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California FTB Releases Updated Proposed Regulations on Market-Based Sourcing Rules – Implications for Asset Managers

Tax Talks on **September 20, 2024**

On September 13, 2024, California's Franchise Tax Board ("FTB") released updated proposed regulations ("Draft Regulations"), which would amend the rules regarding market-based sourcing for sales other than sales of tangible personal property. These proposed rules would have a significant effect on professional service providers, including asset managers. The Draft Regulations would apply to taxable years beginning on or after January 1, 2024.[1]

Proposed changes to these market-based sourcing rules have been formally under consideration by the FTB since 2017, and the Draft Regulations have been updated in each of 2018, 2019, 2020 and 2021 (the 2021 version is referred to herein as the "2021 Regulations").

The Draft Regulations build on the 2021 Regulations, which alter the existing language of section 25136-2 by implementing a look-through approach in how California assigns income to the applicable taxpayer. In particular, the Draft Regulations would continue to source revenues for asset management services to the location of the investor or beneficial owner.[2] This essentially requires a look through to the domicile of a fund's investors or beneficial owners and then adds a "value of interest" component to source the asset management fees to the location of the investors or beneficial owners.[3] For this purpose, (i) master funds, feeder funds and similar entities that pool investors' assets are not considered beneficial owners, and (ii) "the domicile of an investor" is presumed to be the investor's billing address on file with the taxpayer unless the taxpayer has actual knowledge that the investor's principal place of business is different than the investor's billing address.[4]

Receipts from asset management services are assigned to California in proportion to the average value of the interest in the assets held by the assets' investors domiciled in California. The average value of the interest is calculated by first adding the percentage of the value of the interest in the assets held by the investors or beneficial owners domiciled in the state at the beginning of the taxable year to such investors' percentage of value at the end of the taxable year, and then dividing that sum by two.[5]

To the extent the total asset management fees attributable to California domiciled limited partners exceeds the California economic nexus threshold ($711,538 for 2023[6]), such asset manager would be deemed to have California income tax nexus and a related filing obligation, even if it has no physical presence in or connection to California.

In the FTB's initial statement of reasons for the Draft Regulations, the FTB states that "creating specific rules for certain industries" drove the changes behind the amendment. The Draft Regulations are based on additional written comments received subsequent to six interested parties meetings held from 2017-2021.

Per the notice of proposed rulemaking published on the FTB's website on September 13, 2024, the FTB has not scheduled a public hearing on this topic but will hold one if it receives a written request for a public hearing from any interested person no later than October 16, 2024 (which is 15 days prior to the close of the written comment period).[7] Such requests are expected.

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[1] Amended Draft California Code of Regulations, Title 18, section 25136-2(j)(3).

[2] Amended Draft CCR section 25136-2(c).

[3] *Id.* The Draft Regulations provide a computation methodology and explanation with examples.

[4] *Id*.

[5] *Id.*

[6] California Franchise Tax Board, *Doing Business in California, <* https://www.ftb.ca.gov/file/business/doing-business-in-california.html>.

[7] Title 18. “Notice of Proposed Rulemaking”, *California Franchise Tax Board,* Sept. 13, 2024 <https://www.ftb.ca.gov/tax-pros/law/regulatory-activity/25136-2%20Notice-Proposed-Rulemaking.pdf>

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