in that it is based on the amount of business School Street generates from the District (100 percent in the present case). Third, the franchise tax does not discriminate against interstate commerce because it imposed on all businesses receiving income from District sources, regardless of residency status. Fourth, the franchise tax is fairly related to the services that the District provides to unincorporated business since it is solely based on the net income generated within the District.

Petitioner relies on West Lynn Creamery v. Healy, 114 S.Ct. 2205 (1994), to show a Commerce Clause violation. In West Lynn Creamery, the claim was based on a tax (not a deduction) and a subsidy. In addition, residents who were subject to the tax were relieved in part through subsidies paid out of a fund created by the tax, in effect, possibly eliminating the tax altogether. In the instant case, residents are not relieved of the tax over the nonresidents of the District. Both are taxed and neither given a NOL deduction. A NOL deduction, if allowed at all, is permitted to all individuals who live in the District, not merely those with unincorporated businesses. All qualified individuals

are allowed a NOL deduction. By denying the Petitioner the NOL deduction, the statute distinguishes between corporations and unincorporated businesses, not residents and nonresidents.

2. The statute does not violate the Due Process Clause.

Due process principles prohibit discriminatory tax treatment and "require some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax." Quill Corp. v. North Dakota, 504 U.S. 298, 306 (1992), citing Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-45 (1954). The unincorporated business tax does not violate due process principles. School Street's income is entirely generated from the rental of an office building located in the District. The tax is based solely on the amount of income generated by this building. By denying unincorporated businesses a NOL deduction, the District is not taxing these entities for impermissible amounts. The tax is within the powers granted to the District, whether the District chooses to allow a deduction to unincorporated businesses or corporations is within its discretion. Thus, there is a definite link between Petitioner and the District which negates the possibility of

a Due Process violation.

3. The statute does not violate the Equal Protection Clause.

Equal Protection analysis for economic matters requires that the statute bears a rational relationship to a legitimate government purpose. See Hessey v. Burden, 615 A.2d 562, 575 (D.C. 1992). In the instant case, the franchise tax bears a rational relationship to the legitimate purpose of raising revenues for the District by providing a panoply of municipal services to the taxed entity. Stabilizing the District's tax revenue and decreasing its administrative burdens, by maintaining limited conformity to the federal tax scheme, is a legitimate purpose within the police powers of a state. Moreover, the fact that qualifying entities are allowed NOL deductions regardless of whether the owners are residents or nonresidents reinforces the notion that the statute does not discriminate against nonresidents.

C. D.C. Code §47-1803.3(a)(14) Does Not Violate the Home Rule Act.

The Home Rule Act disallows the Council to... "impose any tax on the whole or any portion of the personal income, either directly or at the source thereof, of any individual

not a resident of the District..." §1-233(a)(5). The unincorporated business franchise tax does not impose a tax on the personal income of nonresidents of the District. Rather, it merely disallows a NOL deduction to unincorporated entities, as does the federal structure. This in effect does not impose a tax on nonresidents' personal income. It is the entity level net income that is taxed and not the partners' individual incomes. The fact that the NOL deduction is allowed to pass-through to individuals who reside in the District is irrelevant because the District allows such a deduction for all its residents. Whether a different state denies such deductions to its residents is of no relevance to the District.

Therefore, this Court must conclude that the plain meaning of the statute, its legislative history, and the rules of statutory construction can be interpreted to deny an unincorporated business a NOL deduction. Since deductions are a matter of legislative grace, the District has much discretion. For the following reasons there does not appear to be any constitutional issue present, in that, the subject of the case is a deduction and not a tax, the Petitioner has not overcome the burden of proving that they are entitled to

a deduction. Moreover, the statute does not violate the Home Rule Act by imposing taxes on individuals who are not residents of the District.

Wherefore, it is this 6th day of August, 1997, hereby

ORDERED, that Petitioners' motion for summary judgment is **DENIED**; and it is further

ORDERED, that Respondent's cross-motion for summary judgment is **GRANTED**.

SO ORDERED.

Judge Kaye K. Christian
Associate Judge
(Signed in Chambers)

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