

California FTB Retains New Proposed Method for Sourcing Receipts from Asset Management Services

Overview

On July 21, 2020, the California Franchise Tax Board (“FTB”) will hold its fifth Interested Parties Meeting (“IPM”) regarding the proposed amendments to California Code of Regulations, title 18, (“CCR”) section 25136-2.¹ In anticipation of the fifth IPM, the FTB released its fourth version of draft language proposing amendments to the market-based sourcing regulations promulgated under CCR section 25136-2 (“Amended Draft CCR section 25136-2”).² **Written comments regarding the Amended Draft CCR section 25136-2 are due to the FTB by August 18, 2020.**

The last version was issued on July 19, 2019 (“Prior Draft CCR section 25136-2”).³ Prior Draft CCR section 25136-2 proposed a new methodology that generally sources receipts derived from asset management services based on the average value of the interest in assets held by the asset’s investors or beneficial owners domiciled in California. Amended Draft CCR section 25136-2 retains the majority of the prior proposed rules, but it makes some clarifying changes to those rules.

Importantly, in Amended Draft CCR section 25136-2, **the FTB proposes an effective date for the proposed amendments of taxable years beginning on or after January 1, 2019.**⁴ This Tax Alert summarizes these proposed asset management rules, the FTB’s recent changes and provides some taxpayer considerations.

Background Relating to the Asset Management Rules

The FTB’s prior round of amendments made to CCR section 25136-2 were finalized in September of 2016.⁵ During that round of amendments, the FTB included two examples that illustrated how receipts derived from asset management services should be sourced to California and sourced such receipts to the location of the shareholders, beneficial owners, or investors (*i.e.*, a look through approach).⁶ However, due to concerns raised by some members of the public, the FTB ultimately excluded those examples from the final regulatory language, but indicated that it planned to open a new regulation project to make additional amendments to CCR section 25136-2.⁷

On January 20, 2017, the FTB held an IPM to discuss its next round of amendments to CCR section 25136-2.⁸ Thereafter, to facilitate the second IPM, the FTB issued draft language for its proposed amendments to CCR section 25136-2.⁹ That

¹ FTB Notice of Fifth Interested Parties Meeting Market-Based Rules for Sales Other Than Sales of Tangible Personal Property – California Code of Regulations, Title 18, section 25136-2 (available [here](#)).

² See Amended Draft CCR section 25136-2 (July 21, 2020) (available [here](#)).

³ See Prior Draft CCR section 25136-2 (July 19, 2019) (available [here](#)). The FTB’s prior proposed amendments to CCR section 25136-2 (Prior Draft CCR section 25136-2) are discussed in more detail in our Multistate Tax Alert, dated July 16, 2019 (available [here](#)).

⁴ Amended Draft CCR section 25136-2(j)(3). The proposed amendments also allow a taxpayer to elect to have these amendments apply retroactively to taxable years beginning on or after January 1, 2018, but only if those taxable years are open to adjustment under the applicable statute of limitations. See Amended Draft CCR section 25136-2(j)(5).

⁵ See California Register 2016, No. 38, Office of Administrative Law.

⁶ The FTB’s prior proposed asset management examples were discussed in our Multistate Tax Alert, dated January 12, 2016 (available [here](#)).

⁷ *Id.*

⁸ See Summary of First Interested Parties Meeting, Regulation section 25136-2, Market-Based Sourcing Rules for Sales of other than Tangible Personal Property (available [here](#)).

⁹ See Draft Language for CCR section 25136-2 for the Second Interested Parties Meeting on June 16, 2017 (available [here](#)).

draft language re-inserted the asset management examples into proposed CCR section 25136-2 which sourced these receipts to the "location of the shareholders, beneficial owners, or investors" (*i.e.*, a look through approach).¹⁰

In the FTB's next draft version of this regulation issued for the third IPM on May 18, 2018, the FTB deleted the asset management examples. Instead, the FTB created rules that taxpayers must follow to source receipts from asset management services.¹¹ These rules generally require taxpayers to source these receipts to the "domicile of the shareholders, beneficial owners, and investors" (*i.e.*, a look through approach).¹²

In the FTB's next draft version issued for its fourth IPM on July 19, 2019, the FTB proposed a new methodology that generally sources receipts derived from asset management services based on the average value of the interest in assets held by the asset's investors or beneficial owners domiciled in California (*i.e.*, a look through approach).¹³

Recently, the FTB issued Amended Draft CCR section 25136-2 for purposes of its **Fifth IPM to be held on July 21, 2020**. In this version, the FTB made some clarifying changes to Prior Draft CCR section 25136-2 (which are noted in bold below), but retains the methodology proposed under Prior Draft CCR section 25136-2.

Revamped Rules for Assigning Receipts Derived from Asset Management Services

While the rules proposed under Prior Draft CCR section 25136-2 remain substantially the same in Amended Draft CCR section 25136-2, the FTB made some clarifying changes (discussed in bold print below). The Amended Draft CCR section 25136-2 still uses a look through approach to source asset management receipts based on the location of the investors or beneficial owners. Specifically, for asset management services that are not subject to CCR section 25137-14 (which apply to services provided to regulated investment companies a/k/a mutual funds), the "value of interest" rule is used to determine the location where the benefit of the asset management services is received. This rule assigns receipts from asset management services in the following manner:

- (1) Receipts are assigned to California in proportion to the average value of the interest in the asset(s) held by the asset's investors or beneficial owners domiciled in California. To calculate the average value, the rule uses the beginning of the year and end of the year percentages.¹⁴
- (2) "If the taxpayer does not know the average value of interest in the assets held by the asset's investors or beneficial owners domiciled [in California], the receipts shall be assigned to [California] to the extent the average value of interest in the assets held by the asset's investors or beneficial owners domiciled in [California] is reasonably estimated to be in [California]."¹⁵ **In Amended Draft CCR section 25136-2, the FTB changed the word "approximate" as used in Prior Draft CCR section 25136-2 to "reasonably estimated."**

To determine the interests in assets held by investors or beneficial owners who are domiciled in California, the Amended Draft CCR section 25136-2 provide that:

- The benefit of the asset management services is received at the domiciles of the investors in the assets unless the investor is holding title to the assets for a beneficial owner."¹⁶ The FTB further provided that:

"[t]he domicile of the investor is presumed to be the investor's billing address indicated in the records of the taxpayer. If the taxpayer has actual knowledge that the investor's principal place of business is different than the investor's billing address, there is no presumption."¹⁷ **In Amended Draft CCR section 25136-2, the FTB**

¹⁰ *Id.* The proposed examples also allowed taxpayers to "assign the sales by reasonably approximating the domicile of the shareholder, beneficial owner, or investor by utilizing information based on zip codes or other statistical data." *Id.*

¹¹ See Prior Draft CCR section 25136-2.

¹² *Id.* This version of the proposed amendments also contained alternative rules allowing for sourcing based on a reasonable approximation or U.S. population. *Id.*

¹³ See *supra* n.3.

¹⁴ Amended Draft CCR section 25136-2(c)(2)(A).

¹⁵ Amended Draft CCR section 25136-2(c)(2)(B) (emphasis added).

¹⁶ Amended Draft CCR section 25136-2(c)(2).

¹⁷ *Id.* (emphasis added).

changed the phrase “the presumption does not control” as used in Prior Draft CCR section 25136-2 to “there is no presumption.”

- “If the investor is holding title to the assets for a beneficial owner, the benefit of the asset management services is received at the domiciles of the beneficial owner of the assets”¹⁸ subject to the following presumption:

“[t]he domicile of a beneficial owner of assets managed by an asset manager shall be presumed to be the beneficial owner’s billing address indicated in the records of the entity for whom asset management services are rendered, or on the records of the asset manager. If the entity for whom the asset management services are rendered, or the asset manager, has actual knowledge that the beneficial owner’s primary residence or principal place of business is different than the beneficial owner’s billing address, the presumption does not control.”¹⁹

The FTB has defined “beneficial owner” to mean “any person who made an independent decision to invest assets.”²⁰ For purposes of this definition, “independent decision to invest assets” means “a decision to invest assets made by a person who was not required or committed to do so by contract, agreement, or any other arrangement, understanding, or relationship except pursuant to law.”²¹ The FTB has also provided information on non-beneficial owners:

The following are not beneficial owners for purposes of this definition:

(A) Master funds, feeder funds, and similar entities that pool investors' assets. Master fund entities and feeder fund entities do not make independent decisions to invest their assets because they are required by agreement with their limited partners, feeder funds, or other investors to invest the assets.

(B) A shareholder of a publicly-traded corporation whose board decides to invest the corporation’s excess capital into an investment vehicle. The corporation, not the shareholder, makes the independent decision to invest the capital into an investment vehicle.

(C) A participant of a defined benefit plan. Because participants have no control over whether to invest capital toward the defined benefit plan they are not beneficial owners.²²

Lastly, Amended Draft CCR section 25136-2 retains the first two examples that were provided under Prior Draft CCR section 25136-2 to illustrate how these new rules should apply.²³ **However, Amended Draft CCR section 25136-2 deleted the third example which involved asset management services provided to a “Mutual Fund Corporation.”**²⁴

Considerations

The amendments contained in Amended Draft CCR section 25136-2 are applicable for taxable years beginning on or after January 1, 2019 which effectively applies these proposed amendments retroactively to taxable year 2019. However, these proposed amendments are not yet final, and the FTB has not indicated when they will be finalized. Taxpayers interested in these proposed amendments may want to consider attending the fifth Interested Parties Meeting which will be held on **Tuesday, July 21, 2020. Written comments are due to the FTB by August 18, 2020.**

Taxpayers with receipts from asset management services should consult their tax advisors to evaluate how the FTB’s proposed amendments to CCR section 25136-2 may affect their business.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ Amended Draft CCR section 25136-2(b)(1).

²¹ *Id.*

²² *Id.*

²³ Amended Draft CCR section 25136-2(c)(2)(C).

²⁴ *Id.*

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