



A periodic update of current finance-related issues covering audit and accounting, tax, and regulatory matters affecting organizations that operate within the financial services sector.

FINANCE ALERT

Fund Managers – Be Prepared For the NYC Tax Man

The New York City Department of Finance's worst kept secret is that it is considering a change in its audit policy regarding private equity and hedge fund managers, which would result in higher tax bills.

The sponsors of most funds structure their compensation so that the management fee portion (typically 2%) is paid to a separate entity (e.g., Management Co.), while the incentive fee portion (typically 20% of a Fund's benchmarked earnings) is paid directly to the Fund's general partner or to a separate entity (e.g., Carried Interest).

The management fee income and all of Management Co. expenses are being funneled into Management Co., thereby reducing its income subject to tax. Carried Interest's only source of income will be the carried interest, and their expenses are typically only legal and accounting fees.

If Management Co. is located in New York City, NYC's Unincorporated Business Tax imposes a 4% tax on the income of Management Co., while Carried Interest's income is exempt from New York City income tax because its income is considered self-trading income.

NYC Trial Balloon

New York City has hinted that it is considering implementing a new audit policy (possibly with retroactive application) that would take the



expenses that are currently being paid by and charged against Management Co. and allocate some of those expenses to Carried Interest. This reallocation would result in a higher net income (and tax) to Management Co. New York City argues that the reallocation would more equitably reflect the expenses and taxable income of each company.

What's Next?

As of this writing, no official position has been communicated to the public. Accordingly, although New York City is in dire need of (and therefore actively seeking) additional revenue sources, there is much speculation as to whether the city will actually go forward with this highly-charged issue. There are many constituents who argue against such a position, both on technical grounds and on the grounds that it would adversely impact the financial industry in New York City. **h**

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