

Alert 10-158



New York Budget Bill Impact on Nonresident Individual and Corporate Partners Providing Investment Management Services

New York, like many other states, is facing a budget crisis of epic proportions. New York Governor David Patterson's budget bill has sparked much debate, especially with respect to the revenue proposals intended to fill a portion of the budget gap. After much deliberation and three revisions, the New York State Assembly passed a budget bill based on Governor Patterson's proposal (Assembly Bill A9710D) and delivered the budget bill to the Senate July 1, 2010. In hopes of making a dent in the \$9.2 billion budget deficit, lawmakers made a particularly aggressive play to tax income of certain investment managers who are not New York residents. Much of this income would not normally be treated as New York-source income under current law, and would be taxable, if at all, only in the investment manager's state of residence.

Currently, the investment manager for many hedge or private equity funds participates in the fund through a carried interest. Rather than receiving an explicit management/service fee, the carried interest allows the nonresident member to receive a distributive share of income, gain, loss and deduction from the fund. At the federal level, this distributive share is generally classified as capital gain under current law. For New York income tax purposes, an investment manager's distributive share of fund income, gain, loss and deduction derived from the manager's carried interest is also generally classified as capital gain (passed through from the fund). For a non-New York resident, this gain would not normally be characterized as New York source income. Instead, such gain would typically be sourced to the manager's state of residence.

The budget bill passed by the Assembly would amend the rules for determining the character and source of the carried interest income earned by investment managers. Under this amendment, a partner that performs "investment management services" for a partnership in which it is a member would be required to treat a portion of its distributive share of partnership income and gain as if it were a fee for services. Investment management services are defined under the proposal as (i) advising the partnership as to the advisability of purchasing, investing in or selling assets, (ii) managing, acquiring, or disposing of assets, (iii) arranging financing with respect to asset acquisitions, and (iv) any supporting activity related to these services.

Under the budget bill passed by the Assembly, if a pass-through entity acts as an investment manager for a hedge or private equity fund, and the entity provides investment management services to the fund at least, in part, through the use of employees or property located in New York, then the investment manager entity will be required to treat a portion of its income from its carried interest in the fund as income from carrying on a trade or business in New York. As a consequence, a nonresident member of the investment manager entity would be required to treat a portion of his or her distributive share of income derived from the investment manager entity as New York source income, and that portion treated as New York source income would need to be reported on a New York income tax return filed by the nonresident member.

There is a real risk that the proposal in the budget bill will expose nonresident members of investment management entities to double state taxation. Normally the state in which the member of the investment manager entity is a resident would allow the member to claim a credit for New York income tax paid on the member's New York source income. However, it is far from clear that the state of residence would follow New York's characterization of any portion of the member's distributive share of income from the investment manager entity as New York source income. Thus, if a member of an investment manager entity is a Connecticut resident, and the investment manager entity has used employees or property in New York to provide investment management services, then the member may be required to remit income tax in both New York and Connecticut on his or her distributive share of income from the investment

manager.

Corporate entities providing investment management services to hedge and private equity funds will also be impacted by the budget bill passed by the Assembly. To the extent such entities derive a distributive share of income, gain, loss and deduction from the fund, they will be required to treat a portion of the distributive share in excess of the amount that would have been received had no investment management services been provided as business receipts from the performance of services, and sourced accordingly.

These amendments are expected to raise approximately \$50 million in New York tax revenue annually. If enacted, the budget bill would be effective for tax years beginning on or after January 1, 2010.

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For more information on New York's budget bill, please contact any of the authors of this Alert, or the Reed Smith attorney with whom you regularly work. For additional information on Reed Smith's State Tax Practice, visit www.reedsmith.com/NYtax.

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