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In this installment of Noonan's Notes, the authors argue that two recent hedge fund cases in New York and Connecticut leave open the question of how to resolve issues around intangible income, as well as how and when that income is used in a trade or business.

The taxation of hedge funds and — more directly — their owners and investors has been a hot topic in state tax circles during the last decade, especially in New York and Connecticut, where much of the industry has been based. That's changed a lot in the past few years, with scores of hedge funds leaving the Northeast and mostly going to Florida, taking their high-net-worth owners and employees with them.[1] But because Connecticut and New York still focus enforcement efforts against these well-compensated taxpayers, there hasn't been a letup in audit issues for hedge funds. And late last year, the New York Tax Appeals Tribunal issued a decision in a case involving the allocation of income between these two states that illustrates potential complexities in this area.

In *Greenberg*,[2] the tax appeals tribunal held that a taxpayer was not entitled to a resident credit for taxes paid to Connecticut on "carried interest" from a Connecticut-based hedge fund. While this outcome was not surprising — and we'll explain why later — the tribunal took an interesting path to get there, which raises other interesting questions and potential concerns about how this issue should be handled. And given that a Connecticut court addressed an almost identical issue in *Sobel*[3] and seemingly came out the opposite way, there's even more intrigue about how these two states should be taxing hedge funds — or at least the few remaining in their states.

Background: Hedge Funds and Resident Credits

A "hedge fund" is a term of art, generally referring to an entity that holds a pool of securities and other assets in which the interests are not

[1] *See, e.g.*, Shannon Thaler, "New York Loses $1 Trillion in Wall Street Business as Firms Flee the City: Report," *New York Post*, Aug. 21, 2023; Jack Rogers, "Financial Firm Migration Takes $1T Each Out of NY, CA," Globest.com, Aug. 23, 2023; Brendan Case, "Hedge Funds, Tech Spur Texas Wealth Boom as California Fades," *Bloomberg*, June 4, 2021; Ben Steverman and Katherine Burton, "Hedge Funds Are Ready to Get Out of New York and Move to Florida," *Bloomberg*, Apr. 19, 2021; and Jack Kelly, "Florida Is Fast Becoming the Second Home for Wall Street," *Forbes*, Jan. 6, 2021.

[2] *Matter of Greenberg*, DTA No. 829737 (N.Y. Tax. App. Trib. Nov. 22, 2023).

[3] *Matter of Sobel*, 2017 WL 1240119 (Conn. Super. Ct. 2017).

publicly traded.[4] The typical hedge fund structure involves an entity formed as a limited partnership acting as an investment manager and a separate entity functioning as the general partner (though sometimes these functions take place within the same entity). The investment manager pays a management fee to the fund's manager (the general partner), which is typically tied to the fund's net asset value as of a particular date. The fund's manager (the general partner) also receives a share of investment income from the fund, typically referred to as carried interest, which enjoys the preferential federal tax rates on applicable interest, dividends, and capital gain income.

The issue in *Greenberg* and *Sobel* was the same: whether capital gains and other intangible income flowing through to an investment manager via carried interest (that is, a profits interest in one or more entities owning the investment assets under management) constituted New York or Connecticut source income. And in both cases, the question arose in the context of resident tax credits — namely, whether the taxpayer was entitled to a credit from their home state for taxes paid to the other state on that income.

Both the New York and Connecticut frameworks are similar in this regard. Residents are subject to tax on their income from all sources, but they are entitled to credits for taxes paid to other states in many situations. In both states, to receive a resident credit for income taxes paid in a different state, the income at issue must be both derived from the other state and subject to tax in the resident state.[5] And under both statutory schemes, to determine whether income is derived from another state for purposes of the credit, both New York and Connecticut turn to their own income sourcing rules applicable to the taxation of nonresidents — who are only subject to tax on income derived from sources in the state, not on their worldwide income like residents.[6] For example, in determining whether a New York resident is entitled to a credit for taxes paid to Connecticut, New York would determine whether the income was properly derived from Connecticut sources — not by applying Connecticut's sourcing rules, but by applying New York's sourcing rules. The same is true for Connecticut.

Both states follow the same basic rule for intangible income: that income from intangible property (as opposed to income from personal services, carrying on a trade or business, or the disposition of real or tangible property) does not constitute in-state source income unless that property is used in a business, trade, or profession carried on in the state. Thus, Connecticut and New York follow the same limitation in their resident credit framework: They do not allow a credit on the tax imposed by another state on intangible income "except where such income is from property employed in a business, trade or profession carried on in the other jurisdiction."[7] Given the hedge fund industry's large footprint in Connecticut and New York, the prevalence of commuting between the two states, and the money involved with hedge fund compensation, this sourcing issue for intangibles has unsurprisingly become an issue in audits and litigation, and the treatment of carried interest under this framework is particularly relevant.

Greenberg: Carried Interest in Focus

The taxpayer in *Greenberg* was a New York City resident who worked as marketing director for an investment management group that managed over $13 billion in assets and operated in Connecticut (the Company). As part of her compensation package, she received (1) an interest in the incentive fee earned by the Company for its management of several underlying investment funds managed for investors and in which the Company was also a partner (the Funds), and (2) a membership interest in the Company itself (a limited liability

[4] *See* U.S. Securities and Exchange Commission, "Implications of the Growth of Hedge Funds," at 3 (Sept. 2003).

[5] N.Y. Tax Law section 620(a) provides that a resident shall be allowed a credit against the tax due as a New York resident "for any income tax imposed for the taxable year by another state . . . upon income *both derived therefrom and subject to tax under this article.*" (emphasis added). Conn. Gen. Stat. section 12-704 similarly provides a resident credit for taxes paid in another state on income "*derived from sources therein and which is also subject to tax under this article.*" (emphasis added).

[6] *Id.*

[7] 20 NYCRR section 120.4(d); Conn. Agencies Regs. section 12-704(a)-4(a)(3).

company), entitling her to a share of its profits derived from the Funds.

The taxpayer received a Schedule K-1 from the Company reporting her share of its ordinary income (that is, fees from managing the funds), as well as her share of the interest income, dividends, and capital gains flowing through to the Company from the Funds. And the K-1s she received for the two tax years from the Company at issue sourced the income — all the income — to Connecticut. So in addition to reporting the income as part of her taxable worldwide income on her New York resident returns, she also filed nonresident returns in Connecticut, reporting all income from the K-1s as taxable Connecticut-source income. And on her New York state returns, she claimed a credit for the full amount of tax paid to Connecticut.

So how does this issue arise on audit? As our regular readers know, the New York State Department of Taxation and Finance has a sophisticated and aggressive residency audit program, focused on taxpayers leaving (or trying to leave) the state. But residents aren't immune from scrutiny either. Indeed, for the last decade or so, the department has also focused enforcement efforts on state residents, with attention usually on one issue: the amount of resident credit claimed by the taxpayer for taxes paid to other states.[8] So, no one is safe. Allison Greenberg got caught up in one of these audits, and on audit the department allowed a credit for the tax paid to Connecticut only on the ordinary income portion of the Company's flow-through income, but not on the interest, dividends, and capital gains derived from her carried interest.

On appeal, the tribunal ruled that although the Company itself did business exclusively in Connecticut, the credit was properly denied on the carried interest income, since that income derived from intangible property (the Funds' investments) that was not "employed in" a trade or business carried on in Connecticut. The tribunal rejected the taxpayer's argument that her interest in the Company (which entitled her to the investment profits) was itself used in the conduct of her business and that it represented compensation for her personal services. It held that the intangible property actually generating the income (and thus the property needing to be used in a trade or business) was not the taxpayer's interest in the Company, but the securities held by the underlying investment Funds in which the Company had an interest. The tribunal held that Greenberg failed to show that the intangibles, the profits from which flowed to the Company, were used in a trade or business rather than being traded for the Company's own account.

Initial Takeaways

Is this really all that big a deal? The decision was issued in late November, and — at least in our SALT bubble — there seemed to be little fanfare about it. Perhaps it's because the result wasn't much of a surprise. In New York at least, the general understanding among practitioners and the department is that intangible income (capital gains and so forth) from a carried interest in a hedge fund or investment management entity generally does not constitute New York-source income — either for purposes of taxing nonresidents or providing a resident credit to residents. Indeed, we mostly see this issue for nonresidents — especially in recent years — because so many hedge funds have fully or partially left New York and moved to other states. Questions about whether the tax department can still tax this often-significant carried interest income do arise from time to time. But the question usually goes away as quickly as it arises, since again it's commonly understood that this type of income is hands-off when the taxpayer qualifies as a nonresident.

The other takeaway is that the result of this case could create an unfortunate — and possibly avoidable — double tax situation. Normally, if the amount of tax paid to the state of New York is changed on audit, Connecticut has a special provision that allows an extension of the normal three-year statute of limitations.[9] But that only arises in the resident credit situation. In other words, a Connecticut resident taxpayer whose New York tax liability is adjusted on audit is allowed additional time after the New York audit

[8] Timothy P. Noonan and Elizabeth K. Pascal, "Heads They Win, Tails You Lose: Resident Credit Problems," *State Tax Notes*, Apr. 2, 2012, p. 50.

[9] Conn. Gen. Stat. section 12-704(b)(1).

closes to claim an increased credit for taxes paid to Connecticut. But that same legislative grace does not extend to a Connecticut nonresident taxpayer who New York decides had improperly sourced income to Connecticut. The same dichotomy arises for New Jersey taxpayers. New Jersey residents get additional time to claim a resident tax credit for taxes paid to New York and other states,[10] but New Jersey nonresidents do not have that same right. Practitioners should look out for this in state tax audits in which other-state sourcing issues are involved — and always be on the lookout for expiring statutes of limitations in other states.

Of course, that raises the question: Why did the taxpayer in *Greenberg* report this income to Connecticut and pay Connecticut tax in the first place? If it was commonly understood that such income isn't taxable to a New York nonresident, then it should be equally understood that New York would not provide for a resident tax credit for taxes paid to Connecticut on this type of income. And because Connecticut's tax rate is lower than New York's, there really would have been no benefit to Greenberg to source the income to Connecticut. Her net state tax liability would've been the same had she just sourced the income to New York.

The answer is perhaps a practical one: The K-1 that the taxpayer received sourced all income to Connecticut, and the returns were filed consistent with that approach. And frankly, in most jurisdictions, where there is less focus on resident credit audits, this might be enough. A resident taxpayer who claims a credit for taxes paid to another state on income sourced to another state on a K-1 probably doesn't get questioned. It just so happens that the New York tax department often takes a closer look.

But judging by the arguments in the case, it's possible that the decision to source the carried interest income to Connecticut was deliberate and based on a Connecticut case tackling the same issue. That leads us to the *Sobel* case, where this otherwise ho-hum tax issue takes a surprising turn.

Sobel vs. *Greenberg*?

Sobel,[11] a 2017 decision by the Superior Court of Connecticut, involved essentially a mirror image of the controversy in *Greenberg*. In *Sobel*, a Connecticut resident who founded an investment management business structured much like that in *Greenberg*, but based in New York City, paid tax to both Connecticut (as a resident) and New York (as a nonresident) on the income he received from an interest in an entity that managed — and had a profits interest in — several investment funds trading in securities (the Management LLC). The sole compensation of the Management LLC was a percentage of the capital gain the investment funds earned from trading activities. As a member of the Management LLC, a share of those profits flowed through to the taxpayer. The taxpayer sought a credit from Connecticut for the taxes paid to New York on this income.

The superior court went through the same framework for determining the source of the income at issue, noting that the test for determining whether a Connecticut resident is entitled to a credit for taxes paid to another state "is whether the income is 'derived from sources therein and which is also subject to tax [in Connecticut].'" The court also emphasized Connecticut's regulations (mirroring New York's), which disallow a resident credit relating to intangible income "except where such income is employed in a business, trade or profession carried on in the other jurisdiction." Finally, the court stated that the regulations make it clear that trading for one's own account is not considered carrying on a trade or business for income-sourcing purposes. Thus, for the *Sobel* court, the dispositive issues in the case were (1) whether the taxpayer was trading for his own account and (2) whether the income at issue was from property "employed in a business, trade or profession" in New York.

On the "trading for one's own account" question, the court highlighted the fact that the taxpayer's investment management fund was actively managing the investment assets of the underlying investment partnerships (funds) on behalf of the unrelated limited partners in those

[10] N.J. Rev. Stat. section 54A:4-1(e).

[11] *Matter of Sobel*, 2017 WL 1240119.

partnerships (outside investors). The court concluded that the taxpayer "was in the full-time business of being an investment manager, not an investor," and that "he was splitting large profits — wholly disproportionate and unrelated to his own minimal investment — with clients from trading the client's securities. The plaintiff was not trading on his own account."

On the next question of whether income was derived from intangibles "employed in" a trade or business, the court turned to Connecticut's general definition of "a business, trade, profession or occupation" for a nonresident. The definition (similar to New York's for the same purpose) notes that a nonresident carries on a "business, trade, profession or occupation" in the state when the nonresident occupies a space where business affairs are "systematically and regularly carried on," and that the business's activities are carried on with a "fair measure of permanency and continuity." The court found that the taxpayer met both requirements regarding New York and therefore derived his intangible income from a trade or business carried on in New York. The court acknowledged federal income tax distinctions between persons trading securities who are investors (not carrying on a trade or business) and traders (who are deemed to be carrying on a business), noting that:

> Here, the plaintiff commuted every work day to an office where he worked long hours, met with clients and investors, engaged in millions of trades, and managed approximately $250 million of their money. The daily frequency and enormous volume of the plaintiff's trading activity clearly satisfy the day trading standards.

Based on this, the Connecticut court held that the taxpayer was entitled to the resident credit for the tax he paid to New York. So, to the outside world, this certainly could suggest that in the opposite situation, a New York taxpayer like Greenberg would be entitled to a credit for taxes paid to Connecticut on carried interest from a Connecticut-based hedge fund. Indeed, the taxpayer in *Greenberg* definitely included this argument as part of the basis for her appeal.

But did the *Sobel* court get it right? It is probably always the case that a hedge fund manager who receives both a share of management fee income and carried interest is involved in the day-to-day activities of managing other people's money. So in that respect, such a taxpayer is engaged in a trade or business. But the sourcing issue seems to address a different question. The question isn't whether the taxpayer is engaged in a trade or business; rather, it is whether the taxpayer is receiving income from intangibles that themselves were used in a trade or business. Thus, should the question be less focused on the taxpayer's own activities and more on whether the actual investment assets that generated the intangible income were used in a trade or business?

This distinction has come up in New York, not in the hedge fund context, but regarding partnerships generally. Nonresident partners are taxed on their share of any partnership income derived from New York sources.[12] However, the tax department's own policy guidance confirms that it does not consider a partnership interest *itself* (an intangible) to be "employed in" a New York trade or business for sourcing purposes just because it allows the partner to participate in the business. Thus, for example, a nonresident partner selling his interest in a New York partnership interest wouldn't realize New York-source income from selling the partnership interest. This counters the taxpayer's argument in *Greenberg* that she was using her carried interest in the Company in a Connecticut-based trade or business, which presumably was a reason for the tribunal's decision.

Unfortunately, although the Connecticut Department of Revenue appealed the initial *Sobel* decision, the appeals court never got to the merits, holding instead that the appeal was moot because the DOR failed to challenge all of the trial court's bases for its ruling.[13] And somewhat oddly, the tribunal in *Greenberg* didn't really get to the merits either. Indeed, although the administrative law judge who initially heard the appeal discarded *Sobel* as being inconsistent with New York law (as

[12] N.Y. Tax Law section 632(a)(1).

[13] *Matter of Sobel*, 218 A.3d 581 (Conn. 2019).

well as factually distinguishable), the tribunal took a different approach, focusing more on factual issues. Specifically, it highlighted that the taxpayer's "failure of proof stands in contrast to the evidence presented in [*Sobel*]" and that the "factual differences between *Sobel* and the present matter deprive that case of any persuasive authority."

Does that mean the tribunal would've otherwise agreed with the *Sobel* court's approach, finding that carried-interest income could be derived from intangibles used in a trade or business and therefore sourced to New York? It's hard to say. Indeed, we don't even know how a Connecticut appellate court would treat this kind of argument, given that the *Sobel* appeal was not resolved on the merits of the legal issue. So *Greenberg*, like *Sobel*, leaves open the questions of how states, taxpayers, their lawyers, and the courts are supposed to resolve issues around intangible income, and how and when that income is used in a trade or business. It's not an ideal situation for taxpayers, but it certainly gives practitioners lots to do. ■

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