Asset management examples deleted from proposed amendments to California's market sourcing regulation

Overview

On December 29, 2015, the Franchise Tax Board (FTB) issued a notice announcing changes to the text of proposed amendments to California's market-based sourcing regulation, Cal. Code Regs. (CCR) Section 25136-2.[1] Specifically, the FTB announced the deletion of two proposed examples addressing the assignment of receipts from asset management services provided by business entities *not* subject to the existing rules applicable to managers of regulated investment companies (RICs, also commonly referred to as mutual funds). The deleted examples provided guidance for assigning sales from asset management services to California in a manner analogous to the existing rules for RIC service providers by looking through pension plans, retirement plans, or investment accounts to the location of the underlying shareholder, beneficial owner, or investor. In its notice, the FTB indicated it was removing the examples "due to concerns raised by some members of the public."[2] Absent these examples, California's market-based sourcing regulation will contain no specific guidance on the assignment of asset management service fees for taxpayers that only provide asset management services to non-RICs. Additionally, it is not known what approach any eventual regulatory language may take with respect to the asset management services addressed in the deleted examples, or what the effective date of any future regulation will be.

This Tax Alert summarizes the two deleted examples, and provides taxpayer considerations concerning the potential implications of this development. Interested taxpayers should keep in mind that the FTB is accepting written comments until January 13, 2016, regarding the proposed amendments to CCR Section 25136-2.

Deleted examples addressed asset management services provided to non-RICs

Prior to January 1, 2013, service providers, such as fund managers other than those providing services to RICs, sourced receipts to California based on the costs-of-performance method.[3] This method generally assigns receipts to the location from which services are provided, based on the costs of performance. Beginning in 2007, industry-specific rules were implemented for RIC service providers in CCR Section 25137-14, which took a market-based approach and generally assigned a fund manager's receipts for providing management services to a RIC based on the domicile of the shareholders in the RIC.[4] California's industry-specific regulations, including the regulation for RIC service providers, were all retained with certain

[1] FTB Legal Division, notice (Dec. 29, 2015), accessible here.
[2] Id.
[3] See Cal. Rev. & Tax. Code Section 25136 prior to amendments made by Proposition 39, effective for taxable years beginning on or after January 1, 2013, which repealed the costs-of-performance rules. Note, however, for taxable years beginning on or after January 1, 2011, and before January 1, 2013, a single sales factor formula with mandatory market-based sourcing was electively available for most taxpayers under Cal. Rev. & Tax. Code Section 25128.5.
[4] Applicable to tax years beginning on or after January 1, 2007, CCR Section 25137-14 contains industry-specific apportionment rules for "mutual fund service providers," which it defines as any unitary business that derives income from the direct or indirect provision of management, distribution, or administration services to or on behalf of a regulated investment company as defined under Section 851 of the Internal Revenue Code. Under CCR Section 25137-14, RIC services providers generally assign receipts from RIC services to California using an in-state shareholder ratio, and assign receipts from asset management services to California by looking through each investment account to the domicile of the beneficial owner of the assets.

modifications and incorporated into the initial regulation issued by the FTB in 2012 to implement market-based sourcing, CCR Section 25136-2.[5] However, these rules, as incorporated into CCR Section 25136-2, only apply to taxpayers providing services to RICs, and were silent as to the potential application to taxpayers only providing asset management services to non-RICs. Thus, the examples the FTB has deleted from the proposed amendments to CCR Section 25136-2 were those that had assigned sales from such asset management services to California in a manner analogous to the existing rules for RIC service providers by looking through the pension plan, retirement plan, or investment account to the location of the shareholder, beneficial owner, or investor.

In the first deleted example—which concerned a business entity not subject to CCR Section 25137-14 that provided asset management services to a pension plan, retirement plan, or other investment account—the benefit of the service was specified to be received by the shareholders, beneficial owners, or investors and not the pension plan, retirement plan, or other investment account. Accordingly, the asset management service provider was directed to assign sales from asset management services based on shareholder, beneficial owner, or investor location. In the second deleted example, the same business entity did not have access to data concerning shareholder, beneficial owner, or investor location. Under these circumstances, the second example provided that sales be assigned by reasonably approximating shareholder, beneficial owner, or investor domicile using information based on zip codes or other statistical data. If shareholder, beneficial owner, or investor locations could not be reasonably approximated, the second example provided that receipts associated with such asset management services shall be disregarded from the sales factor.

Considerations

The deleted examples for entities providing asset management services to non-RICs were consistent with the market- based sourcing approach that has been applicable to managers of RICs since 2007, and were also consistent with the principles of market-based sourcing mandated for most California taxpayers by California Revenue & Taxation Code (CRTC) Section 25136 in tax years beginning on or after January 1, 2013. Consequently, it is difficult to envision the FTB applying different approaches to essentially the same industry and revenue stream.

However, the FTB indicated—in its December 29, 2015, notice—that concerns had been raised by some members of the public, and the FTB's deletion of the two examples from the current round of amendments to CCR Section 25136-2 appears to be an effort to address those concerns, at least temporarily. Whether there will be substantive changes to the examples in future amendments to CCR Section 25136-2 cannot be predicted. The effective date and whether such changes will operate retroactively is also uncertain at this time. Fund managers providing asset management services to non-RICs that benefit from the market-based sourcing approach described in the deleted examples (i.e., California-based fund managers) may potentially still have authority under the general principles of CRTC Section 25136—as applicable in tax years beginning on or after January 1, 2013—to source receipts to California in a manner analogous to the existing rules for taxpayers providing services to RICs. Similarly, it is also possible that the FTB may seek to apply a market-based sourcing approach to fund managers—based outside of California and providing asset management services to non-RICs—by assigning sales to California using the location of an account's underlying investors, even without the deleted examples.

In light of these most recent changes to the proposed amendments to CCR Section 25136-2, the FTB is accepting written comments until January 13, 2016. Once the FTB's amendments to CCR Section 25136-2 become final, it is anticipated that the FTB will open a new regulation project concerning updates to CCR Section 25136-2. Fund managers should continue to closely monitor future developments.

[5] The FTB's final regulatory language, submitted to the California Secretary of State on February 27, 2012, can be found here. As incorporated into CCR Section 25136-2, the so-called "throw-back" provisions of CCR Section 25137-14, which relate to a taxpayer not being taxable in a state, and which assign the receipts to the location of the income producing activity that gave rise to the receipts, shall not be applicable.

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