The Many Ways to Source Receipts from Asset Management Services in New York and None Are Clear

By: Barry Halpern, CPA and Katherine Krafchuk, CPA

Published Date: Mar 1, 2021

Executive Summary

With the continued shift to economic nexus and market-based sourcing, many asset management service providers find themselves doing business in more states. The continued shift to single sales factor weighting places a profound focus on the receipts factor and its sourcing for both taxpayers and auditors. This is especially true in New York State and New York City (collectively, "New York"),[1] as New York sourcing rules are complex and can be cumbersome. The focus of this article is to provide an understanding of the uncertainty in New York laws and regulations and how it ultimately affects asset management service providers' sourcing methods to New York, based on the ways they operate. By understanding the ambiguities in New York, a service provider can identify the structure that may provide the most beneficial tax results for its business.

General Sourcing of Services

Asset managers generate income by receiving a fee for providing services to various funds (including private funds, institutional funds and separately managed accounts). These fees are typically structured as a percentage of assets under management (AUM) and are paid either directly by the investors or more traditionally charged out through the fund.

In New York, the method by which asset management service providers apportion their income can be affected by how their businesses are structured. For example, New York State employs a three-factor formula (property, payroll and sales) for partnerships while requiring single–sales factor sourcing for corporations; the same is true as it relates to the sourcing of asset management receipts for the business allocation formula. The structure and operations of the asset manager's business can impact how the fee is sourced. Prior to 2015, New York generally

applied a service location approach, where receipts from services were sourced to the location where such services were performed.[2] Starting with tax years beginning on or after January 1, 2015, New York revised its tax law for corporate taxpayers ("corporate reform") and adopted a customer-based sourcing approach for receipts from services.

On its face, customer location or market-based sourcing may appear simple; however, as will be shown in this article, there are many subtle complexities within these rules. For example, the way receipts are sourced could be different depending on the type of fund or customer and the language contained in the contracts. Furthermore, the structure of the asset manager's business as a partnership, C corporation or S corporation, or being a registered securities broker or dealer, could have an impact on which section within the code applies and on determining how these fees are sourced.

Sourcing Rules for Asset Managers that Are C Corporations

With corporate reform, New York converted from a location-based sourcing approach to one where the benefit is received along with market-based sourcing approach for corporate taxpayers. New York City created a subchapter within its administrative code specifically relating to C corporations, the Business Corporation Tax ("BCT"), as New York City did not extend corporate reform to S corporations. The sourcing rules for the New York State MTA surcharge follows the corporate rules. However, the receipts factor has less of an impact on the MTA surcharge, which includes a property and payroll factor.

***Rules for asset managers that are not broker-dealers and customers that are not registered investment companies*.**

The law. An asset manager structured as a C corporation and that is not a broker-dealer will find itself sourcing receipts for asset manager services in accordance with New York's "catch-all" provisions—"receipts from other services and other business receipts."[3] Under this provision, receipts from services are sourced to New York, based on **customer location,** according to a hierarchy, the first of which is where the benefit is received.[4]

The draft regulation. New York State's draft regulation[5] includes the following relevant interpretations:[6]

- "**Customer** means the party who enters into a transaction with the taxpayer for the purchase of a service or other business activity from the taxpayer. **A customer can be an individual customer, a business customer, or a passive investment customer.**"

- **"Location of the customer** is deemed to be the location where the customer **derives value** from the services."

The primary sourcing rule is where the "benefit is received." Essentially, the focus of the draft regulation is that the customer is receiving benefit where the customer is deriving value.[7] In

determining where the value is derived from asset management services, the draft regulations distinguish between a **passive investment customer ("PIC") and another type of customer**. Asset management services provided to a PIC fall under a special rule, and the benefit received from/value derived location of the PIC is sourced differently than for non-PIC customers.[8]

A PIC is defined as an unincorporated entity that pools capital from passive investors for the purpose of trading or making investments and does not otherwise conduct any active business (essentially, a fund). Per the draft regulations, the value-derived location from which asset management services are provided to PICs is determined based on where the PIC makes decisions. The PIC's decision-making location may depend on the level of authority granted to the manager.

- If pursuant to the contract broad discretionary authority is given to the manager, the location of benefit is presumed to be at the location where the manager executes such decisions ("regardless of the location of the [PIC]").

- If the contract doesn't give broad discretion to the manager, the location of benefit is presumably the location where the PIC makes decisions.

The uncertainty. The tax law does not have language that distinguishes between PIC and non-PIC customers and the level of discretion given to service providers. With fee income as the primary source of revenue, asset managers often have broad discretion regarding decision making. The investors in the fund generally rely on the manager to make the investment decisions. The draft regulations appear to run contrary to market-based sourcing in the statute.

Additionally, if the contract is structured wherein the PIC makes decisions, are such receipts sourced to the location of the fund address, where perhaps it can be designated as "decision location," or to the address of each investor (which would be consistent with a previous version of the draft regulation and consistent with how other states are viewing it)?

The current COVID/telecommuting environment can throw in another wrinkle. Will New York look to each decision maker's location for each fund? What if there are several managers and they are telecommuting from different locations, including New York? Where is the benefit received?

New York draft regulations seem to be a bit clearer when the asset management services are provided to individual customers, presumably at the individual's billing address. However, for other business entities not considered PICs, the benefit received is determined based on where the books and records of the taxpayer indicate such benefit is received (or reasonable approximation). Although it may be difficult to determine where the benefit is received from the books and records, the draft regulations provide for reasonable approximation of such receipts. The rules for both individual sourcing as well as the non-PIC business entity clients appear to be more consistent with the statute's intent at market-based sourcing. The draft regulation, however, is not final and is subject to change.

If an asset manager is considering operating as a C corporation, these are some of the considerations that need to be addressed. Will they will have PICs? And if so, are they given broad discretionary authority to manage the funds? On the other hand, if they are not granted broad discretion, or have non-PIC customers, where is the benefit received? The answers to these question can have significant impact on the amount of receipts allocated and taxed in New York.

Sourcing Rules for Asset Managers that Are S corporations

New York State allows an S corporation the option to make an election ("NY "S" election") to be treated as a flow-through entity (similar to a federal S corporation). New York City does not recognize the federal S election and taxes S corporations as general corporations. As noted above, S corporations are specifically excluded from the 2015 corporate reform in New York City; accordingly, S corporations are taxed under pre-2015 rules.

Rules for asset managers that are not broker-dealers and customers that are not registered investment companies.

The law. In New York State, the sourcing rules for an asset manager structured as an S-corporation that is not a registered securities broker-dealer is similar to a C corporation, with the uncertainties described above. In New York City, an asset manager structured as an S corporation that is not a registered securities broker-dealer will find itself sourcing its receipts for asset manager services in accordance with New York City General Corporation Tax (GCT) rules. Per the City GCT rules, receipts from the performance of services are sourced to the city if the "services are performed within the City."[9]

The regulations.[10]For services performed within and without New York City, "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 performance of, such services within and without New York City, or by some other reasonable method."[11]

The uncertainty. In New York State, similar uncertainties associated with C corporations apply to S corporations. Accordingly, asset managers need to carefully consider where the benefit is received by their customers (as noted above). Additionally, if the NY "S" election is made, the uncertainties and considerations noted above can impact nonresident shareholders.

If the S corporation will also operate in New York City, an asset manager must consider the GCT rules and also determine where the service is provided regardless of its customer base. If the services are provided both within and without the City, an allocation to the City is made by some reasonable method.

Given the current COVID/telecommuting environment, the question may be where such services are provided. If provided remotely, is there time spent in the City, and what can be considered a "reasonable method" of allocation?

Sourcing rules for asset managers that are partnerships.

New York State still employs a three-factor formula for partnership, while New York City has fully phased in a single sales factor. Accordingly, the overall allocation to New York City is impacted by a higher receipts factor than in New York State. The state is still two-thirds impacted by employees and property.

While New York State taxes the owner/partner in a partnership, New York City imposes an entity-level tax, the Unincorporated Business Tax (UBT), on an unincorporated business conducted within the City.

Neither New York State nor New York City has revised its statutes in accordance with the market-based provisions of corporate tax reform.

<u>Rules for asset managers that are not broker-dealers and customers that are not registered investment companies.</u>

The law. In New York State, receipts from services are sourced based on the business carried on within the state as outlined in the personal income tax regulations.[12] In New York City, similar to the GCT, the UBT statute states: "…charges for services performed shall be allocated to the city to the extent that the services are performed within the city."[13]

The current regulations.[14]New York State[15] sources charge for services based on the location of the branch or office (office/location-based approach).[16]

The uncertainty. Although there is some consistency between New York State and New York City, namely the focus of the location of service, there are some subtle considerations. In 2009, New York City revised its statute from language focusing on the location of the office from which the service is provided to the current language, focusing on where the services are actually performed.

While the GCT regulations address payment for services both within New York City and without, there is no such guidance in the regulations for the UBT.[17] Questions remain, especially in a coronavirus (COVID)-based virtual environment, as to the location of the services being performed. Asset managers may find themselves not having receipts for services performed in New York City, but quite possibly having such receipts from managers assigned to the New York City office location—hence, New York State considerations.

Although both S corporations and partnerships can be taxed as flow-through entities in New York State, a nonresident asset manager[18] would need to consider the impact of the different sourcing methods in New York State. A partnership is required to use a location-based approach vs. the market-based sourcing approach for an S corporation, along with all of the uncertainties noted above.

<u>Sourcing rules for asset managers that are registered securities broker-dealers.</u>

Until this point, the assumption was that the asset manager was not a registered securities or commodities broker. If the asset manager does register as a securities or commodities broker or dealer, a different set of rules may apply.

Rules for asset managers that are broker-dealers and customers that are not registered investment companies.

Partnerships

- New York State does not have special sourcing rules for registered securities broker-dealers that are partnerships, and therefore, the rules are the same as noted above for partnerships.
- New York City has special sourcing rules for registered securities broker-dealers. As such, receipts from asset management services are "deemed to arise … at the mailing address in the records of the taxpayer of the customer who is responsible for paying such fees" ("customer-based address sourcing").[19]
- If a registered broker-dealer asset manager is not able to determine the mailing address of the customer, the receipts are "deemed to arise from services performed at the branch or office of the taxpayer that generates the transaction for the customer that generated such receipts."[20]

C Corporations and S Corporations

- New York has special sourcing rules for registered securities broker-dealers that are C corporations and S corporations. As such, receipts from asset management services are deemed generated at the "mailing address in the records of the taxpayer of the customer who is responsible for paying such fees" ("customer-based address sourcing").[21]

- Additionally, for New York State and New York City BCT purposes, if a registered broker-dealer asset manager is not able to determine the mailing address of the customer, "eight percent of the receipts is included in the numerator of the apportionment fraction" ("8% rule").[22]

- The New York City GCT statute does not have an 8% rule.

- The draft regulations address sales of securities through registered broker-dealers and rules for brokerage commissions. The draft regulations are silent on asset management services provided by registered securities broker-dealers.

    - Further, the draft regulations do not provide a clear example as to how and when the 8% rule applies for services by a registered securities broker-dealer.

The uncertainty. As a registered securities broker-dealer, with the exception of a partnership in New York State, an asset manager may have a bit more clarity than a non-broker. For one, the rules clearly utilize customer-based sourcing. However, New York does not attribute broker-dealer status to an affiliate or partner or even to the sole member of an entity registered as a securities broker-dealer. According to New York's interpretation, the entity providing the service/generating the fees needs to be registered. This could be tricky for many asset managers,

including many insurance companies that generally split their broker-dealers and investment advisors in two separate legal entities.

Further, the location of the customer responsible for paying the fees may not be entirely clear. In the context of asset management fees, is the fund responsible or are the investors responsible? At least for New York State and New York City BCT, there is an 8% rule. This rule does not apply to the New York City GCT or UBT.

What's more troubling, the New York City UBT statute appears to have similar language to the New York State partnership rules for sourcing (location-based), where a registered securities broker-dealer taxpayer can't determine customer location. As noted above, this could produce a different answer than for how a nonregistered securities broker-dealer would source its asset management fees for UBT purposes.

Sourcing rules for asset managers that provide services to regulated investment companies.

Regardless of how an entity is structured and whether it is a registered securities broker-dealer, an asset manager also needs to consider its receipts from registered investment companies ("RICs"). A RIC is a company that is defined in section 851of the IRC (e.g. mutual funds) and can be structured as a partnership to which section 7704(a) of the IRC applies (publicly traded partnerships). For the most part, the rules are pretty consistent with receipts from these funds; however, there are some uncertainties to discuss.

Rules for asset managers whose customers are RICs

Partnerships

The New York State partnership rules do not include any special treatment for receipts from services to RICs, and therefore, the rules are the same as noted above for partnerships.

New York City has special sourcing rules for receipts arising from asset management services to RICs, where such receipts are sourced based on the percentage of shares owned by shareholders in the city by the total shares outstanding.[23]

C Corporations and S Corporations

New York has special rules for receipts arising from asset management services to RICs, where such receipts are sourced based on the number of shares held by shareholders in New York divided by the total shares outstanding.[24]

The uncertainty. The rules for RICs generally call for a look-through approach, whereby the receipts are sourced based on the location of shareholders. The uncertainties generally arise where a manager may not have actual shareholder location; this is due to accounts held by brokerage firms for many shareholders (or "omnibus" accounts). The omnibus accounts may have the address or location of the broker but the actual shareholders are unknown. Often, most of the fees received from asset management services provided to RICs come from omnibus accounts. Although there are programs that can drill down to identify shareholders in the

omnibus accounts, many times there are additional omnibus accounts at other levels; in addition, the data is not always accurate.

As there are no regulations on this point; asset managers may look to use certain publicly available data to determine the percentage of asset management fees sourced to New York.

Conclusion

Overall, the sourcing rules for asset management services in New York are complex. Entity structure and type of customer can significantly impact the method of sourcing such receipts. A strong understanding of the different rules is key to helping an asset management service provider be best prepared for the New York tax consequences. As there are uncertainties with each method, an asset manager with a significant presence in New York is almost certain to be subject to an audit. Although audits are unpredictable, working closely with a reputable tax advisor and closely evaluating tax strategy and business model early on, an asset manager can be best prepared for what's to come.

This article originally appeared in the March 2021 *TaxStringer* and is reprinted with permission from the New York State Society of Certified Public Accountants.

Barry Halpern, CPA is a tax & business services partner at Marcum LLP's New York City office. Mr. Halpern helps clients navigate the complexities of all areas of state taxation including general consulting, audit defense, strategic planning, apportionment sourcing studies, nexus considerations and resolutions, sales and use taxes, due diligence for mergers and acquisitions, audits of state income tax provisions, and state tax compliance. He also has extensive experience advising clients on New York State and New York City tax matters, having successfully represented corporations and partnerships before state taxing authorities and negotiated settlements and penalty abatements. Mr. Halpern's focus is on understanding the needs of his clients and delivering high value quality professional services to companies across all industries including financial services, healthcare, private equity, technology and media. Mr. Halpern joined Marcum in 2021. He was previously a senior manager at a "Big Four" accounting firm.

Katherine Krafchuk, CPA, is a tax manager in the alternative investment group at Marcum LLP. With more than 10 years of experience in accounting, she has spent most of her time specializing on partnership and private equity taxation. Prior to joining Marcum LLP in 2014, Katherine worked in the investment management group of one of the "Big Four" public accounting firms. Her areas of expertise include partnership taxation, international tax compliance, notice resolution and state and local tax compliance.

---

[1] Although New York City may not have a "bright line" economic nexus test, many asset management service providers have some physical presence or look to do business in the jurisdiction.

[2] Former N.Y. Tax Law §210.3(a)(2)(B); NYC Admin code §11-604(3)(a)(2)(B)

[3] N.Y. Tax Law §210-A.(10); NYC Admin Code §11-654.2(10)

[4] For this article we will focus on location of where the benefit is received as it is the primary source.

[5] As of the date this article was drafted, New York has not promulgated regulations. New York State has released draft regulations that can be used as indication on how the New York State Department of Taxation and Finance intends on interpreting the law. However, these draft regulations are not precedential and may not be relied upon as such.

[6] See Draft N. Y. Reg. Sec. 4-2.18(c)(5) (July 3, 2019). To the extent the statute is identical, it is assumed that New York City will interpret the statue in a similar manner.

[7] "Benefit received" and "value derived" may be used interchangeably.

[8] Only asset management services provided to PICs are sourced under these special rules. Other services and business activities are sourced under the general rules – similar to asset management services to non-PICs, namely customer location.

[9] NYC Admin code §11-604(3)(a)(2)(B)

[10] As the rules for New York State are the same as C-Corporations, only the New York City regulations are displayed.

[11] 19 RCNY § 11-65(b)

[12] N.Y. Tax Law § 631

[13] NYC Admin code §11-508(c)(3)

[14] As the New York City UBT regulations were not updated in accordance with Ch. 201 (A.B. 8867), Laws 2009, effective July 11, 2009, the NYC UBT regulations are not here.

[15] New York State has an equally weighted property, payroll and sales factor. The focus of this article is on the sales factor.

[16] 20 NYCRR 132.15(f)

[17] New York City has released certain rulings indicating a reasonable allocation based on where the services were performed. However, rulings are not deemed precedential and may apply to specific facts within the ruling.

[18] Corporate partner may be subject to the rules discussed above and face those uncertainties.

[19] NYC Admin code §11-508(e-3)

[20] Id.

[21] N.Y. Tax Law § 210-A(5)(b); NYC Admin code §11-654.2(5)(b); NYC Admin code §11-604(3)(a)

[22] N.Y. Tax Law § 210-A(5)(b); NYC Admin code §11-654.2(5)(b)

[23] NYC Admin code §11-508(e-2)

[24] N.Y. Tax Law § 210-A(5)(d); NYC Admin code §11-654.2(5)(d); NYC Admin code §11-604(3)(a)