

NEW YORK CITY RETREATS FROM UBT HEDGE FUND POSITION

State & Local Tax Alert
September 13, 2012

Fresh off the news that the New York Attorney General is investigating private equity firms for the propriety of so-called management fee waivers, the financial industry received a rare dose of good news this week from the New York City Department of Finance. According to reports, the City has apparently tabled its plans—which had been widely reported earlier this year—to aggressively pursue hedge funds using a new expense-attribution strategy. Typically, hedge funds are structured with a management company (usually some type of partnership) that receives management fees based on the value of the fund's assets for managing the fund's investments and operations. Those management fees, to the extent they are not offset by deductible expenses, are subject to the New York City unincorporated business tax (UBT). A separate partnership, where the general partner(s) receives carried interest or incentive allocation fees based on the fund's performance, would not be subject to the UBT since it represents trading for its own account. The city's proposed audit initiative would have shifted some of the management company's deductible expenses to the partnership receiving the carried interest/incentive allocation fees, thus disallowing those expenses for the management company. The city's theory, arguably, was that the management company is responsible for some of the carried interest income earned by the separate partnership, so shifting management company expenses to the separate partnership would better reflect this relationship between the two entities. This, of course, would result in more income in the management company.

This week, however, the city apparently decided to back away from this audit strategy. The Department of Finance's press secretary, Owen Stone, indicated in an interview with *Tax Analysts* that "[e]xpense attribution remains an ongoing area we review, but we are not pursuing an audit program specific to the hedge fund industry at this time."

While the pending change in audit focus—and its implications for hedge fund management company income taxable under the UBT—has subsided, questions remain about the future audit strategies applicable to hedge funds and the federal tax treatment of carried interest. We expect these issues to stay in the forefront for now.

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