

Hedge Funds and Deferred Management Fees: 2017 State Tax Gold?

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In this edition of Noonan's Notes, the authors discuss a potential state tax issue associated with the deferral of some management-fee-type income that came due in 2017.

In all the hullabaloo over the Tax Cuts and Jobs Act (P.L. 115-97) enacted in 2017 and its impact on high-net-worth individuals and service providers in high-tax states, there has been relatively little discussion of another significant development in 2017, at least for much of the hedge fund and private equity sector. We first highlighted this issue in a 2013 article in this column, sounding the alarm about the potential state tax issue associated with the deferral of some management-fee-type income coming due in 2017.¹ A recent article in *The Wall Street Journal* noted that one hedge fund manager's 2017 IRS tax bill exceeded \$1 billion!²

¹Timothy P. Noonan and Alan S. Kufeld, "Hedge Funds and Deferred Management Fees: State Taxes," *State Tax Notes*, Mar. 4, 2013, p. 661.

²Gregory Zuckerman, "Worried About Your Tax Bill? Hedge-Fund Star John Paulson Owes \$1 Billion," *The Wall Street Journal*, Apr. 11, 2018.

But the *Journal* didn't mention the manager's state tax bill, so we here at Noonan's Notes can help! In this article, we'll explain the issue around this deferred management fee income, and talk about what some states are doing in response.

Background

What's the issue? In 2008 Congress enacted IRC section 457A to eliminate a tax deferral mechanism used by many fund managers. Before then, managers — whether individual service providers or entities — were permitted to enter into a deferral agreement with an offshore fund to defer the receipt of management or incentive fees for up to 10 years. The service providers could then elect annually to defer a portion of or all the fees earned that year, when they would be reinvested by the offshore fund. Under IRC section 409A, the deferred fees, along with any appreciation earned during the deferral period, would then be taxable when recognized at the end of the deferral period. Notably, only incentive fees and management fees, that is, ordinary income, could be tax deferred into an offshore fund; incentive allocations, otherwise known as carried interest and treated for tax purposes as capital gains, were not eligible for deferral.

In 2008 Congress enacted section 457A as part of the Emergency Economic Stabilization Act, telling fund managers that they could no longer enter into those long-term deferral arrangements with offshore funds without incurring significant penalties. But rather than terminating all existing arrangements, it permitted most pre-2009 deferral arrangements to remain. Section 457A required that the grandfathered agreements for deferred fees for services between 2005 and 2008 be recognized for tax purposes no later than December 31, 2017.

Some complicated workarounds have been bandied about, but for the most part, hedge fund managers accepted the change, altered their compensation arrangements from incentive fees to allocations (that is, carried interest), and postponed the inevitable tax bill as long as possible. With global markets exploding over the deferral periods, the amount of payments could be as much as \$100 billion from offshore fees.

So here we are, in the 2017 filing season, and fund managers have already paid their tax estimates and, in some cases, reported the remaining deferred fees that are required to be recognized in 2017. This is particularly a concern in the nonresident taxation area. For state residents, the issue is simple: Residents pay tax on everything! But for a nonresident, or a multi-jurisdictional flow-through entity like a partnership or S corporation, it is not as clear how much of those deferred fees a jurisdiction gets to tax.

That said, how much of those fees that some states want to tax has recently become clearer. In particular, New York, New Jersey, and Connecticut have recently outlined their views on reporting the fees, and in Connecticut, legislation has been passed to address the issue. New Jersey issued a publication in the fall of 2017, and New York came out with guidance in the form of a technical memorandum (TSB-M) a full 11 days before the April 17, 2017, tax return filing deadline and almost a month after S corporation and partnership returns or extension requests were due! Not surprisingly, all those jurisdictions have reminded taxpayers that the income is subject to state tax at the same time that it's subject to federal tax and that the income will be treated as compensation for services taxable in the state if services were performed in the state.

Given the significant amounts likely to be at issue, it's unlikely that this guidance will serve as the end of the debate over state taxation of the offshore deferred fees. But let's look at the issue state by state to get a better idea of what's going on.

New Jersey

On October 12, 2017, the New Jersey Division of Taxation published guidance stating that "if the deferred income was sourced to New Jersey when

it was earned, it is also reportable and taxable on the nonresident Gross Income Tax return." The guidance does not specifically state when the deferred income was earned, nor how it will be treated if the service provider is an entity such as a partnership and the nonresident partner receives its distributive share of the fees in 2017 under the deferral. That is fairly typical of New Jersey, which provides little guidance on how deferred compensation should be allocated to the state. In practice, New Jersey often follows New York's rules, so we'll look at what the Empire State is suggesting.

New York

Surprisingly, New York — almost always ahead of the pack with publishing guidance and addressing new state tax issues — has been silent on the taxation of deferred compensation until very recently. Last year, we saw representatives from the Department of Taxation and Finance address the issue rather quietly in presentations to practitioners, reminding them that the income is compensation subject to New York tax when earned. But nothing appeared in writing until the 2017 tax returns were published, with a question upfront on the personal income tax returns and in the 20 or so questions at the top of the partnership/limited liability company returns and S corporation return. The question is simple:

Were you required to report, under P.L. 110-343, Div. C, section 801(d)(2), any nonqualified deferred compensation on your 2017 federal return?

New York clearly believes that anyone who would answer yes to that question has their return prepared by a sophisticated tax preparer who would know that the legal citation in the question refers to the provision in the 2008 Emergency Economic Stabilization Act that added section 457A. Leave it to New York to take a very tax-wonky approach to asking if you received any offshore deferred compensation this year!

The instructions for the resident and nonresident personal income tax returns also ask a similar question:

General changes for 2017, "If you were required to report certain nonqualified deferred compensation . . . on your 2017

federal income tax return, or if any such amounts flowed through to you from a pass-through entity, you must mark an X in the Yes box.”

Similar instructions appear on the flow-through entity returns.

But until April 6, we thought New York was going to leave taxpayers and practitioners guessing about how it expected service providers to apportion the offshore deferred fee income to New York once one of those boxes was checked. And then, on a Friday when accountants everywhere were buried in finalizing 2017 personal income tax returns due in just over a week, the tax department released a technical memorandum laying out how it thinks taxpayers should apportion the deferred fees to New York.³

The memorandum states that nonresident individual service providers must allocate the income, including any appreciation on the deferred fees, to New York based on the percentage of days worked in New York in the year the services were performed to earn the fees. The memorandum also puts the onus on the taxpayer to document days worked outside New York — a burdensome task for fees earned a decade ago. That approach is not surprising, as it reflects the way New York allocates income from other deferred compensation, such as stock options. Of course, unlike the rules for stock options, these rules are not set forth in New York’s regulations, usually the proper method for issuing guidance for the implementation of multiyear income sourcing rules.⁴

The memorandum also indicates that partnerships and LLCs taxed as partnerships must use the three-factor business allocation percentage in the year the fees were earned to allocate the income to New York. It’s unclear where the legal basis exists for using a prior year’s business allocation percentage. In a 2010 technical memorandum,⁵ the tax department issued

guidance stating that a nonresident individual or flow-through entity should source compensation for services regarding business previously conducted in the state based on where those services were performed, but the guidance focused on previous — not ongoing — businesses.

The 2018 memorandum suggests a wholly different sourcing approach for corporations. Perhaps because the New York apportionment regime for corporations, unlike for partnerships, has changed so significantly since the time when those fees were earned, the memorandum states that corporations must include the offshore deferred compensation in business income and in the apportionment fraction. In other words, the corporation should use the *current year apportionment fraction* to apportion the income to New York, rather than the fraction in the year the services were performed. That makes sense, given that there is nothing in New York Tax Law article 9-A that would seem to allow or require a corporation to apportion a part of its current-year business income using a prior year’s apportionment fraction.

Nevertheless, there does not seem to be anything in the article 22 partnership tax regime permitting or requiring that approach for partnerships. The differential treatment based on choice of flow-through entity will likely spark significant resistance from partnership service providers.

Connecticut

Whether because of its reputation as the home of many hedge fund managers or as a result of its significant budget deficit, Connecticut has taken the most proactive and comprehensive approach to its taxation of the offshore deferred compensation. In 2014 Connecticut passed Act 14-155 to amend section 12-711(a) of its tax statutes to explicitly state that compensation received by a “nonresident natural person” from nonqualified deferred compensation plans, including compensation required to be included in federal gross income under section 457A, would be taxable by Connecticut to the extent attributable to services performed within Connecticut.

Since the passage of Act 14-155, Connecticut has further amended its statutes to try to clarify its position on deferred compensation received by

³New York State Tax Treatment of Nonqualified Deferred Compensation, TSB-M-18(2)C, (3)I (Apr. 6, 2018).

⁴*Matter of Stuckless and Olsen (Stuckless II)*, Tax Appeals Tribunal, (Aug. 17, 2006).

⁵Income Received by a Nonresident Related to a Business, Trade, Profession, or Occupation Previously Carried on Within New York State, TSB-M-10(9)I (Aug. 31, 2010).

any service provider, including passthrough entities. Connecticut amended Gen. Stat. section 12-712 to state that a nonresident partner's share of distributive partnership income derived from Connecticut sources shall be determined in accordance with section 12-711. While that section discusses income allocation for a "natural person," it was also amended to state that beginning in 2017, receipts for services are earned in Connecticut if the services are "used at a location in this state" to reflect Connecticut's new market-based sourcing rules.

Are you confused yet? Well, to help with any confusion, Connecticut put out its instructions for passthrough entity returns to state that deferred compensation paid under IRC section 457A to any service provider (including a partnership or corporation) should be sourced to the extent the services were performed within Connecticut. Thus, the Department of Revenue's interpretation of the new statutes appears similar to New York's position for most taxpayers that the offshore fees are to be allocated to the state based on where the services were performed when the fees were earned, despite Connecticut's move to market-based sourcing for all entity types.

Conclusion

The states have clearly gotten serious, albeit belatedly, in warning taxpayers that they will be keeping a close eye on how those offshore deferred fees are reported for state tax purposes. Not only has Connecticut included questions on its return asking whether the individual or entity received offshore deferred fees under section 457A, but it sent out letters at the end of 2016 to thousands of taxpayers asking them to let the DOR know if they anticipated receiving deferred compensation from offshore funds before the end of 2017. So, it's fair to say that the states believe they have put taxpayers on notice regarding how they are expected to report the income.

But it's also clear that this is not the end of the discussion. There are big dollars at stake, and many hedge fund managers have moved out of their high-tax homes to low-tax jurisdictions before recognizing the offshore deferred fees. Much of the income that will be recognized in 2017 comes from the appreciation of the deferred fees that were invested in offshore funds, raising

questions about whether the appreciation is truly derived from sources within the state. As a result, we can expect new audits of hedge fund managers — both individuals and entities — as states seek their pots of gold in 2018. ■