Client Alert.

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Pending New York State Proposal to Tax Nonresidents on "Carried" Interests

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New York State Governor David A. Patterson and the New York State legislature have each proposed separate revenue bills for New York State's fiscal year 2010/2011 which include substantial tax increases (Assembly Bill A9710-D, Senate Bill S6610-C). Among the most controversial of the proposed tax increases is the revival of last year's proposal to tax non-residents on their "carried interest" allocations attributable to an investment fund doing business in New York State. If enacted, the legislation would among other things treat carried interest allocations received by a nonresident individual partner from an investment fund's general partner entity as New York source income subject to New York State personal income tax if the individual partner provides a substantial quantity of investment management services to an investment fund in New York.

BACKGROUND

Typically, a general partner in a domestic investment fund (such as a private equity fund or a hedge fund treated as a partnership for income tax purposes) receives: (i) a management fee equal to a specified percentage (*e.g.*, 2%) of capital commitments or invested capital per annum and (ii) a "carried interest" equal to a specified percentage (*e.g.*, 20%) of realized capital gains of the investment partnership. Carried interest allocations usually flow through to the general partner entity (and the individual partners in the general partner entity in the investment fund) and, for income tax purposes, retain their tax characteristics.

A New York nonresident individual partner who receives a distributive share of New York State partnership income or gain is taxed by New York on his or her New York source income. In general, New York source income is calculated by multiplying the partner's distributive share from the partnership by an average percentage of the property, payroll and gross income of the business attributable to New York State. A nonresident individual's distributive share of capital gains from the partnership's investments retains its character when distributed and is not considered New York source income.

Under current law, a nonresident individual partner in a general partner entity that manages an investment fund is subject to New York State personal income tax on management fees received to the extent derived from management services actually performed in New York. However, the nonresident partner's share of carried interest allocations made by the investment fund to the general partner, and then allocated to the nonresident partner of that entity, does not constitute taxable New York source income, even if the investment fund or its general partner engage in business in New York. This is because the distributive share of gain retains its character as capital gain and is not considered to be earned in connection with a New York trade or business. Carried interest distributions made to a *corporate* partner, to the extent they represent gains derived from investment capital, are treated as investment income, which in most cases is taxed more favorably than business income.

SUMMARY OF THE CARRIED INTEREST PROPOSAL

Both the New York Governor's and the Legislature's pending bills for taxing carried interest would create a special rule for an individual (or a corporate partner) that performs investment management services for an investment fund in New York as follows:

- An individual partner (including an individual partner in an investment fund's general partner) who performs investment management services would no longer be treated as a partner with respect to his or her distributive share of income, gain, loss or deduction to the extent it exceeds the amount of the distributive share the partner would have received if the partner performed no investment services. Instead, the excess amount -- the carried interest -- would be treated as income derived from a trade, business, profession or occupation carried on by the partner, and characterized as a payment for services rendered by the partner. The carried interest would be sourced to New York using the existing rules for sourcing the income of individual or partnership partners who perform personal services.

- Similar rules are also proposed for corporate partners and for shareholders of an S corporation that perform investment management services for an investment fund.

"Investment management services" are defined under the pending bills as the provision of a "substantial quantity" of the services of (i) advising the partnership as to investing in, purchasing or selling "specified assets" (defined as securities, real estate held for rental or investment, interests in partnerships, or commodities, or options or derivative contracts with respect to these assets), (ii) managing, acquiring, or disposing of specified assets, or (iii) arranging financing with respect to specified asset acquisitions, and (iv) any supporting activity related to these services. These "carried interest" provisions would not apply, however, where at least 80% of the value of specified assets consist of real estate of the partnership or other entity.

Under the pending legislation, a nonresident partner who, through a general partner entity, provides investment management services to an investment fund in New York, would likely be taxed on his or her "carried interest" at the New York State income tax rate (currently as high as 8.97%). Individual partners who reside in New York are already taxed on all types of income attributable to investment funds, and would not be affected by the pending legislation.

New York State's budget is now two months overdue, and its outcome remains uncertain. New York City Mayor Michael R. Bloomberg, as well as many business groups, oppose the carried interest proposals, noting that the investment funds could easily be moved to bordering states to avoid the tax. The New York State Assembly has approved the bill, but as of this writing, the New York State Senate has not indicated when it will vote on the bill. If enacted, the carried interest proposal would take effect immediately, and apply to taxable years beginning on or after January 1, 2010. While most states provide residents with a credit against their income tax liability for income taxes paid to another state on income derived from sources in that other state, it is unclear whether the partner's state of residence (*i.e.*, states other than New York) would allow a tax credit for New York tax paid on the carried interest.

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