

## STATE & LOCAL TAX ALERT

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**April 1, 2014**

### **California Ruling - Sourcing of Management Fees for California Nonresidents**

California recently issued Franchise Tax Board Chief Counsel Ruling 2013-04, which deals with the sourcing of management fees for nonresidents of California for services provided to a private equity fund ("PEF") and to the fund's portfolio investments where the services were performed wholly in California.

#### **Facts**

The taxpayer, an individual nonresident of California was the founder and a member in a limited liability company ("LLC") based in California that provided management services to a PEF and its portfolio investments. Approximately ninety percent of the investment commitments of the fund were from investors located outside of California. Additionally, approximately ninety percent of the PEF's portfolio investments were located outside of California. The LLC maintained its sole office in California and its employees and members, including the taxpayer performed management services wholly in California.

#### **Ruling**

The state ruled that income of the California nonresident from the performance of management services is California source income because the LLC's business is conducted wholly in California. See *California Revenue and Taxation Code ("CRTC") Section 17951-4(a)*.

#### **Conclusion**

The key distinguishing factor in this case appears to be the fact that the services provided by the LLC to the PEF were provided wholly in California. Entities that are providing management services both within and outside of California to a PEF and its portfolio investments would generally determine the source of its management fees based on general corporate apportionment principles, which currently allow the management service provider to source management fees based on either the current market based sourcing principles or based on an allocation formula of services performed in California to services provided everywhere. Proposed legislative changes to the market sourcing rules provide that fees earned from the performance of management services to a fund should be sourced based on where the investors in the fund are located.

#### **Green Hasson Janks Recommendation**

Now is the time for management service providers to PEFs and to portfolio investments to speak to their tax advisors about the income sourcing requirements for their businesses. In particular, management service providers that are performing their services wholly within California may be subject to Chief Counsel Ruling 2013-04, while multistate service providers may eligible to determine the source of their management fees based on California's general corporate apportionment sourcing rules which may allow for some portion of the fees to be sourced outside of California. It is important that the correct determination be made on where management fees should be sourced. &

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