

**New York State Department of Taxation and Finance
Office of Tax Policy Analysis
Technical Services Division**

TSB-A-04(6)I
Income Tax
October 25, 2004

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. I040330D

On March 30, 2004, a Petition for Advisory Opinion was received from McDermott, Will & Emery, c/o Arthur Rosen, Esq., 50 Rockefeller Plaza, New York, New York 10020.

The issue raised by Petitioner, McDermott, Will & Emery, is whether the portion of nonresident partners' distributive shares of partnership income (an upper tier partnership) attributable to an investment in a lower tier partnership that trades in intangible personal property solely for its own account will be New York source income when received by the nonresident partners of the upper tier partnership who are individuals, estates and trusts.

Petitioner submits the following facts as the basis for this Advisory Opinion.

Petitioner's client (Investment Adviser) is a New York limited partnership. Investment Adviser is owned by one general partner and two limited partners. The two limited partners are a third party bank with a minority interest and an individual with a majority interest (hereinafter referred to as Q). Investment Adviser's general partner (with an ownership interest of less than one percent) is an S corporation that is owned 100% by Q, who also owns a limited partnership interest in Investment Adviser. Investment Adviser provides investment advisory services, pursuant to investment advisory agreements, to investment funds that have been organized in a master feeder structure described as follows.

Each investment fund (Master Fund) is a Delaware limited liability company (LLC) that is classified as a partnership for federal income tax purposes (lower tier partnership). Each Master Fund has two members that are treated as partners for federal income tax purposes. The two partners are a domestic feeder fund (Domestic Feeder) and an offshore feeder fund (Offshore Feeder). Each Master Fund, with the assistance of Investment Adviser, trades in stocks and securities for its own account. In addition, one of the Master Funds has investments in other Master Funds. None of the Master Funds is a dealer in stocks or securities or acts as a market-maker in securities. Each Master Fund files a New York State partnership return.

The Offshore Feeders are characterized as non-United States corporations for federal income tax purposes. The investors in the Offshore Feeders are non-United States persons and United States tax exempt entities.

Each Domestic Feeder is a Delaware LLC that is classified as a partnership for federal income tax purposes (upper tier partnership). The investors, i.e., partners, in the Domestic Feeders are United States resident individuals and United States entities that are either estates or trusts. Certain individuals and entities invest in more than one Domestic Feeder. Each Domestic Feeder invests for its own account in a Master Fund, which in turn invests in stocks and other

securities. None of the Domestic Feeders “makes a market” in securities or otherwise acts as a dealer in securities. Each Domestic Feeder files a New York State partnership return and reports its distributive share of the lower tier Master Fund’s items of income, gain, loss, and deduction.

The Domestic Feeders are contemplating investing, by becoming a limited partner, in a new entity that will be organized as a limited partnership (New LP) (a lower tier partnership.) In making their investments from time to time in New LP, the Domestic Feeders may utilize a portion of the income they earn from (or distributions they receive as return of capital related to) their investments in the Master Funds. Similarly, the Domestic Feeders may utilize a portion of the income they earn from (or distributions they receive as return of capital related to) their investments in New LP to make other investments from time to time in the Master Funds. The Domestic Feeders will have no management or other control over the operation or activities of New LP.

New LP will conduct an active loan origination business, based in Texas. The general partner (New GP) of New LP will be a corporation which is wholly- owned by Investment Adviser. Certain of Investment Adviser’s management personnel will serve on the board of directors of New GP. New GP will employ personnel and establish an office in Texas to carry out the activities of New LP. New GP will retain Investment Adviser to provide certain administrative and support services. Additionally, Investment Adviser, as an ultimate owner, will have oversight over the risks incurred by and the operations of New GP.

Initially, it is contemplated that the business of New LP will consist of the following two types of lending activities:

1. The provision of senior and mezzanine financing (loans) to commercial and industrial borrowers, primarily corporations. Such loans are expected to be provided to borrowers that have exhausted other sources of financing. The borrowers would not be related to New LP. New GP, on behalf of New LP, will be responsible for the negotiation and administration of the loans. New LP will earn both fees and interest income on such loans. In addition, in connection with providing such loans, New LP may receive certain equity interests in the borrowing entity, including options and warrants to acquire the common stock of the borrower.

2. The provision of mortgage loans secured by real property to entities or individuals. The borrowers would not be related to New LP. Some of the borrowing entities or individuals will be referred to New LP by an unrelated third party (referring party) pursuant to a contractual arrangement with such referring party. New GP, on behalf of New LP, will negotiate the loans and conduct the necessary due diligence before any such mortgage loan is funded. In addition, New GP will administer such mortgage loans on behalf of New LP.

New GP, on behalf of new LP, will consult with Investment Adviser management personnel in connection with approving the loans described above, assessing the risk profile and exposure related to such loans, and certain other incidental activities. New LP may make loans of either of the two types described above to borrowers secured by assets located in numerous jurisdictions, including New York. For purposes of this Advisory Opinion, it is assumed that at least a portion of the income generated by New LP will be considered trade or business income from New York sources.

Certain of the same management personnel of Investment Adviser who are involved with New LP will also be involved in advising the Master Funds with regard to investments, and may act as managing directors of the Managing Entity for either Domestic Feeder or Offshore Feeder or one or more of the Master Funds. The Managing Entity is a limited liability corporation with two members. The majority member is Q. The minority member is an S corporation that is owned 100% by Q. Q is the same person who owns a limited partnership interest in Investment Adviser. While the Master Funds may invest in certain mortgage related securities, the Master Funds will not be directly involved in New LP's business activities and will not invest directly in New LP. One of the Master Funds owns all of the stock of a corporation that owns two loans but does not intend to pursue an active lending business. From time to time, such Master Fund may receive dividend income from this wholly-owned corporate subsidiary.

Investment Adviser and Managing Entity will typically be compensated by the various feeder entities for their services to the Master Funds, New LP, and the feeder entities. The compensation is based both on a monthly percentage of net assets and the positive annual performance of each entity. Such amounts are likely to be paid with funds distributed to the feeder entities by the Master Funds and New LP. It is anticipated that Investment Adviser will, in turn, allocate appropriate compensation to its subsidiary, New GP, for its services to New LP, as described above.

Applicable law and regulations

Section 601(f) of the Tax Law provides:

Partners and partnerships. A partnership as such shall not be subject to tax under this article. Persons carrying on business as partners shall be liable for tax under this article only in their separate or individual capacities. As used in this article, the term "partnership" shall include, unless a different meaning is clearly required, a subchapter K limited liability company. The term "subchapter K limited liability company" shall mean a limited liability company classified as a partnership for federal income tax purposes. The term "limited liability company" means a domestic limited liability company or a foreign limited liability company, as defined in section one hundred two of the limited liability company law, a limited liability investment company formed pursuant to section

five hundred seven of the banking law, or a limited liability trust company formed pursuant to section one hundred two-a of the banking law.

Section 617(b) of the Tax Law provides, in part:

Character of items. Each item of partnership . . . income, gain, loss, or deduction shall have the same character for a partner . . . under this article as for federal income tax purposes. Where an item is not characterized for federal income tax purposes, it shall have the same character for a partner . . . as if realized directly from the source from which realized by the partnership . . . or incurred in the same manner as incurred by the partnership. . . .

Section 631 of the Tax Law provides, in part:

(a) General. The New York source income of a nonresident individual shall be the sum of the following: (1) The net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income, as defined in the laws of the United States for the taxable year, derived from or connected with New York sources, including: (A) his distributive share of partnership income, gain, loss and deduction, determined under section six hundred thirty-two, and

* * *

(2) The portion of the modifications described in subsections (b) and (c) of section six hundred twelve which relate to income derived from New York sources (including any modifications attributable to him as a partner. . . .

(b) Income and deductions from New York sources.

(1) Items of income, gain, loss and deduction derived from or connected with New York sources shall be those items attributable to:

* * *

(B) a business, trade, profession or occupation carried on in this state; or

* * *

(2) Income from intangible personal property, including annuities, dividends, interest, and gains from the disposition of intangible personal property, shall constitute income derived from New York sources only to the extent that such income is from

property employed in a business, trade, profession, or occupation carried on in this state....

* * *

(d) Purchase and sale for own account. A nonresident, other than a dealer holding property primarily for sale to customers in the ordinary course of his trade or business, shall not be deemed to carry on a business, trade, profession or occupation in this state solely by reason of the purchase and sale of property or the purchase, sale or writing of stock option contracts, or both, for his own account.

Section 632 of the Tax Law pertains, in part, to nonresident partners and provides, in part:

(a) Portion derived from New York sources.

(1) In determining New York source income of a nonresident partner of any partnership, there shall be included only the portion derived from or connected with New York sources of such partner's distributive share of items of partnership income, gain, loss and deduction entering into his federal adjusted gross income, as such portion shall be determined under regulations of the [Commissioner of Taxation and Finance] consistent with the applicable rules of section six hundred thirty-one.

* * *

(e) Application of rules for resident partners . . . to nonresident partners. . . .

(1) A nonresident partner's distributive share . . . of items shall be determined under subsection (a) of section six hundred seventeen.

(2) The character of partnership . . . items for a nonresident partner . . . shall be determined under subsection (b) of section six hundred seventeen.

Section 633(a) of the Tax Law provides, in part:

(a) General. The New York source income of a nonresident estate or trust shall be the sum of the following:

(1) The net amount of items of income, gain, loss and deduction entering into federal adjusted gross income, as determined under paragraph four of subsection (e) of section six hundred one, derived from or connected with New York sources. Such

determination of source shall be made in accordance with the applicable rules of section six hundred thirty-one as in the case of a nonresident individual.

Section 137.6 of the Personal Income Tax Regulations provides:

Tiered partnerships. Where a nonresident partner is a member in a partnership, and such partnership (hereinafter referred to as the "upper tier partnership") is a partner in another partnership (hereinafter referred to as the "lower tier partnership"), the source and character of such nonresident partner's distributive share of each partnership item of the upper tier partnership which is attributable to the lower tier partnership retains the source and character determined at the level of the lower tier partnership using the provisions of sections 137.1 and 137.5 of this Part. Such source and character are not changed by reason of the fact that such item flows through the upper tier partnership to such nonresident partner.

Opinion

Each Master Fund and Domestic Feeder is classified as a partnership for federal income tax purposes and each member of each Master Fund and Domestic Feeder is treated as a partner. Under section 601(f) of the Tax Law each Master Fund and Domestic Feeder is classified as a partnership and is not subject to New York State personal income tax. However, the individuals, estates and trusts that are members of each Domestic Feeder are carrying on business as partners and are liable for income tax in their separate or individual capacities.

Under section 632(a)(1) of the Tax Law, the New York source income of a nonresident partner of any partnership includes only the portion derived from or connected with New York sources of such partner's distributive share of items of partnership income, gain, loss and deduction entering into the individual's federal adjusted gross income. The determination of such portion shall be consistent with section 631 of the Tax Law.

Pursuant to section 631(b) of the Tax Law, items of income, gain, loss and deduction derived from or connected with New York sources include those items attributable to a business, trade, profession or occupation carried on in New York State. However, pursuant to section 631(d) of the Tax Law, a nonresident, other than a dealer holding property primarily for sale to customers in the ordinary course of the individual's trade or business, shall not be deemed to carry on a business, trade, profession or occupation in this State solely by reason of the purchase and sale of property or the purchase, sale or writing of stock option contracts, or both, for the individual's own account.

Section 633 of the Tax Law provides that nonresident estates and trusts determine New York source income in accordance with the applicable rules of section 631 of the Tax Law, as in the case of a nonresident individual.

In *Kenneth S. Davidson Partners*, Adv Op Comm T&F, June 28, 1988, TSB-A-88(11)I, it was held that the purchase and sale by the partnership of options on indexes, foreign currencies, debt obligations and futures contracts and the exercise, closing out or expiration of such options solely for its own account did not constitute the carrying on of a business, trade, profession or occupation in New York State. However, the opinion noted that the partnership would not be considered to be solely trading for its own account if it engaged in certain other activities such as market making activities.

In *Paul E. Singer*, Adv Op Comm T&F, June 4, 1992, TSB-A-92(2)I, it was held that a partnership with two general partners, a nonresident individual and a limited partnership, engaged in trading securities for its own account was not carrying on a trade or business in New York. The income attributable to the partnership was not New York source income under section 631 of the Tax Law, and did not change its character despite the existence of a tiered partnership arrangement where the partnership's income was funneled through the limited partnership before its ultimate distribution, or deemed distribution, to the individual.

In the present case, each Master Fund invests in stocks and other securities for its own account, but is not a dealer in stocks or securities and does not act as a market maker in securities. The Master Funds may invest in certain mortgage-related securities, but Petitioner states that the Master Funds will not be directly involved in New LP's business activities and will not invest directly in New LP. Investment Adviser provides investment advisory services to the Master Funds pursuant to investment advisory agreements. It appears that the Master Funds are investing in stocks and other securities solely for their own account within the meaning of section 631(d) of the Tax Law and as contemplated in *Davidson Partners*, *supra*, and, therefore, the Master Funds will not be deemed to be carrying on a business, trade, profession or occupation in New York State because of such activity.

New LP will conduct an active loan origination business, a portion of the income from which is assumed in this Advisory Opinion to be New York source income from a trade or business carried on in New York within the meaning of section 631(b)(2) of the Tax Law. Investment Adviser will provide investment advisory services to New LP and New GP, which is Investment Adviser's wholly owned subsidiary. Certain of Investment Adviser's management personnel will serve on the board of directors of New GP, and it will have oversight over the risks incurred by and the operations of New GP. New LP will consult with Investment Adviser management personnel in connection with approving loans, assessing the risk profile and exposure related to such loans, and certain other incidental activities.

The Domestic Feeders invest for their own account in one or more lower tier Master Funds and are treated as partners in the Master Funds, and may become limited partners in lower tier New LP. The Domestic Feeders are not dealers in stocks or securities and do not act as market makers in securities. Investment Adviser provides investment advisory services to the Domestic Feeders pursuant to investment advisory agreements. Certain of Investment Adviser's management personnel may act as directors of Managing Entity which provides management services to such Domestic Feeders. However, Petitioner states that the Domestic Feeders will have no management or other control over the operation or activities of New LP.

Nonresident individuals, estates and trusts are partners in the upper tier Domestic Feeders. The upper tier nonresident partners' distributive share of the items of income, gain, loss and deduction of each Domestic Feeder includes the Domestic Feeder's (a) distributive share of the items of income, gain, loss and deduction generated by each lower tier Master Fund from trading in stocks and other securities for its own account, and (b) if the Domestic Feeder is a limited partner in New LP, the distributive share of the items of income, gain, loss and deduction generated by the lower tier New LP from its loan origination business, and (c) if the Domestic Feeder is carrying on a business, trade, profession or occupation in New York State, the distributive share of the items of income, gain, loss and deduction generated by such activities. Following *Paul E. Singer, supra*, the fact that a portion of the nonresident partners' distributive share of the items of income, gain, loss and deduction of a Domestic Feeder includes its distributive share of items of income, gain, loss and deduction generated by New LP, which conducts business in New York, will not change the treatment of the Domestic Feeder's distributive share of items of income, gain, loss and deduction generated by a Master Fund which trades in stocks and other securities solely for its own account.

Under section 137.6 of the Personal Income Tax Regulations, and following *Paul E. Singer, supra*, the nonresident partners' distributive share of a Domestic Feeder's distributive share of items of income, gain, loss or deduction that is generated by a lower tier Master Fund that trades in intangible personal property solely for its own account, will not be New York source income under section 631(b)(2) of the Tax Law.

However, the nonresident partners' distributive share of a Domestic Feeder's distributive share of items of income, gain, loss or deduction that is generated by lower tier New LP's business conducted in New York, will be New York source income under section 631(b)(1)(B) of the Tax Law.

If a Domestic Feeder is carrying on a business, trade, profession or occupation in New York State, and the Domestic Feeder employs its ownership interest in the Master Fund in its business, trade, profession or occupation in New York, any items of income, gain or loss generated by the sale or other disposition by the Domestic Feeder of its ownership interest in the Master Fund would be included in the Domestic Feeder's items of income, gain, loss or

TSB-A-04(6)I
Income Tax
October 25, 2004

deduction from carrying on its business, trade, profession or occupation in New York. (See *Ronald van der Horst*, Adv Op Comm T&F, September 6, 2000, TSB-A-00(5)I.) The nonresident partners' distributive share of a Domestic Feeder's income generated by the Domestic Feeder's business, trade, profession or occupation carried on in New York would be New York source income under section 631(b)(1)(B) of the Tax Law. This treatment of the Domestic Feeder's disposition of its ownership interest in the Master Fund does not affect the treatment of the distributive share of items of income, gain, loss and deduction attributable to the Master Fund as discussed above.

DATED: October 25, 2004

/s/
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NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.