

REQUEST FOR PERMISSION TO HOLD A SYMPOSIUM TO CONSIDER ADOPTING A REGULATION PURSUANT TO SECTION 25137 REGARDING THE APPORTIONMENT OF THE INCOME OF MUTUAL FUND SERVICE PROVIDERS

If the allocation and apportionment provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA) do not fairly represent a taxpayer's business activity in California, Revenue and Taxation Code section 25137 authorizes the Franchise Tax Board (FTB) to require the use of another method to effectuate an equitable allocation and apportionment of a taxpayer's income. Pursuant to this authority, FTB has issued a number of regulations prescribing industry-specific methods of apportionment and allocation. There is no regulation prescribing a method of apportionment and allocation for 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. This regulation project is intended to provide much needed guidance in this area. In order to encourage industry participation in this project, staff is not proposing draft language at this time. Instead, the symposium should discuss the approaches taken in other states and the elements of those approaches that industry would like to see adopted in California, as well as a discussion of the provisions in other states that are seen by staff or industry as potentially flawed or in need of refinement.

The statutes and regulations adopted in other states have many common elements that should likely be incorporated into a California regulation. Among these elements are sections that define the various services that are provided to mutual funds. Typically these include administration services, distribution services and investment advice services. Staff envisions that these terms will need to be defined and included in a California regulation as well. In addition, other states have typically defined the boundaries of the use of the regulation by defining who is a mutual fund service provider. This is usually done by stating that the regulation only applies to companies that make the majority of their income from providing the aforementioned services to regulated investment companies. This appears to be a reasonable approach.

The payroll and property factors are usually not addressed in these alternative methods but are left to function as they would under the normal apportionment rules of the state. This also seems appropriate as there seems to be little controversy in regards to these factors and their relationship to this particular industry.

The crux of the problem for this industry lies in the sales factor. The normal apportionment provisions, set forth in Revenue and Taxation Code section 25136, assign receipts to the location where the income producing activity occurs. Usually this results in most, if not all, of the services income being assigned to one location. This has been remedied in most states by overriding the normal rule 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. Another issue that needs to be addressed is whether the fees received by service providers should be assigned on a collective basis or whether a separate

rule should be applied to each of the fees received. Staff understands that, because of the regulatory environment, each of the various services provided are performed by separate, but related, entities.

There are areas where there is no guidance to be found in the provisions adopted elsewhere. Of primary concern to staff is the adoption of a methodology to deal with the assignment of receipts to a location where the service provider is not taxable. It is a fundamental concern of UDITPA to avoid nowhere income. Many of the industry-specific regulations adopted by California under section 25137 (25137-3, 25137-4.1 and 25137-4.2, for example) contain a throwback rule to address this concern. Staff would like to discuss with industry how such a rule could work in the context of this regulation.

Also, staff envisions receiving input regarding shares in funds that are held by the service providers themselves, and whether they should be included in the shareholder ratio, as well as how income from the sale of such shares should be assigned for sales factor purposes.

The department has received several petitions under section 25137 by members of this industry and has allowed the use of alternative methods generally consistent with the practice of other states that have addressed this issue. Because of the continuing interest in this area, the fact that a number of other states have addressed this question, and in order to ensure consistent treatment of members of the industry, staff believes that it would be appropriate to consider adopting a regulation in this area. Staff requests that the Board authorize it to hold a symposium with members of the industry to develop such a regulation.