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New York Fires Warning Shot at Hedge Funds Issuing Carried Interests

As the current economic downturn continues without signs of abating, many states are looking intently for new sources of revenue to meet their operating needs, and “carried interests” appear to be one of those sources moving onto the state tax chopping blocks. The New York governor recently announced a proposal to tax nonresident partners on profits associated with carried interests issued by New York partnerships and funds. Although only a New York proposal, so far, more states likely will follow suit with changes to their own tax laws if the New York legislature ultimately approves the proposal.

Overview of Carried Interests

A carried interest (or “promote”) is a tool used by hedge funds and private equity funds to compensate their asset managers in a tax-friendly manner with a percentage of profits associated with a fund’s underlying assets. In a common arrangement, a carried interest is issued to the general partner and a management fee is paid to an affiliate of the general partner. Under the current federal tax laws, income from the carried interest is treated as income from the sale of the fund’s underlying assets, thereby, potentially generating capital gain rather than ordinary income, while income from a management fee is treated as ordinary income.

Last week, President Obama revealed his 2010 budget proposal, which would tax carried interests as ordinary income. However, there has been resistance in Congress with respect to this issue. It is uncertain when any such measure would receive sufficient support to be passed by Congress and be signed into law.

New York’s Current Law

Currently, New York resident partners of a partnership are taxed on all of their investment income. On the other hand, nonresident partners generally are not subject to tax in New York if their only connection with New York is the receipt of investment income derived from New York entities, including income from carried interests. Traditionally, carried interests have not been taxed by New York (or other states) because, constitutionally, states may tax nonresidents only on income derived from or connected with sources in that state. It is for that reason that the New York governor has proposed reclassifying the carried interest as New York-sourced management service income, as further discussed below.

New York’s Proposal

Under the proposal, a carried interest would be treated as management service income that is earned in New York and subject to New York taxes. New York’s tax laws would be amended to treat as New York-sourced income any income received from providing a “substantial quantity” of “investment management services” to a partnership or other entity doing business in New York. This proposal would result in an additional \$60 million of annual revenue for the state of New York and would put resident and nonresident fund managers on equal footing.

Under the proposal, the following services will be taxable if performed in substantial quantity: (i) advising the partnership about the value of “specified assets”; (ii) advising the partnership about investing in, purchasing, or selling “specified assets”; (iii) managing, acquiring, or disposing of “specified assets”; (iv) arranging financing with respect to the acquisition of “specified assets”; and (v) any supporting activities related to these services. The term

“specified assets” includes securities, real estate, commodities, options, interest in publicly traded partnerships or trusts, debt, and various derivative contracts.

There remain many unresolved issues under New York’s proposal. Although, given the current economic climate, many other states too may soon wield their tax scalpels in an attempt to keep a greater share of the income associated with carried interests issued to fund managers.

For more information about New York’s proposal or recent federal proposals, please contact one of the attorneys listed below.

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