Re-thinking the New York City Business Tax Treatment of Private Equity Fund and Hedge Fund "Carried Interest"

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Executive Summary

By closing a loophole in its Unincorporated Business Tax (UBT), New York City would realize a net revenue gain of $160 million to $225 million a year, and would put the taxation of private equity funds and hedge funds on the same footing as that of thousands of smaller businesses. New York City taxes the fees received by managing partners in private equity funds and hedge funds but exempts "carried interest" from taxation under the UBT. Carried interest refers to the profit share received by managing partners, usually 20 percent of the profits generated by the pooled investment of the limited partners.

New York City's carried interest exemption was rooted in the principle that partners investing their own capital should not be subject to the payment of a business income tax on the income from that capital since they already are subject to a personal income tax on that income. However, in the debate in Washington on a related issue, most economists and tax law experts conclude that the "carried interest" received by private equity fund and hedge fund managing partners is actually management compensation and should be taxed as ordinary income. The carried interest exemption should be narrowed to apply solely to instances of investment income based on one's own capital and not to compensation for managerial services. A change in state law is needed to clarify the carried interest exemption.

Private equity funds and hedge funds have grown tremendously in recent years, with each now totaling more than $1 trillion. New York City is the leading national and international center for such funds. Eleven of the world's 50 largest private equity firms are headquartered in the city, as are 13 of the world's top 50 performing hedge funds. New York City-based private equity firms account for 44 percent of the capital held by U.S. based private equity firms. The 13 leading New York City hedge funds averaged 80 percent returns in 2007, generating $20 billion in profits.

The net tax effect for partners in private equity funds and hedge funds might be about half of the stated 4 percent UBT tax rate. This results from the likely deductibility of local business tax payments on federal taxes and a generous 23 percent credit for UBT tax payments against New York City personal income tax liability.

While the UBT is often criticized—justifiably—for taxing very small businesses and even independent contractors and free lancers, it is a critical part of the city's approach to business income taxation. The UBT helps to maintain a level playing field between large businesses across the various sectors of the city's dynamic commercial and financial economy. In 2004, 92 percent of UBT taxes were paid by business owners with over $250,000 in profit. The UBT is one of the City's major taxes, expected to generate over $1.5 billion in FY 2008. The UBT taxes the business incomes of highly profitable companies that happen to be organized as partnerships and limited liability companies.

While some commentators undoubtedly will insist that this net two percent tax will trigger fund flight, considering the current concentration of fund activity in New York City and New York City's unsurpassed attraction as a place to conduct financial service

business and as a desirable residence for individuals with very high incomes, it is unlikely that two percent would tip any scale in favor of moving out.

In view of New York's historic income polarization—the greatest in the nation—taxing the compensation of a private equity managing partner that can run into the tens of millions of dollars and higher on the same basis as the business income of a smaller business owner seems like an uncontroversial and overdue tax change. This is particularly true considering that 32 New York billionaires (29 of whom reside in New York City) on the Forbes list of 400 wealthiest Americans owe their fortunes to private equity funds and hedge funds.

I. Background

Recent years have seen tremendous growth in private equity funds and hedge funds. According to an estimate by the Congressional Budget Office, each of these two forms of financial innovation totals more than $1 trillion and represents a growing factor in financial markets. Prior to the onset of the financial market meltdown last fall, there was a lively debate in Washington, D.C. regarding the taxation of “carried interest” received by managing partners in private equity funds, and to some extent, in hedge funds.

As part of a relaxed financial regulatory environment, private equity funds and hedge funds have grown outside the normal bounds of regulation and oversight. These funds raise capital privately from large institutional or wealthy investors rather than through public markets.[1] Funds typically are structured as limited partnerships or limited liability companies (LLCs), which at the Federal level are not subject to the corporate income tax. General partners sometimes invest some of their own capital in funds they manage, with such investments usually accounting for no more that one to five percent of the total capital raised.

Venture capital funds and leveraged buyout funds are two common types of private equity funds, but some private equity funds invest in publicly held companies. Some hedge funds specialize in trading currencies or commodities, and others use complex investment strategies, often involving derivative financing instruments, whether based on changes in the prices of stock, debt, currencies or commodities.[2]

Managing partners in private equity or hedge funds are compensated in two ways: first, through a management fee on invested capital that is generally two percent, and second, through the payment of “carried interest.” Carried interest refers to a set share, usually but not always 20 percent, in the profits generated by the investments made by limited partners. Managing partners may, but are under no obligation to, contribute a share of the financial capital of the fund in order to receive carried interest.[3] The carried interest profit share sometimes is set above a “hurdle” profit rate—often eight percent—that must first be met. Management fees are treated as business income, and in a partnership structure (the predominant organizational form for such funds) this income is “passed through” and taxed as ordinary income on individual income tax returns. Carried interest income has

[1] In 2006, pension funds accounted for 40 percent of private equity capital, wealthy individuals held 10 percent, and university endowments and foundations accounted for 8 percent. Peter R. Orszag, Director, Congressional Budget Office, “The Taxation of Carried Interest,” Testimony before the Senate Finance Committee, July 11, 2007, p. 9. The 20 largest public pension funds in the U.S. (four of the eight largest are New York State or New York City funds) have over $110 billion invested in private equity funds. Bruce Rosenblum, Chairman of the Board, The Private Equity Council, Testimony before the Senate Finance Committee, July 31, 2007.

[2] Orszag, p. 3. In his discussion of hedge funds, Orszag noted, “Despite their name, hedge funds are not necessarily ‘hedged’ in the traditional sense of being insulated from risk; many hedge funds take significant risks either knowingly or unknowingly.”

[3] Aviva Aron-Dine, “An Analysis of the ‘Carried Interest’ Controversy,” Center on Budget and Policy Priorities, Revised August 1, 2007.

been treated as capital gains and is taxed at the 15 percent federal capital gains tax rate rather than at the 35 percent top federal marginal individual income tax rate.

The carried interest tax debate emerged as a result of the enormous wealth flowing to private equity fund and hedge fund managing partners (e.g., in 2006 the top 25 individual hedge fund managers reportedly received $14 billion in compensation) and questions about the economic justification for the preferential tax treatment enjoyed by carried interest. According to Congressional Budget Office Director Peter Orszag,

> Most economists … view at least part and perhaps all of the carried interest as performance-based compensation for management services provided by the general partner rather than a return on financial capital invested by that partner. That perspective would suggest taxing at least some component of the carried interest as ordinary income, as most other performance-based compensation is currently treated, regardless of the nature of the underlying investments generating the profits of the fund.[4]

II. New York City Taxation under the Unincorporated Business Tax

Under state law, New York City has long taxed business partnership income through its Unincorporated Business Tax (UBT). In New York's very large commercial and financial economy, partnerships in many fields—particularly finance, law, real estate, and accounting—are sizable operations with revenues running into the tens of millions of dollars. New York City taxes these partnerships in the interests of creating a more level playing field with businesses of comparable size organized as corporations and subject to the General Corporation Tax (GCT) or the Bank Corporation Tax (BCT). Historically, many of the leading investment banks were partnerships. The New York City UBT dates from the early 1930s, an earlier period of financial turmoil. Over the last decade, most of the large investment banking partnerships have become publicly held corporations. The migration of the leading investment banks from the UBT rolls to the GCT rolls has been offset by the formation and growth in private equity fund and hedge fund partnerships on the UBT rolls. In addition, since 1994 when New York State authorized the formation of limited liability companies (LLCs) that have the limited liability of corporations but the organizational flexibility and tax treatment of partnerships, many corporations have reorganized to take advantage of that option. In 2004, securities firms including private equity fund and hedge fund partnerships accounted for 26 percent of UBT taxes paid in New York City.

New York City taxes the management fees received by managing partners in private equity funds and hedge funds but exempts "carried interest" from taxation under the UBT. The exemption was rooted in the principle that partners investing their own capital should not be subject to the payment of a business income tax on the income from that capital since they already are subject to a personal income tax on that income.

[4] Orszag, p. 2.

In the carried interest debate in Washington last summer, most economists and tax law experts concluded, however, the "carried interest" received by private equity fund and hedge fund managers is actually management compensation and should be taxed as ordinary income.[5] To the extent that hedge funds hold investments for periods of less than one year—not long enough to qualify for the 15 percent long-term capital gains rate—that income is treated as ordinary income for federal tax purposes. However, in New York City, such short-term hedge fund income would be considered exempt.

In contrast, the federal government does not exempt carried interest from taxation, it just taxes it at the lower capital gains rate. And this practice has been widely criticized and legislation was introduced last year that would tax the carried interest received by general partners as ordinary income. Under New York City's UBT, carried interest should be subject to the UBT tax as ordinary business income. The "carried interest" exemption should be narrowed to apply solely to instances of income based on capital invested and not to compensation for managerial services. A change to state law is needed to clarify the carried interest exemption.

III. Estimating the New York City Revenue Impact of Taxing Carried Interest

What would be the revenue impact of such a change? Rough estimates utilizing two distinct methods suggest that the annual New York City revenue impact would be in the $160 million to $225 million range.

To prepare a precise estimate of the revenue impact would require access to unpublished New York City tax records. Even then, business conditions change as does taxpayer behavior, introducing elements of considerable uncertainty regarding any revenue forecast. In the summary statistical reporting by the New York City Department of Finance on business income taxes, the prior tax liability for private equity funds and hedge funds are not broken out. However, reasonable, even if imprecise, assumptions can be made about the extent of such activity taking place in New York City and potentially subject to taxation under the city's UBT.

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[5] Princeton economist and former vice-chairman of the Federal Reserve Board Alan Blinder (appointed by President Clinton) and Greg Mankiw, former Chairman of the President's Council of Economic Advisors under George W. Bush, both favor taxing carried interest as ordinary income. (http://gregmankiw.blogspot.com/2007/07/taxation-of-carried-interest.html). Other highly regarded tax experts, law professors and economists favoring the taxation of carried interest as management compensation include: Robert McIntyre of Citizens for Tax Justice, Stanford law professor Joseph Bankman, University of California economics professor Alan Auerbach, University of Texas law professor Mark P. Gergen, University of Illinois law professor Victor Fleischer, and New York University law professor Daniel Shaviro. Those favoring the continuation of current tax treatment of carried interest as capital gains include: University of Chicago law professors David A. Weisbach and Jack S. Levin, both of whom work for the private equity industry. The *Economist* magazine (June 7, 2007) and the *Financial Times* (July 19, 2007) both editorialized in favor of taxing carried interest as management compensation.

Data are available in the media and on the Internet regarding the largest private equity firms and the performance of major hedge funds. Such data provide the location of these funds as well as the magnitude of invested capital in the case of private equity funds and the performance and amount of fund assets in the case of the top performing hedge funds.

According to the trade publication *Private Equity International*, eleven of the world's fifty largest private equity firms are based in New York City, and these eleven firms account for 44.1 percent of the total invested capital of the 31 U.S.-based firms on the top 50 list.[6] *Barron's* publishes a list of the top performing hedge funds. In its latest list, which includes fund performance for 2007 as well as a three-year average for 2005-2007, 13 of the top 50 performing hedge funds were based in New York City. These 13 funds had a total value of $47.3 billion and a three-year average return of 42 percent.[7]

The first method follows Knoll in using a Black-Scholes approach to estimate carried interest as a percent of invested capital.[8] Knoll assumes a volatility of 20 percent and a four to seven year term of investment. He estimates that the value of carried interest would range from 5.9 percent for a four-year term to 8.6 percent for a seven-year term.[9]

Drawing from Orszag's data that private equity funds in recent years have raised about $200 billion per year,[10] Knoll finds that the aggregate value of carried interest granted each year ranges from $12 billion to $17 billion. Knoll's paper focused on the federal tax implications, and he estimates that taxing carried interest as ordinary income at a 35 percent tax rate instead of as capital gains at a preferential 15 percent tax rate has a static effect on federal tax revenues of $2.2 billion to $3.4 billion.[11]

Private equity activity is highly concentrated. The five largest firms account for 27 percent of the aggregate capital of the 50 largest private equity firms. The five largest private equity firms are all U.S.-based, with three of the five headquartered in New York City. These five account for 40 percent of the aggregate capital of the U.S.-based firms. Among the 31 U.S. firms on the top 50 list, New York City accounts for over one-third of

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[6] Private Equity International, "PEI 50," May 2007.
[7] *Barron's*, "The World's 75 Best Hedge Funds," April 14, 2008. The $47.3 billion figure represents just the amount invested in the individual high-performing New York City hedge funds, not the total amount invested in all of the hedge fund firms.
[8] Michael S. Knoll, "The Taxation of Private Equity Carried Interests: Estimating the Revenue Effects of Taxing Profit Interests as Ordinary Income," University of Pennsylvania Law School, Institute for Law & Economics Research Paper No. 07-20. http://ssrn.com/abstract=1007774.
[9] While the Knoll method estimates the present value of carried interest at the time granted, the result is roughly comparable to the value of carried interest when actually received. Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School, "Testimony: Carried Interest Part II," Senate Finance Committee, July 31, 2007, p. 5. The Knoll method is presented here not to suggest that carried interest be taxed when granted but as a reasonable method to estimate the tax implications of carried interest.
[10] Orszag, pp. 3-4.
[11] Knoll's method also involves a change in the timing of taxation. Given the sizable change in tax rates involved in changing the federal tax treatment, Knoll argues that the structure of private equity transactions likely would change, reducing the net revenue effects. As the discussion later in this report indicates, the magnitude of the contemplated change in New York City tax treatment of carried interest is only a fraction of the magnitude under consideration at the federal level.

the firms and 44 percent of the capital.[12] (See Appendix A: Fifty Largest Private Equity Firms.)

Since not all of the operations of a firm based in New York City will necessarily be located in New York City, firms follow city guidelines to allocate the portion of their business income that is subject to New York City taxation.[13]

In tax year 2004, the latest year that the New York City Finance Department has published statistical summary data for the business income taxes, finance companies accounting for nearly half (47 percent) of UBT liability had allocation percentages of 100 percent—i.e., all of their activity was attributable to New York City for tax purposes.[14] For purposes of this estimate, an allocation percentage of 60 percent was used.[15] Using the Knolls method, and applying a 44.1 percent New York City share and a 60 percent allocation, produces estimates for private equity attributable to New York City of $3.1 billion to $4.5 billion.[16]

The net impact of taxing carried interest on the UBT was then estimated by applying the 4 percent UBT tax rate and adjusting for the 23 percent credit against the New York City personal income tax for UBT taxes paid. This gives a range of $96 million to $139 million for private equity.[17]

In estimating the UBT for hedge funds, data on average returns and fund assets from the financial publication, *Barron's*, were used. The 13 New York City-based funds among the top 50 on the *Barron's* list, had an average return of 42 percent for the years 2005 to 2007 on a combined fund asset base of $47.3 billion in 2007.[18] Using the three-year

[12] After New York City, the U.S. city with the second highest number of private equity firms is Boston, followed by the San Francisco-Silicon Valley area with three, and Greenwich, CT, Los Angeles and Chicago with two each. See Appendix A.

[13] Income allocation is determined either by a separate accounting method for New York City operations or by a three-factor formula based on payroll, property and gross income. New York City Office of Management and Budget, "Tax Revenue Forecasting Documentation, Financial Plan Fiscal Years 2007-2011," 2007, p. 69.

[14] New York City Department of Finance, Office of Tax Policy, "Statistical Profile of New York City Business Income Taxes, Tax Year 2004," December 2007, pp. 28, 35.

[15] Finance Department data indicate that The Blackstone Group, now the largest private equity fund, had a New York City allocation percentage of 86.55 percent in 2006. 2006 GCT Allocation Report.

[16] The lower figure is based on Knoll's 4-year holding period, the higher figure is based on his 7-year holding period.

[17] Since non-New York City residents working in New York City do not pay the New York City personal income tax (the New York City "commuter tax" was repealed in 1999), non-residents will not receive the 23 percent credit. Thus, these estimates understate the net City tax effect of ending the carried interest exemption.

[18] According to data cited by the staff of the Congressional Joint Committee on Taxation, "nearly half of all U.S. domiciled hedge fund managers are based in New York, managing a third of global hedge fund assets." Joint Committee on Taxation, "Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part II," JCX-63-07, September 4, 2007, p. 8. On the *Barron's* list of the top performing funds, there were only eight U.S. funds not located in New York City. Of the eight, the only other ones in the greater New York region are two in Greenwich, Connecticut, and one in Somerset, New Jersey.

average return, this would mean an estimated annual return, after fees, of nearly $20 billion. According to the *Barron's* data for 2007, the weighted average return for the 13 funds headquartered in New York City was 80 percent, a return that would generate nearly $39 billion in profits for 2007. Extraordinary returns were possible even in a year that otherwise saw the onset of the subprime mortgage-induced financial crisis because some hedge funds profited from betting against subprime mortgage and other investments that began to plummet in 2007.

To use a more conservative basis for estimating hedge fund profits, a 2008 average return of zero percent was added to the 2005-to-2007 average return to generate a four-year average return of 31.5 percent. This was done to reflect the volatility in financial markets and the possibility that even hedge funds, on average, might sometimes have a bad year. An allocation percentage of 50 percent was used in the case of hedge funds.

Using the four-year average return as specified and applying that to a fund asset base of $47.3 billion would yield an estimated return of nearly $15 billion.[19] To allow for the possibility that the general partners in hedge funds often invest in the funds they manage, it was assumed that 10 percent of capital was provided by the general partners and that this would still be exempt from a change in state law that ended the exemption for carried interest not directly related to the general partners' capital. Assuming a 50 percent allocation percentage, applying the 4 percent UBT tax rate, and allowing for the 23 percent credit against the city's personal income tax would yield an estimated net UBT impact from hedge funds of $41.3 million.

Combining the estimates for private equity funds and hedge funds produces a range for the net annual impact on New York City taxes of $137.6 million to $179.9 million.

A second method drawing from data published by the Finance Department on the industry shares of UBT liability was developed to provide a crosscheck. In 2004, the latest year for which the Finance Department has published business income tax summary data, securities firms accounted for 26 percent of the total UBT tax liability. This includes partnerships, limited liability corporations (which for tax purposes are treated like partnerships) and sole proprietorships. Given the substantial growth in financial markets in the years since 2004, a projected securities share of UBT liability of 35 percent was also used. Since not all of securities firms subject to the UBT are private equity or hedge funds, it was assumed that 20 percent of the UBT taxes paid by securities companies were from other types of securities firms. Given the very large size of many private equity and hedge funds it is not unreasonable to assume that 80 percent of the UBT tax liability from securities firms stems from private equity funds and hedge funds.

[19] The previous edition of the *Barron's* list of 50 top performing hedge funds included 15 funds based in New York City with a combined fund asset base of $19.3 billion. Many of the funds that were included on both the prior and the latest *Barron's* list showed substantial growth in fund assets between 2006 and 2007, e.g., the Paulson Enhanced Partners fund increased reported assets from $2.8 billion in 2006 to $3.4 billion in 2007, and the Atticus European fund went from $8.2 billion in 2006 to $10.2 billion in 2007.

Further, it was assumed that current private equity-related UBT liability is roughly three times the hedge fund-related UBT liability. To approximate a projected carried interest private equity UBT liability, it was assumed that carried interest received by general partners would roughly equal one half of the income from management fees.[20] For hedge funds, considering the very annual high return profile, it was assumed that carried interest would roughly equal the income from management fees.

The separately derived estimates for the carried interest UBT liability for private equity funds and hedge funds were combined and adjusted for the 23 percent local personal income tax credit to generate an estimated net UBT impact of $192 million under the securities 26 percent share assumption, and $259 million under the securities 35 percent share assumption. Figure 1 presents the summary net estimates from Methods 1 and 2. The high and low estimates for each method were averaged to provide an overall range.

Figure 1. Range of Estimates for Net Impact of Taxing Carried Interest Received by Securities Firms Under the New York City Unincorporated Business Tax.

METHOD 1
Apply Knoll's method to private equity, and use reported average returns for hedge funds.

	BASIS	Net UBT* (millions)
Low estimate	Knoll's lower return	$137.6
High estimate	Knoll's higher return	$179.9
	Average of low and high estimates	**$158.7**

METHOD 2
Estimate private equity and hedge fund shares of 2008 UBT total collections, and apply a ratio of general partners' carried interest to two percent fee amount.

	BASIS	Net UBT* (millions)
Low estimate	2004 26% share of UBT	$192.5
High estimate	35% assumed 2008 share	$258.7
	Average of low and high estimates	**$225.6**

OVERALL RANGE OF ESTMATES: **$160 million to $225 million**

Note: Net UBT is net of 23% credit against the NYC Personal Income Tax for UBT taxes paid.
Source: FPI estimates, April 2008.

[20] See Andrew Metrick and Ayako Yasuda, "The Economics of Private Equity Funds," University of Pennsylvania, The Wharton School, Department of Finance, September 9, 2007, Table VI.

IV. Related Considerations

In addition to the revenue benefits, there are several other factors to consider related to changing the UBT exemption for carried interest.

Promoting equity with other, often smaller businesses

Taxing the carried interest received by general partners as business income would help level the playing field among business partnerships and promote equity and efficiency in the tax system. Allowing fund managers to avoid taxation on a portion of their business income means that a law or accounting business, retailer, manufacturer, or other business would pay a higher effective business tax rate in New York City than a large and highly profitable private equity firm or hedge fund. In Congressional testimony on the carried interest issue last July, Stanford Law School professor Joseph Bankman said:

> A basic and common sense rule of tax policy is that we ought to have the same rate of tax apply across different occupations or investments. The relative profitability of different professions, or investments, ought to be dictated by the market, not the tax law. The subsidy given to fund managers distorts career choice, and in so doing reduces economic welfare. It is also unfair: why should fund managers get a lower tax rate than executives or scientists?[21]

Bankman's testimony examines, and dismisses, several arguments that have been advanced in defense of the current federal tax law's preferential treatment of carried interest.

The net tax effect on fund general partners will be much less than the 4 percent UBT rate

Since 1997, New York City has allowed New York City residents who are unincorporated business owners to take a partial credit against their city resident personal income tax liability for their share of the business's UBT payments. The credit is structured so that the tax credit percent declines as income rises, but since there is no upper income limit on the credit, it is effectively an across-the-board credit. Initially, the credit was 15 percent for those with taxable personal income of $142,000 or more. In 2007, the city council and the mayor pressed for a more generous tax credit for incomes below $142,000 and an increase in the credit from 15 to to 23 percent for incomes over $142,000.[22] As the Fiscal Policy Institute pointed out at the time the council was considering the increased credit, given the way the 2007 change was structured—as an

[21] Joseph Bankman, Ralph M. Parsons Professor of Law and Business, Stanford Law School, "Testimony, Carried Interest Part II," before the Senate Finance Committee, July 31, 2007.
[22] Martha E. Stark, New York City Commissioner of Finance, "Summary of 2007 New York State and New York City Legislation Affecting City Taxes and Department of Finance Programs," March 1, 2008, pp. 8-9.

across-the-board increased credit—about 80 percent ($23 million) of the total dollar value of the tax change benefited those with incomes over $150,000.[23]

For fund managers who are New York City residents, the 23 percent UBT credit on the city personal income tax effectively reduces any increased UBT liability by almost one quarter. In addition, any local business income tax likely would be deductible on the payer's federal income tax. Adding these two tax benefits together would effectively reduce any additional UBT liability by about half.[24] Thus, rather than the 4 percent UBT rate, a New York City resident fund manager would effectively pay only a two percent tax on the added amount of income subject to UBT taxation.

Will taxing carried interest induce funds to restructure or move out of New York?

The debate around changing the federal tax treatment of carried interest involves increasing the tax bite from 15 percent to 35 percent, a difference of 20 percent. Given the magnitude of that change, Knoll suggests that private equity funds likely would alter their transactional structures to reduce the tax impact.[25] While changing the structure of future funds is always possible, existing funds would not be affected, and it is questionable whether the structures would change in response to the much smaller tax difference at the New York City level. It is far from clear whether private equity firms would endure the transactions costs involved in making a change that might only be localized in an otherwise national and international industry. In recent years, New York City and New York State have been monitoring business tax compliance more closely and the state has acted administratively and statutorily to close several tax loopholes.

Changing the New York City tax treatment of carried interest involves a net difference of two percent, not 20 percent. While some commentators undoubtedly will insist that this two percent will trigger fund flight, considering the current concentration of fund activity in New York City and New York City's unsurpassed attraction as a place to conduct financial service business and as a desirable residence for very high income individuals, it is unlikely that two percent would tip any scale in favor of moving out.[26] During the 2003 to 2005 period, both New York State and New York City imposed higher tax rates on the entire amount of taxable personal income and there was no detectable flight from New York City, despite dire warnings to that effect.[27]

[23] James Parrott, FPI Deputy Director and Chief Economist, "Freelancers, Inc." New York Times, op ed, June 3, 2007.
[24] Assuming the tax payer is in the top 35 percent federal income tax bracket, the deduction for net local business income tax would be .35 times .77 (1 minus .23), or .2695. Adding that to the 23 percent UBT credit on the New York City personal income tax yields a combined effective tax reduction of .4995.
[25] Knoll, p. 14.
[26] For data on the current concentration of private equity fund and hedge fun activity in New York City, see Section III, above.
[27] In a March 27, 2008 letter to Albany leaders supporting raising taxes on high income households given tough budget choices, Nobel prize-winning economist, Joseph E. Stiglitz, stated: "In fact, who can point to an exodus in the wake of the similar high-end state (and New York City) income tax hike that was in place from 2003 to 2005? It didn't happen then and New York appears to be as attractive as ever."

While the UBT has flaws, it is a critical part of business taxation

The UBT is often, justifiably, criticized for taxing very small businesses and even independent contractors and free lancers. The more than $25 million in UBT cuts approved last year that overwhelmingly benefited UBT payers with the highest incomes could have been used to exempt nearly everyone with unincorporated business income under $175,000. In 2004, 92 percent of UBT taxes were paid by business owners with UBT liability of $10,000 or higher—that is, from businesses with profits of over $250,000. Half of the UBT liability in 2004 was paid by partnerships (including LLCs) with liability of $1 million or more.[28]

The UBT is a critical part of New York City's approach to business income taxation and its efforts to maintain a level playing field between large businesses across the various sectors of the city's dynamic commercial and financial economy. With the UBT, the city is able to reasonably tax business income regardless of the particular form of business organization.

Given the increased use of non-corporate forms of conducting business, it is essential that New York City maintain its UBT.

What is the outlook for private equity funds and hedge funds?

While some private equity funds and hedge funds have been caught up in the subprime mortgage meltdown, most of these firms have not been as adversely affected as the large Wall Street investment and commercial banks.[29] Several large funds profited handsomely in 2007 by betting against specific stocks or capitalizing on rising prices for commodities. Most private equity firms seek to exit profitably from their investments after holding companies for four to seven years.

Profitability will suffer in the short run but over the longer term private equity firms likely will devise different strategies to realize the higher profits. Some private equity funds and hedge funds have begun specializing in the stocks or bonds of distressed companies, banking on an eventual rebound or betting that the losses will be less than anticipated. The near-term outlook for many funds within both of these industries, particularly for funds whose strategies rely on a lot of leverage, has been dampened by the recession and the severe credit crunch pervading financial markets. Once the economy rebounds, it is likely that private equity funds and hedge funds will be as popular, and possibly as profitable, as they were before the onset of the downturn.

[28] New York City Department of Finance, Office of Tax Policy, "Statistical Profile of New York City Business Income Taxes, Tax Year 2004," December 2007, pp. 27, 34.
[29] The collapse of two hedge funds affiliated with Bear Stearns helped trigger the demise of the parent corporation, and hedge funds run by Carlyle Capital, Peloton and Sailfish have been terminated. Jack Willoughby, "Scaling the Heights," *Barron's*, April 14, 2008, p. 27.

New York City's forecasts for Fiscal Years 2008-2010 show much more resilience in the UBT than in either the General Corporation Tax or the Bank Corporation Tax compared to the peak levels reached for each of these three taxes in 2007.[30]

New York's tremendous income disparities and the growing wealth of private equity fund and hedge fund managing partners

New York State has the greatest degree of polarization between the rich and the poor and one of the widest gaps between the rich and those in the middle of any state.[31] New York City's income gap is even wider than for New York State. Tax data, which are more accurate than Census Bureau survey data in gauging income polarization, indicate that in 2005, the top one percent of New York City tax filers (representing 32,000 returns) received 72 percent of adjusted gross income, including 70 percent of business income and 86 percent of capital gains.[32]

Congressional Budget Office Director Orszag notes that capital gains from partnerships and S corporations were 22 percent of total long-term capital gains realized in 2005 and 27 percent of the capital gains received by the top one percent of taxpayers with the highest incomes. While these figures are national, it is likely that a similar pattern exists in New York State.[33]

In view of this historic income polarization, taxing the compensation of a private equity managing partner that can run into the tens of millions of dollars and higher on the same basis as the business income of a small business owner seems like an uncontroversial and overdue tax change.

The latest list from *Forbes* of the 400 wealthiest Americans shows 73 New Yorkers. Of this number, thirty-two made their billion dollar-plus fortunes from private equity or hedge funds. Collectively, these 32 fortunes total nearly $110 billion. Billionaire hedge fund and private equity general partners in the tri-state area show a distinct preference for New York State, and particularly, New York City. *Forbes* lists a total of 37 billionaires who made their fortunes in either private equity or hedge funds in the tri-state area, with Connecticut accounting for four, New Jersey one and New York State thirty-two. Of New York State's 32 private equity/hedge fund billionaires, New York City is home to 29, according to *Forbes*.[34] That's over 78 percent of the fund billionaires in the tri-state area.

In an editorial, *The Financial Times* summed up the need for far-reaching tax policy changes:

[30] New York City Office of Management and Budget, forecasts as of Jan. 29, 2008.
[31] See Fiscal Policy Institute, *Pulling Apart in New York: An Analysis of Income Trends in New York State*, April 9, 2008.
[32] 2005 New York Personal Income Tax Sample File from the Office of Tax Policy, NYS Department of Taxation and Finance, analyzed by the New York City Independent Budget Office, April 2008.
[33] Orszag, p. 4.
[34] *Forbes*, "The 400 Richest Americans," September 20, 2007.

For another day are bigger questions of whether it ever makes sense to tax capital gains at a lower rate than ordinary income (the policy that gave rise to this problem in the first place), and in the American case, whether the tax system as a whole should be made more progressive. The case for reform on both points is strong, in fact. But the carried interest anomaly can be dealt with promptly, and should be.[35]

[35] *Financial Times*, "The Fair Way to Tax Private Equity," July 19, 2007.

APPENDIX A: Fifty Largest Private Equity Firms

GLOBAL RANK	NAME OF FIRM	HEADQUARTERS	CAPITAL RAISED OVER LAST FIVE YEARS (billions $)
1	The Carlyle Group	Washington, D.C.	32.50
2	**Kohlberg Kravis Roberts**	**New York**	**31.10**
3	**Goldman Sachs Principal Investment Area**	**New York**	**31.00**
4	**The Blackstone Group**	**New York**	**28.36**
5	TPG	Fort Worth	23.50
6	Permira	London	21.47
7	Apax Partners	London	18.85
8	Bain Capital	Boston	17.30
9	Providence Equity Partners	Providence, RI	16.36
10	CVC Capital Partners	London	15.65
11	Cinven	London	15.07
12	**Apollo Management**	**New York**	**13.90**
13	3i Group	London	13.37
14	**Warburg Pincus**	**New York**	**13.30**
15	Terra Firma Capital Partners	London	12.90
16	Hellman & Friedman	San Francisco	12.00
17	**CCMP Capital**	**New York**	**11.70**
18	General Atlantic	Greenwich, CT	11.40
19	Silver Lake Partners	Menlo Park, CA	11.00
20	Teachers' Private Capital	Toronto	10.78
21	EQT Partners	Stockholm	10.28
22	First Reserve Corporation	Greenwich, CT	10.10
23	American Capital	Bethesda, MD	9.57
24	Charterhouse Capital Partners	London	9.00
25	**Lehman Brothers Private Equity**	**New York**	**8.50**
26	Candover	London	8.29
27	**Fortress Investment Group**	**New York**	**8.26**
28	Sun Capital Partners	Boca Raton, FL	8.00
29	BC Partners	London	7.90
30	Thomas H. Lee Partners	Boston	7.50
31	Leonard Green & Partners	Los Angeles	7.15
32	Madison Dearborn Partners	Chicago	6.50
33	Onex	Toronto	6.30
34	**Cerberus Capital Management**	**New York**	**6.10**
35	PAI Partners	Paris	6.05
36	Bridgepoint	London	6.05
37	Doughty Hanson & Co.	London	5.90
38	AlpInvest Partners	Amsterdam	5.40
39	TA Associates	Boston	5.20
40	Berkshire Partners	Boston	4.80
41	Pacific Equity Partners	Sydney	4.74
42	**Welsh, Carson, Anderson & Stowe**	**New York**	**4.70**
43	Advent International	Boston	4.60
44	GTCR Golden Rauner	Chicago	4.60
45	Nordic Capital	Stockholm	4.54
46	Oak Investment Partners	Palo Alto, CA	4.06
47	**Clayton, Dubilier & Rice**	**New York**	**4.00**
48	ABN AMRO Capital	Amsterdam	3.93
49	Oaktree Capital Management	Los Angeles	3.93
50	Summit Partners	Boston	3.88
	TOTAL		$551.3
	U.S. TOTAL		$364.9
	NYC TOTAL		$160.9
	NYC SHARE OF U.S.		44.1%

Source: Private Equity International, May 2007.

APPENDIX B: Fifty Top-Performing Hedge Funds (2007)

GLOBAL RANK	FUND NAME	FUND ASSETS (millions $)	3-YR. ANNUALIZED RETURN	COMPANY NAME	LOCATION	TOTAL FIRM ASSETS (billions $)
1	Passport II - Global	860	65.50	Passport Capital	San Francisco	3.7
2	Dynamic Power	641	60.20	Goodman & Company	Toronto	26.6
3	**Paulson Enhanced**	**3,352**	**50.66**	**Paulson & Co.**	**New York**	**29.0**
4	**Balestra Capital Partners**	**450**	**48.59**	**Balestra Capital**	**New York**	**0.7**
5	**Renaissance Technologies Medallion Fund**	**7,500**	**48.10**	**Renaissance Technologies**	**New York**	**30.0**
6	Metage Special Emerging Market	367	46.81	HIG Capital	London	N/A
7	**Atticus European - Class A**	**10,200**	**44.38**	**Atticus Management**	**New York**	**N/A**
8	**Harbinger Capital Partners Flagship Fund**	**14,100**	**43.90**	**Harbinger Capital Partners**	**New York**	**18.0**
9	Children's Investment Fund, The	5,000	41.98	The Children's Investment Fund Management	London	5.0
10	Aisling Analytics Pte Ltd Merchant Commodity Fund	1,377	39.99	Aisling Analytics Pte	Singapore	N/A
11	Blackhorse Emerging Enterprises Fund	380	38.32	Blackhorse Asset Management Pte.	Singapore	0.6
12	Sabre Fund	560	38.10	Matthews Capital Partners	Sydney, Australia	0.9
13	Global Emerging Markets Fund (USD)	497	37.94	Nevsky Capital	London	4.4
14	Long-Term Investment Fund (SIA) (USD)	2,409	37.58	Strategic Investment Advisors	Pfaeffikon, Switzerland	2.8
15	**Zweig-DiMenna International**	**1,960**	**37.40**	**Zweig-DiMenna International Managers**	**New York**	**4.1**
16	Polar Capital Paragon Absolute Return Fund (GBP)	605	37.02	Polar Capital Partners	London	3.3
17	**Eastern Advisors**	**358**	**33.80**	**Eastern Advisors**	**New York**	**0.4**
18	**Paulson Advantage**	**3,552**	**32.97**	**Paulson & Co.**	**New York**	**29.0**
19	Value Partners Classic Fund	1,203	32.36	Value Partners	Hong Kong	7.3
20	SR Global Fund Class C - International Portfolio	1,900	32.20	Sloane Robinson	London	15.1
21	**Libra Fund**	**1,180**	**31.79**	**Libra Advisors**	**New York**	**1.4**
22	Horseman Global Fund - Class A (USD)	2,615	31.76	Horseman Capital Management	London	3.6
23	Nevsky Fund Limited - Class A (USD)	1,610	31.40	Nevsky Capital	London	4.4
24	Blenheim Fund	3,000	30.80	Blenheim Capital Management	Somerset, N.J.	4.5
25	SR Global Fund Class G - Emerging Mkts Portfolio	2,700	30.50	Sloane Robinson	London	15.1
26	**Platinum Partners Value Arbitrage Fund (USA)**	**681**	**30.09**	**Platinum Management**	**New York**	**0.7**
27	Value Partners High-Dividend Stocks Fund	425	29.28	Value Partners	Hong Kong	7.3
28	Parvus European Absolute Opportunities	2,300	28.78	Parvus Asset Management	London	3.5
29	Millenium Global High Yield	854	28.75	Millenium Asset Management	Guernsey	12.1
30	Lone Cyprus	8,000	28.15	Lone Pine Capital	Greenwich, CT	19.0
31	Apis Offshore Capital	403	27.64	Apis Capital Advisors	Old Greenwich, CT	0.6
32	**JLF Partners I**	**795**	**26.97**	**JLF Asset Management**	**New York**	**0.8**
33	Sprott Offshore Fund (USD)	607	26.96	Sprott Asset Management	Toronto	6.2
34	Everest Capital Global	775	26.71	Everest Capital	Bermuda	3.0
35	Clarium	2,938	26.70	Clarium Capital Management	San Francisco	2.0
36	Boyer Allan Pacific Fund	1,464	26.45	Boyer Allan Investment Management	Hong Kong	1.7
37	Kinetics Partners	367	25.82	Kinetics Advisers	Sleepy Hollow, N.Y.	5.5
38	Global Undervalued Securities Fund	3,547	25.68	Kleinheinz Capital Partners	Cayman Islands	3.5
39	Altis Partners (Jersey) Ltd Global Futures	944	25.50	Altis Partners	Jersey, Channel Islands	0.9
40	**Paulson International**	**2,727**	**25.49**	**Paulson & Co.**	**New York**	**29.0**
41	Bay Resource Partners	910	25.44	GMT Capital	Atlanta	3.6
42	RAB Special Situations Fund - Class A (USD)	2,066	25.21	RAB Capital	London	7.2
43	North of South Emerging Markets Fund	529	25.00	North of South Capital	London	0.6
44	**Bay Harbour Partners**	**466**	**24.85**	**Bay Harbour Management**	**New York**	**1.3**
45	Tell Fund	716	24.84	Tell CP	Malta	0.8
46	QCM Global Diversified Program	441	24.54	Quality Capital Management	Weybridge, U.K.	0.5
47	MaxQ Fund Limited (USD)	374	24.22	North Asset Management	London	1.0
48	East of Suez	695	23.89	Brooke Capital	Hong Kong	0.7
49	Citadel Wellington	3,500	23.88	Citadel Investment Group	Chicago	20.0
50	Sprott Opportunities Hedge	331	23.77	Sprott Asset Management	Toronto	6.2
	NYC Total	47,321				
	NYC Weighted Average		41.99			

Source: Barron's, April 14, 2008.

Appendix C: New Yorkers on the Forbes List of 400 Wealthiest Americans with Hedge Funds or Private Equity Firms Cited as Principal Source of Wealth (2007)

NATIONAL RANK	NAME	NET WORTH (billions $)	RESIDENCE	SOURCE
18	Carl Icahn	14.5	New York, NY	Private Equity
28	Ronald Perelman	10.0	New York, NY	Private Equity
33	George Soros	8.8	Westchester, NY	Hedge Funds
40	Stephen Schwarzman	7.8	New York, NY	Private Equity
57	Henry Kravis	5.5	New York, NY	Private Equity
57	James Simon	5.5	East Setauket, NY	Hedge Funds
82	Leon Black	4.0	New York, NY	Private Equity
91	Stanley Druckenmiller	3.5	New York, NY	Hedge Funds
91	Bruce Kovner	3.5	New York, NY	Hedge Funds
91	Daniel Ziff	3.5	New York, NY	Hedge Funds
91	Dirk Ziff	3.5	New York, NY	Hedge Funds
91	Robert Ziff	3.5	New York, NY	Hedge Funds
165	John Paulson	2.5	New York, NY	Hedge Funds
165	Peter Peterson	2.5	New York, NY	Private Equity
165	David Shaw	2.5	New York, NY	Hedge Funds
239	J. Christopher Flowers	2.0	New York, NY	Private Equity
239	Joshua Harris	2.0	New York, NY	Private Equity
239	Thomas Lee	2.0	New York, NY	Private Equity
297	Wesley Edens	1.6	New York, NY	Private Equity
317	Peter Briger, Jr.	1.5	New York, NY	Private Equity
317	Israel Englander	1.5	New York, NY	Hedge Funds
317	Hamilton James	1.5	New York, NY	Private Equity
317	Jerome Kohlberg, Jr.	1.5	New York, NY	Private Equity
317	Marc Lasry	1.5	New York, NY	Hedge Funds
317	Michael Novogratz	1.5	New York, NY	Private Equity
317	Daniel Och	1.5	New York, NY	Hedge Funds
317	Marc Rowan	1.5	New York, NY	Private Equity
361	James Dinan	1.4	New York, NY	Hedge Funds
361	Nelson Peltz	1.4	Bedford, NY	Private Equity
380	Glenn Dubin	1.3	New York, NY	Hedge Funds
380	Barry Rosenstein	1.3	New York, NY	Hedge Funds
380	Henry Swieca	1.3	New York, NY	Hedge Funds

Source: Forbes.com, 9/20/07.

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