

This Week in State Tax (TWIST)

January 13, 2025



New York: Tax Tribunal Applies Apportionment Percentage from Year of Performance to Deferred Hedge Fund Fees

The New York Tax Tribunal recently ruled that deferred fees earned by a hedge fund should be apportioned to New York using the Business Allocation Percentage (BAP) of the year in which the fees were earned, rather than the year in which they were included in income. The taxpayers were partners in an investment management partnership. The partnership voluntarily deferred a portion of the management and performance fees that it earned for services provided from 1998-2003, a period in which the partnership operated exclusively from a New York office. For federal purposes, most of the deferred fees and related appreciation (from reinvestment of the deferred fees) were recognized in the income of the partnership in Tax Year 2017. (The partnership had recognized portions of the deferred fees and appreciation in prior tax years.)

In April 2018, the Department of Taxation and Finance (Department) issued a Technical Memorandum (TSB-M-18(2)C, (3)I) providing guidance on the state treatment of nonqualified deferred compensation and its inclusion in New York income. In the Technical Memorandum, the Department stated that nonqualified deferred compensation (and any earnings thereon) for services performed prior to January 1, 2009, must be included in New York-source income when the business was conducted only in New York. In filing its 2017 New York returns, the partnership included the full value of deferred fees and appreciation as New York-source income when computing its 2017 BAP (i.e., included the full value in the numerator and denominator of the sales factor). The deferred fees and appreciation flowed through to the taxpayers based on their proportionate share of the partnership income. On audit, the Division rejected use of 2017 BAP (a three-factor formula which was less than 100 percent, due to having added a Connecticut office location) to apportion the fees and allocated the entire amount to New York based on the partnership's BAP in tax years 1998 through 2003 – the years the services were performed. The taxpayers challenged their proportionate share of the audit adjustment. An ALJ ultimately found in favor of the Department, and the taxpayers appealed.

At issue was whether the deferred fees and appreciation should be allocated as New York source income based on the 2017 BAP, or whether the income should be allocated to New York using the BAP for the years when the services were performed. The Tax Tribunal ruled that the statute clearly requires that the deferred fees and appreciation received by a nonresident related to a business previously carried on within or partially within New York be treated as ordinary income and would require you to look to the BAP in the year the income was earned (i.e., 1998 through 2003) in allocating to New York. Because the taxpayers' business was carried on entirely

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within New York during the years in which the fees were earned, the Tax Tribunal determined that the fees must be entirely allocated to New York once included in income. The Tax Tribunal rejected the taxpayers' position that "taxable year" must mean the year in which the fees were reported. Having found that the law was clear on this matter, and that the Technical Memorandum did not articulate new rules of interpretation, the Tax Tribunal found the memorandum constituted proper technical guidance. Finally, the Tax Tribunal upheld the assessment of penalties even though they acted under written tax advice from advisers; in the Tribunal's opinion, the taxpayers' position was contrary to New York law, making penalties appropriate. The taxpayer has four months from the date of the Tribunal decision (December 12, 2024) to appeal the case to the New York intermediate appellate court. If no appeal is taken, or is taken but unsuccessful, the Tribunal would become binding precedent. Contact [Russell Levitt](#) with questions about [Matter of Techar and Matter of Frascella](#).

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