October 31, 2024

Via Electronic Mail: hanna.cho@ftb.ca.gov

Hanna Cho, Attorney
Legal Division MS A260
Franchise Tax Board
P.O. Box 1720
Rancho Cordova, CA 95741-1720
Fax: (916) 855-5786

Re: California Code of Regulations Title 18, Division 3, Chapter 3.5, Subchapter 17, Article 2.5, Section 25136-2 Regarding Market-Based Rules for Sales Other Than Sales of Tangible Personal Property

MFA[1] appreciates the opportunity to provide feedback to the California Franchise Tax Board (the "**Board**") on the text of proposed rules under regulation section 25136-2 of the California Code of Regulations,[2] regarding the market-based sourcing rules for sales other than sales of tangible personal property, in particular, relating to the sourcing of gross receipts from "asset management services."[3] MFA represents the global alternative asset management industry with over 180 member fund managers that collectively manage over $3.2 trillion in gross assets. Institutional investors, many based in California—such as pension plans, university endowments, and nonprofits—rely on MFA members to meet financial obligations, diversify their investment portfolios, and manage risk.

We commend the Board for its recognition that the asset management services industry may face specific compliance issues with the default marked-based sourcing rules and its effort to provide the necessary clarity and guidance to taxpayers in the industry to reduce confusion as well as promote consistency and efficiency.

[1] Managed Funds Association (MFA), based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 180 member fund managers, including traditional hedge funds, credit funds, and crossover funds, that collectively manage over $3.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

[2] Unless otherwise indicated, all "section" and "regulation" references are to the California Revenue and Taxation Code and the California Code of Regulations Title 18 (Public Revenues) promulgated thereunder.

[3] Cal. Franchise Tax Bd., proposed regulation section 25136-2, https://www.ftb.ca.gov/tax-pros/law/regulatory-activity/25136-2%20draft%20text.pdf, (last updated September 13, 2024).

We believe that the proposed regulations, as currently drafted, still present significant administrative and practical difficulties for taxpayers in the asset management services industry. Accordingly, we urge the Board not to proceed to finalize the proposed regulations without addressing certain issues and clarifications.

At a minimum, in consideration of the significant administrative and practical difficulties described in further detail below, we urge the Board to provide an "**Assignment Rule for Large Volume Asset Management Services**." Under such a large volume assignment rule, taxpayers providing asset management services to more than 100 investors and beneficial owners, aggregated across investment and co-investment vehicles of funds to which the taxpayer provides such services, should be permitted, on an elective basis, to assign gross receipts from such services in accordance with the default market-based sourcing rule of proposed regulation section 25136-2(c)(1) under which the location of the benefit of the service is first presumed to be received at the location where the taxpayer's contracts or books and records indicate the benefit of the service is received.

Investment managers often provide asset management services to many investment and co-investment vehicles of funds, the investors and beneficial owners of which number in the hundreds or even thousands. In the context of hundreds or even thousands of investors and beneficial owners, we reasonably expect that the requirement to diligence the domiciles of investors and, even more remote, beneficial owners (including beneficial owners of assets held by "aggregators")[4] may be commercially impracticable, if not impossible.

We believe the 100-investor-and-beneficial owner-threshold strikes the appropriate balance between accuracy and administrability as this threshold has been employed for other, federal income tax administration purposes. For example, prior to the repeal of the Tax Equity and Fiscal Responsibility Act (TEFRA) audit rules, the audit rules for electing large partnerships allowed certain partnerships with 100 or more partners to elect the application of simplified reporting rules and a centralized audit regime with features similar to the current audit regime enacted under the Bipartisan Budget Act of 2015 (BBA). The electing large partnership regime was a legislative response to the recognition that "[a]udit procedures for large partnerships are inefficient and more complex than those for other large entities. The IRS must assess any deficiency arising from a partnership audit against a large number of partners, many of whom cannot easily be located and some of whom are no longer partners."[5] Likewise, from both a taxpayer compliance and an audit and enforcement perspective, the proposed regulations face significant administrative and

---

[4] The term "aggregator" is used to refer to a pooled investment vehicle that raises capital from investors to invest in multiple other pooled investment vehicles.

[5] Joint Comm. on Taxation, JCS-23-97, *General Explanation of Tax Legislation Enacted in 1997*, 363 (1997).

practical difficulties as a result of the size and complexity of modern partnership structures for which a simplification, such as a large volume assignment rule, is warranted.

We address discrete issues with the proposed regulations as currently drafted in our recommendations below.

MFA Recommendations—Executive Summary

We believe modifications to address the issues described in further detail below are necessary to ensure and enhance the fairness, accuracy and administrability of the rules relating to the sourcing of asset management receipts. This comment letter describes our recommendations at a high level; we would appreciate the opportunity to meet with the Board to further discuss our recommendations, including what specific refinements to the regulatory language might be appropriate.

1) Permit a direct tracing method for asset management receipts, in addition to the "average value of interest" method, for purposes of computing the sales factor.
2) Provide a prospective applicability date when the regulations are finalized; or, alternatively, provide automatic relief from penalties for taxable years beginning before the publication date of the final regulations.
3) Provide guidance on how to source asset management receipts that are attributable to investors or beneficial owners whose locations cannot reasonably be determined.
4) Provide guidance on how to source asset management receipts that are attributable to certain foreign feeders.
5) Provide standard certification forms that taxpayers may use to verify the location of investors or beneficial owners.

MFA Recommendations—Discussion

1) Permit a direct tracing method to asset management receipts, in addition to the "average value of interest" method, for purposes of computing the sales factor.

We recommend that the Board modify proposed regulation section 25136-2(c)(2) to also permit taxpayers to use direct tracing of asset management receipts to determine the appropriate amount of California-source receipts, in addition to the currently proposed "average value of interest" method. The currently proposed "average value of interest" method (measured as the average value of interest at the beginning and the end of the taxable year) may be appropriate for funds that do not offer multiple fee classes and generally do not have significant contributions or redemption activity throughout the year, and so would find the currently proposed method less administratively burdensome. However, in a number of fact patterns, the currently proposed "average value of interest" method does not accurately reflect the economic realities of market-standard asset management services arrangements and imposes undue burdens on the taxpayer.

First, the "average value of interest" method results in imprecision where asset management receipts (i.e., fees and expenses) are not borne by investors on a pro rata basis. In commercial practice, asset managers may charge fees and allocate expenses on a non-pro rata basis. Consider, for example, a fact pattern where the fee structure for a California investor in a fund requires payments to the investment managers <u>only</u> if and when fund performance clears a preset hurdle rate, while other non-California based investors do not have a hurdle rate in their fee structures.[6] In the event that the fund does not achieve a return equal to or greater than the California investor's hurdle rate, the investment manager would not receive any fee from the California investor, but would receive fees from others. Under the "average value of interest" method, the California investor's assets nonetheless would be taken into account, which would result in California-source income for the investment manager despite the investment manager in fact receiving zero income from California. Such an apparently unfair outcome—which we respectfully submit could create vulnerabilities to constitutional challenges—could be avoided by direct tracing.

The "average value of interest" method also would result in imprecision whenever the asset manager offers multiple fund share classes that have different terms related to fees and expenses (along with liquidity, transparency, etc.). Investment managers often will offer different fee arrangements to different investors within a single investment fund, meaning that the amount invested in the fund might not correspond with the proportional amount of management fees paid by that investment fund to the investment manager. The two examples below illustrate how an "average value of interest" method would result in an imprecise apportionment of asset management receipts sourced to California:

- ***Example A.*** A large anchor investor (Investor A) is located in California. Investor A commits to a fund as an anchor investor and negotiates a reduced rate of management fees. Investor A pays 1% of invested capital annually in fees, commits $25 million and comprises 25% of the total commitments of the fund. Other investors, all located outside of California, pay fees of 2% of the remaining 75% of commitments. The investment fund calculates fees to pay to the investment manager based on the negotiated fees. Thus, the investment fund pays the investment manager $250,000 annually in fees attributable to Investor A's capital, while the remaining capital generates fees of $1.5 million, for a total sum of annual fees of $1,750,000. However, if the "average value of interest" method were applied, then $437,500 (or 25% of $1,750,000) would be sourced to California, when only $250,000 was actually attributable to Investor A.

We note that the inverse of the general fact pattern described in Example A (Investor A located outside of California, all other investors located in California) would "under-assign" asset management receipts to California in the amount of $1,312,500, when $1,500,000 was actually attributable to California-domiciled

[6] The term "hurdle rate" is used to refer to the minimum return to investors before which fees would not otherwise be payable.

investors. The under- and over-assignment of asset management receipts under the “average value of interest” method are equally likely.

- ***Example B.*** An investment fund with $100 million in invested capital offers two classes of interests with different economic rights. Class A interests pay traditional fees of 1% of the net asset value attributable to the investor. Class B interests only pay fees if the fund exceeds a threshold level of profit 15% in any given year (the “hurdle rate”) but would then pay fees at a higher rate of 2% of the net asset value attributable to the investor. The only investor in Class B interests is Investor B, who is located in California. All investors in Class A interests are located outside of California. Investor B invests 10% of the value of the fund, and after the first year, before applying management fees, holds 10% of the net asset value of the fund, which has grown to $110 million. Because the fund has not exceeded the hurdle rate of profit, no fees are due with respect to the net asset value attributable to Investor B. Fees due on the remaining net asset value of the fund are $990,000 (1% of 90% of the net asset value of $110 million). Applying the “average value of interest” method, $99,000 would be sourced to California, based on Investor B’s interest in the capital of the investment fund, even though Investor B’s interests generated no management fees in that year.

Second, open-end funds and funds with more liberal redemption terms risk additional imprecision under the “average value of interest” method as investors can and do enter and exit the fund frequently and throughout the year. The “average value of interest” method, which captures only a snapshot of investors’ economic interests at the beginning of the taxable year and at the end of the taxable year, is prone to, as the case may be, under- or over-state investment management receipts sourced to the location of investors that made contributions or received redemptions throughout the year and under- or over-state those receipts sourced to the location of non-redeeming, non-contributing investors.

Third, the “value of interest” is often difficult to determine in practice, particularly in the partnership context—a common entity form in which many of our members are structured. The determination of a partner’s economic interest in or control relationship to a partnership is complex even in instances where partnership interest is defined,[7] because investor-partners in a fund partnership structure rarely share in profits, loss, and capital in the same ratios. Consequently, the “average value of interest” method is likely to drive imprecision in practice, with equally significant costs to administration and enforcement.

[7] In certain federal income tax references, a partner’s interest is defined as a partner’s interest in partnership profits or capital.

2) *Provide a prospective applicability date when the regulations are finalized; or, alternatively, provide automatic relief from penalties for taxable years beginning before the publication date of the final regulations.*

The proposed regulations, as currently drafted, prescribe an "applicability date" of taxable years beginning on or after January 1, 2024. Such a retroactive applicability date would impose undue hardship on taxpayers, absent any relief from penalties. Since the Board only issued the Notice of Proposed Rulemaking on September 13, 2024, over three years after the last regulatory activity with respect to proposed regulation section 25136-2 took place,[8] asset manager taxpayers have already missed the filing and payment deadline for estimated taxes for earlier quarters of this year.

To allow asset manager taxpayers sufficient time to be able to comply with the regulations when they are published in final form, we urge the Board to adopt a prospective applicability date as it has consistently done for its recent issuance of final regulations (*i.e.*, taxable years beginning on or after January 1st of the year following the year in which final regulations are issued);[9] or, in the alternative, provide for automatic relief from penalties for all retroactive years.

3) *Provide guidance on how to source asset management receipts that are attributable to investors or beneficial owners whose locations cannot reasonably be determined.*

The proposed regulations essentially require an asset manager taxpayer to "look through" to the "beneficial owners" who make independent decisions to invest assets.[10] Information regarding beneficial ownership can be difficult—and in some instances, impossible—for asset managers to obtain. For example, in a fund structure where investment capital comes from a limited partner or investor in the form of an "aggregator," such as a fund-of-funds or family office, the investment manager may lack both the ownership information and the power to compel such information. The manager of a fund-of-funds, for example, typically would refuse the disclosure of its investor list on trade secret grounds; on the other hand, the ultimate investors may also wish to remain anonymous for privacy and confidentiality reasons.

As currently drafted, the proposed regulations may source asset management receipts to the domicile of the aggregator to the extent the aggregator exercises investment discretion because the definition of "beneficial owner" requires a person so defined to make "an independent decision to invest assets." At the same time, the central thrust of the proposed regulations is to more precisely define the location where the benefit of certain industry-specific services, which otherwise may be difficult to determine under the default market-based sourcing rules, are received. Although an aggregator in this

---

[8] The Sixth Interested Parties Meeting took place on June 4, 2021.

[9] *See* a list of recently finalized regulations by the board, the dates filed with the California Secretary of State and Effective Dates at https://www.ftb.ca.gov/tax-pros/law/final-regulations/.

[10] *See* definition of "beneficial owner" in subsection (b)(2) of the proposed regulations.

context may exercise investment discretion, so, too, do the beneficial owners of the aggregator's assets. This circumstance highlights the ambiguity present in the definition of "beneficial owner" as multiple, tiered beneficial owners may make independent decisions to invest assets. Accordingly, in this narrow circumstance, we urge the Board to adopt a flexible rule under which a taxpayer may elect to assign receipts to the domicile(s) of either the aggregator *or* the beneficial owners of the aggregator's assets if the taxpayer can substantiate the location of domiciles of those beneficial owners.

4) *Provide guidance on how to source asset management receipts that are attributable to certain foreign feeders.*

The proposed regulations categorically exclude "master funds, feeder funds, and similar entities" from the definition of "beneficial owner" under the rationale that these 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." This exclusion sweeps in feeder funds that otherwise meet the definition of "beneficial owner" as persons which "made an independent decision to invest assets." We therefore urge clarification of the "beneficial owner" definition to not exclude feeder funds and other entities to the extent these entities meet the definitional requirement of having independent decision-making power to invest their assets set forth in subsection (b)(2).

The exclusion of feeder funds from the definition of "beneficial owner" creates additional complexities in the context of feeder funds organized in certain foreign jurisdictions and treated as corporations for U.S. federal income tax purposes ("**foreign feeders**"). The activities of foreign feeders are not wholly circumscribed by agreement with their shareholders. Indeed, in the most common foreign fund domiciles, local country law mandates those foreign feeders—which are frequently regulated entities under local country law—establish, implement, and maintain a corporate governance framework which provides for *management oversight* of the entity's business and the legitimate interests of shareholders. These corporate governance mandates include the structure, composition, and governance of a governing body; the allocation of oversight and management responsibilities; independence and objectivity; risk management and internal control systems; etc.

Moreover, management fees are typically charged at the foreign feeder-level only, with such feeders having a standard management fee rate. Foreign feeders often retain capital to cover the fees. In these circumstances, investment discretion is arguably shared in several respects. Although shareholder-beneficial owners in this context may make independent decisions to invest their assets, so, too, do the foreign feeders retain a degree of investment discretion. Accordingly, we urge the Board to modify the definition of "beneficial owner" to include the types of foreign feeders described above as "investors" or "beneficial owners" to which domiciles asset management receipts may be assigned.

5) *Provide standard certification forms that taxpayers may use to verify the location of investors or beneficial owners.*

The proposed regulations should include safe harbor substantiation provisions allowing investment managers to gather information from investors at the outset of an investment and on a set periodic basis. By comparison, federal Forms W-8 are typically required to be updated at least once every three years, but U.S. withholding agents are permitted to rely on Form W-8 for that full three-year period, in the absence of actual knowledge that the form is not correct. Providing standard forms that can be relied upon for a set period of time will substantially reduce the burden of substantiating location of investors, as well as decrease the likelihood of disputes between taxpayers and the Board regarding the adequacy of a taxpayer's books and records.

* * *

We appreciate the opportunity to submit our comments on the Board's proposed regulation and would like to engage with the Board to further discuss our comments. If the Board has any questions or comments, please do not hesitate to call Joseph Schwartz, Vice President and Senior Counsel, at jschwartz@mfaalts.org.

Respectfully submitted,

/s/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Global Regulatory Affairs
Managed Funds Association