

Request for Permission to Proceed with Formal Regulation Process on Proposed Regulation 25137-14, Relating to Mutual Fund Service Providers

The need for an alternative apportionment methodology for mutual fund service providers has led to the issuance of regulations and statutory amendments in many of the states that have a significant mutual fund service provider presence. California, while being home to many such companies, has not addressed this issue. Staff has received Revenue and Taxation Code section 25137 petitions from members of the industry over the last several years and, with either action by, or the knowledge of, the Board has granted relief to the petitioners. Staff believes that it is appropriate to formally recognize the need for a variance from the standard Uniform Division of Income for Tax Purposes Act (UDITPA) provisions so that it will no longer have to deal with these requests on a piecemeal basis. This regulation project is intended to provide much needed guidance in this area.

The normal apportionment provisions set forth in Revenue and Taxation section 25136 assign receipts to the location where the income producing activity occurs. For mutual funds service providers, this usually results in most, if not all, of their receipts for services being assigned to one location. This is at odds with the purpose of the sales factor, which is to reflect the market for a taxpayer's goods and services. This problem has been remedied in most states by overriding the normal UDITPA rules and assigning receipts to the numerator of the sales factor based upon the location of the underlying shareholders of the mutual funds. This location is usually deemed to be the mailing address on file with the fund. Such a methodology would appear to be appropriate for use in California as well.

Because staff wished to have industry input regarding the substance of this proposed regulation, a symposium was held prior to the creation of a draft regulation. (A Report on the Symposium discussions is attached as Exhibit A) This enabled staff to have discussions with interested parties regarding what other states have adopted and what language should be incorporated into a proposed draft regulation. The symposium was successful in this regard and led to the creation of the draft regulation language, attached as Exhibit B, that staff now requests to take into the formal regulatory process. An explanation of the proposed regulation is attached as Exhibit C.

REPORT ON SYMPOSIUM ON PROPOSED REGULATION FOR MUTUAL FUNDS AND INVESTMENT ADVISORS, PROPOSED REGULATION 25137-14

The symposium was held at 10:00 a.m. on October 28, 2005, at the Franchise Tax Board's Central Office in Sacramento, California. The facilitator was Carl Joseph, Tax Counsel for the Franchise Tax Board.

Prior to the symposium, a discussion paper was made available setting forth that other states have adopted alternative apportionment methodologies for mutual fund service providers and that it is the opinion of staff that California should do so as well. The discussion paper explained that staff was not proposing any regulation language for discussion at the symposium. Rather, staff provided methodologies that had been enacted in other states. The purpose of this was to discuss what other states had adopted and elicit input regarding what elements of these approaches should be incorporated into a California regulation.

The symposium was attended by mutual fund industry representatives as well as representatives from other asset managements businesses. Representatives from accounting firms and law firms also participated. The mutual fund representatives provided both oral and written comments setting forth their strong desire for the adoption of a regulation and provided language that they believe should be included in the regulation. Similarly, the representatives of asset management companies also expressed a desire for the regulatory scheme and requested that the regulation be drafted in a way that would include their firms in addition to the mutual fund service providers.

There was input received regarding the use of a throwback provision as well as the proper approach for a determination of nexus. The mutual fund representatives expressed a desire that there should not be a throwback provision included in the regulation, but that if a throwback provision was necessary to avoid income escaping taxation, that the determination of nexus should be made utilizing the *Finnigan* approach.

Staff also received input from other parties in attendance regarding specific substantive provisions of other state's rules and how and why the California regulation should or should not adopt the various methodologies utilized elsewhere.

After the symposium, additional written comments were received and staff endeavored to move forward to create a draft regulation. A draft regulation was created and sent to attendees of the symposium along with an explanation of the draft regulation. Additional comments were then received.

Section 25137-14 is adopted to read:

§ 25137-14. Mutual Fund Service Providers and Asset Management Service Providers.

(a) Definitions

As used in this section, unless the context otherwise indicates, the following terms have the following meanings:

- (1) "Administration services" include, but are not limited to, clerical, fund or shareholder accounting; participant record-keeping, transfer agency, bookkeeping, data processing, custodial, internal auditing, legal, and tax services performed for a regulated investment company. Services qualify as administration services only if the provider of such service or services during the taxable year also provides, or is affiliated with a person that provides, management or distribution services to the same regulated investment company during the same taxable year.
- (2) "Distribution services" include, but are not limited to, the services of advertising, servicing, marketing or selling shares of a regulated investment company. The services of advertising, servicing or marketing shares qualify as distribution services only when the service is performed by a person who is, or in the case of a closed-end company was, either engaged in the business of selling regulated investment company shares or affiliated with a person that is engaged in the service of selling regulated investment company shares. In the case of an open-end company, such service of selling shares must be performed pursuant to a contract entered into pursuant to 15 United States Code, Section 80a-15(b), as amended.
- (3) "Management services" include, but are not limited to, the rendering of investment advice, directly or indirectly, to a regulated investment company, making determinations as to when sales and purchases of securities are to be made on behalf of the regulated investment company or the selling or purchasing of securities constituting assets of a regulated investment company, and related activities. Services qualify as management services only when such activity or activities are performed pursuant to a contract with the regulated investment company entered into pursuant to title 15, United States Code, Section 80a-15(a), as amended, for a person that has entered into such a contract with the regulated investment company or for a person that is affiliated with a person that has entered into such a contract with a regulated investment company.
- (4) "Domicile" of a shareholder of a regulated investment company is presumed to be the shareholder's mailing address on the records of the regulated investment company or the mutual fund service provider. If the regulated investment company or the mutual fund service provider has actual knowledge that the shareholder's primary residence or principal place of business is different than the shareholder's mailing address, the presumption does not control. Shareholders of record that are not individuals are subject to the special rule contained in subsection (b)(1)(A)1. of this regulation.

(5) "Mutual fund service provider" means 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.

(6) "Regulated Investment Company" means a regulated investment company as defined in Section 851 of the Internal Revenue Code.

(7) "Asset management services" means the direct or indirect provision of management, distribution or administrative services to entities other than regulated investment companies.

(b) **Apportionment of Business Income.** The property, payroll and sales factors of the apportionment formula for mutual fund service providers shall be computed pursuant to Sections 25128 through 25137 of the Revenue and Taxation Code and the regulations adopted pursuant thereto, except as provided in this regulation:

(1) **Sales Factor.** For purposes of determining the numerator of the sales factor:

(A) Receipts from the direct or indirect provision of management, distribution or administration services to or on behalf of a regulated investment company are assigned by the use of a shareholder ratio. This ratio is calculated by multiplying total receipts for the taxable year from each separate regulated investment company for which the mutual fund service provider performs management, distribution or administration services by a fraction, the numerator of which is the average of the number of shares owned by the regulated investment company's shareholders domiciled in this State at the beginning of and at the end of the regulated investment company's taxable year, and the denominator of which is the average of the number of the shares owned by the regulated investment company's shareholders everywhere at the beginning of and at the end of the regulated investment company's taxable year.

1. If the domicile of a given individual shareholder is unknown to the mutual fund service provider because the shareholder of record is a person that holds the shares of a regulated investment company as depositor for the benefit of a separate account, the mutual fund service provider may utilize any reasonable basis derived from information that it receives from the shareholder of record, such as the zip codes of underlying shareholders, in order to determine the proper location for the assignment of these shares. If no information is available from the shareholder of record, then all of the shares held by the shareholder of record shall be disregarded in computing the shareholder ratio for the fund in issue.

2. The regulated investment company's taxable year for computing the shareholder ratio shall be the taxable year that ends during the taxable year of the principal member of the mutual fund service provider's combined reporting group.

(B) If a mutual fund service provider has receipts from performing asset management services, in addition to performing services for regulated investment companies, these services shall be assigned to this state if the domicile of the individual owning the assets is located in this state.

1. In the case of asset management services directly or indirectly provided to a pension plan, retirement account or institutional investor, such as private banks, national and international private investors, international traders or insurance companies, receipts shall be assigned to this State to the extent the domicile of the beneficiaries of the plan, beneficiaries of the account or beneficiaries of the similar pool of assets held by the institutional investor, is in this State.

2. In the event the domicile of the beneficiaries is not or cannot be obtained, and the taxpayer cannot devise a reasonable method to approximate this information statistically, the receipts shall be disregarded for purposes of the sales factor.

(C) If a mutual fund service provider has non-taxpayer members that are providing management, distribution or administration services to or on behalf of a regulated investment company with shareholders in this State, the receipts from these activities that are assigned to the numerator of the sales factor by virtue of this regulation shall be included in the numerator of the sales factor in determining the unitary group's business income apportionable to this State, even though the specific entity that performed the services is not a taxpayer in this State.

1. In lieu of the provisions contained in Regulation section 25106.5(c)(7)(B), the taxpayer member's property, payroll and sales factors are calculated as follows:

a. Each taxpayer member of the combined reporting group (and only the taxpayer members) determines its California property factor, payroll factor and sales factor.

b. The taxpayer member's California property factor is a fraction, the numerator of which is the California property of that member, and the denominator of which is the total property of the group everywhere. Property values are determined in accordance with Sections 25130 and 25131 of the Revenue and Taxation Code.

c. The taxpayer member's California payroll factor is a fraction, the numerator of which is that member's California payroll, determined under Section 25133 of the Revenue and Taxation Code, and the denominator of which is the total payroll of the group everywhere.

d. The taxpayer member's California sales factor is a fraction, the numerator of which is the California sales of that taxpayer member, determined under this regulation, and the denominator of which is the total sales of the group everywhere.

2. In lieu of the provisions contained in Regulation section 25106.5(c)(7)(C), the taxpayer member's California source combined report business income is then calculated as follows:

a. First, the taxpayer's California apportionment percentage is determined. It is the sum of that member's California payroll, property, and a doubled weighted sales factor (or a single weighted sales factor, if applicable), with that sum divided by either four or three (as applicable).

b. Next, the taxpayer member determines its intrastate apportionment percentage. That percentage is the ratio of the taxpayer member's California apportionment percentage to the sum of all of the California taxpayer members' California apportionment percentages.

c. Finally, the taxpayer member multiplies the group's California source combined report business income by its intrastate apportionment percentage to arrive at the taxpayer member's California source combined report business income.

(D) If the shareholder ratio calculated under section (b)(1)(A) of this regulation assigns receipts to a state where no members of the mutual fund service provider's unitary group are taxable, these receipts shall not be assigned to that state. Instead, these receipts shall be assigned to the location of the income producing activity that gave rise to the receipts, as determined under Revenue and Taxation Code section 25136.

Explanation of Discussion Draft 25137-14

The discussion draft has been completed. The draft attempts to take into account the concerns of the various interested parties, but as always, decisions had to be made that resulted in not all parties' recommendations being adopted. The key points of the draft are set forth with explanations below:

1. **Definitional Sections.** The first part of the draft addresses the definitions of the various terms contained in the rules to follow. These definitions were largely taken from the Maine regulatory language because this language appears to be adopted in large part in many other states and therefore provides a level of uniformity. However, there are some modifications.

The term "domicile" is defined as a shareholder's mailing address in the records of the regulated investment company. The definition does not discuss what the domicile is in regards to a shareholder of record who holds shares for the benefit of a separate account. This is because the regulatory scheme assigns these receipts by looking through the shareholder of record. (See subsection (b)(1)(A)1.)

The term "mutual fund service provider" is defined as a *unitary business* that derives income from performing management, distribution or administration services to a regulated investment company. This is necessary to recognize that the various services may be performed by affiliates, and not by the California taxpayer directly. Furthermore, this section does not contain a limitation to unitary businesses that derive more than 50% of their gross income from performing these services. This decision was based on input received from interested parties that the 50% threshold was artificial and unnecessary.

There is an additional definition provided regarding "asset management services". This is included to allow mutual fund service providers to assign receipts from services provided to entities, other than regulated investment companies, utilizing a market approach rather than the normal rules of Revenue and Taxation Code section 25136. The interested parties requested this addition.

2. **Apportionment Rules.** Subsection (b) of the draft regulation contains the apportionment rules for mutual fund service providers. It adopts a shareholder ratio approach calculated on a fund-by-fund basis. As requested by the interested parties, the ratio is based on the average number of shares owned by shareholders domiciled in California over average number of shares outstanding everywhere, and is computed based on the taxable year of the fund itself rather than the taxable year of the entity providing the services. The taxable year of the fund is defined in subsection (b)(1)(A)2. as the year that ends during the taxable year of the principal member of the combined reporting group.

Subsection (b)(1)(A)1. contains rules regarding the assignment of shares owned by a shareholder of record that holds the shares for the benefit of a separate account. As was discussed at the symposium, the rule allows these shares to be assigned based upon a reasonable method derived from information received from the shareholder of record. If no information is received, then the shares are disregarded in determining the ratio for the given fund. At the symposium it was

suggested that a level of known share information for a given fund be reached in order to trigger the throw out. This was not included at this time because there are concerns regarding where the level should be set for such a rule (what amount of shareholder location information should be deemed statistically valid?) and that if a given fund is below the threshold how these receipts should be assigned. Further input from the interested parties will be appreciated.

Subsection (b)(1)(B) provides rules for the assignment of receipts from asset management services. The rule only applies to unitary businesses that are also mutual fund service providers. This was done to limit the scope of the regulation. The rule adopts a domicile concept to represent the market. It also provides rules for pension plans and other entities and assigns these based on the domicile of the beneficiaries, (b)(1)(B)1., and if this is not known, by a reasonable method to approximate this information statistically, (b)(1)(B)2. If no method is developed, the receipts are thrown out. The throw out could be replaced by resorting to Revenue and Taxation Code section 25136 if this is determined to be more reasonable.

Subsection (b)(1)(C) sets forth an approach to deal with the assignment of receipts to California when the underlying entity providing the services to California shareholders is not a California taxpayer. This section is included to make sure that there will be market assignment of receipts based on the activities of the entire unitary group rather than on an entity-by-entity basis. As was discussed at the symposium, it is fairly common for mutual fund service providers to separate their various service activities into separate entities for regulatory or other purposes. Nevertheless, it is the group, acting as a unitary business, which provides all of the services required by the funds. The regulation recognizes this by assigning receipts on a unitary basis.

Subsections (b)(1)(C)1. and 2. contain all of the rules necessary to implement this approach in determining the combined report business income to be assigned to each taxpayer member of the mutual fund service provider

Subsection (b)(1)(D) contains a throwback rule based on the activities of all members of the unitary business. If no member of the mutual fund service provider's unitary business is taxable in a given state, then the receipts assigned to that state are thrown back to the state where the general rules of Revenue and Taxation Code section 25136 would have assigned the receipts. This rule is necessary to eliminate nowhere income concerns. While this seems the only way to address this concern, further input from the interested parties regarding this provision is welcome.