

New York Hedge Fund to Chip in \$30 Million in Additional Settlement

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By Andrea Muse

The New York attorney general announced a \$30 million settlement for tax abuses with a hedge fund manager, adding to a previous \$40 million settlement with the investment management company, Harbert Management Corp. (HMC).

In a [September 28 release](#), New York Attorney General Barbara Underwood announced that the settlement resolves claims against Harbinger Capital Partners Offshore Manager LLC (Offshore Manager) of failure to apportion performance fees for investment activities to the state and New York City.

The state previously [entered into](#) a \$40 million settlement with HMC and the Alabama members of Offshore Manager, stemming from the same whistleblower lawsuit. HMC sponsored and organized the hedge fund managed by Offshore Manager, and members of Offshore Manager included several senior executives of the investment management company.

Zal Kumar of Mayer Brown LLP told *Tax Notes* on September 28 that the settlement showed that New York City and the state are learning how the asset management industry works in order to "more effectively tax it." The case "involves the complicated concept of apportioning income and shows that aggressive tax planning can be more dangerous than fraud," he continued, but added that "written, fully-informed, contemporaneous professional advice can be extremely valuable."

Timothy Noonan of Hodgson Russ LLP told *Tax Notes* that the case "really highlights how broadly the state is interpreting the term 'knowingly' in False Claims Act cases." He said the case involves "an especially complex area of tax law where minimal guidance had been issued," which raises the question of "how a person can 'knowingly' violate a tax law that is not even clear in the first place."

Offshore Manager was paid annual performance fees by one of the hedge fund's offshore feeder funds equal to 20 percent of the feeder fund's net profit for the year. Under Philip Falcone, Offshore Manager's senior managing director, the hedge funds made billions in profits by betting against subprime mortgages, resulting in hundreds of millions of dollars of performance fees for Offshore Manager.

Offshore Manager apportioned 100 percent of the income to Alabama, where HMC's corporate headquarters and its executive management are located. Offshore Manager served as a passthrough entity for its members, who paid Alabama taxes on the income.

A False Claims Act suit was brought against Offshore Manager in 2015, which claimed that the

company had failed to pay New York state income tax for tax years 2004 through 2009, and New York City unincorporated business tax for tax years 2004 through 2007. The relator argued that the performance fees should have been apportioned to New York and not Alabama because of Offshore Manager's business activities in New York.

Randall Fox of Kirby McInerney LLP told *Tax Notes* that the case illustrates how important it is for whistleblowers to come forward. He said that a common defense of taxpayers in False Claims Act cases is that they have already been audited by state tax officials, but in this case, the attorney general alleged false and misleading statements were made during the audit.

Fox also said that this case makes it clear that taxpayers won't be able to avoid investigations or liability by simply saying that a professional was consulted, because there will be an inquiry into what facts the professional had, what advice the professional gave, and whether the advice was followed. He also noted that a superseding complaint was filed in this case along with the settlement, a first for investigations led by the Taxpayer Protection Bureau, adding that the "world gets to see exactly what the AG's office viewed as the misconduct."

The Complaint

In a [September 26 superseding complaint](#), the attorney general, the city, and the state said Offshore Manager ignored professional advice that it should pay New York state and New York City taxes on the performance fee income, and pointed to handwritten notes in which the company's chief administrative officer said that not apportioning any of the income to New York was an unsupportable position.

The complaint claimed that Offshore Manager's principal office was in New York City for the tax years at issue, but Offshore Manager had concealed its business activities in New York "by pretending that it had left New York."

The complaint also argued that the company misled the New York State Department of Taxation and Finance by amending the company's limited liability company agreement to change the location of the company's principal office from New York to Alabama without alerting state tax officials that the address had been changed during the audit.

The attorney general's release said that the claims in the complaint would be discontinued upon compliance with the settlement terms.

The Settlement Agreement

As part of the [settlement agreement](#), Offshore Manager admitted that it had an obligation to apportion its income as taxable to the state because it carried on its business in New York and that, in connection with a 2009 sale of Offshore Manager to Falcone, "the purchaser and its representatives received advice that apportionment to New York was required and thus was on notice that Offshore Manager had such an obligation."

According to the settlement agreement, PwC, which represented Offshore Manager during an

audit for tax years 2009 through 2011, sent a letter to the New York Department of Taxation and Finance stating that all of the company's revenue-generating activity in 2009 was completed in Alabama. The letter said in a footnote that the company's New York property was leased by an affiliate of the company and "was only used for receiving mail during the year."

But under the settlement agreement, Offshore Manager admitted that it "conducted business and engaged in the activity of investing and reinvesting capital from an office in New York City."

The settlement requires Offshore Manager to pay the state \$9.9 million, New York City \$13.5 million, and the whistleblower \$6.6 million. The company also paid New York City \$4.8 million to resolve an outstanding tax judgment, according to the attorney general's release.

Under the agreement, 100 percent of the performance fee income earned from 2004 through 2009 by Offshore Manager that was deferred and received effective January 1, 2018, will also be apportioned to New York state and New York City. Offshore Manager represented that the fair market value of the deferral, which is taxable for the 2017 tax year, was at least \$100 million.