The Questionable Legality of New York City's Proposed UBT Audit Position

by Cara Griffith

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The New York City Department of Finance let slip some news about a potential new audit position it may be asserting against private investment funds, though the city is providing little details or guidance about the possible position change. The impending change was first reported by several accounting firms late in 2011, and rumors have now spread.[1] Cameron Keng, a CPA, said that the department "issued an informal private memo and told everyone in the City that carried interest is now open for discussion." However, the new audit position being considered by the department is not focused on treating carried interest as taxable income for purposes of the unincorporated business tax (UBT). Perhaps in an effort to avoid having to enact legislation that would subject carried interest to UBT, but to still glean some additional revenue from private investment funds, the department is preparing to assert a position that would shift expenses from the investment management entity in a private investment fund to the entity that receives carried interest. That shifting of expenses would increase the investment management entity's UBT liability because the entity would have fewer expenses to deduct. And because the carried interest entity is generally not subject to UBT, it does not benefit from having the expenses to deduct.

This article first examines the UBT, the structure of most hedge funds, and how the UBT applies to the typical hedge fund structure. The article then outlines the new position being considered by the department and looks at whether the department has the legal authority to assert that position.

New York City UBT

The New York City UBT is a 4 percent tax assessed on every individual or unincorporated entity carrying on a trade, business, or profession in the city.[2] Unincorporated business is defined to include trades, professions, and some occupations of an individual, partnership, limited liability company, fiduciary association, estate, or trust unless otherwise exempt.[3] The tax is imposed regardless of whether the business is active or is being liquidated, or whether the business is wholly or partially conducted in the city. UBT is imposed on net income (as determined by federal income tax principles) from business that is sourced to New York City. Some modifications are made to federal taxable income to arrive at the net income that is subject to UBT. For purposes of determining deductions under the UBT, the New York City administrative code permits deductions that are deducted for federal income tax purposes, with some modifications, and are "directly connected with or incurred in the conduct of the business."[4]

For private investment funds structured as a partnership, UBT will not apply if the partnership's activity is limited to holding a carried interest in a partnership that qualifies for the "trading for one's own account" exemption. The reason for this is that persons (other than dealers) are not treated as conducting business in the city merely because they are engaged in the purchase, holding, and sale of property for their own personal account. Under this exemption, a private investment fund that is structured as an unincorporated entity will not be subject to UBT if it is primarily engaged in self-trading and it primarily receives income from investments or trading in the form of incentive allocations. If a

[1]Note that although hedge fund managers seem to be the focus of the department's attention, the position is not limited to hedge funds. It seems likely that if the department adopts this as a standard position when examining investment funds, it will use a similar analysis with other private investment funds, including private equity and real estate investment funds.

[2]New York City Admin. Code section 11-503(a).
[3]New York City Admin. Code section 11-502(a).
[4]New York City Admin. Code section 11-507.

taxpayer does not fully qualify for this exemption, it may still qualify for a partial exemption provided it is primarily engaged in trading for its own account.[5] If that is the case, the taxpayer will be permitted to exclude income from trading for its own account, subject to a disallowance for expenses regarding the excluded income.

Structure of Private Investment Funds

In general, most hedge funds are structured as partnerships, in which the general partner receives a management fee (often 2 percent of total assets under management), as well as an incentive allocation, or carried interest, equal to a set percentage of realized capital gains (often 20 percent). However, to avoid the imposition of UBT on the carried interest payment, many hedge funds actually consist of two separate legal entities: an investment management entity (investment manager) and a general partner affiliate (general partner). That bifurcated structure not only helps to clearly establish functions for each entity, but it also distinguishes the source of income for each entity. The investment manager, which may be structured as either an unincorporated entity (often an LLC) or as a corporation, performs services for the hedge fund in exchange for a management fee. The general purpose of the investment manager is to receive and hold assets for the fund. The investment manager also generally incurs most of the expenses associated with management of the business, including salaries for employees, office rental, and other general business expenses. The management fee income is subject to UBT (or to general corporation tax (GCT) if the investment manager is a corporation); however, the expenses incurred by the investment manager are generally deductible, which reduces the amount of income subject to UBT.

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In addition to the investment manager, a hedge fund using a bifurcated structure will have a separate general partner affiliate. The general partner is principally in charge of the management of the fund (that is, trading and investment of the assets in the fund), in return for which it receives an incentive allocation or carried interest payment. Because the investment manager incurs most of the expenses associated with management of the fund, including salaries, the general partner usually does not have any employees and has limited expenses. Also, because the general partner performs few administrative functions and primarily engages in self-trading, the general partner is typically eligible for at least the partial exemption from UBT.

New Audit Position

Though no formal guidance has yet been provided, the department has indicated it is considering changing its position on the treatment of expenses incurred by the investment manager of a hedge fund or other similarly structured private investment fund. New York City officials have informally told many firms and practitioners that the department will require an attribution of expenses for partnerships that are generating carried interest. Owen A. Stone, press secretary for the New York City Department of Finance, said in an e-mail to Tax Analysts:

> One of the areas of responsibility of the Finance Department's audit division is the issue of expense attribution among related parties. Whether the expense attribution is appropriate or not requires an analysis of the specific facts in a case. We are currently reviewing expense attribution for the investment partnership industry, as we have done for other industry sectors.

Auditors for two large consulting firms were among the first to notice the change in practice. In an alert to clients, PricewaterhouseCoopers LLP said that it "was informed that a position has been developed by the Department to offset exemptions claimed for the carried interest income by denying expenses of the management company (specifically compensation) or moving such expenses to the general partner." If the department were successful in asserting that position, the result would be that the investment manager would have more net income (because it would have less net loss to deduct) subject to UBT. That would translate into higher UBT liability on the management fee income.

Legal Authority

Whether the department is legally permitted to reallocate expenses between the investment manager and the general partner is up for debate. Several practitioners have questioned whether the department has the legal authority to assert the new position. According to a November 2011 alert issued by Deloitte LLP, "in contrast to the City's General Corporation Tax, the UBT does not provide the Department with broad authority to re-characterize items of income and deductions to, when necessary,

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[5]New York City Admin. Code sections 11-506(c)(9) and 11-507(c)17.

properly determine the tax base."[6] The alert is referring to New York City Administrative Code section 11-605.5, which permits the commissioner of revenue to "adjust items of income, deductions and capital" to properly reflect a corporation's "activity, business, income or capital" in the city or to make adjustments to the income of a taxpayer to correct the effects of non-arm's-length transactions between the taxpayer and related parties. That authority is granted for purposes of the city's GCT; it is not set forth in the city's administrative code for purposes of the UBT.

> ***Authority to make adjustments is granted for purposes of the city's GCT; it is not set forth in the city's administrative code for purposes of the UBT.***

The department has suggested, however, that even though it does not specifically have the authority to recharacterize items of income or deductions for purposes of the UBT, it is nonetheless permitted to make some adjustments to items of income, deduction, or capital when necessary to properly and accurately reflect income of a taxpayer in the city pursuant to IRC section 482. That argument is not entirely correct. Generally, section 482 permits the U.S. Treasury Secretary to reallocate income and losses between related entities in order to more clearly reflect the entities' incomes for federal income tax purposes. Although a reallocation of expenses from the investment manager to the general partner may be based on a section 482-type theory that the reallocation is appropriate to prevent the evasion of taxes or to more clearly reflect the income of related entities, section 482 does not grant any authority to the city. For the city to rely on section 482 to disallow or recharacterize management company expenses for purposes of the UBT, it would have to specifically reference section 482 in the sections of its administrative tax code that deal with the UBT or otherwise incorporate language from section 482 into its code.

The department would likely argue, based on a section 482 theory, that there is no economic substance if a business uses a bifurcated system to allocate all the expenses of two entities (which in essence create one fund) to one entity for the purpose of avoiding UBT. The economic substance of the structure is even more questionable if the investment manager and the general partner are owned by the same entity. Looking at the economic reality of the structure, it only makes sense that some of the expenses are attributable to activities engaged in by the general partner and benefit the fund as a whole. Also, even if the general partner could prove that all the expenses claimed by the investment manager were properly incurred by the investment manager, some of the investment manager's expenses were undoubtedly necessary for the general partner to produce investment or trading income.

Another somewhat conceptually related argument the department could assert is that some expenses claimed by the management company as expenses incurred in managing the fund were actually incurred by the general partner and therefore relate to the activities of the partnership that is receiving the carried interest. According to the PwC alert, on recent audits of investment managers, the department has cited section 11-507(c)(17) as providing legal authority to disallow some expenses incurred by a fund manager in connection with management of the fund. The department's argument is that if expenses are incurred by the recipient of the carried interest, those expenses are attributable to exempt income and, under section 11-507(c)(17), may be disallowed.

Although that attribution of expenses seems reasonable on first glance, the department's use of section 11-507(c)(17) may not provide it with sufficient authority to make that adjustment. Section 11-507(c)(17) provides that:

> Notwithstanding any other provision of this chapter to the contrary, no deduction shall be allowed for any expenses directly or indirectly attributable to activities described in paragraph two of subdivision (c) of section 11-502 [the self-trading exclusion] of this chapter if, and to the extent that, such activities are not deemed an unincorporated business carried on by the taxpayer pursuant to the provisions of subdivision (c) of section 11-502 of this chapter.

The major flaw for the department's use of this provision as the legal basis to disallow expenses claimed by the management company is that the management company does not claim a self-trading exclusion and is not involved in trading activities. Therefore, the expense deduction claimed by the investment manager technically has nothing to do with the self-trading exclusion, because the investment manager does not trade on behalf of its own account.

However, the department could counter that section 11-507(c)(17) is not focused on the taxpayer that is claiming the self-trading exclusion, but rather on the activities themselves. The section provides that

[6]"New York City Unincorporated Business Tax: Informal Department of Finance Advice Suggests Position Change Regarding Investment Management Partnerships," Deloitte, Nov. 30, 2011, *available at* http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/Tax/us_tax_multistate_NY%20Cit y_Alert_12012011.pdf.

a deduction will be disallowed for expenses directly or indirectly attributable to self-trading activities. On audit, the department could allege that some expenses claimed by the investment manager are not expenses regarding the investment management business, but rather are attributable to the self-trading activities of the general partner. That argument would be stronger if those expenses are properly attributable to the general partner (that is, the expenses directly relate to the act of trading) and not to the investment manager. For example, although the lease of property might benefit the general partner insofar as it provides space to work, the general partner could argue that the space is not vital to its work and therefore is more beneficial to the management of the business than to the conduct of trading activities.

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Assuming that the department has the legal authority to require a reallocation of expenses, there is also some question about how the department would compute an expense attribution for purposes of the UBT. The department has stated that "the purpose of expense attribution is to avoid a double tax benefit resulting from giving favorable tax treatment to income from investment and subsidiary capital while simultaneously allowing a deduction against business income for expenses related to investment or subsidiary capital."[7] In a statement of audit procedures issued for purposes of the GCT, the department said that:

> if the GCT return reports investment or subsidiary capital or income, or a UBT return reports investment income and, in either case, it appears that the taxpayer's direct and indirect attribution of non-interest expenses to the respective forms of capital is reasonable, no further examination should be made of the attribution of non-interest expenses as part of a desk audit.

Although this document refers to the UBT, it was issued for purposes of the GCT, and there is no guarantee that the department would use that guidance for UBT purposes.

[7]New York City Department of Finance, Statement of Audit Procedure GCT 2008-04.

Although it would be helpful for taxpayers if the department established a position on the issue and put out guidance directly regarding expense allocation for purposes of the UBT, taxpayers can until then look to that GCT guidance for some indication of what the department will permit. Regarding management fees, Statement of Audit Procedure GCT 2008-04 provides that:

> Compensation received through a management or similar fee arrangement between the taxpayer and a corporation or other entity, whether or not affiliated with the taxpayer, must be treated as business income, and deductions for non-interest expenses compensated for by such management or similar fee must be directly attributed to business income and capital. Non-interest expenses can be treated as compensated for through a management or similar fee provided the fee is paid pursuant to a written agreement. Absent a written agreement, the nature of the transaction as one involving compensation through a management or similar fee must be proven by the taxpayer, for example, by submission of contemporaneous corporate minutes or memoranda.

The Future

There is still a good bit of uncertainty surrounding this new audit position. Despite taxpayers' wish for certainty regarding the positions the department will take on audit — and a good argument can be made that taxpayers actually *need* it — the department is not required to make a public pronouncement of an audit position. That means that it can take its time and test out a new position for as long as it wants before providing any formal guidance on the matter. To date, the department has only partially acknowledged the new UBT position change. Although the department informally notified some practitioners, it was auditors who noticed the change during specific taxpayer audits and began spreading the word via client alerts and by word of mouth. Despite repeated requests from reporters at Tax Analysts, the department declined to provide clarity on the new audit position or how it would be applied.

Still, if knowing is half the battle, taxpayers should be thankful that they are getting a little heads-up about this new position because there may be ways to modify management structures to minimize the likelihood that the department will be making expense reallocations on audit. The best advice tax practitioners can give their investment fund clients at the moment is to immediately begin thoroughly documenting and categorizing all management expenses. Because so little is known about the exact position the department will take, being prepared for an audit may be the best form of defense. And an additional word of caution: The department is reportedly considering applying the new audit position retroactively. Several accounting firms have speculated that the position could be applied retroactively, perhaps even as broadly as to any open tax year.

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Second, the general partner could separate itself from the investment manager by disposing of all or a substantial portion of its equity interests in the investment manager. Ideally, the general partner would dispose of its interests to persons who work at the firm but who do not own or control the entity that receives the carried interest (in essence, to the fund's employees, not principals). Using a divestiture strategy could be helpful if the department attempts to rely on a section 482-type theory to justify the disallowance of expenses. As noted above, under that theory, the department would have more success if the reallocation of expenses is between related or commonly controlled entities, because in that instance, it appears more likely that there are related expenses being shared between the two entities.

Finally, several practitioners have suggested that the easiest, though perhaps most extreme, solution is for the investment manager to move its operations out of the city. If multiple investment managers took that route, it could affect the department's position. If the city believes that numerous investment managers would leave and that would result in a loss of tax revenue from those entities, the department might rethink its new audit position. Voting with their feet could work in that instance.

It is no secret that the tax landscape in New York City was designed to further its position as a prime location for the headquarters of financial companies. It is also widely known that the city relies heavily on tax revenue from the financial sector. However, the city is in need of additional revenue. The significant decline in tax revenue generated by the financial sector since the onset of the financial crisis has been particularly difficult for the city. And although the city would likely prefer to tax carried interest rather than having to adjust its audit strategies for private investment funds and take on the difficult task of determining exactly what expenses were more attributable to the general partner's investment activities than the investment manager's management activities, passing that legislation may be almost impossible. In this case, as Keng said, "hedge funds and private equity funds are easy targets to drive additional revenues without drawing the ire of the voting population."

Conclusion

The New York City Department of Finance is facing a conundrum. It wants to subject carried interest to tax in one form or another. But doing so requires a legislative change, and making that sort of change has proven difficult (at the local, state, and federal levels). The proposed new UBT audit position may be the department's solution to gleaning some additional revenue from private investment funds without needing a legislative change. Nonetheless, although the department can make changes to its audit positions without any public fanfare, taxpayers should closely examine what the department asserts as its legal basis for the change. Taxpayers should also challenge the department if it appears to have overstepped its bounds. Taxpayers can and should force the department to go through the appropriate legislative channels to make any significant changes to its enforcement of the city's administrative tax code. (For a related news story, see *State Tax Notes*, Feb. 20, 2012, p. 591, *Doc 2012-2895*, or *2012 STT 3049*.) ✰