March 9, 2012

Proposed Changes to New York State Taxation of Carried Interests

By: Joseph Lipari

Over the past few years, there have been numerous proposals in Congress[1] and in President Obama's Budget Proposals[2] to change the federal taxation of so called "Carried Interests." With the recent revelation that Republican Presidential hopeful Mitt Romney had paid an effective federal tax rate of less than 15 percent on his income in 2011, a substantial portion of which appears to have been attributable to Carried Interests on investments from his time with Bain Capital, the issue has again come into the news. This article will briefly touch upon the proposed federal changes but will primarily focus on the impact such changes would have on the New York State Personal Income Tax ("PIT") and the New York City Unincorporated Business Tax ("UBT")

Background

A Carried Interest is generally considered to be an interest in a partnership or limited liability company ("LLC") that entitles the holder of such interest to a share of the profits of the partnership or LLC that is greater than the holder's share of the capital of the entity.[3] Carried Interest arrangements are often seen in hedge funds, private equity funds, venture capital funds, and real estate funds. Although there are a variety of possible forms Carried Interest arrangements may take, a typical structure has the following characteristics:

- An LLC is formed between money investors and a manager or developer.
- The investors agree to put up all or almost all of the capital required for the venture or fund.
- The manager or developer will be obligated to oversee the investments or business of the entity, and may put up a small amount of capital or agree to guarantee certain obligations of the entity.
- The LLC agreement will often provide that distributions from the entity are made first to the investors until they recover their capital invested, plus an agreed upon return on investment ("ROI").
- The LLC agreement will also provide that distributions over and above the investors' capital recovery and the agreed upon ROI are to be shared by and between the investors and the manager/developer pursuant to an agreed upon ratio (often 80 percent to the investors, 20 percent to the manager/developer).
- In some cases, the manager/developer or a related management company would also receive an annual fee for managing the project, typically equal to 2 percent of the assets under management, but such management fees are often offset by expenses of the management company and, for that reason, constitute only a small part of the manager's overall income from the entity.

The important tax advantage of this typical structure to the individuals who participate as managers and developers is that under the partnership tax rules of Subchapter K of the Code, profits allocated by a partnership or LLC to its members retain the tax character such profits have inside the entity.[4] For example, if a partnership recognizes long-term capital gain from the sale of its investments, every partner who is allocated a share of such gain would report it as long-term capital gain, which is taxable at favorable, lower rates rather than ordinary income tax rates.

Critics of the current system for taxing Carried Interests argue that, to the extent the profit allocations to a manager or developer are greater than such person's share of the capital of a partnership or LLC, the profit participation is economically in the nature of compensation rather than gain on investment.[5] Such critics claim that the favorable rates applicable to long-term capital gains should only be made available to those investors who have capital at risk. Defenders of the current system argue in response that managers and developers take on the entrepreneurial risk of the venture as much as those who invest money, that they often have additional contingent economic risks (such

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as guarantees), and that their "sweat equity" should receive the same favorable treatment as the cash equity of the investors.[6] Defenders of the current system also point out the complications of the proposed changes and the resulting uncertainty and unintended consequences that will arise. This article does not have the space to do justice to the issues under debate.

The various proposals to change the federal taxation of Carried Interests differ in certain respects but, in general, they all take the same underlying approach. The proposals change the character of profits allocated to a manager or developer to the extent the share of such profits is greater than the manager or developer's share of qualified capital. The excess profits are treated as ordinary income and are also treated as self-employment income. As a result, not only would such excess profits be ineligible for the lower rates available for long-term capital gain, but, in addition, such amounts would be subject to payroll taxes, including Social Security and Medicare.

Effect of Legislation on PIT

Although the PIT does not provide for a lower tax rate on long-term capital gains, a change in the character of Carried Interest income for federal income tax purposes would likely have a tremendous impact on the New York State taxation of such income. First and foremost, income that is, under the current rules, not taxable to nonresidents of New York would likely become taxable. Under the PIT, residents of New York State are taxable on their worldwide income.[7] New York nonresidents, however, are taxable only on New York source income.[8] For the most part, capital gains, particularly those deriving from the sales of stocks, bonds, or other intangibles, are not New York source income.[9]

In contrast, New York source income includes compensation earned by a nonresident to the extent that such income is attributable to services performed by the nonresident in New York.[10] With respect to individuals who work both inside and outside New York, compensation income is generally allocated using a formula that divides the number of days worked in New York during the year by the number of total days worked during the year.[11]

Take, for example, a venture capital fund where the manager, a Connecticut resident who works full-time in New York, receives a management fee of 2 percent per year and a carried profits interest of 20 percent of gains on sales of investments. Under current New York law, this manager would include the 2 percent management fee as New York source income, but he would not be subject to the PIT on his share of the capital gains recognized by the fund since that income is gain from the sale of intangibles. Under any of the various Carried Interest proposals, however, all of the manager's income would potentially be subject to tax in New York if the income is recharacterized as compensation.

There may be some question as to whether any change to the Internal Revenue Code would automatically result in a change in New York's income tax regime. We would expect that some taxpayers will argue that, even if gain from a Carried Interest is recharacterized as ordinary income for federal tax purposes, it is still gain from the sale of an asset, and, if the asset sold is an intangible (*e.g.*, stocks or securities) or property located outside New York, such gain should not be taxable by New York. In part, this position is supported by the language of the New York State Constitution.[12]

Even assuming that there is agreement that the Carried Interest portion of gains can be treated as compensation for services rendered under the PIT, determining what portion of such income is New York source income will be difficult. For example, the evaluation regarding what portion of such gains is New York source income would depend, at a threshold level, upon whether the fees were earned by the manager/developer individually or earned as a partner in another partnership. If earned individually, the determination as to what portion is New York source income would likely depend upon where the individual performed services. If earned as a partner in another partnership, however, the activities of that partnership would be relevant to the determination as to what portion is New York source income.

Calculating the New York source allocation become even more complex when one considers that the capital gains recognized by a partnership or an LLC on a sale of assets often involve investments held for several years. Notably, the proposed federal changes to the taxation of Carried Interests do not just apply to newly formed entities, rather they apply to any sale of an asset after the date of enactment, regardless of when the entity was formed or the asset acquired.[13] Thus, for example, a manager of a venture capital fund who receives an allocation of gains on the sale of an investment by the fund may have worked full-time in New York for a portion of the period of time when the investment was held, and he may have worked full-time elsewhere during a portion of the time. The manager may have worked for the fund for years before the investment was acquired, or the entity may have acquired the investment before the manager was admitted as a member of the fund. Also, the manager may have spent all of his time working on other unrelated investments of the fund. As a result of any of these potential factual variations, any attempt to determine what portion of the manager's share of gain is attributable to work performed by the manager in New York is pure guesswork.

An analogous issue arises in connection with other forms of deferred compensation, as well as stock options, which often are attributable to work performed over a number of years. Although New York's rules relating to stock options have changed several times over the years, the current regulations provide that the portion of compensation income recognized on the exercise of a stock option allocable to New York is derived by a days count formula for the period between the grant of the option and its vesting date or, if the option vests immediately upon grant, the allocation formula is applied for the year of the grant.[14] Grafting these concepts onto income attributable to Carried Interests raises a number of issues, including how to apply vesting concepts.

If any of the proposals to change the federal taxation of Carried Interests take effect, as a result of the state-level uncertainty in this area, there would be a significant risk of multiple state taxation on the same income. In general, states provide state tax credits for state taxes that their residents pay to other states in which their residents earn income. However, most states insist that the income allocation be made under the allocation principles the state of residence uses on its own residents. A New York nonresident's home state will not necessarily agree with New York as to what portion of the income is attributable to work the New York nonresident performed in New York.

The proposed changes to the federal taxation of Carried Interests may, in some circumstances, cause New York to actually lose tax revenues by the recharacterization of a share of gains as compensation. For example, gains attributable to the sale of New York real property constitute New York source income taxable to nonresidents.[15] If, however, Carried Interests are held by nonresidents who work outside New York (say, for a large national real estate company with assets all over the country), the recharacterization of such gains as compensation income would appear to exempt such income from the PIT.

Effect of Legislation on UBT

The UBT applies to individuals and unincorporated entities, such as partnerships and LLC's, that engage in business activities in New York City. However, many investment partnerships are not required to pay UBT because there are exemptions for the ownership, leasing, and sale of real property,[16] as well as for trading for one's account.[17] Consequently, many investment funds are organized as LLC's where a related party of the manager obtains the annual management fee (which is largely or completely offset with expenses), and the manager is a member of the fund entitled to a carried interest in the fund's profits. Although the related party may be subject to UBT on its net profit from receipt of the management fee, the fund (including the share allocated to the manager) is exempt.

The proposed changes to the federal taxation of Carried Interests could support the position that the share of profits of the manager is not exempt trading or real property income but, instead, is compensation for services which would be subject to UBT. Such a determination would bring with it similar allocation complications to the ones described above. Some of these issues already have to be dealt with under current law in connection with the taxation of the management fee to the related party, but applying these rules to the Carried Interest share of gains increases the stakes dramatically.

Conclusion

Any of the proposals to change the federal taxation of Carried Interests will, if adopted, dramatically complicate the formation and operation of partnerships and LLC's. Although some attention has been paid to some of the issues, we are just scratching the surface.

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1 *See, e.g.,* H.R. 4016, 112th Cong. (2d Sess., 2012) (the "Carried Interest Fairness Act of 2012"); H.R. 4213, 111th Cong. (1st Sess., 2009); H.R. 1935, 111th Cong. (1st Sess., 2009); H.R. 6275, 110th Cong. (2d Sess., 2008); H.R. 2834, 110th Cong. (1st Sess., 2007).

2 *See* President Obama's fiscal-year 2013 budget proposal released on Feb. 13, 2012; President Obama's fiscal-year 2012 budget proposal released on Feb. 14, 2011; fiscal-year 2011 budget proposal released on Feb. 1, 2010; and fiscal-year 2010 budget proposal released on Feb. 26, 2009 (all of which include a line item that states: "Tax carried interest as ordinary income"). *See also* the U.S. Dept. of the Treasury's *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals, General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals,* and *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (all of which include a revenue item entitled "Tax Carried (Profits) Interests As Ordinary Income").

3 For more information, see P. Carman, "Taxation of Carried Interests," 87 Taxes 111 (Mar. 2009); Staff of Joint Comm. on Tax'n, 110th Cong., 1st Sess., *Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues* (2007).

4 See Code Section 702(b).

5 *See, e.g.,* U.S. Dept. of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, at 61 ("By allowing service partners to receive capital gains treatment on labor income without limit, the current system creates an unfair and inefficient tax preference.").

6 *See, e.g., "Carried Interest": Hearing Before the S. Comm. on Finance*, 110th Cong., 1st Sess., at 5 (July 11, 2007) (testimony of Kate D. Mitchell, Managing Director of Scale Venture Partners), *available at* http://finance.senate.gov/imo/media/doc/071107testkm.pdf ("As venture investors, we assert that it is appropriate to reward investors of sweat equity with the same long-term capital gain tax benefits that investors of financial equity receive.").

7 N.Y. Tax Law § 612(a).

8 N.Y. Tax Law § 631(b)(1).

9 N.Y. Tax Law § 631(b)(2).

10 N.Y. Comp. Codes R. & Regs. tit 20, §§ 132.2(b), 132.4(b) and (c).

11 N.Y. Comp. Codes R. & Regs. tit 20, § 132.18.

[12] N.Y. CONST. art. XVI, §3 which provides "Moneys, credits, securities and other intangible personal property within the state not employed in carrying on any business therein by the owner shall be deemed to be located at the domicile of the owner for purposes of taxation, and, if held in trust, shall not be deemed to be located in this state for purposes of taxation because of the trustee being domiciled in this state, provided that if no other state has jurisdiction to subject such property held in trust to death taxation, it may be deemed property having a taxable situs within this state for purposes of death taxation. Intangible personal property shall not be taxed ad valorem nor shall any excise tax be levied solely because of the ownership or possession thereof, except that the income therefrom may be taken into consideration in computing any excise tax measured by income generally. Undistributed profits shall not be taxed."

[13] *See, e.g.,* the Carried Interest Fairness Act of 2012.

[14] N.Y. Comp. Codes R. & Regs. tit 20, § 132.24 (applicable to taxable years beginning on or after Jan. 1, 2006).

[15] N.Y. Comp. Codes R. & Regs. tit 20, §§ 132.2(a), 132.3.

[16] Sec. 11-508(e), N.Y.C. Admin. Code; N.Y.C. Dept. of Finance Rul. Sec. 28-07(f).

[17] Sec. 11-508(e-3), N.Y.C. Admin. Code; N.Y.C. Dept. of Finance Memo. 09-2.