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In this edition of Noonan's Notes, the authors discuss the whistleblower recovery in *Harbinger*. The settlement — the largest to date under the New York State False Claims Act — centered on the proper apportionment of specific income from the investment management entity of a hedge fund. But as the authors note, the case and a recent *State Tax Notes* article featuring information from a source close to the case raise some compelling questions.

Over the past several years, the New York State Department of Taxation and Finance has stepped up its enforcement efforts on issues related to partnerships, limited liability companies, and other passthrough entities. For many years these efforts have been overseen by a specialized team of auditors in a flow-through audit unit. By all accounts these efforts have been successful, enabling the tax department to tackle difficult issues — many of which cross into areas of federal taxation — that otherwise wouldn't come up in the typical income tax or residency audit. And quite frankly, having specially trained auditors deal with issues in this area is needed, given the complexities that can arise when dealing with complicated structures, tiered entities, federal tax issues, and so forth.

So it was interesting to see the news in April of the largest tax whistleblower recovery to date under the New York False Claims Act (FCA), in a case involving the complicated area of flow-through entity taxation.[1] The case, *State of New York ex rel. v. Harbinger Capital Partners Offshore Manager LLC*,[2] centered on the proper apportionment of specific income from the investment management entity of a hedge fund. Specifically, the case focused on whether the income should have been apportioned entirely to the Alabama headquarters of the fund's parent company, where mostly back-office and middle-office functions were performed.

News of the record settlement broke April 18, when the attorney general issued a press release linking to a copy of the 32-page settlement reached by the parties a few weeks earlier. A few weeks later, *State Tax Notes* ran a great piece by Amy Hamilton

[1] "A.G. Schneiderman Announces $40 Million Settlement With Investment Management Company for Tax Abuses, Marking Largest Tax Whistleblower Recovery in Office's History," New York State Attorney General (Apr. 18, 2017).

[2] Settlement Agreement, *State of New York ex rel. v. Harbinger Capital Partners Offshore Manager LLC*, Index 100416/2015 (N.Y. Cty. Sup. Ct. Apr. 3, 2017).

outlining an alternative portrayal of the facts underlying the settlement based on information provided by a "person familiar with the matter."[3] The article raised some compelling questions about the case as well as broader FCA policy issues.

We're not here to relive all that. Certainly there are two sides to every story, and without being personally involved in the case, it's hard for us to draw direct conclusions about what happened. But we do think there are issues about the complications in New York's apportionment rules that make for an interesting article. So let's get at it.

Partnership Apportionment: Nuts and Bolts

New York resident partners of a partnership (and members of an LLC taxed as a partnership) must pay tax to New York on all their income from the partnership. But nonresident partners pay tax to New York only on the "items of income, gain, loss and deduction derived from or connected with New York sources."[4] New York's tax regulations indicate how a partnership doing business in and outside New York should determine which income is New York-sourced, thereby telling their nonresident partners how much income they must include in their New York taxable income.[5]

Of course, the threshold question even before determining apportionment is whether the partnership has nexus, or sufficient connections with New York, to give the state the constitutional authority to impose tax on the income that flows to the partners. In *Harbinger*, though, nexus wasn't really the issue, so far as we can tell. The main question was related to how income should have been apportioned to New York.

On that question, particularly for folks in the hedge fund space, there are two sets of rules or considerations to take into account.

First are the rules around trading and investment income. Under New York law, nonresident partners of specific investment partnerships would generally not be considered engaged in a trade or business in New York and consequently would not be taxable on their distributive share of income. This so-called self-trading exemption is predicated on two conditions: the nature of the partnership's activity in New York (limited to buying and selling securities for its partners) and whether this constitutes the sole activity of the partnership.[6]

But that's often not the only relevant inquiry in the trading and investment scenario. That's because of the nature of the intangible income that often arises from those activities. The tax department takes the position that although the receipt of even a small amount of business income from customers would taint the income from self-trading and theoretically subject a nonresident partner to tax, the partner would generally avoid taxation anyway if the income is exclusively intangible — that is, income from the purchase or sale of securities and other investment assets.[7] The only limited exception to this is when the intangibles themselves are employed in a business, trade, profession, or occupation. But that very limited scenario applies, for example, only if the intangible property is used as collateral for a business loan or otherwise employed as an asset in the business, which happens a lot less than most people (and some tax auditors) realize.

This leads into the next set of issues for hedge funds. Often, performance fees or management fees are also often paid for direct services, so the issues turn to how that income is apportioned to New York. And there, New York's rules set forth two possible methods.

The first method — and the one that's preferred under the law — requires partners to allocate items of income, gain, loss, and deduction to New York based on the partnership's books and records.[8] The Tax Department's "Nonresident Income Allocation Audit Guidelines" provide an example of a law firm whose books and records separately tracked the net income earned by each of the firm's three offices.[9] In that case, the firm (and its nonresident partners) would be required to apportion their income using this direct accounting approach.

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[3] Amy Hamilton, "Harbert Management's Side of the $40 Million Tax Settlement Story," *State Tax Notes*, May 8, 2017, p. 521.

[4] New York Tax Law section 631(c).

[5] *See* 20 N.Y. Comp. Codes R. 137.1-137.7.

[6] New York Tax Law section 631(d).

[7] *See also* New York State Department of Taxation and Finance, "Nonresident Allocation Guidelines," at 25-26 (2013), *available at* http://bit.ly/2q9MbSl.

[8] 20 N.Y. Comp. Codes R. 132.15(b).

[9] *Supra* note 7, at 27-28.

But although this is the preferred method, this direct accounting approach doesn't appear to be the most common. Instead, most partnerships apportion income to New York based on an equally weighted three-factor formula of property, payroll, and receipts, the alternative method required under New York's rules.[10] And here's where things get especially interesting for partnerships and their nonresident partners.

Generally, the property and payroll factors are straightforward. The partnership determines the value of its real and tangible property (owned or rented) in New York and divides that by the value of its property everywhere. Similarly, the payroll percentage is determined by dividing total wages and salaries (but not payments to partners) in New York by wages and salaries everywhere.

But the receipts factor (known as the gross income percentage) for partnerships and LLCs is calculated a lot differently in New York than in many other states and certainly is different from the way corporations compute their receipts factor in New York. Under the partnership and LCC rules, charges to be allocated to New York state include "all sales negotiated or consummated, and charges for services performed, by an employee, agent, agency or independent contractor chiefly situated at, connected by contract or otherwise with, or sent out from, offices, branches of the business, or other agencies, situated within New York State."[11]

There are some oddly placed commas within this definition, so let's interpret that explanation. Essentially, the language lays out the "origin rule," looking to allocate the receipts based on where the business is located. It is categorically not a market-based rule that would look to where goods or services are delivered. Instead, a "receipt" is allocated to New York under this gross income percentage factor if the sale is consummated in New York or performed by a person sent out from New York.[12]

But you won't find a lot of explanation about this factor in New York's regulations. Even the guidelines, which generally provide excellent examples and analysis on several topics, are largely silent on the issue, including only a section that parrots the statutory language. So what's a taxpayer to do when faced with questions about how these rules are employed? And what happens if they mess it up? The taxpayers in *Harbinger* found out the hard way. Let's turn to that next.

Harbinger

The hedge fund in *Harbinger* was established in 2001 by Harbert Management Corp. (HMC), a corporation headquartered and based in Alabama.[13] Around that time, HMC's executives in Alabama hired Philip Falcone to serve as the fund's chief investor. From 2002 through early 2009, Falcone and his investment team worked from an office in New York City, where Falcone also lived. The investment team consisted of traders, analysts, and other investment professionals, all of whom reported to Falcone. The fund, which focused on distressed investments, enjoyed tremendous growth and investment success from 2004 through 2008.

The fund used a common two-tiered investment structure known as the "master feeder structure," under which the investors' capital went into a feeder fund that in turn invested in a master fund, which was the entity actually investing in the market. The fund, like many master feeder structures, had two feeder funds: one onshore (Onshore Feeder) and one offshore (Offshore Feeder). Onshore Feeder was a U.S. limited partnership that served as a passthrough entity for U.S. taxable investors. Offshore Feeder was a corporation that served as a conduit for U.S. tax-exempt investors and non-U.S. investors.

Harbinger Capital Partners Offshore Manager LLC (Offshore Manager) was the investment management entity for the fund from 2002 through 2009. In that capacity, Offshore Manager had the authority to trade securities on behalf of Onshore Feeder and Offshore Feeder. As is relevant here, Offshore Feeder paid performance fees to Offshore Manager, the amount of which depended on the

[10] 20 N.Y. Comp. Codes R. 132.15(c).

[11] 20 N.Y. Comp. Codes R. 132.15(f).

[12] Note, however, that there are different rules for registered broker-dealers and investment advisers to regulated investment companies, which source their receipts to the location of their customers.

[13] HMC has its own set of New York tax troubles. On April 27, 2017, the New York City Tax Appeals Tribunal, Administrative Law Judge Division, decided that HMC-New York Inc., a subsidiary of HMC, should have filed on a combined return with several related corporations for NYC general corporation tax purposes, resulting in a tax liability that could exceed $4 million.

fund's profitability. The performance fees were paid in an annual lump sum that was distributed to Offshore Manager's members (that is, its investors).

As noted above, Falcone and his investment team worked from an office in New York City, where Falcone also lived, from 2002 through early 2009. All trading activity occurred in New York City. Middle- and back-office functions for Offshore Manager were performed in Alabama, where several officers were located. These functions included executive oversight, fundraising, accounting, investor relations and reporting, legal, compliance, and risk management for the fund and Offshore Manager. Hamilton also noted in her recent article that Falcone was hired by people in Alabama, he reported to people in Alabama, and he could have been fired at any time by people in Alabama. To that end, Offshore Manager was managed and governed in Alabama, where its board chair, president, CEO, CFO, and chief operating officer were located.[14]

The crux of the FCA case was the apportionment of Offshore Manager's income. Its 2004 and 2005 New York state partnership returns apportioned none of the performance fee income to New York state. Only the Alabama office was listed on the portion of the return form that instructs the taxpayer to list "all places, both in and out of New York state, where the partnership carries on business." Offshore Manager's parent, HMC, took the position that the apportionment was proper because Alabama was the location of Offshore Manager's commercial domicile, operations, and management.

The settlement reflects that Offshore Manager decided to use 0 percent apportionment after the issue was discussed with tax professionals from one of the Big Four accounting firms. The settlement stated that after the meeting, one of the fund's officers sent an email to some of the fund's members indicating the accountants' initial reaction that New York City and state taxes were owed. In the next few days, the same officer sent an email describing the 0 percent allocation as unsupportable (the suggestion being that Offshore Manager ignored the advice of the accountants and allocated 100 percent to Alabama). But Hamilton's article asserted that the settlement mischaracterized those events. It countered that the conversation did not even reach the apportionment issue but instead concerned the threshold inquiry — discussed in our analysis above — of the character of this income.[15] In other words, the initial questions focused on whether Offshore Manager's income was intangible income that per se wouldn't be allocable to New York, as opposed to management-fee-type income that would be subject to apportionment.

If that's the case, we can at least partly see why the taxpayer could have struggled with how to apportion Offshore Manager's income. It's somewhat murky how the origin rule for sourcing partnership service receipts operates in the hedge fund management context, given how little guidance there is for the gross income percentage. A hedge fund investment adviser or manager, such as Offshore Manager in this case, typically earns performance or allocation fees by making investment decisions for the underlying funds. Depending on how the arrangement is structured, the manager earns those fees based on a percentage of profits, sometimes after a specific benchmark is reached in a particular year.

But even before the manager looks at which office its employees or partners are "chiefly situated at" or "sent out from," the more important question is: Which employees of partners are we talking about? The manager may earn its performance fees based purely on the efforts of its partners or with the work of analysts, researchers, and other employees of the manager. But who truly earned the receipt? All of the partners? Only the principal decision-makers? The decision-makers plus other employees who provided the analysis for the investment decisions? There is no clear guidance, so to some extent, it is up to the partnership to come up with a method that apportions income to New York fairly and equitably.[16] And from the reports, it sounds like Offshore Manager's partnership returns for 2009 through 2011, which reflected 100 percent apportionment to Alabama, were audited by the New York State tax department and accepted as filed. In sum, according to the *State Tax Notes* article, the 100 percent apportionment to Alabama reflected HMC's understanding of New York's state

[14] *Supra* note 3, at 6.

[15] *Supra* note 3, at 4.

[16] 20 N.Y. Comp. Codes R. 132.15(a).

apportionment rules for partnerships under the origin rule.[17]

Conclusion

The first and most basic reaction upon reading all this is whether this was the proper case for FCA action. The FCA is in place to punish taxpayers for knowingly violating the tax law in cases in which taxpayers take a position premised in deliberate ignorance or reckless disregard — that is, something more than a mistaken understanding or conflicting but reasonable interpretations.[18] Here, we do not have all the facts of the *Harbinger* situation. There very well may be pieces we are missing. Indeed, even if we struggle about the application of the origin rule, normally partnerships would still allocate income inside and outside New York based on two other factors (property and payroll). So we expect there's more to the story.

Still, the sheer absence of guidance for taxpayers on the application of the origin rule could suggest that it could be very difficult to knowingly violate law, regulations, or interpretations when there is little guidance in the first place. We have seen this firsthand in many of our own cases. The rules that apply to partnerships and LLCs can be difficult, particularly when delving into issues surrounding the origin rule. Moreover, we often believe that the books and records method can be used to allow taxpayers to allocate income outside New York based on where it most clearly was earned, even if an allocation under a regular three-factor method would yield a higher New York percentage.

This general point has been made with the ongoing *Sprint* litigation, the first big FCA case brought by the attorney general.[19] The defendants in *Sprint* made similar arguments about their inability to "knowingly" engage in bad behavior in connection with a set of laws that were extremely ambiguous and difficult to interpret.[20] But obviously this kind of argument is not working. The *Sprint* litigation continues, and *Harbinger* settled for $40 million so the, "Oh, it's too confusing" defense in the FCA arena does not appear to be taking hold.

The other important point for tax practitioners is to recognize the extreme differences between how partnerships and LLCs apportion income, compared with other flow-through entities. In fact, the difference between an S corporation's apportionment and a partnership's apportionment is so stark as to almost be illogical. For instance, a nonresident who operates a service company through an S corporation in New York will pay tax to New York only to the extent it has customers or clients in New York.[21] That percentage could be extremely low. On the other hand, the same nonresident service provider would probably allocate 100 percent of its income to New York if it operates through a partnership or LLC structure. So look out! Choice of entity matters more now than ever in New York.

Finally, a plug for us lawyers: Taxpayers need to understand that communications with their accountants or other professionals are not privileged. It appears the attorney general found what he believed to be a smoking gun in email correspondence between Harbinger and its accountants that seemed to suggest Harbinger knew that its positions were not justified. Of course, according to the *State Tax Notes* article, Harbinger representatives clarified the nature of that correspondence as related to the general taxability question and not apportionment. But still, it's a dangerous world out there. Whistleblowers seem to be lurking around every corner. When necessary, it is important for taxpayers to keep confidential discussions about how to approach difficult tax issues to themselves and their lawyers. ■

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[17] *Supra* note 3, at 6.

[18] *See* N.Y. State Finance Law section 188(3)(a).

[19] *See People ex rel. Schneiderman v. Sprint Nextel Corp.*, 26 N.Y.3d 98 (2015), *cert. denied*, 136 S. Ct. 2387 (2016).

[20] Brief of defendant-appellants in *People v. Sprint*, at III.A., *available at* http://pdfs.taxnotes.com/2015/2015-23294-1.pdf.

[21] This is because an S corporation determines its apportionment percentage based on a single receipts factor only, determined by reference to where the benefit of such service is received.