Clients&FriendsMemo

New York State Bill Would Alter Taxation of Carried Interest

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A bill recently introduced in the New York State Assembly would impose additional tax on carried interest.[1] The taxation of carried interest has been widely discussed over the last decade, with a number of bills introduced (but not enacted) in Congress that generally would tax such carried interest at ordinary Federal income tax rates (rather than at lower capital gain rates). The Assembly bill, which notes that it is an attempt to get around "the considerable gridlock at the federal level," generally would impose New York state franchise or income tax on investment managers' carried interests.

Overview

Carried interest is the term given to an investment manager's share in the net profits of an investment fund in excess of any amount contributed by the manager to such fund. When an investment manager organizes a fund and provides management services to it, the manager usually receives a share of the fund's future net profits (a "carried interest"), along with a fixed management fee. The investors who provided most of the capital for the fund share the rest of the fund's future profits. Under current law, each investor's share of the fund's net profits, including the investment manager's share, generally is taxed at the lower rate for capital gains (rather than at ordinary income tax rates).

Proposed Changes to New York Law

The Assembly bill makes three main changes to the taxation of carried interest under New York law.

"*Investment Management Services*" – The bill defines a new category of "investment management services" that are subject to a new taxation regime. "Investment management services" generally are defined as the provision of a "substantial quantity" of advisory or management services with respect to "specified assets" (*i.e.*, securities, real estate held for rental or investment, interests in partnerships, commodities or options or derivative contracts with respect to any of the foregoing).[2]

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1 New York Assembly Bill A. 9459 (2016).

2 Assembly Bill 9459 defines "investment management services" as "a substantial quantity" of any of the following services provided to a partnership, S corporation or other entity: (i) advising on the advisability of investing in, purchasing, or selling

A manager will not be deemed to provide "investment management services" if 80% or more of the average fair market value of the partnership, S corporation or other entity's specified assets during the taxable year consists of real estate.

Amount of Income Affected – The bill will recharacterize a partner's distributive share (or pro rata share, in the case of an S corporation shareholder) of income, gain, loss and deductions, including guaranteed payments, in excess of the amount the partner or shareholder would have received if the partner or shareholder had not provided investment management services (at least zero).

Recharacterization of Income – The bill would recharacterize income earned from the provision of investment management services from intangible income to service or business income (as the case may be) by amending the New York State nonresident income tax and the corporate franchise tax statutes. This change would move income earned by a nonresident individual partner or corporate partner as a result of providing investment management services from a category that was not subject to New York tax into a category that is or can be subject to New York tax.

Effective Date

If enacted, the bill would not become effective until the enactment of legislation "having an identical effect" in Connecticut, Massachusetts and New Jersey. When this condition is met, the bill would take effect immediately, without any delay or interim period to allow taxpayers to prepare for compliance.

Takeaways

Given its status as a perennial topic of tax reform discussion, it would not be surprising if some form of carried interest legislation eventually is enacted by Congress. The New York State Assembly bill suggests a novel multijurisdictional approach to changing the taxation of carried interest at the state level that, if enacted, would increase the possibility of additional New York State tax on partnership and LLC services income.

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If you have any questions about the foregoing, please contact Shane Stroud, Linda Swartz or any other member of our Tax Department.

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any specified asset, (ii) managing, acquiring or disposing of any specified asset, (iii) arranging financing with respect to acquiring any specified asset, or (iv) any activity in support of (i) through (iii).