California Tax Considerations for UK Fund Managers

Executive summary

California has adopted a new approach to the sourcing of receipts from services that means asset managers who earn fees from California investors (directly or via funds) may have part of their fee income sourced to California.

This can create Californian tax liabilities and filing obligations for asset managers, even if they have no presence there. An overview of the relevant rules is set out below.

Asset managers who have California investors should review their position to determine any exposure to California state tax and consider steps to address this.

Economic nexus and market-based sourcing

In recent years, California has moved towards economic presence and a market-based sourcing approach for sourcing receipts from services. Under this approach, receipts from services may be sourced to the state of the ‘customer’ (i.e. where the benefit of the service is received) for the purpose of Californian state taxes.

Previously, there was uncertainty in the asset management industry as to who is the customer – is it the fund or is it the investor? The latest draft of the California Regulations (currently under the formal approval process), sets forth examples where a fund manager’s customer is deemed to be the investor. Thus, the Regulations provide for a ‘look through’ approach to determine state sourcing of receipts based on the investor’s domicile.

There is also a risk that these look through provisions may apply to sub-advisors and result in both managers and associated sub-advisors having a California filing requirement and potential tax liability.

Economic Nexus: Factor Presence Standards

A fund manager will be considered to be ‘doing business’ in California if it meets any of the following bright-line tests:

- the taxpayer has annual fee income from California that exceeds $529,562 or 25 percent of their total receipts
- the taxpayer has real and tangible personal property in California that exceeds $52,956 or 25 percent of the total value of their property;
the taxpayer has compensation in California that exceeds $52,956 or 25 percent of their total compensation, or

- the taxpayer is organised or commercially domiciled in California.

If a fund manager is considered to be doing business in California as a result of meeting one or more of the above tests, the fund manager (and potentially sub-advisors) may have a California tax return filing requirement and a potential California tax liability.

**How is taxable income determined?**

Once nexus has been established, California taxable income must be determined. The first step is to compute the percentage of worldwide receipts derived from California investors. This percentage is then applied to the fund manager’s worldwide taxable income, to determine the fund manager’s California taxable income which is subject to a corporate tax rate of 8.84%.

Certain non-US corporations may be eligible to file a ‘water’s edge’ election in order to limit their tax base to US federal taxable income. Thus, if the corporation does not have federal taxable income, it would also not have California source income.

**Effective date**

The new Regulations apply for tax years beginning on or after 1 January 2015; however taxpayers may elect to apply these retroactively to tax years beginning on or after 1 January 2012.

Non-US entities wishing to file a ‘water’s edge’ election as described above will also need to ensure the timely filing of any entity classification elections that may be required to do this.

**Next steps**

UK fund managers should determine whether there are California investors in the funds they manage and whether the fee income that they earn from these investors is likely to exceed the bright line thresholds above.

If the nexus thresholds are met, further analysis should be undertaken to determine the potential California tax exposure. A water’s edge election may be available for certain corporations to limit their tax base to US federal taxable income. Additionally, there may be opportunities for partnerships to elect corporate status under the US ‘check-the-box’ regulations to take advantage of the water’s edge election.

Please consult with your regular EY contact or the one of the contacts overleaf if you would like to discuss further.

We will also be in contact with you shortly to invite you to a webcast we will be hosting to further discuss these and other important US state and local tax developments.
About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization and may refer to one or more of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP

The UK firm Ernst & Young LLP is a limited liability partnership registered in England and Wales with registered number OC300001 and is a member firm of Ernst & Young Global Limited.

Ernst & Young LLP, 1 More London Place, London, SE1 2AF.

© 2015 Ernst & Young LLP. Published in the UK.
All Rights Reserved.
ED None

Information in this publication is intended to provide only a general outline of the subjects covered. It should neither be regarded as comprehensive nor sufficient for making decisions, nor should it be used in place of professional advice. Ernst & Young LLP accepts no responsibility for any loss arising from any action taken or not taken by anyone using this material.

ey.com/uk