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Legal Update
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Indirect Attack on Carried Interests: the NYC Department of Finance's Contemplated Change in Unincorporated Business Tax Policy

Decision-makers at the New York City Department of Finance have notified practitioners that the Department is actively considering the implementation of a new unincorporated business tax ("UBT") audit policy targeted at investment partnerships, such as hedge funds and private equity funds. The likely upshot of the new policy, if ultimately adopted, is that the Department will increase its audits of such funds and will seek to deny certain expense deductions claimed by the funds.

Background

To understand the Department's contemplated change in position, it is necessary to understand how funds are generally compensated and structured.

Typically, funds receive both a management fee (often 2 percent) and a "carried interest" that is often a specified percentage (generally 20 percent) of realized capital gains.

Funds are usually structured so that the management fee income and the carried interest income are received by different partnerships.

The partnership that receives the management fee (the "Management Partnership") is subject to the 4 percent UBT, but it can reduce its UBT liability by claiming ordinary and necessary business expenses relating to operating and managing the fund.

The partnership that receives the carried interest (the "Carried Interest Partnership") is not subject to UBT because it is receiving investment income and is considered to be trading for its own account. It does not ordinarily claim expense deductions.

The Department's Proposed Attack on Management Partnership Deductions

High-ranking officials at the Department say that they are studying the attribution of at least some of the expense deductions of Management Partnerships to Carried Interest Partnerships. Such attribution would have the effect of increasing the UBT liability of Management Partnerships, while Carried Interest Partnerships would be unable to utilize the attributed expense deductions because they are not subject to UBT.

This approach to increasing the tax liability of investment partnerships and their managers thus differs starkly from the approach incorporated into recent proposed federal legislation. See the Carried Interest Fairness Act of 2012.[1] The federal legislation would treat the carried interest as compensation for services performed and would tax it at ordinary income tax rates (rather than investment income taxed as lower capital gains rates). As explained above, and in contrast to the federal legislation, the Department's contemplated approach does not assert that the carried interest should be treated like wage compensation, but rather the Department would seek to attribute expense deductions from Management Partnerships to Carried Interest Partnerships.

The Department has not issued guidance explaining how such expense attribution would work (such guidance may also have application to other industries). In particular, the Department has yet to set forth its contemplated methodology. Auditors could, for example, attribute some specified percentage of deductions to the Carried Interest Partnership (e.g., 15 percent of all deductions claimed by the Management Partnership). As a possible alternative, the Department could determine how much annual gross income the Management Partnership earns relative to the Carried Interest Partnership, and could base expense attribution on that relationship (e.g., if the Management Partnership receives $9X in management fees and the Carried Interest Partnership generates a $1X carried interest, one-tenth of the deductions would be attributed to the Carried Interest Partnership because it makes one-tenth of the overall income).

Discussion

The Department's contemplated position is difficult to fully and fairly evaluate as it has yet to be reduced to writing. Members of the Department have been discussing the contemplated change in position with practitioners for months, but have been sparse on details.

Given what the Department has articulated to date, a few issues immediately spring to mind. One is that the Department may lack the authority to attribute expenses between partnerships. In litigation the Department would presumably rely on NYC Administrative Code § 11-508(d), which provides that "the portion allocable to the city shall be determined in accordance with rules and regulations of the commissioner of finance if it shall appear to the commissioner of finance that the income from the city is not fairly and equitably reflected …" The corresponding regulation, 19 RCNY 28-07(e)(1), grants the Department the power to allocate "income" in a "fair and equitable" manner.[2]

Based on the plain language of the statute and administrative guidance, it appears that the statute is designed to permit the Department to allocate an unincorporated business's income between jurisdictions, rather than to allocate an unincorporated business's deductions to another unincorporated business. Thus, there may be an argument that the Department lacks legal authority to make the proposed expense deduction adjustments.

Even if the Department possesses the authority to allocate deductions between partnerships, it still may not be "fair and equitable" within the meaning of the statute to allocate deductions from the Management Partnership to the Carried Interest Partnership if the Management Partnership is really managing and operating the business. The expenses would seem most fairly and equitably attributable to the Management Partnership if the Management Partnership is responsible for oversight of the investment business.

Additionally, if there is a partnership agreement in place that specifically allocates the expense deductions to the Management Partnership, it is unclear whether the Department can override that agreement, unless the Department can show that such an allocation somehow lacks substantial economic effect. This may be difficult for the Department to show in the typical case.

Accordingly, investment partnerships with this issue that are audited may have both legal and factual bases for challenging any audit notice or proposed assessment.

If the Department ultimately proceeds with this new policy, it should first issue detailed and specific guidance explaining its policy and how it will be implemented. In particular, the guidance should set forth the methodology the

Department intends to use to allocate deductions between partnerships, and the legal basis that the Department believes supports that methodology. This would ensure fair and consistent treatment across the board for all investment partnerships tat are affected by the new change in policy.

The Department should only apply its new policy on a going-forward basis. It would be poor administrative policy for the Department to permit its auditors to audit investment partnerships on this issue retroactively to all open periods. For past periods tax return preparers had no way to anticipate the Department's new policy and could not have known how to file returns consistently with the Department's new policy. The assessment of interest and even penalties for back periods is unfair punishment for not anticipating a change in policy that could not reasonably have been anticipated. Even now it is not possible to determine how to file correctly under the Department's proposed policy as the Department has yet to fully explain how expense deduction attribution would work.

Endnotes

1 H.R. 4016, Carried Interest Fairness Act of 2012.

2 There are a few administrative decisions and determinations that interpret the statute and the regulation. *See, e.g., Arthur I. Maier Associates*, Docket No. 93-2 (NYC Tax App. Trib., September 2, 1994); *First Capital Strategists*, Docket No. 93-8 (ALJ Determination, April 9, 1999); *Ashalatha Metal*, Docket No. 96-49 (ALJ Determination November 12, 1999).

For more information about the Department's contemplated change in policy, or any other matter raised in this Legal Update, please contact any of the following State & Local Tax Professionals.

Alvan L. Bobrow (Leader)
+1 212 506 2313
abobrow@mayerbrown.com

Jason S. Bazar
+ 1 212 506 2323
jbazar@mayerbrown.com

Christine Cagnina
+1 704 444 3631
ccagnina@mayerbrown.com

James E. Clegg
+1 212 506 2529
jclegg@mayerbrown.com

Paul A. DiSangro
+1 650 331 2045
pdisangro@mayerbrown.com

C. Wells Hall
+ 1 704 444 3553
whall@mayerbrown.com

Jeffrey S. Reed
+1 212 506 2104
jreed@mayerbrown.com

Arthur J. Roth
+ 1 212 506 2844
aroth@mayerbrown.com