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Whistleblowers

New York State Record Tax Whistleblower Settlement Illustrates Pitfalls of Domestic Tax-Shifting Schemes

Apr. 27, 2017

By Vincent Pitaro, *Hedge Fund Law Report*

In March 2015, an unnamed whistleblower (Whistleblower) filed a *qui tam* action in New York State Supreme Court under the state's False Claims Act against Harbert Management Corporation (HMC), Harbinger Capital Partners Offshore Manager LLC (Offshore Manager) and others. The suit asserted that those entities, as well as several affiliated entities and individuals, had failed to report and pay New York State income tax on millions of dollars of performance fee income derived from their fund-management activities in New York.

For more on the tax treatment of performance fee income, see "Are Compensatory Options on Offshore Hedge Fund Shares Subject to the Anti-Deferral Provisions of Internal Revenue Code Section 457A?" (Jun. 13, 2014).

Several parties to the action recently entered into a Stipulation and Settlement Agreement (Stipulation) pursuant to which the respondents have agreed to pay over $40 million in the aggregate, including an award of more than $8.8 million – approximately 22 percent of the total settlement amount – to the whistleblower. The settlement is the largest such recovery in New York and serves as an important reminder that fund managers must comply with the tax regime of each jurisdiction in which they operate. This article analyzes the terms of the Stipulation and its potential ramifications on the hedge fund industry.

For coverage of actions involving Harbinger, see "Settlement by Harbinger's Former COO Calls Into Question the Utility for Hedge Fund Manager Executives of Indemnification Provisions in Fund Documents and D&O Insurance Policies" (Aug. 1, 2014); "Important Implications and Recommendations for Hedge Fund Managers in the Aftermath of the SEC's Settlement With Philip A. Falcone and Harbinger Entities" (Aug. 22, 2013); and "SEC Charges Philip A. Falcone, Harbinger Capital Partners and Related Entities and Individuals With Misappropriation of Client Assets, Granting of Preferential Redemptions and Market Manipulation" (Jun. 28, 2012).

Parties and Relevant Background Information

The whistleblower action was prosecuted by Eric T. Schneiderman, the Attorney General of the State of New York (NYSAG). See "Regulators from the SEC, CFTC and New York Attorney General's Office Reveal Top Hedge Fund Enforcement Priorities (Part Two of Four)" (Dec. 18, 2014).

The settling respondents in the action are HMC, HMC Investors LLC, Raymond J. Harbert, Michael D. Luce, David A. Boutwell, Charles D. Miller, William W. Brooke, Joel B. Piassick, Sonja J. Keeton, Michael P. White, Carole B. Schafer, Raymond Jones Harbert Jr. Trust, Mary Kathryn Harbert Trust, John Murdoch Harbert II Trust and HMC-New York, Inc. (collectively, the Respondents). All Respondents other than HMC, Keeton and HMC-New York, Inc. were members of the Offshore Manager and residents of Alabama.

HMC, which is headquartered in Birmingham, Alabama, was the sponsor of Harbinger Capital Partners Master Fund I Limited and its offshore feeder fund (together, the Fund). HMC hired non-party Philip Falcone to be the Fund's senior managing director, causing him to serve as the "primary decision-maker for matters concerning the Harbinger Fund's investment strategy, day-to-day investment and securities trading, and portfolio construction activities."

From 2002 through 2009, the Offshore Manager served as the Fund's investment manager. During that time, Falcone also served as vice president, senior portfolio manager and senior managing director of the Offshore Manager. The offshore feeder Fund paid the Offshore Manager performance fees equal to 20 percent of its net profits. The Offshore Manager had taxable income for the first time in 2004.

The basis of the Whistleblower's claim was that the Respondents had "made, used, or caused to be made or used, false statements that were material to their obligation to pay or transmit money" – *i.e.*, income tax – to New York City and New York State. The

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Respondents countered that "the tax law provisions at issue in this investigation are ambiguous and that they consulted with tax professionals and obtained advice supporting [their] tax positions."

New York City Operations

At relevant times, Falcone was a resident of New York City. He and "a group of traders, analysts, and investment professionals" worked out of the Offshore Manager's New York City office, which was identified in its operating agreement as its principal office. The Stipulation indicates that Falcone and his team conducted the following activities for the Fund from that office:

- development of investment ideas and strategy;
- investment due diligence;
- trading;
- interaction with "players in the distressed investment community";
- development of return expectations, position sizes and exit strategies; and
- communications with investors and other investor-relations activities.

In short, the NYSAG asserted that "the trading activity, without which no revenue would have been generated, occurred in New York City, where the man hired to conduct it lived."

In contrast, the members and officers of the Offshore Manager who were based in Alabama primarily performed back- and middle-office functions. Specifically, they "provided certain executive oversight, and were primarily responsible for operational, fund-raising, accounting, investor relations and reporting, legal, compliance, and risk management functions on behalf of Offshore Manager and the [Fund]."

Offshore Manager Did Not Allocate Any Income to New York

LLC Taxation Generally

Limited liability companies (LLCs) commonly elect to be taxed as partnerships in order to eliminate tax at the entity level, with the LLC's income and losses passed through to its members. Members of an LLC that conducts business in New York are subject to income tax on New York-source income, while an entity operating in New York City may also be subject to its Unincorporated Business Tax (UBT). According to the Stipulation, New York State taxes the portion of an LLC member's "distributive share of partnership income derived from New York sources."

For an overview of partnership taxation issues, see "Hedge Fund Tax Experts Discuss Allocations of Gains and Losses, Contributions to and Distributions of Property From a Fund, Expense Pass-Throughs and K-1 Preparation at FRA/HFBOA Seminar (Part One of Four)" (Jan. 16, 2014); and "What Critical Issues Must Hedge Fund Managers Understand to Inform Their Preparation of Schedules K-1 for Distribution to Their Investors?" (Mar. 14, 2013).

Offshore Manager Tax Filings

The Offshore Manager filed New York State partnership income tax returns on Form IT-204 for the 2004, 2005, 2008 and 2009 tax years, but failed to apportion any of its performance fee income to New York in any of those years. The Offshore Manager did not file a New York State return in either 2006 or 2007.

On the New York State returns that the Offshore Fund did file, it failed to list its New York City office as a place where it "carries on business" and stated that it "has no nexus in New York State and has no income derived from New York sources." In addition, from 2004 through 2007, the Offshore Fund did not file a New York City UBT return.

For more on state and local taxation of private funds, see "Accounting for Uncertain Income Tax Positions for Investment Funds" (Jan. 14, 2011).

Due to the tax position taken by the Offshore Manager, New York State did not receive income tax on "hundreds of millions of dollars of performance fees" from the Fund. Moreover, by allocating all its income to Alabama instead of New York, the Offshore Manager dramatically reduced the total taxes payable by its Alabama-based members. Finally, "New York residents who received performance fee income – chiefly Mr. Falcone – paid lower New York State taxes as a result of a credit for tax these members paid to Alabama . . . ."

Certain Respondents were also members of HMC Convertible Offshore Manager, LLC, which took the same position as the Offshore Manager with respect to the performance fee income that it earned.

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Offshore Manager's "Unsupportable" Position

The NYSAG asserted that the Offshore Manager ignored the advice of both internal and external tax professionals in taking the position that it was not required to allocate any of its income to New York.

The Offshore Manager's chief administrative officer (CAO) and its executive vice president were primarily responsible for its internal tax compliance. In preparing returns for 2004, the CAO advised that allocation of 100 percent of the Offshore Manager's performance fee income to Alabama was "unsupportable" and later indicated that the company "may get aggressive" in order to allocate income in that manner.

Regarding external tax advice, the Offshore Manager consulted with Ernst & Young (EY) over a period of days when preparing its returns for 2004. The CAO advised other members of the LLC that EY's "initial reaction" was that taxes were owed to New York City and State.

Additionally, when Falcone became the sole owner of the Offshore Manager in 2009, his external tax adviser, PricewaterhouseCoopers, concluded that the members of the Offshore Manager owed income tax and UBT to New York on its performance fee income. The Alabama members of the Offshore Manager agreed to be responsible for such taxes if New York challenged the position they had taken.

In light of these internal and external tax recommendations, the tax position ultimately taken by the defendants was "a brazen and deliberate decision to avoid paying millions in taxes owed to New York State," according to NYSAG Schneiderman in his press release announcing the settlement. The defendants "made a clear choice to skirt the rules and as a result, ordinary New York taxpayers were left footing the bill," he added.

Settlement Terms

The Respondents have agreed to pay $40,073,823 in the aggregate, representing $31,257,582 to New York State and $8,816,241 to the Whistleblower. They have also agreed not to claim such payments as a deduction or credit on any New York State or New York City return.

As part of the settlement, certain Respondents are also entering into separate closing agreements with the New York State Department of Taxation and Finance. Those agreements specify the amounts to be paid by the respective Respondents. If the Respondents fail to pay the agreed amounts in full, New York State may rescind the Stipulation or pursue other specified remedies.

See our two-part series on the tax treatment of False Claim Act settlements: "Are Legal Settlements Tax Deductible?" (Nov. 6, 2014); and "Ten Steps That Hedge Fund Managers Can Take to Maximize the Tax Deductibility of Settlement Payments" (Nov. 13, 2014).

The Stipulation also contains the following mutual releases:

- Upon payment in full of the agreed amounts, New York State releases each of the Respondents from any claim it may have arising out of the tax positions taken by the Offshore Manager and the Respondents' failure to pay income tax on New York-source income described above (Covered Conduct). Notably, the release specifically excludes "[a]ny civil, criminal, or administrative liability arising under state or municipal tax laws," but such matters may be covered in the separate closing agreements.
- The Whistleblower releases (1) each of the Respondents from any claims the Whistleblower may have on behalf of New York State or New York City in connection with the Covered Conduct; and (2) New York State, its agencies, employees and agents from any claims arising out of the Covered Conduct or the investigation and prosecution of this action.
- The Respondents release the Whistleblower and New York State, its agencies, employees and agents from any claims arising out of the Covered Conduct or the investigation and prosecution of the action.

Finally, the Stipulation makes clear that the releases by New York State and the Whistleblower do not extend to Falcone or the Offshore Manager. The NYSAG's investigation of these actors concerning this matter is continuing.

Key Takeaways

"This is a landmark case from any of a number of perspectives," stated Neil V. Getnick, the managing partner at law firm Getnick & Getnick who represented the Whistleblower in this settlement. Specifically, this is due to the fact that the settlement represents the largest New York tax whistleblower recovery, the largest New York percentage share to a whistleblower and the largest dollar amount for a whistleblower in a New York False Claims Act case not involving Medicaid, he explained.

Emphasis on Domestic Tax Evasion

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While these benchmarks highlight the significance of the settlement generally, Getnick also emphasized several important takeaways for the hedge fund industry. The most significant "wakeup call" for hedge fund managers, he noted, "has to do with this case revealing a new tax evasion method involving the shifting of tax obligations to another state instead of offshore."

This is significant because hedge fund tax evasion efforts have traditionally involved complex, offshore transactions and structures, Getnick noted. What this case concerned, however, is much closer to home and is easily accomplished – the shifting of taxes from a higher tax jurisdiction to a lower tax jurisdiction, he explained. "From the perspective of a governmental agency, the impact of both the domestic and the offshore efforts is the same – zero dollars get paid."

The NYSAG office's aggressive stance in pursuing this settlement should also give hedge fund managers operating entities in multiple jurisdictions pause. In his press release announcing the settlement, NYSAG Schneiderman cautioned that "this sends a forceful reminder to businesses that if they think they can get away with tax evasion in New York, they should think again." This warning is particularly notable, according to Getnick, because the New York False Claims Act has a 10-year statute of limitations.

Remedying Historical Violations

Aside from just addressing its tax treatment going forward, any fund manager with a nexus of activity in New York needs to evaluate its tax filings over the last decade in light of the statute of limitations to determine if they ran afoul of the law. Fund managers typically weigh the importance of this task against the likelihood of authorities unearthing the violation, Getnick said.

This calculus changes, however, "in light of the generous awards available under the whistleblower laws, which incentivize a whole new set of eyes and ears – and an empowerment of individuals with this type of knowledge – to step forward," Getnick noted. This omnipresent threat presented by whistleblowers – in the form of current or former employees, as well as outside consultants or professionals – means that fund managers "cannot hide their activities behind closed doors as they have done in the past," he reasoned.

In light of this, the optimal approach for fund managers and other companies that discover a historical tax violation would be to self-report to government authorities, Getnick recommended. "In addition to reducing the amount of any penalty imposed by the governmental authorities," he continued, "this approach allows a manager to control the narrative for how its investors learn about – and perceive – the tax violations."

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