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New York Governor Proposes Taxing Nonresidents on "Carried Interest"

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On December 16, 2008, New York State Governor David A. Patterson announced his Executive Budget recommendation for consideration by the New York State Legislature. It includes a variety of tax increases, including a proposal to tax non-resident individuals on "carried interest" allocations attributable to an investment fund doing business in New York State. (Budget Bill, S. 60, A. 160, Part N). If enacted, the legislation may 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 nonresident individual partner, through a general partner entity, provides a substantial quantity of investment management services in New York to an investment fund.

Background

In general, most domestic investment funds (such as a private equity fund or a hedge fund) are partnerships for federal income tax purposes. A general partner, typically a limited liability company or limited partnership that manages this type of investment partnership, may receive: (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 often flow through the general partner entity to individuals who for tax purposes are partners in the general partner.

Although New York State taxes all income earned by its resident individuals, it may constitutionally tax nonresidents only on income that is derived from or connected with New York sources. New York source income of a nonresident includes income attributable to a business, trade, profession or occupation carried on within New York State. When a nonresident engages in a business partly in New York and partly in another state, the nonresident's New York source income is determined by apportionment and allocation (typically based on the ratio of total days worked in New York to total days worked both in and outside of New York). The New York source income of a nonresident who receives a distributive share of New York State partnership income or gain is generally determined by multiplying the partner's distributive share by an average percentage of the property, payroll and gross income of the business attributable to New York State.

Under current law, a nonresident partner (e.g., an individual residing in Connecticut) in a general partner entity that manages an investment fund may be subject to New York State personal income tax on any 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.

Summary of the Governor's Proposal

Governor Patterson proposes to amend the New York Tax Law, specifically to include as an item of New York source income under Tax Law § 631(b)(1)(B), any income, gain, loss and deduction that is attributable to providing a "substantial quantity" of "investment management services to a partnership or other entity" in New York. Investment management services are defined under the proposal as (i) advising the partnership as to asset valuation, (ii) advising the partnership as to purchasing or selling assets, (iii) managing, acquiring, or disposing of assets, (iv) arranging financing with respect to asset acquisitions, and (v) any supporting activity related to these services. Thus, a nonresident partner who, through a general partner entity, provides investment management services in New York to an investment fund, partnership or other entity could be affected by the proposed legislation and taxed on his or her "carried interest" at the New York State income tax rate (currently as high as 6.85%). As individual partners who reside in New York are already taxed on all types of income attributable to investment funds, they would not be affected by the Governor's proposal.

The proposal defines the type of assets with respect to which the provision of investment management services would generate New York source income. The specified assets include stock, interests in publicly traded partnerships or trusts, debt, various derivatives, and commodities. The specified assets also include real estate, and therefore partners who provide investment management services to real estate partnerships may also be affected.

If enacted, the carried interest proposal would take effect immediately, and apply to taxable years beginning on or after January 1, 2009. While most states do 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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