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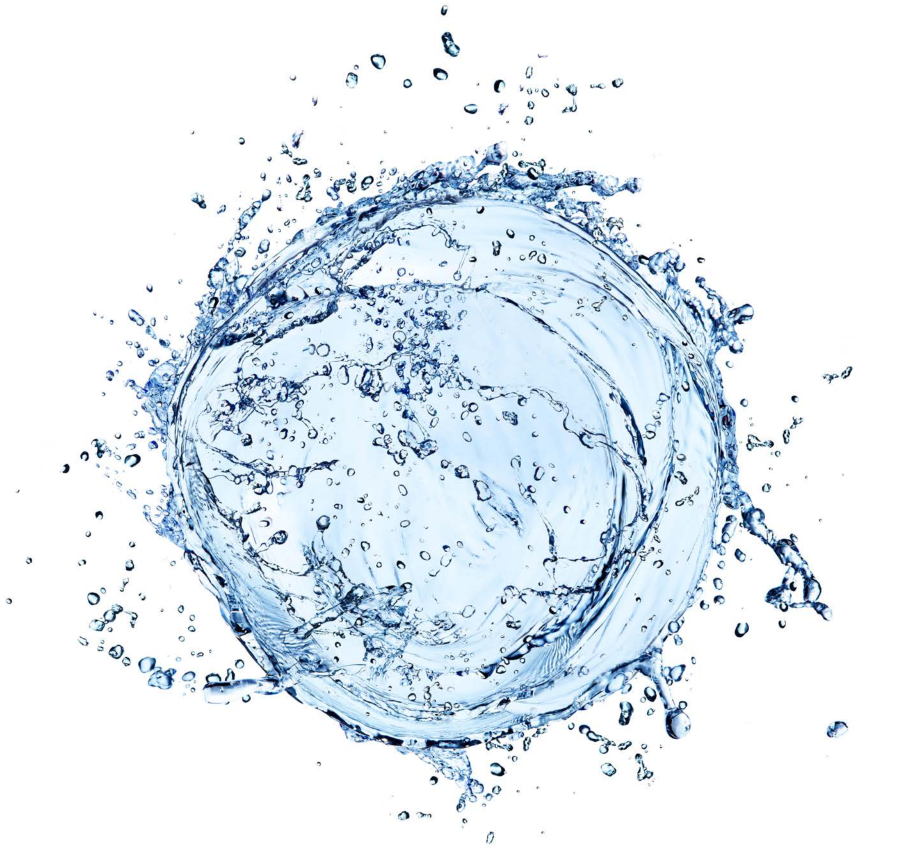

The still-rising tide

Will investment managers be swept up in state income tax trends?

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The Still-Rising Tide—Will Investment Managers Be Swept Up in State Income Tax Trends?

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More and more states are looking to increase state income tax revenues by expanding their definition of nexus beyond physical presence to include "economic activity" in the state—a trend that has continued for several years. In addition, more states are moving from cost of performance to market-based sourcing for receipts from services and intangibles. The question thus arises: Do these new rules apply to investment funds and investment managers? If they do, the partners in the funds and fund managers may face new state tax liabilities as well as some sticky compliance and withholding rules.

Introduction

Two state tax trends—economic nexus and market-based sourcing of the receipts factor—create challenges for investment funds and investment managers. Many in the industry are wondering just how far the states intend to go in taxing out-of-state businesses. Do these economic nexus and market-based

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sourcing rules apply to investment funds treated as partnerships for federal tax purposes and investment managers, or is investing not considered a business?[1] In this article, we will discuss both trends and highlight some of the related issues that have arisen for investment managers.

Economic Nexus

The term "nexus" describes the degree of activity that an out-of-state business must have in a state before that state has the right to impose a tax or filing obligation on the business. Economic nexus is a recent concept where a state, through statute or administrative guidance, asserts that economic activity in the state other than physical presence in the state is sufficient to create nexus. For example, in California a specified level of sales to customers in the state creates nexus,[2] while in Michigan the "active solicit[ation] of customers in the state" (e.g., maintenance of an internet site over and through which customers may browse products/services and place orders)[3] could create nexus.

Before discussing in greater detail the aspects of economic nexus and the implications for investment funds and investment managers, a review of general state income tax nexus concepts is worthwhile.

Overview of Nexus. Nexus is measured by state statutes, case law, and the Due Process and Commerce Clauses of the U.S. Constitution. In most if not all states, nexus exists for state tax purposes when a business has a physical connection to the state, through either (1) owning or leasing property in the state or (2) employing personnel in the state, provided that such in-state activity is deemed to be greater than a "de minimis" level of activity. Interpreting the Due Process Clause, courts have held that the minimum connection standard is met if the business purposefully directs its activity into a jurisdiction.[4] A more stringent connection standard exists under the Commerce

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[1] For example, in *Appeal of Bass*, 89-SBE-004 (Jan. 25, 1989), available at https://www.boe.ca.gov/legal/pdf/89-sbe-004.pdf, the California State Board of Equalization held that a partnership that acquired, held, monitored, and disposed of corporate stock and other securities was engaged in investment activities that did not rise to the level of a trade or business.

[2] California's "doing business" statute also contains bright-line thresholds based on payroll and property in the state, which, if triggered, establish nexus through physical presence rather than through "economic activity." We also note that the sales factor statutory threshold arguably serves as a proxy for a more holistic analysis of "economic activity" in the state. In this article, we focus on the "economic activity" implications of exceeding only the sales factor threshold where there is no physical presence and, thus, the term "economic nexus" is generally used throughout.

[3] Mich. Comp. Laws § 206.621(1); Rev. Admin. Bull. 2013-9, available at http://www.michigan.gov/documents/taxes/RAB2013-9_423463_7.pdf.

[4] See Nat'l Bellas Hess, Inc. v. Dep't of Rev. of Illinois, 386 U.S. 753 (1967).

Clause, which requires the business to have a "substantial presence" in the state before the requisite connection is established.[5]

Based on the U.S. Supreme Court's decision in *Quill Corp. v. North Dakota*,[6] many commentators believe that in order to satisfy the Commerce Clause "substantial nexus" requirement, a business must have a "physical presence" in a state before the state may impose a net income tax on the entity. However, many state tax administrators contend that the physical presence standard identified in *Quill* is limited to sales and use taxes, and therefore a business need not have a physical presence in a state before the state can subject the business to a net income tax. This has also been the trend in recent litigation, where state courts in various jurisdictions have held that a physical presence is *not* required to impose an income-based tax.[7] Note that none of these cases involved investment funds or investment managers. While legislation has been introduced in Congress in recent years that would specifically apply the *Quill* standard to all state business activity taxes, including net income taxes, this legislation has generally not made it out of committee.[8]

Additionally, nexus can be created by using independent contractors to conduct business in a state. In *Scripto, Inc. v. Carson*,[9] the U.S. Supreme Court ruled that the use of independent brokers satisfied the due process requirement that there be a definite link or a minimum connection between a state and the person the state wants to tax. In *Quill* the Court indicated that independent contractors in *Scripto* actually created a physical presence. As stated in *Quill*,

> The furthest extension of that power was recognized in *Scripto*, *Inc. v. Carson*, in which the Court upheld a use tax despite the fact that all of the seller's in-state solicitation was performed by independent

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[5] See Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977).

[6] 504 U.S. 298 (1992). In *Quill* the U.S. Supreme Court held that North Dakota could not require an out-of-state mail order retailer to collect use tax for sales to customers in the state because the retailer did not have physical presence in North Dakota.

[7] See, e.g. MBNA Am. Bank, N.A. v. Indiana Dep't of Rev., 895 NE2d 140 (In. Tax Ct. 2008); KFC Corp. v. Iowa Dep't of Rev., 792 NW2d 308 (Ia. 2010), *cert. denied*, 132 S. Ct. 97 (2011); Geoffrey, Inc. v. Comm'r, 899 NE2d 87 (Ma. 2009), *cert. denied*, 557 U.S. 920 (2009); Lanco, Inc. v. Div. of Tax'n, 879 A2d 1234 (N.J. Super. Ct. App. Div. 2005), *cert. denied*, 551 U.S. 1131 (2007); Geoffrey, Inc. v. South Carolina, 437 SE2d 13 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993); Tax Comm'r of West Virginia v. MBNA Am. Bank, 640 SE2d 226 (W. Va. 2006), *cert. denied*, 551 U.S. 1141 (2007); Secretary, Dep't of Revenue v. Gap (Apparel), Inc., 886 So.2d 459 (La. Ct. App. 1st Cir. 2004); Couchot v. State Lottery Comm'n, 659 NE2d 1225 (Oh.), *cert. denied*, 519 U.S. 810 (1996); Crutchfield Corp. v. Testa, 2016-Ohio-7760, 2016 Ohio LEXIS 2809 (Oh. 2016).

[8] The "Business Activity Tax Simplification Act" was introduced several times. See H.R. 3220, 108th Cong. (2003); H.R. 1956, 109th Cong. (2006); H.R.1439, 112th Cong. (2011); H.R. 2992, 113th Cong. (2013); H.R. 2584, 114th Cong. (2015). On June 12, 2017, H.R. 2887, 115th Cong. (2017)—the No Regulation Without Representation Act of 2017—was introduced.

[9] 362 U.S. 207 (1960).

> contractors. These cases all involved some sort of physical presence within the State. . . .[10]

Scripto involved a state sales tax, but many practitioners and tax administrators believe the standard also applies to net income taxes.

Limited Exception for Sales of Tangible Personal Property. Although an out-of-state business's "substantial presence" in a state constitutionally permits imposition of an income tax, the U.S. Congress has created an exception. In 1959, Congress enacted Public Law 86-272[11] to prohibit a state from imposing a net income tax on an out-of-state person if the person's only business activities within the state consist of the solicitation of orders for sales of tangible personal property and the orders are approved and filled from outside the state. Because investment funds and investment managers are not sellers of tangible personal property, however, they are generally not afforded the protection of Public Law 86-272. As a result, solicitation or relationship visits to current or potential customers by employees, officers, or independent contractors within a state (if such activities are not "de minimis") may create income tax nexus for an investment fund or investment manager.[12]

Focus on Economic Activity. As noted previously, a recent state tax trend has been the adoption, via statute or regulation, of "economic nexus" standards under which entities are deemed to have sufficient nexus if a certain level of receipts is generated from customers within the state, even if the entity does not have any physical presence in the state.[13] For example, under California's economic nexus provisions, which apply to taxable years beginning after 2010, an out-of-state taxpayer (which includes a partnership) is doing business in California, and thus is subject to California's taxing provisions, if its California sourced receipts, payroll, or property exceeds the lesser of 25 percent of the entity's total (receipts, payroll, or property) for the year or one of the threshold amounts (receipts, property, or payroll), as indexed

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[10] *Quill*, 504 U.S. at 306 (citation omitted).

[11] Codified at 15 USC § 381.

[12] Only a few states provide specific rules describing the amount or type of in-state activity that is required to establish a physical presence and those that do generally have a low threshold, such as Michigan's more-than-one-day standard pursuant to Mich. Comp. Laws § 206.621(1).

[13] Many of the states that have adopted such receipts or factor-based economic nexus provisions also include nexus thresholds based upon specified levels of payroll and property in the state. These tend to be non-controversial given that the existence of payroll and property in a state otherwise represents the existence of physical presence.

each year.[14] For taxable years beginning after 2015, the threshold amount of receipts is $547,711.[15] Other states that have adopted economic nexus standards for the imposition of net income or gross receipts taxes include Alabama, Colorado, Connecticut, New York, Ohio, Tennessee, and Virginia.[16] Each of these states establishes a threshold amount of in-state sales or transactions which create nexus.

The Ohio Supreme Court recently addressed the constitutionality of a receipts-based economic nexus standard relative to the levy of the Ohio Commercial Activity Tax on out-of-state taxpayers, holding that a receipts-based economic nexus standard did not violate the Dormant Commerce Clause of the U.S. Constitution.[17]

Application of Economic Nexus Rules to Investment Funds and Fund Managers

In some states, economic nexus statutes may subject investment funds and their managers to tax and/or the filing of state tax returns. The states that have adopted these economic nexus rules generally have drafted the statutes broadly to include as many taxpayers as possible, and typically do not provide an exemption for investment funds or investment managers. With respect to investment funds, many in the industry point out that investing is different from other businesses and that the generation of "nonbusiness" income should not create nexus. However, there is concern that the states may take the position

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[14] Cal. Rev. & Tax. Code § 23101. In its December 2013 publication, "Business Income Where Are We Today–Part 3," *Tax News*, the California Franchise Tax Board (FTB) explains how the economic nexus provisions apply to partnerships. See https://www.ftb.ca.gov/Archive/Professionals/Taxnews/2013/December/BigBusiness.shtml.

[15] The threshold level of receipts is adjusted annually to take inflation into account. For ease of discussion, we refer to the threshold effective for 2016 in the remainder of this article. In computing the amount of California receipts, the state's market-sourcing provisions must be applied. See Cal. Rev. & Tax. Code §§ 23101(b)(2) and 25136; Cal. Code Regs. tit. 18, § 25136-2. Those provisions generally attribute the sale to the location of the customer and, as noted later in this article, it is possible that in the case of an investment manager, the receipts may be attributed to the location of the investors in the fund.

[16] See Ala. Code § 40-18-31.2; Colo. Code Regs. § 39-22-301.1(2)(b); Conn. Gen. Stat. § 12-216a(a); State of Conn., Dep't of Revenue Servs., Q&A on Exonomic Nexus, Informational Publication 2010(19.1), available at http://www.ct.gov/drs/lib/drs/publications/pubsip/2010/ip2010-29.1.pdf; N.Y. Tax Law § 209.1; Ohio Rev. Code Ann. § 5751.01(I); Tenn. Code Ann. § 67-4-2004; Va. Ann. Code § 58.1-400, 23 Va. Admin. Code § 10-120-90, Ruling of Tax Commissioner, P.D. 90-128 (Aug. 22, 1990) ("a corporation will have Virginia source income if any apportionment factor is positive"), available at https://www.tax.virginia.gov/laws-rules-decisions/rulings-tax-commissioner/90-128; and Wash. Rev. Code § 82.04.067. Whether any of these states, other than California, Connecticut, and Washington, apply their economic nexus standards to partnerships and/or their owners is beyond the scope of this article.

[17] *Crutchfield Corp.*, supra note 7, at ¶ 56.

that investing is a business and that, accordingly, these economic nexus rules apply. To date the states have provided limited guidance on the application of these economic nexus rules to investment funds. Two California cases on the surface may appear to hold that investing in a limited partnership or limited liability company (LLC) is not doing business in California—*Swart Enterprises, Inc. v. Franchise Tax Board*[18] and *Appeal of Amman & Schmid Finanz AG.*[19] However, the tax years in dispute in both of these cases were prior to the law change in California adopting factor-based economic nexus.[20]

There is also limited guidance on the application of the economic nexus rules to investment managers. However, as discussed below, a growing number of states—including Washington, Connecticut, and California—have either issued guidance or are considering the issuance of guidance on the application of their market-based sourcing rules to investment managers. The combination of these market-based sourcing rules and the states' economic nexus rules may create new filing obligations and taxes for investment managers.

Some observers argue that these economic nexus rules may overreach, especially when applied to investment funds, because the investors who are the potential taxpayers may not have a substantial presence in the state as required by the Commerce Clause. However, litigating constitutional nexus issues can be costly and typically such litigation is not economically advantageous for investment managers to pursue.

Investment managers may not be too concerned about a particular fund having nexus in a state if that fund does not have income attributable to that state. In the following sections, we discuss how states have historically apportioned business income and the implications of the shift to market-based sourcing of services and intangibles.

Apportionment of Business Income

For taxpayers that have nexus in more than one state, the states generally use an apportionment formula to determine the amount of business income taxable in each of the states. However, the states are not required to adopt the same apportionment formula, and the apportionment formulas vary significantly among them.

Historically, states have used an apportionment formula based on the average of the property, payroll, and receipts factors, with each factor being

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[18] 7 Cal. App. 5th 497 (2017).

[19] 96-SBE-008 (Cal. St. Bd. of Equal. 1996).

[20] The taxpayers were still subject to the California income tax on their California income. Although both cases held that the taxpayers were not doing business in California and were not subject to the California Franchise Tax, California has a nearly identical tax for corporations that are not doing business in the state but that have income from California sources. The biggest difference between the two taxes is that the income tax does not impose the $800 minimum tax.

computed by determining the percentage in the state (e.g., the receipts factor equals the taxpayer's receipts in the state divided by the taxpayer's total receipts). The modern trend is for states to give the receipts factor additional weight. Many states, including California, have adopted a single receipts factor formula, thus no longer giving any weight to the property and payroll factors. As a result, taxpayers' business incomes are being attributed to the states based solely on the receipts factor and not based upon where the business has property and payroll.

Costs of Performance. Historically, most states considered receipts from intangibles and services to be located in or sourced to the state where the costs of performing the activity that gave rise to the receipts occurred. Under the costs-of-performance provisions, receipts from intangibles and services are generally located in the state where the services are performed, which in the case of an investment manager is typically where the investment manager has offices. Today, fewer than half of the states continue to compute the receipts factor using costs of performance for receipts from intangibles and services.

Market-Based Sourcing of Receipts. Another growing trend—the shift to market-based sourcing from costs of performance—changes the methodology by which sales of intangibles and services are sourced. In recent years, a number of states—including California, Connecticut, Illinois, Massachusetts, Montana, Nebraska, and Tennessee, plus the District of Columbia—have shifted from costs of performance to a market-based approach.[21] While other states—including Louisiana, Michigan, New York, Pennsylvania, and Rhode Island—have also adopted a market-based approach for corporations, such provisions may *not* be applicable to partnerships if all the partners are individuals.[22]

Under these market-based sourcing rules, receipts from services and intangibles are generally sourced to the state where the benefit of the services is received. If these rules apply to investment funds and investment managers, then the funds and their managers may find that they have income sourced to states in which they have no physical presence.

Double Whammy When Economic Nexus and Market-Based Sourcing Rules Are Combined. The combination of economic nexus rules (which can create a filing requirement for out-of-state taxpayers) and

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[21] See Cal. Rev. & Tax. Code § 25136; Conn. Gen. Stat. § 12-218(b); 35 Ill. Comp. Stat. 5/304(a)(3)(C-5)(iv); Mass. Gen. Laws ch. 63, § 38(f); MCA § 15-1-601.Art.IV.(17)(a); Neb. Rev. Stat. § 77-2734.14(3); Tenn. Code Ann. §§ 67-4-2012(i), (j); D.C. Code § 47-1810.02(g)(3).

[22] See La. Rev. Stat. Ann. § 47:287.95(L); Mich. Comp. Laws §§ 206.123 & 206.665(2); New York S.B. 6359-D, A-85559-D (Ch. 59, § 10(a) 2014); R.I. Gen. Laws § 44-11-14(b)(1); 72 Pa. Cons. Stat. § 7401(3)2(a)(16.1)(C)(I).

market-based sourcing rules (which can increase the amount of taxable income that an out-of-state taxpayer sources to the state) may create state tax issues for investment managers. In many situations it is the partners who have the potential tax exposure. Similar to federal tax law, most states do not tax a partnership and instead tax the partners on their distributive shares of the partnership's income. If the partnership has nexus in the state and receipts are sourced to the state, the partnership typically has to file a return and the partners usually have a filing requirement and tax liability in the state.

To ensure that state tax attributable to the partnership's income is paid to the state, most states now require partnerships to withhold tax for the nonresident partners, placing a significant compliance burden on the investment manager and creating potential exposure for partnerships that fail to withhold. These withholding requirements are often only a mechanism for the state to collect the tax efficiently and do not satisfy the partners' filing requirement in the state. While most states do have a mechanism for partnerships to satisfy the filing requirement for nonresident individual partners who elect to participate in a composite return, there are limitations on the types of partners who are eligible to be included in the composite return. Although composite returns can significantly reduce the compliance costs for nonresident individual partners, composite returns address only one element of the additional compliance burden that the combination of economic nexus rules and market-based sourcing may potentially create for investment managers.

Private Equity Fund—California Example of Potential Problem

California's market-based receipts factor regulations generally provide that the receipts associated with business income from the sale of a non-publicly traded corporation or partnership are considered California receipts to the extent that the entity being sold (the target) had California activities. If 50 percent or more of the target's assets consist of real and tangible property, then the California receipts are determined based on the average of the target's percentage of property and payroll in California. If more than 50 percent of the target's assets consist of intangible property, then the California receipts are determined based on the target's sales factor.[23]

Hypothetical Scenario 1. If a fund sells a closely held corporation (the assets of which consist of more than 50 percent real and tangible property) for $50 million and 10 percent of the corporation's property and payroll are in

[23] Cal. Code of Regs. tit. 18, § 25136-2(d)(1)(A)1(a). If the corporation or partnership primarily held intangible assets, only its sales factor would be used. Cal. Code of Regs. tit. 18, § 25136-2(d)(1)(A)1(b).

California, then, assuming the gain is considered business income, the fund has $5 million of California receipts, which exceeds the $547,711 economic nexus receipts threshold for 2016. If the fund is a limited partnership or LLC and has nexus in California, then it is liable for the $800 minimum tax.[24] If the fund is an LLC with over $5 million of California receipts, it is also liable for an additional $11,790 LLC fee.[25]

The fund may be liable for these fees even if it meets the definition of an investment partnership.[26] (See the discussion below for the definition of "investment partnership.") If the fund is an LLC and not a qualified investment partnership, it could also be subject to the nonconsenting member tax, which applies when nonresident members of an LLC do not consent to California's jurisdiction to tax.[27]

To date, the California Franchise Tax Board (FTB) has not indicated that these economic nexus rules are inapplicable to out-of-state investment partnerships.[28] Depending on the applicable facts, there may potentially be a position that the investment partnership's income is nonbusiness income and the investment partnership does not have California receipts.[29]

Filing and Withholding Issues for Investment Fund and its Partners. While the fees or tax levied directly on the investment fund can be challenging, a far more significant concern arises with the potential tax on the fund's investors/partners if the fund does not fall within California's definition of "investment partnership." Similar to most states, California requires partnerships to withhold California tax if the partnership makes distributions

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[24] Cal. Code of Regs. tit. 18, § 25136-2(d)(1)(A)1; Cal. Rev. & Tax. Code §§ 17935 & 17941.

[25] Cal. Rev. & Tax. Code § 17942.

[26] Generally, it has been the FTB's view that investment partnerships are engaged in a trade or business and therefore are subject to the annual $800 minimum tax and LLC fee if they have California nexus. See Appeal of Estate of Marion Markus, 86-SBE-097 (May 6, 1986), available at http://www.boe.ca.gov/legal/pdf/86-sbe-097.pdf; see also FTB 2016 Form 565 Booklet, at 9, available at https://www.ftb.ca.gov/forms/2016/16_565bk.pdf.

[27] Cal. Rev. & Tax. Code § 18633.5(e)(1).

[28] The FTB has indicated on its website that in applying the sales factor threshold set forth in Cal. Rev. & Tax. Code § 23101(b), corporations that are entitled to exclude from their income distributive share amounts of gain or loss from the sale or exchange of qualifying investment securities pursuant to subsection (a)(1) of Cal. Rev. & Tax. Code § 23040.1 (regarding corporate partners in investment partnerships) shall not take into account their pro rata shares of the sales, property, and payroll attributable to such sales or exchanges in determining whether they are doing business under Cal. Rev. & Tax. Code § 23101(b). See https://www.ftb.ca.gov/businesses/Doing-Business-in-California.shtml. However, the FTB's guidance specifically addresses only corporate partners and not other types of partners, such as partners that are limited liability companies.

[29] See *Appeal of Bass*, supra note1.

of California-sourced income to domestic nonresident partners, or on allocations of income, whether or not distributed, to foreign nonresident partners.[30] If the fund does not meet the investment partnership test, then the fund may be required to withhold tax on California-sourced income allocated to the nonresident partners. The partners may also have a California filing requirement and tax liability caused by the investment in the fund.

Funds that potentially have an issue should consult with their advisers to determine whether it is appropriate for the fund to reserve for the uncertain withholding obligations and potential penalties. State tax audits typically do not occur until a few years after the tax returns are filed. Funds face a number of issues when they make delinquent withholding payments after a state audit. One significant practical challenge is the withholding on partners who have liquidated their investments in the fund. Fund managers may end up absorbing the cost when they are unable to recover from their former partners the delinquent withholding amounts paid to the state.

Safe Harbor—Investment Partnership Rules

The investment partnership rules, which generally provide an exception to the normal apportionment rules described above and an exemption from withholding, may limit the state tax issues for many funds. However, fewer than half of the states have adopted such investment partnership provisions—and for those that have, the definition of qualifying investment partnership varies significantly. For example, the California definition of investment partnership has two tests. First, 90 percent or more of the partnership's income must be interest, dividends, and capital gains from qualified securities. Second, 90 percent or more of the partnership's assets must be qualified investment securities. If the partnership is an investment partnership, then the interest, dividends, and capital gains from qualified securities are not California-sourced income for nonresident partners.[31]

Investment Partnership—California Example of Potential Problem

Although California's investment partnership rules provide that interest, dividend, and capital gain income from qualifying investment securities is not California-source income for the partners in the investment partnership, the rules do not apply to the investment partnership itself. As a result, an investment partnership not based in California may nevertheless be considered to

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[30] Cal. Rev. & Tax. Code §§ 18662 (regarding domestic nonresident partners) and 18666 (regarding foreign nonresident partners).

[31] Cal. Rev. & Tax. Code § 17955.

be doing business in the state if its California-sourced sales for 2016 exceed the $547,711 threshold under the economic nexus provisions. This would cause the investment partnership to have a tax return filing requirement and be subject to the $800 minimum tax. It is also possible the California FTB could impose per-partner penalties on investment partnerships that fail to file a California tax return.[32] As noted earlier, to date, the FTB has not indicated that the economic nexus rules are inapplicable to out-of-state investment partnerships.[33] Depending on the applicable facts, the investment partnership may contend that the investment partnership's income is nonbusiness income such that the investment partnership would not have resulting California-sourced receipts.[34] However, it has been the FTB's view that investment partnerships are engaged in a trade or business and the market-based sourcing rules apply.[35]

Sourcing Rules for Specific Types of Investment Income. In September 2016, California published market-based sourcing regulations addressing the sourcing of interest and dividend income, and defining the term "marketable security."[36] These provisions are generally effective for tax years beginning on or after January 1, 2015. The rules for interest and dividend income, as well as the sourcing of gross proceeds on the sale of marketable securities, are summarized below:

- *Interest Income:* The regulations provide that interest income from investments other than loans is sourced to the location at which the investment is managed.[37] Although this rule is included as part of the market-based sourcing regulations, it is similar in application to the historical costs-of-performance rule. The treatment of interest from loans applies market-based sourcing principles and mirrors the longstanding California rules applicable to banks and financial corporations.[38] Interest from loans secured by real estate is sourced to the location of the property. Interest on unsecured loans is sourced to the location of the borrower.[39]

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[32] Per-partner penalties for failure to file are $216 per partner if the partnership return is filed more than six months after the due date. Cal. Rev. & Tax. Code § 19131.

[33] See note 28 supra.

[34] See *Appeal of Bass*, supra note 1.

[35] See *Appeal of Estate of Marion Markus*, supra note 26; see also FTB 2016 Form 565 Booklet, at 9, supra note 26.

[36] Cal. Code of Regs. tit. 18, § 25136-2.

[37] Cal. Code of Regs. tit. 18, § 25136-2(d)(1)(A)2a.

[38] Cal. Code of Regs. tit. 18, § 25137-4.2(c)(3)(C) and (D).

[39] Cal. Code of Regs. tit. 18, § 25136-2(d)(1)(A)2b & c.

- *Dividends:* California's market-based receipts factor regulations provide that dividend income is considered a California receipt to the extent that the corporation paying the dividend had California activities. Thus, if 50 percent or more of the corporation's assets consist of real and tangible property, then the California receipts are determined based on the average of the corporation's percentage of property and payroll in California. If more than 50 percent of the corporation's assets consist of intangible property, then the California receipts are determined based on the corporation's sales factor.[40]

- *Sales of Stock and Partnership Interests:* Proceeds from the sale of partnership interests and stock, other than marketable securities, are sourced in a similar fashion as dividends, as noted above (i.e., based on the underlying entity's California activities).[41]

- *Sales of Marketable Securities:* Proceeds from the sale of marketable securities are California receipts if the customer is located in California.[42] The definition of marketable securities is any security that is actively traded on an established stock or securities market.[43] Ironically, sellers on stock exchanges rarely know who the buyer is, making it difficult to determine if the buyer is located in California. If the customer's billing address or commercial domicile cannot be determined, then the location of the customer shall be reasonably approximated. In some cases, U.S. census data may be considered a reasonable approximation.[44] Whether this "back door" nexus based on sales "reasonably approximated" to the state satisfies the Due Process and Commerce Clause nexus requirements is an open question.

Hypothetical Scenario 2. If an investment partnership has dividend income of $10 million and 10 percent of the corporation's property and payroll is in California, then—assuming that (1) the dividend is considered business income and (2) more than 50 percent of corporation's assets

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[40] Cal. Code of Regs. tit. 18, § 25136-2(d)(1)(A)1(a). If the corporation or partnership primarily held intangible assets, only its sales factor would be used. Cal. Code of Regs. tit. 18, § 25136-2(d)(1)(A)1(b).

[41] Cal. Code of Regs. tit. 18, § 25136-2(d)(1)(A)1(a). If the corporation or partnership primarily held intangible assets, only its sales factor would be used. Cal. Code of Regs. tit. 18, § 25136-2(d)(1)(A)1(b).

[42] Cal. Code of Regs. tit. 18, § 25136-2(e).

[43] Cal. Code of Regs. tit. 18, § 25136-2(b)(5).

[44] Cal. Code of Regs. tit. 18, § 25136-2(e)(3).

consists of real and tangible personal property—the investment partnership has $1 million of California receipts, which is well above the $547,711 nexus receipts threshold for 2016. If the investment partnership is a limited partnership or LLC, then it may be liable for the $800 minimum tax.[45] In addition, if the investment partnership is an LLC, it may also be liable for the LLC fee, which for LLCs with over $5 million of California receipts is $11,790.[46]

Investment funds that (1) are taxed as partnerships and (2) invest directly or indirectly in operating partnerships may be significantly affected by these rules. In many instances, the income derived from the investment in the operating partnership could exceed 10 percent of the fund's income in a year. In such instances, the partnership would not qualify for the favorable investment partnership treatment and may be required to withhold California tax for the nonresident partners. A fund that is an LLC and not a qualified investment partnership could be subject to the nonconsenting member tax, which applies when nonresident members of an LLC do not consent to California's jurisdiction to tax.[47] Many private equity funds potentially may have this issue because they are structured as partnerships and invest in operating partnerships.

When structuring a fund, it is important that investment managers pay attention to the various state investment partnership definitions and rules in California and other states where such provisions exist. Qualification for investment partnership treatment could help mitigate many of the potential state income tax issues for the fund's investor-partners. If the private equity fund in Hypothetical Scenario 1 above were an investment partnership, for example, the gains from the sale of the closely held corporation would not be considered California-sourced income to the California nonresident investor-partners, the fund would not be required to withhold California tax, and the investor-partners might not be subject to California tax on the qualified investment income.

The new market-based sourcing rules increase the relevance for qualification under the investment partnership rules in California and other states. In California, as noted previously, managers should seek to structure the fund so that 90 percent or more of the fund's assets are qualified securities and 90 percent or more of the fund's income is interest, dividends, and capital gains from qualified investment securities. This may require the fund manager to set up two funds—one that invests in corporate stock and securities and another

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[45] Cal. Code of Regs. tit. 18, § 25136-2(d)(1)(A)1; Cal. Rev. & Tax. Code §§ 17935 and 17941.

[46] Cal. Rev. & Tax. Code § 17942.

[47] Cal. Rev. & Tax. Code § 18633.5(e)(1).

that invests in partnerships—so that at least the fund that invests in securities would qualify as an investment partnership.

Issues for Investment Managers

The market-based sourcing rules also create potential issues for the investment manager. California is proposing guidance regarding market sourcing for investment managers, and Washington and Connecticut have recently issued guidance, as detailed below.

Washington. Washington imposes a gross receipts tax, referred to as the Business and Occupations tax ("B&O tax"), rather than an income tax on business activities conducted within the state. Unlike a tax based on net income, almost no deductions are allowed from taxable gross receipts. Activities are taxed at different rates, depending on the activity. Management services fall within the "Service and Other Activities" category and are subject to B&O tax at a rate of 1.5 percent.[48] Certain international investment management services may be taxed at a lower rate of 0.275 percent.[49]

A company providing services has economic nexus in Washington when (1) gross receipts attributable to the state exceed $267,000 per tax year, regardless of whether the company has a physical location or employees based in the state; or (2) if either its payroll or property in the state exceeds $53,000.[50] In addition, once a taxpayer has established nexus under Section 82.04.067, the law automatically deems it to have nexus for the following tax year.[51]

Washington sources receipts from services based on where the benefit of the services is received.[52] There is a specific example in the B&O tax regulations containing the lookthrough rule for investment managers:

> Investment Manager receives a fee for managing the fund based on the value of the assets in the fund on particular days. Investment Manager knows or should know the identity of the investors in the fund and their mailing addresses. The fees received by Investment Manager (whether from the mutual fund or from individual investor's accounts) are for the services provided to the investors. Investment Manager's services do not relate to real or tangible personal property and do not

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[48] Wash. Admin. Code § 82.04.290.

[49] Id.

[50] Wash. Admin. Code § 82.04.067(1)(c). Nexus is also established if 25 percent of a taxpayer's total property, payroll, or receipts is attributable to sources within the state.

[51] Wash. Admin. Code § 82.04.220(2).

[52] Wash. Admin. Code § 458-20-19420(303)(d)(iii).

> require that the client be physically present, *therefore, the benefit of Investment Manager's services is received where the investors are located and Investment Manager's apportionable receipts must be attributed to those locations*.[53]

If the fee earned by an investment manager exceeds the $267,000 economic nexus threshold, the manager is subject to B&O tax and is required to file a tax return. In our experience, the Washington Department of Revenue (WADOR) has been actively auditing out-of-state investment managers who might be subject to B&O tax and who have not filed tax returns, assessing taxes and penalties back to 2010. Penalties can be as high as 39 percent of the unpaid tax.[54] Interest is also assessed. The law provides a voluntary disclosure program that can reduce or eliminate penalties. However, to qualify, the taxpayer must submit its voluntary disclosure application prior to being contacted by WADOR.

Connecticut. For tax years beginning in 2017, Connecticut expanded its market-based sourcing rules to flowthrough entities, including LLCs, limited partnerships, and S corporations.[55] Connecticut previously had enacted market-based sourcing rules for C corporations (effective for 2016), and market-based sourcing with a lookthrough rule for investment management services provided by "financial service companies" (in 1998).[56] Under Connecticut's lookthrough rule, receipts for investment management services are sourced to the state based on the ratio of the average value of the interests in the investment entity where the billing address of the owner is in Connecticut and divided by the average value of the total interests in the investment entity.[57] This rule was applicable to receipts received by corporations from investment funds not organized as regulated investment companies (RICs), for which another, similar rule existed for corporate taxpayers, based on the location of the shareholders in the RIC.[58]

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[53] Wash. Admin. Code § 458-20-19420(304), Ex. 32 (emphasis added).

[54] Wash. Rev. Code § 82.32.100(1).

[55] Conn. Gen. Stat. § 12-711(c).

[56] Conn. Gen. Stat. §§ 12-218b(b) and 12-218b(j). Financial service companies are generally C corporations. Management services are the rendering of investment advice directly or indirectly to an investment entity, pension fund, or retirement account, or the selling or purchasing of property constituting assets of an investment entity, pension fund, or retirement account and related activities, but only where such activity or activities are performed pursuant to contract. Conn. Gen. Stat. § 12-218b(a)(12). An investment entity means an investment partnership, a real estate investment trust, a real estate mortgage investment conduit, or a financial asset securitization investment trust. Conn. Gen. Stat. § 12-218b(a)(9).

[57] See Conn. Gen. Stat. § 12-218b(j).

[58] See Conn. Gen. Stat. § 12-218(e).

Effective January 1, 2017, Connecticut extended its market-based sourcing provisions to non-corporate taxpayers.[59] In Special Notice 2017-1, the Connecticut Department of Revenue Services specifically stated that non-corporate taxpayers subject to the Connecticut income tax who receive financial services income, which includes asset management revenue, are to utilize the existing corporate sourcing rules in Connecticut General Statutes Section 12-218b(j), which provides a lookthrough rule for asset managers.[60]

Market-based sourcing, coupled with the economic nexus provisions that have been effective since January 1, 2010,[61] can cause out-of-state fund managers to be subject to Connecticut income tax even though the manager does not have physical presence or employees based in Connecticut.[62] A company has economic nexus in Connecticut if its receipts from business activities attributable to sources within the state are $500,000, or more, per tax year.[63] For flowthrough entities subject to Connecticut's mandatory composite income tax, the January 1, 2017, effective date of these market-based sourcing rules will first require cash payments of tax on the original due date of their 2017 Connecticut tax return, because Connecticut does not require quarterly estimated tax payments of composite tax liabilities. It is unknown at this time how aggressive Connecticut will be in applying these rules to out-of-state taxpayers organized as flowthrough entities.

California. Although the rules are not yet final, California appears to be heading in the same direction as Washington and Connecticut with respect to the application of its market-sourcing rules to asset managers. California introduced proposed amendments in 2013 to Regulation 25136-2, which included examples that took a lookthrough approach for determining where the benefit of services provided by an asset management company is received. In the examples, management fees for services provided to pension plans, retirement accounts, or "other investment accounts" are assigned to the domicile of the account shareholders, beneficial owners, or investors, similar

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[59] Conn. Gen. Stat. § 12-711(c); Conn. Dep't of Rev. Servs., Special Notice 2017(1), Legislative Changes Regarding Single-Sales Factor Apportionment and Market-Based Sourcing (Apr. 17, 2017), available at http://www.ct.gov/drs/lib/drs/publications/pubssn/2017/sn2017-1.pdf.

[60] See Conn. Dep't of Rev. Servs., Special Notice 2017(1), supra note 59.

[61] Conn. Gen. Stat. § 12-216a(a); see also Conn. Dep't of Rev. Servs., Informational Publication 2010(29.1), supra note 16.

[62] Conn. Gen. Stat. § 12-216a(a); Conn. Dep't of Rev. Servs., Informational Publication 2010(29.1), supra note 16.

[63] Conn. Dep't of Rev. Servs., Informational Publication 2010(29.1), supra note 16.

to existing California regulations applicable to advisors of RICs.[64] Although the lookthrough examples were unexpectedly deleted from the regulation adopted in September 2016, the FTB is holding Interested Parties Meetings (IPMs) to discuss a new set of revisions to Regulation 25136-2, including the re-insertion of lookthrough examples for asset managers that are very similar to those that were previously deleted.[65] Under the FTB's approach, the receipts factor would be computed by sourcing fees paid by a fund based on the percentage of the fund's investors who live in or are commercially domiciled in California. In other words, if the lookthrough provision is adopted and an investment manager receives a $6 million fee from a fund that has 10 percent of its investors in California, then the investment manager could have $600,000 of California receipts, which exceeds the $547,711 receipts threshold for 2016.

It is interesting to note that, despite California's market-based sourcing rules, the FTB ruled in 2013, in Chief Counsel Ruling 2013-04, that a California-based investment manager's business was conducted wholly within California even though 90 percent of the investors in the fund were located outside the state.[66] The ruling did not discuss market-based sourcing rules or how the investment manager should source the fee income that the investment manager received from the fund, because the investment manager was not conducting business outside California. Nor did the ruling discuss California's economic nexus rules. Instead, it focused on where the nonresident individual partner performed the services that he provided to the investment manager. The nonresident individual stipulated that all of his services were performed in California. Based on this stipulation, the ruling concluded that the investment manager's business was conducted entirely in California and all of the income was from sources within California.

The ruling failed to discuss the more interesting issues of how the new economic nexus and market-based sourcing rules affect the determination of where a taxpayer's business is conducted. It is unclear from the ruling if a nonresident individual's business is conducted where the services are performed (i.e., the test remains the same as it was when California sourced revenues from services using costs of performance rules) or if the business is conducted where the taxpayer has nexus under the economic nexus and market-based sourcing rules.

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[64] See Cal. Code of Regs. tit. 18, § 25137-14.

[65] The first IPM was held on January 20, 2017, and a second on June 16, 2017. The draft of the regulation discussed at the June meeting is available at https://www.ftb.ca.gov/law/regs/25136-2/06162017-Draft-Text.pdf.

[66] FTB Chief Counsel Ruling 2013-04 (Dec. 30, 2013), available at https://www.ftb.ca.gov/law/ccr/2013_04.pdf.

Chief Counsel Ruling 2015-03[67] is another FTB pronouncement that casts doubt on the application of the lookthrough approach to investment managers under current law. In the ruling, sales of non-marketing services[68] by a provider of integrated financial information and analytical applications were assigned to the location of the taxpayer's customer, and not to the location of its customer's customers. The taxpayer's customers were typically portfolio managers, market research and performance analysts, risk managers, marketing professionals, sell-side equity researchers, investment bankers, and fixed income professionals. These customers used the information and applications received from the taxpayer to manage their portfolios or to create product offerings for their own customers, who indirectly benefited from the taxpayer's services. The FTB analogized to the rules in the regulations applicable to sales of non-marketing intangibles, which source sales to the location in which the customer uses the intangible in its business. This analogy led the FTB to conclude that non-marketing services were properly sourced to the location of the taxpayer's customer, and not to the ultimate customers who may have benefited indirectly. Administrative, distribution, and management services provided to a fund would appear to be non-marketing services. Therefore, applying this approach to a fund manager would appear to result in management revenue being sourced to the location of the fund paying the fee, and not to the location of the fund's customers, i.e., not to the location of the investors in the fund.

However, as noted above, the FTB has been holding a series of Interested Parties Meetings and has proposed re-inserting the asset management lookthrough examples into the regulations. Based on this, the FTB appears to believe the lookthrough approach is the most appropriate sourcing methodology for all types of asset managers, despite the contradictions in Chief Counsel Rulings 2013-4 and 2015-3. The FTB's removal of these examples from the regulations adopted in September 2016 creates additional uncertainty. For example, if the FTB is successful in inserting these examples in the next set of regulations, what will be the effective date?

The issue of nexus is extremely important for investment managers. If the investment manager is a limited partnership or LLC and has nexus in California, then it is liable for the $800 minimum tax.[69] If the investment

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[67] FTB Chief Counsel Ruling 2015-03 (Dec. 31, 2015), available at https://www.ftb.ca.gov/law/ccr/2015/2015-03.pdf.

[68] "Marketing" is defined in the Chief Counsel Ruling as "the action or business of promoting and selling products or services." Marketing services are those provided to sell, promote, or advertise a service or product. Non-marketing services are not specifically defined, but it appears to be the FTB's view that they are services other than marketing services. FTB Chief Counsel Ruling 2015-03, supra note 67.

[69] Cal. Rev. & Tax. Code §§ 17935 & 17941.

manager is an LLC with over $5 million of California receipts, it is also liable for an $11,790 LLC fee.[70] In contrast to an investment fund, it is generally difficult for the investment manager to meet the qualified investment partnership test, because the fee income is typically more than 10 percent of the investment manager's receipts. It may also be more difficult for the investment manager to take the position that the fee income is nonbusiness income since the investment manager is in the business of managing the fund. Therefore, if the investment manager is a partnership, it may be required to withhold California tax on distributions of California-sourced income to nonresident partners of the investment manager. The investment manager's partners may also have a California filing requirement caused by the investment manager's nexus. If the investment manager is an LLC, it could be liable for the nonconsenting member tax, which applies when nonresident members do not consent to California's jurisdiction to tax.[71]

Outlook for the Future

It will probably be a number of years before the U.S. Supreme Court or Congress addresses the legal issues raised by economic nexus. In the meantime, the trend of states adopting economic nexus standards and market-based sourcing seems likely to continue. Industry groups may seek to pursue carve-out legislation for investment funds and investment managers that would exempt funds and their managers from the economic nexus provisions. However, achieving favorable carve-outs in the state legislation may be difficult given the perceived political expediency of exporting the tax burden to out-of-state taxpayers through economic nexus standards.

The bottom line is that these issues are not going to go away any time soon. Although investment funds and their managers may not have been the focus of legislators when economic nexus rules were enacted, the investment management industry appears to have been swept up by the legislation. The investment management industry is not alone, as there are many other industries trying to address these new rules. However, the investment management industry may have stronger arguments that (1) the investment funds are not a business and (2) their investors do not have enough of a connection to the state. While it remains to be seen how aggressively the states may attempt to apply these rules to the investment management industry, investment managers are advised to closely monitor their state tax footprints as well as developments in state tax law and their application to the industry.

[70] Cal. Rev. & Tax. Code § 17942.

[71] Cal. Rev. & Tax. Code § 18633.5(e)(1).