

TITLE 18. FRANCHISE TAX BOARD
AMENDMENTS TO PROPOSED
REGULATION SECTION 25137-14, RELATING TO
MUTUAL FUND SERVICE PROVIDERS

A hearing was held on December 18, 2006, by Carl A. Joseph of the Franchise Tax Board Legal Department, the "hearing officer," on proposed new Regulation Section 25137-14, which was noticed in the California Regulatory Notice Register on October 27, 2006. Section 25137 of the Revenue and Taxation Code authorizes the Franchise Tax Board to promulgate regulations regarding alternative apportionment methodologies. The indicated regulations, if adopted, would provide rules for the apportionment of income of mutual fund service providers.

After department staff reviewed the regulations and considered the comments submitted at and before the hearing, the hearing officer recommends that certain amendments to the proposed regulations be made for purposes of clarity and to insert clear language regarding the effective date of the regulation. These nonsubstantial changes (within the meaning of Govt. Code Section 11346.8) and sufficiently related changes (within the meaning of Govt. Code Section 11346.8) recommended by the hearing officer are reflected in the attachment hereto. Deletions to the indicated regulations are reflected by strikeout, and additions to the regulations are reflected by underscore. The proposed changes are summarized below:

1. Subsection (a)(3), the definition of management services, is revised to clarify that the mutual fund service provider is providing the service of selling or purchasing assets for the RIC rather than buying and selling for its own account. Comments were received that this needed clarification.

(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 providing services related to 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 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.

2. The definition of "domicile" contained in subsection (a)(4) was not clear in how it would apply to customers who were being provided asset management services. Therefore, the definition of "domicile" contained in subsection (a)(4) is split into two sections; one for shareholders in a RIC, and the other for beneficiaries who are receiving asset management services. Prior to the change, there was no clear

definition of domicile for asset management services. The sales factor assignment section for asset management did not speak in terms of domicile. This was seen as confusing. Comments were also received that the two sales factor sections should parallel each other.

Also, a change is being made in the subsection (a)(4)(A) definition of domicile to expand the scope of possible shareholders subject to the rules contained in subsection (b)(1)(A)1. This change was requested because it was pointed out that some corporate entities own shares for themselves, and not for the benefit of others, and therefore could be assigned to a principal place of business address rather than under the special rules.

(4) "Domicile" is defined as follows:

(A) The 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 own shares for the benefit of others ~~are not individuals~~ are subject to the special rule contained in subsection (b)(1)(A)1. of this regulation.

(B) The domicile of a beneficial owner of assets managed by a mutual fund service provider shall be presumed to be the beneficiary's mailing address on the records of the entity for whom the asset management services are rendered, or the records of the mutual fund service provider. If the entity for whom the asset management services are rendered, or the mutual fund service provider, has actual knowledge that the beneficiary's primary residence or principal place of business is different than the beneficiary's mailing address, the presumption does not control. Owners of record that are not the beneficial owner are subject to the special rule contained in subsection (b)(1)(B)1 of this regulation.

3. Subsection (a)(7) changed to make it clear that the definitions of management, distribution or administrative services contained in subsections (a)(1), (a)(2) and (a)(3) also apply to asset management services. Before this change, it was not clear that the same definitions applied.

(7) "Asset management services" means the direct or indirect provision of management, distribution or administrative services to entities other than regulated investment companies, if those services would be management, distribution or administrative services within the meaning of subsections

(a)(1), (a)(2), or (a)(3) of this regulation, if provided directly or indirectly to a regulated investment company.

4. Subsection (b)(1)(A) is modified in order to clarify that the ratio calculation should be performed for *all* states and not just California. It is necessary to clarify this because the throwback provision in subsection (b)(1)(D) only applies to states where the ratio is assigning receipts. If the ratio only were calculated for California, this section would never apply.

(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~~ the 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.

5. Subsection (b)(1)(A)1 is modified to make it apply to all shareholders and not just individuals. Comments were received that this subsection was confusing because the term "individual shareholder" was used to mean "a single shareholder" when the term "individual" is later used to describe a human being, as opposed to a corporation. Also the term "benefit of others" is included to replace "benefit of a separate account". This was done to be consistent with the change in subsection (a)(4)(A) set forth above. This subsection is further modified to take out the limitation that information used to develop a reasonable assignment mechanism must come from the shareholder of record. It was suggested that this was too limiting and that information may come from sources other than the shareholder of record. Also, an additional change was made to remove the term "available" and replace it with "obtained". Available, it was argued, is too subjective.

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~~ others, 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~~ obtained such that a reasonable basis can be developed to determine the proper location for the assignment of these shares 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.

6. Subsection (b)(1)(A)2 is modified to allow greater flexibility, as requested by commenters, such that the ratio can be calculated either on the RIC's year end or the mutual fund service provider's year end. In addition, language is added to require that the chosen method be consistently applied in subsequent years.

2. The regulated investment company's taxable year for computing the shareholder ratio shall be either the taxable year that ends during the taxable year of the principal member of the mutual fund service provider's combined reporting group or the taxable year of the principal member of the mutual fund service provider's combined reporting group. Once a method for computing the shareholder ratio is chosen, that methodology should be applied consistently in later years.

7. Subsection (b)(1)(B) is modified to be consistent with the new definition of domicile, which uses the term "beneficial owner" instead of "individual."

(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~~ beneficial owner of the assets is located in this state.

8. Subsection (b)(1)(B)1. is modified to be consistent with the change made in (b)(1)(A)1.

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 California. If the domiciles of the beneficiaries are not available, a mutual fund service provider may utilize any reasonable basis in order to determine the domiciles of the individual beneficiaries, including information based on zip codes or other statistical data.

9. Subsection (b)(1)(B)2 is modified because input was received that the term "statistically" was confusing and unnecessary, so the term is being deleted.

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.

10. Subsection (b)(1)(C) is modified to make it clear that the section applies to both services provided to RICs and asset management services provided by the mutual fund service providers.

(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, or that are providing asset management services directly or indirectly for beneficiaries who are domiciled 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.

11. Subsection (b)(1)(C)1(d) is clarified pursuant to a comment that this section was unclear regarding whether sales made by a mutual fund service provider that were not addressed under the regulation could still be included in the sales factor of the mutual fund service provider. This was always staff's intention, as set forth in subsection (b), but staff agrees that this change provides greater clarity.

The taxpayer member's California sales factor is a fraction, the numerator of which is the California sales of that taxpayer member, determined under Sections 25133 through 25137 of the Revenue and Taxation Code and the regulations adopted pursuant thereto and as modified by this regulation, and the denominator of which is the total sales of the group everywhere.

12. Subsection (b)(1)(D) is modified to match the addition made in subsection (b)(1)(C) to insert asset management services into the section.

(D) If the shareholder ratio calculated under section (b)(1)(A) or asset management services assigned under (b)(1)(B) 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.

13. In addition, subsection (b)(1)(D) is further modified to tie the definition of "taxable" to the definition found in Revenue and Taxation Code section 25122. This was requested by comment in order to clarify the term. This was already staff's interpretation of the regulation, under the language in subsection (b), and this simply provides clarity.

(C) If the shareholder ratio calculated under subsection (b)(1)(A) or asset management services assigned under (b)(1)(B) of this regulation assigns receipts to a state where no members of the

mutual fund service provider's unitary group are taxable as defined in Revenue and Taxation Code section 25122, 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.

14. Section (c) is added to set forth that the regulation is applicable to taxable years beginning on or after January 1, 2007. It was requested that staff include an effective date in the regulation and the January 1, 2007 date is reasonable as the process of regulating was well under way by this date.

(c) This regulation is applicable to taxable years beginning on or after January 1, 2007

These nonsubstantial and sufficiently related changes are being made available to the public for the 15-day period required by Government Code section 11346.8(c) and Section 44 of Title 1 of the California Code of Regulations. Written comments regarding these changes will be accepted until 5:00 p.m. on March 12, 2007.

A copy of the proposed amendments is being sent to all individuals who requested notification of such changes, as well as those who attended the hearing and those who commented orally or in writing, and will be available to other persons upon request. All inquiries and written comments concerning this notice should be directed to Colleen Berwick (916) 845-3306, FAX (916) 845-3648, E-Mail: colleen.berwick@ftb.ca.gov, or by mail to the Legal Department, Attn: Colleen Berwick, P.O. Box 1720, Rancho Cordova, CA 95741-1720. This notice and the proposed amendment and adoption will also be made available at the Franchise Tax Board's website at <http://www.ftb.ca.gov/>.