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Financial Services Newsletter

The Carried Interest Battleground Now Moves to the State Level

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President Trump signed the Tax Cuts and Jobs Act of 2017 into law on December 22, 2017. A collective sigh of relief could be heard across the investment management community as the worst fear of investment managers apparently had not materialized: the carried interest had survived. Although not completely intact, the new requirement of a three-year holding period was viewed as relatively benign.

However, on January 16, 2018, New York State Governor Cuomo unveiled his 2019 Executive Budget, which contained a proposed "fairness fee" of 17% to be levied on most investment-related management fee income. The 17% tax would supposedly eliminate the rate differential that some investment managers enjoy between the 20% capital gain rate and the highest marginal 37% rate on personal service income. (Interestingly, New York currently taxes capital gain income and personal service income at the same rate.)

The fee was explained as an attempt to "close the Federal carried interest loophole."

Under the proposal, where a partner or S corporation shareholder performs "investment management services" (defined below), they would not be treated for tax purposes as receiving an investment return with respect to the amount by which their distributive share exceeded the amount otherwise receivable if the partner or shareholder had not rendered services to the entity. In simpler terms, this means that the holder of a carried interest escapes the 17% "Fairness Tax" only on the portion of his or her allocation attributable to invested capital.

"Investment management services" are defined in the proposal as:

- providing investment advice on the purchase or sale of securities, real estate, partnership interests, commodities, or options (including any related derivative contracts);
- managing, acquiring, or disposing of a specified asset;
- arranging financing in the acquisition of these assets; or
- any other activity supporting these services.

The proposed tax would not apply where 80% of the average fair market value of the managed assets consists of real estate.

Anticipating that the enactment of the newly proposed tax might induce some investment managers to leave the State of New York, by its terms the proposed levy would take effect only if identical proposals are enacted by the States of Connecticut, New Jersey, Massachusetts, and Pennsylvania.

The application of the general language of the proposal raises a number of issues, the discussion of which is beyond the scope of this release. Suffice it to say, however, if enacted the devil would be in the details. In the meantime, we will monitor the situation and keep our readers apprised of developments.

Contact Us

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