Tax in asset management: State and local taxes

Transcript

SPEAKERS:

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ERIC COOMBS: Welcome to the Grant Thornton podcast, where we share information about the latest trends in business issues of the day.

My name is Eric Coombs and I'm the tax services leader for Grant Thornton's asset management practice.

As part of our series on key tax issues in the asset management industry, I'm speaking today with Rob Michaelis, partner in our state and local tax practice, about some of the current multi-state income tax considerations for asset management.

Rob, thanks for joining us today.

ROB MICHAELIS: No problem, Eric. Thanks for having me.

ERIC COOMBS: Yeah, of course. So just wanted to kick it off by asking you, in your view what are the three or four primary challenges or items that you see asset managers focusing on and dealing with in state and local income taxes?

ROB MICHAELIS: That's a great question, Eric. There are various areas in the state and local tax arena that asset managers and their compliance providers struggle with day in and day out that are somewhat evolving and changing over the last several years.

The first one that kind of comes into play, and this really depends upon what type of fund or structure we're talking about, is do I even have a filing responsibility in states and in which states do I have that filing responsibility with your traditional type of funds that have simply, let's say, portfolio income in it.

There's still the general premise out there that folks would say, “Well, it's investment income, it's portfolio income, I should only have to file a return, let’s say, in a domicile jurisdiction for the fund itself,” and then the investors would pick up the income in

their residence states and possibly in that domicile if on that fund return, the partnership return, if there was any income allocated there.

But you also have the underlying investment partnership roles that do exist in some states similar to the federal construct there, where states will have provisions that say, "Well, if you do have an investment partnership, only the resident or domiciled state is going to tax the owner on that."

But when you get beyond that and you're talking about partnerships that might have some kind of active trade or business in it, it could be lending funds, right, interest income, gains, losses on those types of loans, portfolios, things of that nature, it gets a little more complex because you don't fall under this portfolio income exception, this investment partnership exception. You're falling into more like an operating partnership, and you're dealing with, OK, now where does this thing have nexus, right?

It may very well be being managed in only one state. But, you know, if you have a fund that's lending money to folks around the country and those folks are paying interest to the fund, you get into, does that in itself just create nexus and the filing responsibility for the fund on each of these particular states.

And what we've seen in recent years is this notion of market-based sourcing kind of cropping up in most states today, which has evolved over the last 10–12 years to a great extent.

Also, the notion of economic nexus laying on top of that, right? So a lot of states with the sourcing rules with economic nexus, if you have receipts beyond a certain threshold, right, you should be filing.

And they base those receipts measurements based on the underlying apportionment factor sourcing rules for the sales or the interest income in that case. And oftentimes that goes to where the borrower might be sitting.

So that combination of factors are switched to market-based sourcing, OK, and the economic nexus provisions whether there is a specific threshold or a more general income derived from sources view with no threshold is kind of making it far more likely that you could end up with a filing responsibility in states.

ERIC COOMBS: Sure. And I know that can be tremendous compliance burden with respect to any asset managers that sort of fall into those categories.

ROB MICHAELIS: Absolutely, it can, and there's still some interesting concepts there with, particularly if you're talking about a fund that's in the business of lending, right, a lot of states do have provisions that are applicable to what they call financial organizations, OK, or banks, definition can vary by state, that even have nexus provisions for special taxes that exist in those states with different tax rates, maybe different apportionment regimes, that is more kind of based on, well, if you have a borrower in the state, that's enough to trigger a nexus.

Now there's some debate as to whether or not those types of provisions would be applicable to partnerships, or they're only applicable to corporations, because typically you see those provisions in the corporate provisions under state law.

And then even if they are, then you get into this notion of, OK, well, what if I'm not regulated like a bank, because a lot of these financial work provisions are kind of based on, you're subject to this.

If you're regulated by a state or federal banking agency or savings and loan-type regulatory regime, or if you're in substantial competition with banks now, whether or not you're substantial competition with banks, that's a loaded question, right?

They're really going after the same type of borrowers, so whether it's a banking regime or it's just a normal state and local tax nexus and sourcing regime, with the advent of market-based sourcing and economic nexus, which really came on strong after the Wayfair decision back in '18 on the sales and use tax side, and we've seen more and more states come out on the income tax side and really basically publish authority, "Hey, you've got the receipts over this amount, you're in." And some have come out with authority and said, "We don't care what the receipts amount are. If you have income derived from sources under the sourcing provisions, we expect that filing."

That of course causes leakage into the investment return. And I think that's something that we see asset managers and these funds struggling with a bit.

ERIC COOMBS: Sure, sure.

So in thinking about ways that tax providers add value in the asset management space, I think a lot of value is added up front in the structuring and planning for setting up a given fund and taking into consideration its investment strategy.

Can you talk about the way that planning in terms of structuring upfront can mitigate some of the issues that you described on the nexus front?

ROB MICHAELIS: Yeah, sure. I think it's very dependent upon, and you know this, Eric, every fund could be different from another because of the nature of the investments, number one, right?

ERIC COOMBS: Sure.

ROB MICHAELIS: And then the nature of the investors too, right? And particularly when you have foreign investors coming in, it gets a heck of a lot more complex, right? You talk about whether there's a withholding requirement. You talk about whether there's treaty applicability to get around the withholding, and even if there is a treaty requirement applicability to get around the withholding, that doesn't necessarily apply in states, right?

There's a lot of interesting constructs out there that that are very difficult to structure and work around. The one thing we see a lot out there with regard to not just state, but maybe even federal, is the use of block or sometimes if there's something that's problematic maybe in the investment pool that you don't want to have kind of taint the rest of the rest of the investments or the chain up to the investors.

We see a lot, like for example if there's a loan, let's say, or portfolio loans and some kind of security is taken back, and that security could be equity, let's say, in a borrower. Or you're taking a security in some of their assets or real estate, right?

And in some of these structures, not having real estate interests coming into it can be really important, particularly when you get into other things like RICs and BDCs and things like that as well.

But the use of blockers we see from time to time used for strategic investments that might be sitting in a larger fund, right? And obviously the time to identify that is at the onset of making the investments, it's kind of hard to unring the bell sometimes once you're already down a path, but that's one way to work around it.

The other the other issue that comes into play even with these ones that are not, let's say, generating an active trade or business, but have your traditional portfolio income, the question becomes, hey, maybe most of these states might have this investment partnership view context anyway, right? This concept anyway, in which

you know we're only going to tax the owners in their state of domicile, let's say, but maybe for some reason the state doesn't have that exact rule or it doesn't necessarily apply in this particular context.

And then you're kind of concerned about, well, where is this thing being managed from, right? And by whom? Maybe having something managed out in New York isn't a good answer, right, but having it managed in Florida or something is, right?

ERIC COOMBS: Sure.

ROB MICHAELIS: So there are any number of different levers one can pull through the use of blockers. Who's managing it where? It just is so very investment-specific and investor type-specific. Not just type, but jurisdiction of the investor too, that it's hard to say, "Hey, here's the magic bullet to get around all this."

It's really a lot of work and having good advice through your attorneys and your accountants to get that buttoned up on the front end of the investment and knowing what that leakage might look like and if there are ways to structure to avoid the worst case scenario or unexpected results even at that, right? Because no fund wants to surprise the investors later with an oops, right? The earlier you get ahead of that stuff, the better.

ERIC COOMBS: Yeah, certainly. I think you know from my perspective, one of the more interesting analyses that I continue to ponder with clients and prospects is just simply whether or not a blocked structure or pass-through structure makes sense, right?

Oftentimes there's this assumption that just a pure pass-through structure can be beneficial, or more beneficial, I'd say, relative to a blocked structure from a tax efficiency standpoint.

But I think oftentimes folks that aren't performing this analysis tend to forget some of the tax leakage that you mentioned in the pass-through structure that can potentially exist along with just the general compliance burden and the strain that can put on internal resources and cost to providers and such.

So it's certainly an interesting topic from my perspective. I'm sure we could spend an entire hour just debating the pros and cons of those two approaches.

ROB MICHAELIS: Oh, absolutely you know, Eric, something as simple as particularly when you have a fund that might have a bunch of SPVs sitting beneath it, right?

ERIC COOMBS: Yep.

ROB MICHAELIS: Getting that tax classification when upon formation, sometimes people when they set it up, don't check the right box on that form.

ERIC COOMBS: Yep.

ROB MICHAELIS: And then you find out a year or two later that, hey, this thing was set up as a DRE and it was meant to be a Corp, right?

So the more complex the investment structure and the different types of investment assets, the pooling of assets and the different type of SPVs that are set up that might be rolling into a fund as opposed to having compartments, might be having the SPVs below, making sure those are all classified correctly. It seems like the basic ABC's, but things can happen.

ERIC COOMBS: Yeah, it's a big part of the ball game.

ROB MICHAELIS: Right, right.

ERIC COOMBS: Yeah, certainly, Rob, any opportunities from your perspective for asset managers as it pertains to state and local income taxes?

ROB MICHAELIS: I don't know so much about opportunities, so to speak.

I think it's more about being vigilant about ensuring that you have things set up appropriately and efficiently from a tax perspective. I think, Eric, listen at the end of the day these funds, whatever it is, are set up for a particular reason or purpose, right?

And oftentimes an investment manager might have some kind of bespoke opportunity, right, that the fund can invest in, and it becomes kind of a take-it-or-leave-it type of thing from the sponsor right?

ERIC COOMBS: Sure.

ROB MICHAELIS: Here's a unique opportunity. This is the way that it's structured coming into you, right? Do you want it or not? And there's not necessarily a lot of opportunity to go and kind of, for lack of better term, re-engineer what it looks like coming in, right?

ERIC COOMBS: Yep.

ROB MICHAELIS: But I think what's important to know, and again from a state and local tax perspective, we never say we can necessarily minimize tax because the tax kind of is what it is sometimes. But it's about being efficient about it, right, not paying

more than you should be paying, not putting structures in place that are inefficient for sure, right? Like having something be a Corp and having it taxed at two different levels. I think there are situations where you can have a vehicle that's taxed for state purposes, but it isn't for federal purposes, right?

Things like that and understanding that having something in a pass-through form versus a corporate form could really to a different result in a state than it could federally, I think it's those types of things, depending on the jurisdictions involved, the type of investments involved.

Like I said, unfortunately, there's no one magic bullet. I think it's just being vigilant and talking it through on the front end. There are different levers you can pull.

For example, if you were going to be doing something in the lending space, let's say, right, you could consider, “Well, if I did this out of a corporation as opposed to a partnership, or depending on the types of loans I'm doing, am I a financial organization and should I be subject to a different taxation regime in apportionment rules in tax rates in some of these states?

So maybe sometimes there are opportunities to structure things a little differently to get you under a different taxation regime. But that takes a lot of detailed work on the front end and you know, unfortunately there's just again, no magic bullets.

ERIC COOMBS: What does sound important is to have a clear understanding of what the investment thesis is, your targeted group of investors and what tax attributes are important or not important to them, and it feels to me like as long as you've got a clear idea on those two things as you form the fund, then generally speaking, that's a great starting point. And then you're able to structure around those considerations appropriately.

ROB MICHAELIS: Yep.

ERIC COOMBS: Well, thanks, Rob. Appreciate you joining us today. For more information on this topic and other issues related to tax and asset management, please visit our website at GT.com.