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Investment Advisors Beware: New State Nexus and Souring Rules May Snare You

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"Economic nexus" and "market based sourcing" are two phrases many investment advisors will wish they had never heard. Growing budget deficits and in-state lobbying have caused states to become more aggressive in raising revenue, especially from non-local businesses. One appealing way for a state to broaden or shift the tax base is to tax income of persons that benefit from a state's market or consumer base but do not otherwise have a physical presence in the state. The emerging economic nexus standards and market based sourcing rules, including in states such as California and Washington, could become a major headache to investment advisors around the country, if not the world. Although Congress has considered legislation that may have the effect of limiting a state's ability to tax taxpayers without physical presence in their state, and thus undercut these new economic nexus provisions, to date the legislation has not been enacted.

As of January 1, 2011, a taxpayer is considered to be "doing business" (i.e., have nexus) in California, for purposes of applying California's income or franchise tax, if such person satisfies one of three bright-line thresholds or tests. Most notable for investment advisors is that a taxpayer that has apportionable "sales" in California in excess of the lesser of (i) $500,000 or (ii) 25% of the taxpayer's total sales will be considered to be doing business in California. For this purpose, "sales" generally include receipts from the provision of services. If a taxpayer is considered to be doing business in California, at the very least, the taxpayer will be required to file a tax return and pay a minimum fee.

Under the new California "doing business" standard, the amount of sales/services apportionable to California is based on a "market based sourcing" approach. In other words, the source of income or receipts from services is determined by where the taxpayer's client or customer is located as opposed to where the costs generated to perform such services are incurred by the taxpayer.

In 2007, California adopted specific rules governing management fees received by mutual fund advisors. The source of management fees received in connection with advising mutual funds or RICs is based on the domicile or residency of the shareholder base. Thus, the RIC is viewed as a mere conduit for this purpose and the shareholders in effect are treated as if they paid the management fee directly to the investment advisor. As a result, a large California shareholder base could result in the RIC investment advisor being considered doing business in California under the new doing business standards discussed above. Although the rule is specific to mutual fund advisors, it is not a stretch that California would apply similar concepts and rules to advisors of private equity, venture capital, and hedge funds.

As a result of these new nexus/doing business and sourcing rules, investment advisors should consider the following:

- If the investment advisor is structured as a limited partnership or LLC, additional filing obligations may be required of its partners/members. Although California generally allows for the filing of composite partnership returns (with withholding for non-resident partners), in some circumstances effective state tax crediting may only be available if the individual partners file separately.

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- In the case of an entity that could be considered doing business in California, there may be certain tax related elections or decisions an investment advisor may make that could otherwise reduce or eliminate the amount of apportionable income to California for purposes of determining the actual amount of California tax payable.
- In the case of comingled non-public investment funds (e.g., hedge funds, private equity funds and venture funds), these new rules strengthen the case for separating the vehicle that receives management fess (which potentially may be allocated to California) from the entity that receives allocations of "carried interest" (which may not be subject to California tax).
- State income tax planning structures that previously limited the amount of apportionable income to certain high tax states should be reexamined to ensure that they still provide the anticipated benefits under the new California tax regime.

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