Hedge Funds and Deferred Management Fees: State Taxes

by Timothy P. Noonan and Alan S. Kufeld

Timothy P. Noonan *Alan S. Kufeld*

As is often the case in state tax practice, changes in federal law have had a major impact on tax planning and compliance. A few years ago, Congress eliminated a common mechanism used by hedge fund managers that enabled them to defer the receipt of incentive or management fees earned. Under IRC section 409A, which was effective for fees earned for services rendered on or after January 1, 2009, hedge fund managers would be limited in their ability to defer those fees.

The deferral mechanism created a potential for multiple state taxation, particularly in circumstances in which taxpayers are living or working in different states from the time of the deferral. This article will examine the state and local tax questions associated with those deferred fees.

Background: Basic Hedge Fund Structure

Various structures are used when setting up a hedge fund. Most of those structures consist of a domestic and foreign or offshore fund. The most common structures are master feeder, mini-master feeder, and side-by-side. The deferral issue we're discussing arises with the offshore fund. This offshore fund is normally set up as a corporation in a foreign country. Generally, foreign, tax-exempt, and other types of investors invest in that offshore corporation. The offshore fund enters into an investment management contract with the management company. The management company is typically owned by the hedge fund managers. Under that investment management contract, the management company is hired to manage the assets of the fund in exchange for an incentive fee and a management fee. Generally, the incentive fee is based on 20 percent of the positive performance of the fund and the management fee is 2 percent of the assets under management.

Before IRC section 409A, the management company was able to defer the receipt of the incentive or management fees (per the deferral agreements) that were charged to the offshore fund. Those fees were able to grow with tax deferred for up to 10 years. Because the management company would elect to be a cash basis taxpayer, the management company and therefore its owners did not have to recognize that taxable income until the cash was received by the management company.

Changes reflected in IRC section 409A revised those deferral rules. Under the new rules, the ability to defer fees earned after January 1, 2009, would be limited. Any fees earned and deferred before January 1, 2009, would have to be recognized for tax purposes by 2017.

Typical Scenarios

So what happens for state tax purposes in 2017 when that income is picked up? Who gets to tax it? Let's examine those questions under a couple of different scenarios:

- **Scenario One:** A hedge fund manager lives and works for the fund in New York City. In 2008 the manager defers $20 million of fees. In 2013 the manager sells his New York City apartment and moves himself and his family to Florida, places his kids in Florida schools, closes the New York office of the fund, and opens an office in Florida. Fees are deferred and reported in 2017.
- **Scenario Two:** A hedge fund manager lives and works in New York City. In 2008 he defers $20 million of fees. In 2013 he purchases a home in Greenwich, Conn., but keeps his New

York apartment and effectively splits his time in both locations. An office is opened in Connecticut but the manager keeps the office in New York and splits his time between both locations. Fees are deferred and received in 2017.

- **Scenario Three:** A hedge fund manager lives and works for the fund in Connecticut. In 2008 he defers $20 million worth of fees. In 2013 he sells his home in Connecticut, purchases a home in New Jersey, places his kids in New Jersey schools, closes the Connecticut office, and opens an office in New York City. Fees are deferred until 2017.

Examining the State Tax Issues

So in 2017 each of those three taxpayers is going to receive his $20 million in deferred fees and, of course, pay full federal taxes as required. But what about the state taxes? Do we look to where they earned the fees? Do we look to where they lived when they earned it? Do we look to where they live now?

In trying to answer those questions, each of those three taxpayers will have to understand three (and possibly four) separate state and local tax issues.

Residency

This is one of the most basic concepts in all of state taxes, and one that's often covered in this column. Residents of a state are taxed on all of their income, regardless of its source. In general, most states use two tests to determine residency. One of the tests is based on domicile, or where the taxpayer's permanent and primary home is located. The secondary test is generally called statutory residency, because many state statutes include in the definition of resident a taxpayer who spends more than 183 days in the state and maintains living quarters or a "permanent place of abode" in the state.[1] So the first step in any analysis is to figure out where the taxpayer is going to be a resident in 2017.

Nonresident Allocation

Nonresidents, though, aren't completely off the hook. In any state that imposes an income tax, nonresidents of that state are subject to tax on income that is earned in the state, often referred to as source income. In the case of hedge fund managers deferring management fees, generally the fees are not paid out on a Form W-2 or 1099, but are paid to a management company (usually a limited liability company) and flow through to the fund manager via Schedule K-1. So an understanding of how the sourcing rules work for LLCs or partnerships in each state has to be examined as well.

The Accrual Rule

States don't like it when people leave, so some have special rules designed to tax soon-to-be nonresidents on the way out. Those rules are often referred to as "accrual rules," since they put taxpayers leaving the state (or entering the state) on an accrual basis for the purposes of determining income in the year of move-in or move-out. Accrual basis taxpayers have to attribute items of income, gain, loss, or deduction to their former state of residence if two requirements are met: (i) they had the right to receive the income before the move; and (ii) the amount of the income could be determined with reasonable accuracy.[2] Connecticut has an accrual rule that mirrors New York's,[3] but New Jersey does not appear to have such a rule. In each of the scenarios outlined above, the taxpayer is moving from one state to another before the receipt of the deferred management fees. Thus, the implications of the accrual rule must be considered as well.

Entity-Level Taxes

Here, the most likely entity-level tax that could apply is New York City's unincorporated business tax (UBT). Under New York City law, partnerships, LLCs, and other unincorporated entities doing business in the city are subject to an entity-level tax calculated similar to income-based taxes on corporations, historically based on the three-factor formula of property, payroll, and receipts. But beginning in 2009, the city began a slow move toward single-factor apportionment based on the sales factor, calling for a fully phased-in single sales factor by 2018.[4] So the company will have to determine to what extent there is 2017 UBT liability when the fees are taken into income.

Analysis of Scenarios

Scenario One: 2013 Move to Florida

Residency

Under scenario one, the taxpayer moved his family from New York to Florida, sold his apartment, closed his office, and so on. Under the normal rules of domicile, it would appear that this taxpayer has done what is necessary to change his domicile from New York to Florida. And because he no longer maintains living quarters in New York, he is not subject to the alternative statutory residency test. So this taxpayer likely doesn't have to worry about a residency issue.

---

[1]*See* N.Y. Tax Law section 605(b)(1)(B), section 1305(a)(2); Conn. Gen. Stat. section 12-701(a)(1)(B); N.J. Stat. Ann. section 54:8A-3.

[2]*See* N.Y. Tax Law section 639(a).
[3]*See* Conn. Gen. Stat. section 12-717(c).
[4]*See* N.Y.C. Administrative Code section 11-508.

Allocation

Because of the deferral of the management fees payable to the management company to 2017, the individual owner of the management company is likely to see a large Schedule K-1 in 2017. Though this taxpayer is now a nonresident of New York, and though the management company is now located in Florida, the questions about how to allocate that K-1 income has to be examined. Under New York's apportionment rules, individual partners or members of LLCs are required to allocate Schedule K-1 income based on the entity's three-factor formula, comparing the property, payroll, and receipts of the LLC.[5] Thus, in 2017 the firm will have to determine an appropriate allocation percentage based on that three-factor formula. In 2017 the management company likely will have no property or payroll allocable to New York, and likely have no receipts that were earned in 2017. The only question would be whether the receipts regarding the deferred management fees must be treated as New York receipts because they were earned in New York in prior years.

Note, however, that there is no "allocation" to New York City for purposes of the city's personal income tax because it does not impose a tax on nonresidents. Thus, even though these deferred management fees were earned while the taxpayer was living and working completely in New York City, no New York City tax is imposed on this income provided he is a nonresident when it is received. Well . . . probably. Keep reading.

Accrual Rule

This could be the most hotly contested question when the ticking time bomb goes off in 2017. As noted above, the accrual rule transforms a cash basis taxpayer into an accrual basis taxpayer in the year that residency changes. Here, the taxpayer's residency changed in 2013. Thus, the question is going to be whether, in 2013, the expected income from the deferral of management fees had "accrued" to the taxpayer by that time. The accrual rule is based on federal tax concepts, and generally looks to whether the right to receive the income is fixed, and whether the amount of the income can be determined with reasonable accuracy. We will not endeavor, however, to answer the accrual question in this article, because the answers will vary as widely as the factual circumstances that will undoubtedly arise in each case.[6] The analysis will have to be made in 2013 under the two accrual factors: Was this taxpayer's right to receive the 2017 deferred fees fixed, and could we determine in 2013 what the amount of the income would be with reasonable accuracy? Answer those questions, and you'll have your answer on the accrual rule.

UBT

Clearly, in 2012 the fund was subject to the UBT. The question is going to be whether, in 2017, the fund — having moved to Florida — no longer has nexus in New York. If it doesn't, the fund shouldn't be subject to New York City tax. If nexus still existed for whatever reason, we'd have to determine the three-factor allocation as outlined above (though, by 2017, the apportionment factor would be largely based on receipts only).

Scenario Two: 2013 Move to Connecticut

Residency

Here is a situation in which the residency issue can be sticky. In 2013 this taxpayer purchased a home in Greenwich, Conn., but he kept his New York apartment, kept his New York office, and split time in both locations. Thus, this taxpayer is going to find himself in a fun residency audit, in which the auditors will be comparing various domicile factors in both New York and Connecticut to determine which is his permanent and primary home. Moreover, regardless of the domicile analysis, this taxpayer could have a statutory residency issue in either state if his day count exceeds 183 days in either location. Thus, under any scenario, it well may be that this taxpayer qualifies as a resident of both states (that is, he is domiciled in Connecticut but is a statutory resident of New York). This is, quite frankly, a doomsday scenario in 2017, because this taxpayer could find himself subject to double tax in both states. And because of difficult and contradictory resident credit rules in each state — previously covered in this space last year[7] — it is unlikely that this double tax will be alleviated by resident credits.

Allocation

If we assume that the taxpayer is able to establish nonresidency in New York, this wouldn't eliminate the New York tax, of course. The analysis here is largely the same as in scenario one, except that the management company would continue to have New York property and payroll and therefore likely have a higher allocation percentage in 2017. Here again, double tax is possible to the extent that Connecticut's apportionment rules differ from New York's.

---

[5]*See* Tax Law section 658(c); 20 NYCRR 132.15. Note that this is different from the single-factor apportionment provisions applicable for corporate franchise tax purposes under Article 9-A of the Tax Law. Perhaps that oddity in New York law will be corrected by 2017?

[6]For more details on the accrual rule, see Timothy P. Noonan and Joseph N. Endres, "Watch Out for New York's Accrual Rule," *State Tax Notes*, Aug. 4, 2008, p. 343, *Doc 2008-15529*, or *2008 STT 151-4*.

[7]*See* Timothy P. Noonan, "An Easier Fix to New York's Statutory Residency Problem?" *State Tax Notes*, May 9, 2011, p. 425, *Doc 2011-8930*, or *2011 STT 89-6*.

That said, this is generally a situation in which double tax can be alleviated since New York is theoretically getting tax only on New York-source income, and Connecticut will generally allow credit to its residents for taxes paid on source income in another state. However, a comparison of the Connecticut and New York apportionment rules will be necessary to determine the extent of the credit.

Accrual Rule

Again, the accrual concept becomes relevant only if the taxpayer is able to establish nonresidency in New York and residency in Connecticut. The analysis, however, is the same as in scenario one, with an added twist. Connecticut, like New York, has an accrual rule. So we'll also have to look to how the Connecticut accrual provisions — which mirror New York's — will apply.

UBT

Under this scenario, the fund retains an office in New York City, so it clearly would have nexus for UBT purposes. Again, the issue would simply be to determine the right three-factor apportionment percentage in 2017.

Scenario Three: 2013 Move From Connecticut To New Jersey

Residency

This taxpayer appears to have changed his domicile from Connecticut to New Jersey in 2013. Thus, he will be a full-year resident of New Jersey in 2017 and will be required to pay full New Jersey state tax on the deferred fees, subject to the potential for resident tax credits for taxes paid to Connecticut or New York. Unlike Connecticut and New York, New Jersey has a much more favorable regime for the allowance of resident tax credits, requiring simply that the income being subject to tax in New Jersey was also subject to tax in another state.[8] So assuming there was tax in Connecticut (or New York), New Jersey would likely allow a credit for such taxes paid.

Allocation

The issue here could get a little complicated. When the funds were earned, the company was based in Connecticut, so the fees were arguably earned there. However, in 2013 the company opened up an office in New York. Thus, in 2017 the taxpayer could have nonresident tax obligations in both New York and Connecticut. The company would use a three-factor-type apportionment calculation to determine income allocable to each state. It would have high New York payroll and property and some New York receipts, while it would have no Connecticut payroll and property but possibly significant Connecticut receipts. Whatever the case, the company would have to calculate separate apportionment percentages in both Connecticut and New York and the taxpayer would pay tax accordingly. Again, however, the resident credit rules in New Jersey would likely permit full credit in New Jersey for taxes paid to New York or Connecticut.

Accrual Rule

There is absolutely no accrual issue in New York, because the taxpayer was never a resident of New York in this scenario. New Jersey has no accrual rule, so it's a nonissue there too. But we still have to look to Connecticut's rules to determine whether they would expect full tax in the year of the move based on the provisions of the Connecticut accrual rule.

UBT

Neither Connecticut nor New Jersey has a UBT-type tax, so we're in the clear there. But since the fund opened up an office in New York City in 2013, it will have a UBT responsibility. As with the other scenarios, the fund would use the city's three-factor apportionment rules to determine how to allocate its 2017 income. To limit (and possibly eliminate) the city tax liability, the fund will have to argue that the receipts attributable to the deferred fees are not sourceable to New York City because they were earned out of the fund's Connecticut office, before the 2013 move.

Conclusion

We obviously have not endeavored to answer every question that will arise in 2017 when state and local tax departments will be looking for their respective chunks of tax on this deferred income. That is much too complicated, and heavily dependent on specific facts and circumstances for the individual taxpayer and fund. However, as is often the case, sometimes half the battle is simply identifying the type of questions that have to be considered, and this article should give practitioners a good feel for that. Moreover, even though this ticking time bomb isn't set to go off until 2017, practitioners have to be aware of it now, as clients are making decisions about where to live, move, or work, so that they can properly advise their clients on the potential state tax consequences that will hit them in 2017. So procrastinators beware. This is one 2017 issue that has to be addressed now. ✰

Noonan's Notes on Tax Practice is a column by Timothy P. Noonan, a partner in the Buffalo and New York offices of Hodgson Russ LLP. This month's column was coauthored with Alan S. Kufeld, a principal in the New York City office of Rothstein Kass.

[8]*See* N.J. Stat. section 54:8A-16.