Managed Funds Association
The Voice of the Global Alternative Investment Industry
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Via Electronic Submission: tax.regulations@tax.ny.gov

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

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to provide feedback to the New York Department of Taxation and Finance (the "**Department**") on the text of proposed 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 alternative asset management industry, of which over 900 New York State-based investment managers, in total, manage over $3.3 trillion in gross assets.[4] Institutional investors—like pensions, university endowments, and nonprofits—rely on MFA members to meet financial obligations, diversify their investment portfolios, and manage risk.

For regulatory, tax, and other reasons, our members may structure their management companies as business entities classified for federal and state income tax purposes as corporations or partnerships with corporate partners. The proposed Regulations will ultimately dictate how those members (and the Department) measure taxable in-state investment management activities. We are supportive of the Department's 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 commend the Department for its receptivity to the overwhelming view of respondents that receipts for administration, distribution, and management services provided to a passive investment customer (collectively, "**investment management receipts**") should be sourced to the investors[5] in the

[1] Managed Funds Association ("**MFA**"), based in Washington, D.C., New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 170 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly $2.2 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.

[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 Taxation & Fin., Corporate Tax Reform draft regulations (last updated July 26, 2023), https://www.tax.ny.gov/bus/ct/corp_tax_reform_draft_regs.htm.

[4] *Number of Hedge Fund and Fund-of-Funds Firms by State or US Territory*, HEDGE FUND ALERT (June 28, 2023).

[5] We refer to "investors" and "beneficial owners", as contemplated by *Proposed* Regulation section 4-4.4(c)(2)(i), collectively and generically as "investors".

passive investment customer.[6] We continue to believe that this view is consistent with the 2014-2015 corporate tax reform legislation and the Legislature's decision to expand the use of market sourcing of receipts to a full range of service industries.[7] We also believe, in turn, that such rules eliminate a clear disincentive to investment managers locating or expanding operations in New York State, relative to other jurisdictions that have adopted or proposed to adopt similar rules.

Accordingly, we encourage the Department to proceed to formally adopt the proposed Regulations with the following recommended modifications to further enhance the accuracy and administrability of the rules relating to the sourcing of investment management receipts:

(a) A ***direct tracing method of apportionment*** should apply to investment management receipts, rather than the "average value of the interests" method.

(b) Clarify that investment management receipts attributable to ***investors the locations of which <u>can</u> be identified*** should be sourced to them, notwithstanding whether the remaining share of investment management receipts can be similarly traced.

(c) The ***reasonable approximation methods*** of *Proposed* Regulation sections 4-4.5 and 4-4.6, including the ***sourced receipts method***, should apply to investment management receipts that are attributable to investors the locations of which cannot be identified, rather than the location where the contract for such services is managed by the passive investment customer.

(d) The definition of "management services" should specifically include services performed under an ***investment sub-advisory agreement***.

(e) Clarify that investment management receipts include receipts for services that do not fit squarely within the definitions of "administration services", "distribution services", and "management services" but are ***ancillary or closely related to such services***.

(f) Clarify that the principles of the rules relating to the sourcing of investment management receipts also apply where the investment management receipts are received by a ***registered broker or dealer*** under Section 210-A(5)(b)(5).

<u>MFA Recommendations</u>

A. A ***direct tracing method of apportionment*** *should apply to investment management receipts, rather than the "average value of the interests" method.*

We recommend that the Department modify *Proposed* Regulation section 4-4.4(c)(2)(iii) to provide that a direct tracing method of apportionment, akin to New Jersey's "asset management services" allocation rule,[8] applies to investment management receipts, rather than the currently proposed "average value of the interests" method. New York State embarked on industry- and activity-based market sourcing rules to reflect more accurately the economics of specific service provider-customer arrangements. However, the accuracy (and, therefore, the value) of the "average value of the interests"

[6] N.Y. Dep't of Taxation & Fin., Regulatory Impact Statement (July 25, 2023), https://www.tax.ny.gov/pdf/rulemaking/jul2523/corpreform/sapa/ris.pdf.

[7] Letter from Managed Funds Association to N.Y. Dep't of Taxation & Fin. (Aug. 26, 2022) ("**August 2022 letter**"), https://www.managedfunds.org/wp-content/uploads/2022/09/MFA-New-York-Corporate-Sourcing-Regulations-Comments.pdf.

[8] *See* N.J. ADMIN. CODE § 18:7-8.10A(a)(8).

method is severely constrained for several reasons rooted in standard commercial practices and economic realities.

First, the "average value of the interests" method presumes that investment management receipts (or "fees and expenses") are borne by investors in a passive investment customer (or "fund") on a pro rata basis. Frequently, however, investment managers charge fees and allocate expenses on a non-pro rata basis. This may occur, for example, when an investment manager forms bespoke structures for large or strategic investors, such as separate accounts, funds-of-one, and co-investment vehicles, that invest in other funds managed by the investment manager. Another example where different fee arrangements may apply is when an investment manager broadly offers multiple fund share classes, each with different terms related to, most notably, fees and expenses, but also liquidity, transparency, etc.

In such cases, investors in a passive investment customer may bear fees and expenses disproportionately to the "value of the interests" they hold in the passive investment customer. As a result, the "average value of the interests" method may inappropriately source a greater proportion of investment management receipts to the location of a large (by interest) investor even though that investor economically bears a smaller proportion of fees and expenses. In addition to its inaccuracy, this uneconomic result upsets the principle of tax neutrality, *i.e.*, that pooling capital in a fund should not distort the tax consequences (to investors or the investment manager) that would follow from investors' capital being managed separately.

Second, the "value of the interests" is often difficult to determine. In the partnership context, a large and increasing number of Internal Revenue Code provisions, the regulations thereunder, and administrative guidance refer to the ownership percentages of a partner's interest in a partnership. In some places, the reference specifies a partner's interest in partnership profits or capital, and in others, the reference is not defined. Although the goal of these references is often simple—to describe a partner's economic interest in or control relationship to a partnership—the order of complexity of making such a determination when the reference is left undefined is compounded by the fact that passive investment customers are rarely "straight-up" partnerships in which the partners share in profits, loss, and capital in the same ratios. As a result, the "average value of the interests" method is likely to drive significant diversity in practice, with equally significant costs to administration and enforcement.

Third, and more fundamentally, open-end funds and funds with more liberal redemption terms risk even more severe distortion under the "average value of the interests" method as investors enter and exit the fund frequently and throughout the year. The "average value of the interests" method, which essentially takes a snapshot of investors' economic interests at the beginning of the taxable year and at the end of the taxable year, is prone to understate investment management receipts sourced to the location of investors that made contributions or received redemptions throughout the year and overstate those receipts sourced to the location of non-redeeming, non-contributing investors.

Accordingly, we urge the Department to modify *Proposed* Regulation section 4-4.4(c)(2)(iii) to provide that investment management receipts will be included in the numerator of the business apportionment factor to the extent attributable to an investor the location of which is determined to be New York State under *Proposed* Regulation section 4-4.4(c)(2)(ii). This direct tracing method of apportionment is not only more accurate but also more administrable than the "average value of the interests" method. Investment managers already prepare detailed fee and expense disclosures and are readily able to provide investors with statements of fees and expenses allocated to them. This market-standard practice may easily serve the purpose of sourcing investment management receipts.

B. *Investment management receipts attributable to* ***investors the locations of which <u>can</u> be identified*** *should be sourced to them, notwithstanding whether the remaining share of investment management receipts can be similarly traced.*

We recommend that the Department clarify in its adoption of final regulations or other administrative guidance that the rules in *Proposed* Regulation section 4-4.4(c)(2) do not depend on the investment manager's ability to identify the locations of *all* investors in a passive investment customer. In other words, to the extent that the investment manager is able to identify *some* investors in a passive investment customer in accordance with *Proposed* Regulation section 4-4.4(c)(2)(ii), investment management receipts attributable to investors the locations of which can be identified should be sourced in accordance with the primary rule, however formulated, in *Proposed* Regulation section 4-4.4(c)(2)(iii). The remaining share of investment management receipts attributable to investors the locations of which cannot be identified should be subject to the rules applicable to the investment manager if it cannot determine the location of investors.

For administrability reasons, nearly every jurisdiction in which market sourcing applies to service revenue has adopted a hierarchical approach with successive substitute rules that are applicable where the information required by the previous rule was unknown or otherwise indeterminable. The nature and order of these substitute rules rest on a policy judgment that each rule before the next is a more accurate characterization of the location at which the benefit of such services is received. Again, New York State embarked on industry- and activity-based market sourcing rules to reflect more accurately the economics of specific service provider-customer arrangements. Accordingly, we request that the Department clarify that investment managers should not entirely abandon a more accurate, or higher tier, sourcing rule merely because of the inability to identify some investors in a passive investment customer; only investment management receipts attributable to those residual investors the locations of which cannot be identified should be subject to a "back-up," or lower tier, sourcing rule.

C. *The* ***reasonable approximation methods*** *of Proposed Regulation sections 4-4.5 and 4-4.6, including the* ***sourced receipts method****, should apply to investment management receipts that are attributable to investors the locations of which cannot be identified, rather than the location where the contract for such services is managed by the passive investment customer.*

We recommend that the Department modify *Proposed* Regulation section 4-4.4(c)(3) to provide that, if the investment manager cannot determine the locations of some investors under *Proposed* Regulation section 4-4.4(c)(2)(ii), it may source such receipts in accordance with the reasonable approximation methods of *Proposed* Regulation sections 4-4.5 and 4-4.6, including where applicable, in the same proportion as its sourced receipts (the "**sourced receipts method**"), as described in *Proposed* Regulation section 4-4.5(c)(3). The reasonable approximation methods set forth in *Proposed* Regulation sections 4-4.5 and 4-4.6 should serve as a substitute for the currently proposed "back-up" rule which requires the benefit of management, distribution, and administration services provided to a passive investment customer to be presumed to be received at the location where the contract for such services is managed by the passive investment customer.

Notably, this currently proposed "back-up" rule was formerly the primary sourcing rule in *Draft* Regulation section 4-4.4(c)(2) (2022) that suffered from the tendency to produce cost-of-performance sourcing results contrary to the text of the authorizing statute and its legislative intent. Indeed, separate and apart from the concerns expressed in our August 2022 letter, the rationale for the recent determination of the Division of Tax Appeals in *Matter of Jefferies Group LLC & Subsidiaries*[9] casts doubt on whether such a rule would ever be appropriate under either the authorizing statute[10] or Commerce and Due Process Clause principles.[11] At best, such a rule seems universally vulnerable to alternative apportionment as described in Section 210-A(11) under which an investment manager could

[9] *Matter of Jefferies Group LLC & Subsidiaries*, Administrative Law Judge DTA, Nos. 829218 & 829219 (Aug. 31, 2023).

[10] *Id.* at 72-82.

[11] *Id.* at 99-102 (citing *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931)).

easily carry its burden by showing that the rule, in effect, sources all investment management receipts to New York State.

Relatedly, the sourcing hierarchy in Section 210-A(10)(b) and *Proposed* Regulation section 4-4.2(b) goes to great lengths to avoid cost-of-performance sourcing results—first, allowing reasonable approximation based on customer information under *Proposed* Regulation section 4-4.5, including the sourced receipts method, or general information under *Proposed* Regulation section 4-4.6, and then, the delivery destination method under *Proposed* Regulation section 4-4.7, and then, the preceding taxable year method under *Proposed* Regulation section 4-4.9, and in the final instance, the current taxable year method under *Proposed* Regulation section 4-4.10. At no point does the proposed general framework for market sourcing concede to simply sourcing receipts to New York State, without more. Moreover, the Department is promulgating the rules relating to the sourcing of investment management receipts under the authority of Section 210-A(10) under which any such rules are necessarily, and without further discretion, subject to the hierarchy of methods in Section 210-A(10)(b). Therefore, the Department should permit the use of the reasonable approximation methods of *Proposed* Regulation sections 4-4.5 and 4-4.6, consistent with the methods prescribed in Section 210-A(10)(b)(3) and (4).

Further, the special rules in *Proposed* Regulation section 4-4.3 provide that the reasonable approximation methods under *Proposed* Regulation section 4-4.5 and 4-4.6 apply to determine where the benefit of certain services is received. Similarly, these reasonable approximation methods should apply to determine where the benefit is received under *Proposed* Regulation section 4-4.4, including in the case of a passive investment customer. Moreover, we are not aware of any other jurisdiction, which has adopted or proposed to adopt similar rules, that would not permit reasonable approximation prior to defaulting to an in-state presumption.[12] Accordingly, we urge the Department to align the rules relating to the sourcing of investment management receipts with this general framework and permit the use of the sourced receipts method as a "back-up" rule, rather than the location where the contract for such services is managed by the passive investment customer.

D. The definition of "management services" should specifically include services performed under an ***investment sub-advisory agreement****.*

We recommend that the Department modify the definition of "management services" to specifically include services performed under an investment sub-advisory agreement. The definition of "management services", as currently proposed, contemplates the rendering of investment management or advisory services to, and pursuant to a contract with, a passive investment customer. However, some investment managers operate in a structure under which the investment manager delegates one or more duties, which would otherwise be described by the definition of "management services", to one or more sub-advisers (which are often affiliates of the investment manager), with the investment manager obligated to monitor and oversee the actions of the sub-adviser(s). Generally, sub-advisers contract with and are compensated by the "primary" investment manager. The definition of "management services", therefore, seemingly excludes such services performed under an investment sub-advisory agreement because the language "rendering…to a passive investment customer" or "on behalf of a passive investment customer" does not clearly encompass the performance of such services indirectly and, more explicitly, because the limiting clause, "but only where such activity or activities are performed pursuant

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[12] *See*, *e.g.*, *Draft* CAL. CODE REGS. tit. 18, § 25136-2(c)(2)(B) (2021) ("If the taxpayer does not know the average value of interest in the assets held by the asset's investors or beneficial owners domiciled in this state, the receipts shall be assigned to this state to the extent the average value of interest in the assets held by the asset's investors or beneficial owners domiciled in this state is reasonably estimated to be in this state."); N.J. ADMIN. CODE § 18:7-8.10A(a)(8)(ii)(1) ("In the event the domiciles of the beneficiaries are not or cannot be obtained, a reasonably proxy may be used to allocate receipts to new Jersey that reflects the trade or business practice and economic realities underlying the generation of receipts from the asset management services.").

to a contract with the passive investment customer," excludes services performed under a market-standard investment sub-advisory agreement.

There is no policy reason to exclude services performed under an investment sub-advisory agreement from the definition of "management services", especially where the sub-adviser is an affiliate of the investment manager and where the arrangement is dictated by regulatory or other legal considerations (for example, because the passive investment customer is organized in a different jurisdiction from where the investment management or advisory services are being performed). The duties performed by sub-advisers are precisely those described in *Proposed* Regulation section 4-4.4(c)(4)(iv)—"the rendering of investment advice…, making determinations as to when sales and purchases of securities are to be made…, or the selling of securities…, and related activities."

Nor is there an administrability reason to exclude such services. Often, as noted, sub-advisers are affiliated with the primary investment manager which should obviate any concern that a sub-adviser would be unable to diligence the location at which the benefit of such service is received in accordance with the primary sourcing rule. Even with respect to unaffiliated sub-advisers, we do not foresee any concerns with the primary investment manager disclosing the necessary information for the sub-adviser to properly source such receipts in accordance with the primary sourcing rule. Indeed, as part of the confidentiality provisions of a market-standard investment sub-advisory agreement, each party to the agreement is generally permitted to disclose, without limitation of any kind, the tax treatment and tax structure of the passive investment customer and any of its transactions, and all materials (including opinions or tax analyses) relating to such tax treatment and tax structure. Accordingly, we urge the Department to modify the definition of "management services" by either (i) including language contemplating the performance of such services "directly or indirectly" and deleting the limiting clause beginning with "but only if…", or (ii) making separate provision for services performed under an investment sub-advisory agreement in the definition of "management services".

E. *Clarify that investment management receipts include receipts for services that do not fit squarely within the definitions of "administration services", "distribution services", and "management services" but are* ***ancillary or closely related to such services****.*

We recommend that the Department clarify in final regulations that when investment management receipts are comprised of both receipts from services specifically described by the definitions of "administration services", "distribution services", and "management services", and receipts from services ancillary or closely related to the same, but not so neatly defined, the receipts should not be divided into separate components for purposes of the application of the rules in Part 4 but rather should be considered one receipt, regardless of whether the components are separately stated in any fee or expense disclosure.[13] The definition of "management services" in *Proposed* Regulation section 4-4.4(c)(iv) includes "related activities", but the definitions of "administration services" and "distribution services" in *Proposed* Regulation sections 4-4.4(c)(i) and (iii) are not as flexibly drafted. We recommend that the catch-all "related activities" concept be added to the definitions of "administration services" and "distribution services".

The types of fees and expenses chargeable to investors that may be contemplated by a passive investment customer's organizational and offering documents are varied and may include, in addition to investment management receipts as strictly defined in the proposed Regulations, fees and expenses from origination and distribution[14] services, deal sourcing activities related to unsuccessful investments

[13] We note that an analogous issue is presented in the context of a sale that is comprised of both a digital product and a digital service, as to which *Proposed* Regulation section 4-1.3(a) applies a "lump sum payments" concept to treat the payments as one receipt rather than disaggregating the separate components.

[14] We use "distribution services" in this context to refer to the distribution of securities in connection with a portfolio investment, rather than the distribution services or investor account servicing in connection with the passive investment customer contemplated by *Proposed* Regulation section 4-4.4(c)(4)(iii).

(or "broken deal expenses"), or services performed pursuant to a contract other than directly with a passive investment customer. Moreover, fees and expenses associated with examinations, investigations, or other regulatory or compliance matters may not be considered "legal" services for purposes of the definition of "administration services" because the services do not involve the practice of law strictly understood. Investment managers may also utilize a pass-through expense model under which the passive investment customer pays for most of the investment manager's expenses, but the investment manager does not charge a management, advisory, or similar fee.

In any case, certain fees and expenses may not fit squarely within the categories of investment management receipts but are either aggregated with or so closely related to the same that considering such fees and expenses as one receipt (or, at a minimum, receipts of a similar kind) is both the most administrable, and likely the most accurate, characterization of the location at which the benefit of such service is received. The definition of "management services" appears to recognize the breadth of services for which an investment manager may charge a management, advisory, or similar fee, through the inclusion of the catch-all "related activities" concept. However, the meaning of this catch-all "related activities" concept may be construed as limited by the kind or class of activities that immediately precede the catch-all language and, therefore, exclude certain ancillary services. The definitions of "administration services" and "distribution services" do not include similar catch-all language. Accordingly, we request that the Department both add the catch-all "related activities" concept to the definitions of "administration services" and "distribution services" and clarify in final regulations that rules relating to the sourcing of investment management receipts apply to receipts from aggregated, ancillary, or closely related services.

F. Clarify that the principles of the rules relating to the sourcing of investment management receipts also apply where the investment management receipts are received by a ***registered broker or dealer*** *under Section 210-A(5)(b)(5).*

We recommend that the Department clarify in final regulations that a service provider sources investment management receipts from a passive investment customer in accordance with the principles of *Proposed* Regulation section 4-4.4(c), regardless of whether the service provider is a registered broker or dealer.

Although most investment managers are not registered as brokers or dealers, some are registered due to regulatory requirements or other considerations. For example, a registered securities broker-dealer may be involved in the marketing or selling of interests in a passive investment customer which is a "distribution service" described in *Proposed* Regulation section 4-4.4(c)(iii). As described above, as set forth in our August 2022 letter, and as recognized by the proposed Regulations, the true customers of these types of services are generally the investors in a passive investment customer, rather than the passive investment customer itself. There is no policy reason why the rules relating to the sourcing of investment management receipts should not apply merely because the recipient is a registered broker or dealer. Regardless of whether the investment management receipts from the passive investment customer are received by a registered broker or dealer, customer-based sourcing principles mandate that the receipts be sourced to the location of the investors in the passive investment customer, for the reasons set forth in our August 2022 letter.

Well before the 2014-2015 corporate tax reform legislation that expanded customer-based sourcing to a full range of service industries, the Legislature recognized that it was important to provide customer-based sourcing for registered brokers and dealers in order to preserve New York State's preeminent position in the securities industry.[15] Thus, Section 210-A(5), originally enacted in 2000 as

[15] *See*, *e.g.*, 2002-03 New York State Executive Budget, Revenue Article VII Legislation, Memorandum in Support 10 (2002) ("The customer sourcing provisions for registered brokers and dealers enacted by Chapter 63 of the Laws of 2000 were intended to alleviate the tax burden placed on the securities industry under existing tax statutes and act as an incentive for the

former-Section 210(3)(a)(9), provides customer-based sourcing for a wide range of receipts of a registered securities broker or dealer. Specifically, Section 210-A(5)(b)(5) provides that, "[r]eceipts constituting fees for management or advisory services . . . shall be deemed to be generated within the state if the mailing address of the customer who is responsible for paying such fees is within the state."

Accordingly, we request that the Department clarify in final regulations that, for purposes of Section 210-A(5)(b)(5), in the case of investment management receipts from a passive investment customer, the "mailing address of the customer who is responsible for paying such fees" shall be deemed to be the mailing address of the investors in such passive investment customer as determined under *Proposed* Regulation section 4-4.4(c)(2).

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We appreciate the opportunity to provide our feedback to the Department on the text of proposed rules under Part 4 of the Article 9-A Business Corporation Franchise Tax Regulations, 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, Regulatory Affairs, or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Jennifer W. Han

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financial services industry to retain its strong presence in New York."), https://www.budget.ny.gov/pubs/archive/fy0203archive/fy0203articleVIIbills/revenue_memo.html.