

## State of Confusion: Sourcing Financial Services Receipts

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In this article, Noonan and Pascal discuss the difficulties facing financial service companies when sourcing receipts. They write that those companies can be significantly affected by new tax apportionment trends, especially in New York, given the differences in how the state taxes corporations versus partnerships or limited liability companies taxed as partnerships, as well as the different apportionment rules for New York City.

Service providers have always faced more ill-defined rules for sourcing receipts for apportioning business income than, say, your typical seller of tangible property. And the problems may only be getting worse. First, more states have moved or are moving toward receipts-only apportionment, at least for corporations. Second, states are moving toward customer-based sourcing of receipts, rather than the cost-of-performance method. For some states (for example, Arizona), the customer's location is determined by the mailing address. For others, such as California (beginning in 2013) or New York (beginning in 2015), customer-based sourcing is determined based on where the benefit of the service is received. Finally, many states have adopted economic nexus provisions, subjecting corporations to tax based on their economic presence in the state, even if they have no physical presence. Together, those trends are subjecting service providers to tax in states where they have never been required to file. But importantly, they are simply trends. Many states still use a three-factor apportionment formula, source receipts based on cost of performance, or use market-based sourcing for only specific industries, creating a hodgepodge of rules. In other words, it's just a mess for multistate companies.

Investment management companies — including investment advisers, registered broker-dealers, hedge fund man-

agers, and similar financial services companies — can be particularly hard-hit by the new trends in multistate apportionment. Under more traditional cost-of-performance rules, investment managers with a single office in New York or Greenwich, Connecticut, or Austin, Texas, were less likely to apportion income among states. Now, for economic nexus purposes and to correctly source receipts in many states, financial service providers must determine who is their customer (the payer of their fees or the ultimate investor), where the income is earned under myriad state sourcing rules, and whether the customer falls into any of the industry-specific categories for some financial service providers. That is not an easy task.

Perhaps no state illustrates the complexities facing financial service companies more than New York. Because many such companies are based in New York City, or at least have some activities located there, they are often subject to the taxing jurisdictions of both New York state and New York City. New York state, in particular, has very different tax regimes for corporations versus partnerships or limited liability companies taxed as partnerships. The regimes differ still from the apportionment rules for the New York City general corporation tax (imposed on all corporations, including S corporations) and the unincorporated business tax (imposed on partnerships, LLCs, associations, and sole proprietorships).

In this article, we'll illustrate the complexity of those rules by reviewing a few specific situations we've seen in our practice.

### I. Sample Scenarios

Let's take three fairly straightforward examples within the category of asset or investment managers.<sup>1</sup> First is an S corporation (NYC Hedge Fund Manager) that provides investment management services to numerous hedge funds with similar owners. The hedge funds pay the S corporation a management fee based on the value of the funds. The S corporation has its principal office in New York City but also has an office in Florida where its two principal shareholders live.

<sup>1</sup>Banking institutions face an entirely separate set of complications, as many states have completely separate tax regimes for corporations that fall within that category.

Second is an S corporation with its sole office in Florida (FL Investment Adviser). It receives advisory fees from a regulated investment company located in New York City.

Third is an LLC (taxed for state and federal purposes as a partnership) — a registered broker-dealer that provides private placement services to unrelated investment funds (NYC Private Placement Provider). It receives its fees based on the value of the investments it places with the funds. The LLC has its sole office in New York City, although two of its principal partners live primarily in Florida.

## II. New York State Analysis

### A. NYC Hedge Fund Manager

NYC Hedge Fund Manager, although not subject to an entity-level tax in New York state as an S corporation, must apportion its income under the article 9-A franchise tax laws to determine the income taxable by New York for its non-resident shareholders. Since 2007 New York has used a receipts-only apportionment formula. And before 2015, receipts (other than for specific industries) were sourced based on where the services were performed.<sup>2</sup>

So how did the old rules apply to that company? The regulations simply state that all receipts from “services performed in New York” are allocated to the state.<sup>3</sup> Interpretative guidance from New York’s Department of Taxation and Finance suggests that only the location of activities that generate income (rather than simply administrative activities) should be used to apportion receipts.<sup>4</sup> For our investment company, that might mean where the principal investment advisers, or members of the investment committee, are physically located when they do what they do. Or a basic cost-of-performance calculation might be applied. There are no clear rules.

Beginning in 2015, however, New York has a new regime in place for assessing corporate franchise tax. Under Tax Law section 210-A, receipts will be sourced based on either the location of the customer (primarily for tangible or digital property) or where the benefit of the service is received. For NYC Hedge Fund Manager, assuming that it does not fit into the special market-based sourcing rules for registered broker-dealers or some financial services companies, that could be a fairly simple calculation based on the location of the hedge fund from which it receives fees, assuming that is considered where the “benefit is received.”<sup>5</sup> But the tax department may raise some questions about how the sourcing rules apply to New York-based hedge fund managers of offshore funds. If the manager uses the address of the fund — say, for example, the Cayman Islands — to identify where the benefit is received, even if there is no office or

employees at that location, New York may question whether any “benefit” of the investment management service is actually received there.

California has recently taken steps to identify where the benefit is received for asset managers. In 2011 the state adopted market-based sourcing for its sales factor using a “benefit received” method. Although the state adopted regulations to source receipts from services to RICs based on the location of the shareholder, no such regulations were adopted for other asset managers to determine where the benefit of the service was received. In 2014 the Franchise Tax Board proposed new regulations (section 25136-2) to source all receipts from the management, distribution, and administrative services for pension plans, retirement accounts, and other investment accounts to the domicile of the investor or beneficial owner.<sup>6</sup> New York may take a similar route to repatriate at least a small portion of the income “lost” under the new customer-based sourcing rules.

### B. FL Investment Adviser

For our investment adviser in Florida allocating receipts to New York under the old corporate tax regime, it would first have to determine whether it had enough contacts with New York to create nexus. If it did, FL Investment Adviser would have been subject to the market-based sourcing rules applicable to some financial services companies, including advisers to RICs. Under Tax Law section 210.3(a)(6), receipts from management, administrative, and distribution services provided to a RIC are allocated to New York according to the percentage of shareholders located in New York.

Under the post-2015 tax regime, FL Investment Adviser would still allocate services to New York based on the percentage of shareholders located in the state. The only question would be that of nexus. Even if the investment adviser previously did not have enough contacts with New York to require it to apportion income to the state, under the new economic nexus rules, it could be required to file beginning in 2015 if it has more than \$1 million in New York receipts during the year.<sup>7</sup>

### C. NYC Private Placement Provider

As noted above, NYC Private Placement Provider provides private placement services to third-party funds looking to find large institutional investors for its private securities. New York has yet to change its rules governing the business allocation percentage for nonresident individuals and partnerships. It still uses the three-factor formula of property, payroll, and receipts.

<sup>2</sup>N.Y. Tax Law section 210.3(a)(2)(B).

<sup>3</sup>20 NYCRR 4-4.3(a).

<sup>4</sup>See TSB-A-95(5)C.

<sup>5</sup>N.Y. Tax Law section 210-A.10(b)(1).

<sup>6</sup>Interestingly, the proposed regulations state that if the asset management corporation cannot reasonably approximate a method for determining the domicile of the shareholders, investors, or beneficial owners, those receipts would be disregarded for purposes of the sales factor.

<sup>7</sup>N.Y. Tax Law section 209.1(b).

Moreover, it uses a fairly cumbersome sourcing rule to apportion receipts. New York receipts (the gross income percentage) “include all sales negotiated or consummated, and charges for services performed, by an employee, agent, agency or independent contractor chiefly situated at, connected by contract or otherwise with, or sent out from, offices, branches of the business, or other agencies, situated within New York State.”<sup>8</sup> Under that definition, the LLC would allocate all its receipts to New York state because all its employees and partners are chiefly connected with that office. Were the LLC to establish a Florida office for its Florida resident partners, it could apportion the fees generated by those partners outside New York.

### III. New York City Analysis

Under New York state rules, there is a vast difference between the old and new corporate tax and the partnership apportionment rules. Under the corporate tax rules, we move from sourcing business receipts primarily based on where they are earned to the location of the customer. Under the partnership rules, we determine sourcing based primarily on where the partnership is located. New York City adds yet another layer of rules, which share many similarities with the state's old corporate and partnership rules.

New York City imposes an entity-level income tax on all businesses (incorporated and unincorporated) doing business in the city. Both the general corporation tax (GCT) and the unincorporated business tax (UBT) are in the process of moving toward a receipts-only formula; both will be receipts-only in 2018. For now, however, property and payroll still play a limited role in determining the apportionment of income to the city. Neither tax has moved to customer-based sourcing for receipts. The New York City Department of Finance has indicated that despite the state's revisions to its corporate franchise tax laws, it has no intention of following suit, as it believes that it would result in a significant loss of revenue for the city. New York City Mayor Bill de Blasio (D) announced, however, that the city would reform its corporate tax code to the state and adopt economic nexus rules to make up for any lost revenue as a result of the reform.

The GCT and the UBT have fairly similar sourcing rules. Both generally allocate services based on whether the “services are performed” in New York City. The GCT and UBT also have special sourcing rules (similar to those in New York's corporate tax laws) for some investment managers that could apply to our Florida S corporation (FL Investment Adviser) and our LLC (NYC Private Placement Provider).

Here's how the convoluted rules might play out in our various scenarios.

#### A. NYC Hedge Fund Manager

Under New York City's current GCT rules, NYC Hedge Fund Manager won't benefit from market-based sourcing for its New York City receipts. Instead, as with the old New York corporate franchise rules, it would have to determine where its services are performed, and whose services matter for apportioning receipts. New York City also does not have any specific guidance as to how to make that determination. Its regulations state that “the amount attributable to services within New York City is to be determined on the basis of the relative values of, or amounts of time spent in the performance of, such services within or without New York City, or by some other reasonable method.”<sup>9</sup> In the context of an audit, we have seen the city try to use the payroll factor as a proxy but also be willing to use an analysis of time spent by members of the manager's investment committee.

#### B. FL Investment Adviser

The Florida S corporation is the only one of our examples to face consistent rules across both New York state and New York City. It would again have to determine whether it had the requisite nexus with the city to require it to file a GCT return. But if it did, it would apportion its receipts in the same manner for New York City as it does for the state based on the location of the shareholders of the RIC it advises.<sup>10</sup>

#### C. NYC Private Placement Provider

Here's where we've seen things get especially nutty. For the New York City LLC providing private placement services, it would appear that it could use market-based sourcing under the special rules applicable to registered broker-dealers included in both the GCT and the UBT. Under those rules, a registered broker-dealer uses the mailing address of its customer, who is responsible for paying the commission to source receipts from “brokerage commissions derived from the execution of securities or commodities purchase or sales orders for the accounts of customers.”<sup>11</sup> New York state enacted customer-based sourcing for registered broker-dealer corporations for tax years beginning in 2001, presumably to encourage those businesses to keep their operations in New York state by decreasing their business allocation percentage to New York if they had customers outside the state.

Even though many such businesses are located in New York City, it took until 2009 for the city to enact legislation to conform its sourcing rules governing broker-dealers and other financial service providers. So it would appear that NYC Private Placement Provider would apportion its private placement receipts based on the mailing address of the payer of the fees, right? After all, private placement companies sell securities to investors just as other brokers do; they simply do so through a private offering. Those providers are

<sup>8</sup>20 NYCRR 132.15(f).

<sup>9</sup>19 RCNY 11-65(b)(3).

<sup>10</sup>N.Y.C. Admin. Code section 11-604.3(a)(5).

<sup>11</sup>N.Y.C. Admin. Code section 11-508(e-3)(1)(A).

typically required to be registered with the SEC, the Financial Industry Regulatory Authority, and state securities regulators. So, for all intents and purposes, they operate and are regulated the same as any other securities broker and must comply with all state securities laws. In other words, NYC Private Placement Provider can look to the broker-dealer sourcing rules to determine its New York City apportionment.

Not so fast. New York City appears to be conflicted about how those rules should be applied. On the one hand, New York City recently issued a pair of rulings<sup>12</sup> to a taxpayer that asked whether it could apply the broker-dealer customer sourcing rules even though it was not, in fact, actually registered as a broker-dealer. The taxpayer solicited investors for a partnership that managed securities funds and received fees for generating investments in the partnership's funds. Because the taxpayer met some exceptions under the SEC's rules, it was not required to register as a broker-dealer. The New York City Department of Finance concluded that because the taxpayer seemed to be doing what a registered broker-dealer does, it was as if it were registered for purposes of the customer-based sourcing rules.

That would suggest an impressive common-sense application of the broker-dealer sourcing rules. But on audit, the Department of Finance has previously applied a much narrower interpretation of the rules that would seem to exclude our NYC Private Placement Provider. As noted above, receipts "derived from the execution of securities or commodities purchase or sales orders" for customers are sourced to the customer's mailing address. For private placement providers, that should be an easy mark. The Securities Act of 1933 defines a security broadly — "any note, stock, treasury stock, security future, security-based swap, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement." You get the picture. But buried in the broker-dealer sourcing provision in the New York City Administrative Code (and in New York state tax law, for that matter) is a reference to IRC section 475 (mark-to-market accounting) for a definition of securities, rather than the more commonly used definition in the Securities Act. And although the definition of a security includes shares of

stock in a corporation under the IRC's definition, it excludes partnership interests except those that are "widely held."

Of course, there is no definition of the term "widely held" anywhere in any related or underlying regulation. So it becomes a mystery as to how it should apply to many private equity and hedge fund investments, such as those placed by our LLC and other private placement firms. And that is the ambiguity that the Department of Finance is exploiting on audit, contrary to its publicly available guidance, which is more rational. Indeed, because NYC Private Placement Provider is deemed to be dealing in securities for purposes of every possible state or federal law or regulation, it strains credulity to think that for New York City tax purposes it is not dealing in them. But for now that is the position the Department of Finance is taking, and it could very well drive some private placement providers right out of the city — the exact result the broker-dealer sourcing rules attempted to avoid.

#### IV. Conclusion

So the private placement firm, as well as other investment managers, are left to their own devices to figure out ill-defined and ever-changing apportionment rules. Relatively small companies (granted, some of those small companies handle billions of dollars in assets and receive millions in management fees) that once needed only to calculate income tax in a single state now must figure out the effect of new economic nexus and market-based sourcing rules on their tax compliance in multiple states. For some businesses with offices in a cost-of-performance state, that could result in double taxation of the same income (if they have nexus and receipts in a market-based sourcing state). For those based in a market-based sourcing state and providing services to customers in cost-of-performance states, that could result in no tax on some receipts.

Of course, if states determine that too much revenue is lost under that arrangement, we might see new rules to redefine where the benefit of services is received, particularly for financial service providers, or an attempt to throw back receipts that are not taxed. But for now, the apportionment rules provide plenty of room for some financial service providers to plan for a more multistate-tax-efficient structure and, of course, for tax authorities to interpret the rules to bring more revenue into public coffers. ☆

<sup>12</sup>Finance Letter Ruling 12-4934 (Aug. 19, 2013) and Finance Letter Ruling 13-4950 (Mar. 28, 2014).