

Client Advisory | September 2012

The New York Attorney General and Management Fee Waivers

On September 1, 2012, the *New York Times* published an article reporting that the New York attorney general, Eric Schneiderman, is investigating whether several private equity funds located in the state of New York have improperly converted management fee income into lower rate capital gains.

Many investment funds have some form of management fee waiver mechanism in their fund agreements and these types of arrangements have been in use for many years. In a typical management fee waiver arrangement, a portion of the general partner's future right to management fees is reduced in an exchange for an interest in the investment fund's future profits. If such interest is treated as a profits interest for federal income tax purposes, the receipt of such interest should not be subject to federal income tax. Instead, income tax would be owed when the profits associated with the interest are recognized and allocated to the general partner. The tax would be paid by the partners of the general partner. Such profits could be ordinary income or capital gains; however, most profits generated by an investment fund are capital gains.

The scope of the attorney general's investigation is unclear and is limited to New York state law. While ordinary income is taxed at a higher rate than capital gains for federal income tax purposes, New York taxes them both at the same rate. The attorney general's focus may be to have the capital gains

received by the general partner in satisfaction of its profits interest in the investment fund's profits reclassified as fee income so that New York can tax that income as New York source income for any partners of the general partner entity who are not New York residents. New York state tax law generally provides that capital gains of a partner of a partnership that is not a New York resident and is not engaged in a business in New York is not New York source income. In general, a typical investment fund that is investing for its own account (and its general partner) would not be treated as being engaged in a business in New York. Another potential effect of New York reclassifying income as New York source is that it may increase the tax that an individual partner of the general partner entity that is not a New York resident will pay in his or her home state if that home state does not also treat the income as New York source income. In such a case, a non-New York resident may pay tax on the income in both states unless a tax credit or other means of reducing the tax is available in the partner's home state. This sourcing reclassification should not affect any partner of the general partner entity who is

a New York resident, as the gains would already be subject to New York tax. The attorney general may also be trying to change the time when the income is recognized, by asserting that New York tax is owed on the receipt of the profits interest, rather than when the profits are actually recognized by the general partner.

While the scope of the investigation is limited to New York state law, other jurisdictions may follow and the scope of any such investigations will depend on the particular laws of such jurisdiction. For example, New York City has its own income tax laws and the reclassification of gains received by the general partner as fee income could subject that income, and any other income of the general partner, to the city's unincorporated business tax. Also, the state of California could make arguments similar to those being made in New York, such that a partnership with an office in California would have some of its capital gains sourced to California for any individual partners of the general partner entity who are not California residents. California tax law generally provides that capital gains of a non-California

resident partner in a partnership that is treated as an “investment partnership” is not treated as California source income. The receipt of fee income may cause a partnership with an office in California to cease to qualify as an investment partnership.

We will continue to monitor the investigation and provide any significant updates. If you wish to talk further about the New York attorney general’s investigation specifically, or management fee waiver arrangements in general, please contact one of the Edwards Wildman Tax partners listed below.

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