Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York | Brussels

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Re: Text of Draft Rule related to Part 4; Proposed Updates to the Article 9-A Business Corporation Franchise Tax Regulations

Managed Funds Association[1] ("**MFA**") appreciates the opportunity to provide feedback to the New York Department of Taxation and Finance (the "**Department**") on the text of draft rules under Part 4 of the Article 9-A Business Corporation Franchise Tax Regulations,[2] regarding apportionment, including, in particular, rules relating to "passive investment customers".[3] MFA represents the global hedge fund and alternative asset management industry and its investors. Of MFA's more than 150 member firms, over 70 collectively manage nearly $645 billion in assets across a diverse set of investment strategies from seats of management located in New York.

We are concerned that, at a minimum, the draft Regulations disincentivize New York-based investment managers from locating or expanding operations in New York. More likely, the draft Regulations incentivize New York-based investment managers to relocate to avoid the risk of double taxation present in the draft Regulations. In such case, New York would not only be deprived of significant corporate tax revenues but also other revenues from the migration of highly qualified, highly compensated jobs to less punitive taxing jurisdictions. Indeed, in response to increasing tax pressures, many in the alternative investment industry have either exited or may consider exiting New York for low-tax states.[4]

For regulatory, tax, and other reasons, our members may structure their management companies as business entities classified as corporations or partnerships with corporate partners for federal and state income tax purposes. The draft Regulations will ultimately dictate how our members (and the Department) measure taxable in-state investment management activities. We are supportive of the Department's

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[1] Managed Funds Association ("**MFA**") represents the global hedge fund and alternative asset management industry and its investors by advocating for regulatory, tax, and other public policies that foster efficient, transparent, and fair capital markets. MFA's more than 150 member firms collectively manage nearly $2.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, Brussels, London, and Asia. www.managedfunds.org.

[2] Unless otherwise indicated, all "Section" and "Regulation" or "Reg." references are to the Consolidated Laws of New York, Chapter 60 (Tax), Article 9-A (Franchise Tax on Business Corporations), as amended, and the Official Compilation of Codes, Rules & Regulations of the State of New York promulgated thereunder.

[3] N.Y. Dep't of Tax'n & Fin., Corporate tax reform draft regulations (July 2022), https://www.tax.ny.gov/bus/ct/corp_tax_reform_draft_regs.htm.

[4] *See*, *e.g.*, Ben Steverman & Katherine Burton, *Hedge Funds Are Ready to Get Out of New York and Move to Florida*, BLOOMBERG (April 17, 2021), https://www.bloomberg.com/news/articles/2021-04-17/wall-street-hedge-funds-are-ready-to-get-out-of-new-york-and-move-to-florida#xj4y7vzkg.

continued effort to marry the New York State legislature's (the "**Legislature**") intent to apply customer-based, or market, sourcing rules with administrable regulations which reflect the economics of specific service provider-customer arrangements and, in doing so, submit for public feedback multiple iterations of such regulations. We are concerned, however, that the draft Regulations, as currently proposed, do not accurately describe the organization of a "passive investment customer" (*i.e.*, an alternative investment fund); produce origin-based, or cost of performance, sourcing results contrary to the Legislature's intent; and incentivize investment managers to relocate to neighboring states with more consistent market sourcing rules.

We urge the Department to make the following changes, below, to the draft Regulations as it considers beginning the State Administrative Procedure Act ("**SAPA**") process to formally propose and adopt the draft Regulations.

MFA recommends:

(a) Proposing a rule which provides that, in the case of a passive investment customer, the benefit of the service or other business activity is presumed to be received at the billing address or commercial domicile of the ultimate investors in the passive investment customer; and

(b) In the interest of administrability, providing in the rule a hierarchy under which, if the taxpayer does not know the billing address or commercial domicile of the ultimate investors in the passive investment customer, the benefit of the service or other business activity is presumed to be received at the location where the investment in the passive investment customer is managed by the investor.

I. MFA Comments

With the passage of the 2014-2015 corporate tax reform legislation,[5] the Legislature decided to expand the use of market sourcing of receipts to a full range of service industries. In doing so, the Legislature concluded that the contributions of labor and capital in generating income should not be taken into account, a decision reportedly driven by the desire to eliminate any disincentive to corporations to locate or expand operations in New York.[6] Accordingly, Section 210-A generally requires service receipts

[5] N.Y. Laws 2014, S. 6359-D, c. 59.

[6] 2014-15 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support 5 (2014) ("New York's current sourcing rules fail to acknowledge the shift to a service-based economy. Companies that generate significant receipts from services can incur greater tax liability if they increase their activity in New York. This reform proposal would source a business's receipts to the location of its customers…This removes a previous disincentive to locating in New York."), https://www.budget.ny.gov/pubs/archive/fy1415archive/eBudget1415/fy1415artVIIbills/REVENUE_ArticleVII_MS.pdf.

Overview of Assembly Budget Proposal, State Fiscal Year 2014-2015 17 (2014) ("Part A: Corporate tax reform. The Assembly accepts the Executive's proposal to merge the Corporate and Bank taxes and reform the underlying calculation of liability."), https://assembly.state.ny.us/Reports/WAM/20140312/2014_assembly_budget.pdf.

New York State Revenue and Fiscal Outlook, Fiscal Year 2013-14 and 2014-15 149 (Feb. 25, 2014) ("The Executive's reform proposal adopts the Department's recommendations and seeks to restructure the State's corporate and bank taxes…In particular, the reform proposal…Adopts a customer-based single sales receipts formula for both corporations and banks…"), https://assembly.state.ny.us/Reports/WAM/2014revenue/2014revenue_report.pdf.

Review Existing Tax Policy and Discuss Reform Initiatives, Joint Hearing Before the New York State Senate Standing Committee on Finance and Senate Standing Committee on Investigations and Government Operations (Oct. 4, 2013) (statement of Sen. John A. DeFrancisco, Chairman, NYS Senate Standing Committee on Finance, recognizing "how important the financial industry is to the revenues of the state of New York" and raising "the risk of other states coming in, luring some of the industry to their states,

to be sourced based on the location of the customer. However, the statute does not provide a specific sourcing rule for investment management receipts received by a corporation which is neither a broker-dealer nor providing such services to a regulated investment company. In the absence of a statutory rule, sub-section (10) provides that 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.

Most recently, in July 2019, the Department published draft Regulations which would have sourced investment management receipts to the location where a passive investment customer makes the decision to utilize the investment or management decisions. If, however, a passive investment customer had granted, pursuant to a contract, broad discretionary authority to the taxpayer or another party to execute the investment advisory or investment management decisions on behalf of the passive investment customer, then the location where the benefit is received would have been presumed to be the location where the entity granted such authority executes those decisions, regardless of the location of the passive investment customer. The Department withdrew the July 2019 draft Regulations, which we believe were plainly inconsistent with market sourcing concepts present in the statute and the Legislature's intent.

The current draft Regulations fall short for similar reasons. First, the draft Regulations misconstrue the organization of a fund. *Draft* Reg. 4-4.4(c)(2) would source investment management receipts to the location where the contract with an investment manager is managed by the fund. *Draft* Reg. 4-4.1(e) further provides that the "[l]ocation where a contract is managed by the customer means the primary location at which an employee or other representative of a customer serves as the person with responsibility for monitoring or managing the day-to-day execution of the contract of sale with the corporation."

Strictly speaking, a fund rarely, if ever, has employees of its own. The organizational form of most funds is designed to fit within certain regulatory requirements under the federal securities laws and produce efficient tax results for investment managers and their anticipated investor base. Typically, investment professionals will form two entities: one entity—the investment manager—to manage the fund's portfolio and receive investment management fees and a separate entity—the general partner—to participate in the profits of the fund. Although the day-to-day responsibility of managing the fund is delegated to the investment manager, the general partner retains authority granted to it under state law and over other fund operations not otherwise assigned to the broad investor base or an investor committee.[7] At best, the draft Regulations tend toward the sourcing of investment management receipts to the location of the general partner (or, at worst, the investment manager) as an "other representative of a customer [that] serves as the person with responsibility for monitoring or managing the day-to-day execution of the contract" with the investment manager. However, sourcing investment management receipts to the location of the general partner (as opposed to the location of the investment manager) is a distinction without a difference—the general partner and investment manager often share an identity of interest (*i.e.*, both entities are controlled by the same persons). This result is no different than the result under the July 2019 draft Regulations and resembles cost of performance sourcing, contrary to the Legislature's intent.

Importantly, the cost of performance sourcing result runs the very risk that the Legislature sought to avoid—disincentives to corporations locating or expanding operations in New York, including increased

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and, thereby, affecting [New York State] revenues"), https://www.nysenate.gov/transcripts/public-hearing-10-04-13-nysenatedefranciso-marcellinofinancenycfinaltxt.

[7] Other responsibilities typically are set forth in the limited partnership agreement. For example, the consent of the broad investor base or an investor committee (often called a "limited partner advisory committee" or "LPAC") may be required for any principal transaction or other conflict of interest. The investor base may also remove the general partner and investment manager and terminate the fund (for cause or without). *See*, *e.g.*, Institutional Limited Partners Association, Model Limited Partnership Agreement (July 2020), https://ilpa.org/model-lpa/.

exposure to New York tax and the heightened risk of double taxation. Other states which boast similarly large numbers of investment managers located within their borders have adopted or proposed to adopt investment management receipt sourcing regulations more consistent with market sourcing than the draft Regulations. Among others, California,[8] Connecticut,[9] and New Jersey[10] have adopted or proposed to adopt rules which provide that, in the case of a passive investment customer or its equivalent in the state's parlance, the benefit of investment management services is received at the location where the investors in the passive investment customer are domiciled.[11] Notably, these states, in addition to New York, also boast a substantial share of institutional capital allocated to alternative investments and, therefore, would be the states to which significant investment management receipts would be sourced under regulations which provide that the benefit is received at the location where investors are domiciled.[12]

If the Department is determined to proceed with the draft Regulations, investment managers located in New York would be disincentivized from locating or expanding operations in New York. New York-based investment managers would be exposed to increased New York tax and the heightened risk of double taxation. Further, New York-based investment managers would be incentivized to exit New York for Connecticut or New Jersey, locations which are both proximate and offer a more favorable tax environment.

Suppose, for example, that an investment manager maintains offices in New York, from which it manages one fund in which two investors—one domiciled in New York, the other domiciled in Connecticut—are equal limited partners, and Connecticut, from which it provides only back-office functions and is not involved in the day-to-day responsibility of managing the fund. Suppose further that the investment manager generates $2 million of investment management receipts. Under this fact pattern, the investment manager would source $2 million of investment management receipts to New York for New York business corporation franchise tax purposes and $1 million of investment management receipts to Connecticut for Connecticut corporation business tax purposes. All other things being equal, the investment manager would be taxable on 150% of its taxable income for state income tax purposes. The investment manager would be prudent to relocate its New York operations to its Connecticut office for tax savings. In such case, the investment manager would source $0 of investment management receipts to New York for New York business corporation franchise tax purposes and $1 million of investment management receipts to Connecticut for Connecticut corporation business tax purposes. If, however, New York adopted regulations which provide that the benefit is received at the location where investors are domiciled, the investment manager would source $1 million of investment management receipts to New York for New York business corporation franchise tax purposes and $1 million of investment management receipts to Connecticut for Connecticut corporation business tax purposes, regardless of the location of its investment management operations, thereby eliminating the incentive to relocate its New York operations.

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[8] *Draft* Cal. Code Regs. tit. 18, § 25136-2(c)(2).

[9] Conn. Gen. Stat. § 12-218b(j).

[10] N.J. Admin. Code § 18:7-8.10A(a)(8).

[11] *See Draft* Cal. Code Regs. tit. 18, § 25136-2(c)(2) ("The domicile of an investor is presumed to be the investor's billing address indicated in the records of the taxpayer. If the taxpayer has actual knowledge that the investor's place of business is different than the investor's billing address, there is no presumption."). *See also* text accompanying n.13.

[12] California: $179 billion, https://investinginopportunity.org/state/california/.

Connecticut: $35 billion, https://investinginopportunity.org/state/connecticut/.

New Jersey: $45.9 billion, https://investinginopportunity.org/state/new-jersey/.

New York: $132.8 billion, https://investinginopportunity.org/state/new-york/.

Accordingly, we urge the Department to reconsider the draft Regulations and make the following changes, below, to the draft Regulations as it considers beginning the SAPA process to formally propose and adopt the draft Regulations.

II. MFA Recommendations

A. The Department should propose a rule which provides that, in the case of a passive investment customer, the benefit of the service or other business activity is presumed to be received at the billing address or commercial domicile of the ultimate investors in the passive investment customer.

The Department should propose a rule which is consistent with market sourcing concepts present in the statute and the Legislature's intent. The practical reality for many investment managers is that the draft Regulations tend toward the sourcing of investment management receipts to the location of the general partner or investment manager. This cost of performance sourcing result disincentivizes investment managers from locating or expanding operations in New York and incentivizes investment managers to relocate to neighboring states with more consistent market sourcing rules to avoid increased exposure to New York tax and the risk of double taxation. Such flight would deprive New York of significant corporate tax revenues and other revenues from the migration of highly qualified, highly compensated jobs to states with more favorable tax regimes for investment managers.

We recommend that the Department propose a rule which provides that, in the case of a passive investment customer, the benefit of the service or other business activity is presumed to be received at the billing address or commercial domicile of the ultimate investors in the passive customer.[13] This rule would be consistent with the current or proposed regulations in states in which the alternative investment industry and institutional capital allocated to alternative investments are predominantly located, thereby reducing the risk of double taxation. We appreciate that the Department may be concerned about the revenue impact of such a rule; however, we reasonably expect such a rule to sustain current levels of corporate tax revenues, promote the location and expansion of investment management operations in New York, and directly result in in the retention and creation of highly qualified, highly compensated jobs in New York.

B. In the interest of administrability, the Department should provide in the rule a hierarchy under which, if the taxpayer does not know the billing address or commercial domicile of the ultimate investors in the passive investment customer, the benefit of the service or other business activity is presumed to be received at the location where the investment in the passive investment customer is managed by the investor.

We appreciate that the Department may be concerned that our proposed business address/commercial domicile rule may not be administrable in the context of certain investors, namely,

[13] Whether the billing address of an investor is the relevant location where the benefit of the service or other business activity is presumed to be received would be determined according to the generic rule under *Draft* Reg. 4-4.4(a) (*i.e.*, if an investor would be considered an "individual customer" had the taxpayer provided investment management services directly to the investor, then the investor's billing address is the appropriate location).

Whether the commercial domicile of an investor is the relevant location where the benefit of the service or other business activity is presumed to be received would be determined according to rules comparable to *Draft* Regs. 4-2.5(b)(2), -2.6(d), -2.7(a), (c)(4), & -2.12(c)(1), regarding various sources of interest income and net gain, and applied according to the rule in *Draft* Reg. 4-1.1(b) (*i.e.*, if an investor would be considered a "business customer" had the taxpayer provided investment management services directly to the investor, then the investor's commercial domicile is the appropriate location).

other passive investment customers, such as a fund-of-funds or family office, and certain institutional investors, such as a pension. In such case, the taxpayer would be unable to diligence the business addresses or commercial domiciles of the ultimate beneficial owners—the taxpayer has no privity of contract with the ultimate beneficial owners, and the necessary information is likely to be a trade secret, confidential, or otherwise unavailable to it.[14] Out of concern for the confidentiality of investor and beneficiary information, such an investor should not be compelled to share its investor or beneficiary lists with the investment managers of funds in which it invests.

In the interest of administrability, we recommend that the Department provide in the rule a hierarchy under which, if the taxpayer does not know the billing address or commercial domicile of the ultimate investors in the passive investment customer, the benefit of the service or other business activity is presumed to be received at the location where the investment in the passive investment customer is managed by the investor. This "back-up" rule would be administrable in the context of available documentation—investment managers are expected to have such information readily available from their customer due diligence (anti-money laundering, know-your-customer, and counter-terrorism financing) compliance processes—and remain consistent with market sourcing concepts without having to rely on imprecise estimations.

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We appreciate the opportunity to provide our feedback to the Department on the text of draft rules, and we would be pleased to meet with the Department to discuss our feedback. If the Department has questions or comments, please do not hesitate to contact Joseph Schwartz, Director and Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

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[14] In this respect, a comparable rule to that which applies to intermediary transactions under *Draft* Reg. 4-3.8(b), regarding the making of inquiries to an intermediary, would be inappropriate and likely result in the sourcing of receipts to states in which the benefit of investment management services received is tenuous.

For example, a New York-based investment manager that manages a fund in which a fund managed by an unrelated investment manager invests should source investment management receipts to the commercial domicile of the unrelated investment manager. The unrelated investment manager, in turn, should source investment management receipts to the billing address or commercial domicile, as the case may be, of the ultimate investors in the fund which it manages. This result would differ to the extent the respective investment managers are related.

Similarly, a New York-based investment manager that manages a fund in which a pension invests should source investment management receipts to the commercial domicile of the pension (rather than the states in which its pensioners reside).