

## New York Releases Revised Draft Corporate Regulation on Market-Based Sourcing for Investment Managers

### Overview

On July 3, 2019, the New York State Department of Taxation and Finance ("Department") issued a revised version of a draft regulation that adds draft Reg. Sec. 4-2.18, Receipts from Other Services and Other Business Activities ("draft regulation").<sup>1</sup> The draft regulation applies only to corporations and does not apply to partnerships owned by individuals. Under the revised draft regulation, investment managers with management fee agreements with a passive investment customer (*i.e.*, a fund)<sup>2</sup> could be required to source receipts to the location of the investment manager. If adopted, the draft regulation could have a significant impact on New York based investment managers that are either corporations or have corporations in the ownership structure.<sup>3</sup>

This Tax Alert summarizes some of the changes to the draft regulation that effect investment managers and provides some taxpayer considerations.

### The Department Reverses Position on Market-Based Sourcing for Certain Investment Managers

The draft regulation reverses the Department's original position reflected in draft regulations previously issued on September 28, 2016, which contained language in draft Reg. Sec. 4-2.12 that generally looked through to the location of the fund's investors for the sourcing of receipts. A subsequent draft issued in August of 2017 eliminated draft Reg. Sec. 4-2.12.

The draft regulation looks to the location of the investment manager for purposes of sourcing receipts if certain conditions are met. Under draft Reg. Sec. 4-2.18 released on July 3, 2019, an investment manager must source service and other business receipts to the location where the customer receives the benefit of the service. The draft regulation further states that if the passive investment customer has granted "broad discretionary authority" to the investment manager to execute investment management decisions on behalf of the passive investment customer, New York will look to the location of the investment manager's offices where investment management and advisory decisions are made. The draft regulation does not currently provide a definition for "broad discretionary authority". If the passive investment customer does not grant the investment manager broad discretionary authority, New York would continue to look to the location of the investor.

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<sup>1</sup> New York draft Reg. Sec. 4-2.18, located [here](#).

<sup>2</sup> As defined in the draft regulation, passive investment customer means a customer that is an unincorporated entity, such as a limited partnership, general partnership, limited liability company, limited liability partnership or trust, that pools capital from passive investors for the purpose of trading or making investments in stocks, bonds, securities, commodities, loans, or other financial assets, but that does not otherwise conduct an active business. An entity is considered as engaged in an active business if the average value, determined on a quarterly basis, of its loans, federal, state and municipal debt, asset backed securities and other government agency debt, corporate bonds, reverse repurchase agreements and securities borrowing agreements, federal funds, stocks and partnership interests, physical commodities and other financial instruments that it owns does not exceed fifty percent of the average value of its total assets.

<sup>3</sup> It is important to note that the draft regulation provides an exclusion for Regulated Investment Companies (RICs), which continue to be sourced to the investor's location with an expanded hierarchy of sourcing methods to follow if underlying investor data cannot be obtained. Further, the draft regulation impacts sourcing for New York corporate tax purposes only, it does not impact personal income tax or New York City Unincorporated Business Tax.

## Example

The draft regulation includes numerous examples, many of which are highly fact-specific and complex. Example 12 below provides insight into the sourcing for investment managers:

Example #12: Management Corp, an investment management corporation, with an office located in New York, provides investment advisory services in exchange for a fee. Management Corp enters into a contract with Hedge Fund to provide the fund with investment advisory services. In addition, the contract authorizes Management Corp to have broad discretionary authority to manage funds and securities of Hedge Fund (including authority to purchase, sell, and otherwise trade securities of Hedge Fund) in a manner consistent with the investment strategy of the fund. Management Corp is providing its services to an entity that is not an investment company as defined under Tax Law Section 210-A(5)(d); therefore, receipts from these services are sourced under the rules in this section. The service provided by Management Corp is a management service provided to a passive investment customer, so Management Corp must use the rule for management services to passive investment customers to source this receipt to the location where Hedge Fund utilizes the investment advice to make investment decisions. Because Hedge Fund has granted broad discretionary authority to Management Corp to manage funds and securities of Hedge Fund, it is presumed that the location where Hedge Fund receives the benefit is the location where Management Corp executes these investment advisory and management decisions. Management Corp makes and utilizes the investment advisory and management decisions for Hedge Fund at Management Corp's office located in New York; therefore, the entire receipt is included in both New York receipts and everywhere receipts.<sup>4</sup>

In Example 12, Management Corp entered into a contract with Hedge Fund that provided "broad discretionary authority" to Management Corp to manage the funds and securities of Hedge Fund. Under this fact pattern, New York looks to the location of Management Corp's office. When Management Corp's office is located in New York, the entire receipt will be included in the New York receipts factor.

## Considerations

The terms of the contract between the investment manager and passive investment customer could play a significant role in determining New York sourcing of management fees. It is recommended that investment managers (especially New York based investment managers) review the terms of contracts with passive investment customers to analyze the impact of draft Reg. Sec. 4-2.18, if it is adopted.

When considered in combination with market-based sourcing requirements for other states, including a recent California draft regulation sourcing receipts to the underlying investor<sup>5</sup>, there is an inconsistency between the draft regulation and the approach taken by other states that look through to the location of the investor for corporate sourcing purposes (e.g., draft California regulations).

Taxpayers interested in or impacted by the draft regulation may provide feedback or comments to the Department by October 9, 2019. The Department can be contacted via email at [tax.regulations@tax.ny.gov](mailto:tax.regulations@tax.ny.gov).

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<sup>4</sup> See Draft N. Y. Reg. Sec. 4-2.18(c)(5) (July 3, 2019).

<sup>5</sup> See Amended Draft Cal. Code Regs. tit. 18, § 25136-2 (July 1, 2019).

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