

Cite as Det. No. 14-0178, 33 WTD 600 (2014)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of)	<u>D E T E R M I N A T I O N</u>
Letter Ruling for)	
)	No. 14-0178
...)	
)	Registration No. . . .
)	

[1] ETA 3183; RCW 82.04.290, RCW 82.04.293: B&O TAX – INTERNATIONAL INVESTMENT MANAGEMENT SERVICES – PRIMARILY ENGAGED. A company primarily engaged in providing investment management services is entitled to the preferential B&O tax rate when at least 10% of its gross income is derived from investment management services for collective investment funds with at least ten percent of their investments located outside the United States.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

M. Pree, A.L.J. – A mutual fund advisor appeals a ruling that its gross income could not be taxed at the preferential rate for international [investment management] services. When the proportion of the advisor's income from investment management services to total income exceeds 50%, and 10% of their income comes from qualified clients, the advisor can pay business and occupation (B&O) tax on its income from investment management services multiplied by the preferential rate. We revise the ruling subject to verification.¹

ISSUES

1. Under RCW 82.04.290, RCW 82.04.293, and Excise Tax Advisory (ETA) 3183.2014, does a mutual fund advisor that has discretionary authority to buy and sell fund assets provide investment management services to the funds?
2. Under RCW 82.04.290, RCW 82.04.293, and ETA 3018.2014, can the mutual fund advisor include 12b-1 fees charged to the mutual funds to determine whether the advisor primarily provided investment management services?

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

FINDINGS OF FACT

[Taxpayer] provides investment services to five regulated mutual funds. The taxpayer charges the funds management fees, 12b-1 fees, underwriting commissions, accounting fees, transfer agent fees, and other administrative fees. The taxpayer also earns income from other sources for investment services. The taxpayer seeks the international investment management services preferential B&O tax rate under RCW 82.04.290(1), which is lower than the B&O tax rate on services and other business activities, on its income.

The taxpayer wrote the Department of Revenue (Department) seeking a ruling that charges for its services were taxable under the preferential rate for international management investment services. On May 8, 2013, the Department's Taxpayer Information and Education Section (TI&E) responded advising the taxpayer to report its income under the service and other activities business and occupation (B&O) tax classification. The taxpayer appealed the ruling. The taxpayer contends that it meets the requirement of the law and the Department's ETA 3183.2014.

On appeal, the taxpayer states that it has discretionary authority to purchase and sell securities for the funds. As manager of the five funds, the taxpayer states that only it purchases and sells the securities of the funds. The taxpayer provided copies of three investment advisory agreements. One agreement states that the taxpayer has complete and exclusive authority to handle any business for the funds, which the taxpayer considers advantageous for the funds, subject to direction and control of the funds' officers and directors. [Investment Advisor Agreement 1]. Specifically, the taxpayer is authorized to place purchase and sale orders with brokers. *Id.* The taxpayer indicates that only it provides such services for the funds.

The agreement with the second fund (. . .) does not give the taxpayer exclusive authority,² but it does authorize the taxpayer to, "place orders pursuant to its investment determinations for the Fund either directly with the issuer or with any broker, dealer or futures commission merchant (collectively, a "broker")." [Investment Advisor Agreement 2].

Another agreement with a third fund conferred more general authority to the taxpayer. That agreement employed the taxpayer,

. . . [T]o act as its investment adviser and to manage the investment and reinvestment of the assets of the Fund, and otherwise to administer the Fund's affairs to the extent requested by the Board of Directors of the Fund, all subject to the supervision of the Board of Directors of the Fund and the applicable provisions of the Articles of Incorporation and the Bylaws of the Fund, for the period and on the terms herein set forth.

[Investment Advisor Agreement 3]. We did not receive agreements for the other two funds.

² As manager of the fund, the taxpayer states that only it purchases and sells the securities of the fund.

On the taxpayer's current, on-line filings with the Securities and Exchange Commission (SEC), Form ADV,³ the taxpayer indicated that it had discretionary authority for 98% of its clients' regulatory assets under its management (Item 5, F.(2)). "Discretionary Authority" is defined in the glossary of terms for the ADV form instructions to mean, "Your firm has discretionary authority if it has the authority to decide which securities to purchase and sell for the client." <http://www.sec.gov/pdf/fadvpo.pdf>, Glossary p. 2 (last accessed May 1, 2014). The taxpayer has discretionary authority to decide what securities to purchase and sell for its clients, according to its current filings with the Securities and Exchange Commission.

Given the taxpayer's representation to us and the SEC that it has discretionary authority to purchase and sell securities of the funds, we will consider the taxpayer's ruling request based upon a finding that it does have such authority with respect to the five mutual funds that it currently manages. That finding is subject to future verification.

The taxpayer provided a schedule (Exhibit "A". . .), which identified and quantified the source and charge for its various services, including management fees, to the mutual funds. In addition to management fees, the schedule also showed separate "12b-1" income, accounting fees, and transfer agent fees from the five funds. The taxpayer also had other income not associated with the mutual funds, including annuities and interest income. In 2012, most of the taxpayer's income was from the mutual funds, but the total of management fees alone was less than half of the taxpayer's total income.

The taxpayer also provided schedules of investments as of December 31, 2012 for each mutual fund that it manages. For four of the mutual funds, the value of the investments comprised of specific securities issued in foreign countries exceeded 10% of the value of those four funds.

The taxpayer states that over 50% (69%) of its worldwide service income came from investment management services, representing its charges to four of the five mutual funds. Those four funds each have at least 10% of their investments in foreign securities issued in foreign countries based on a list provided by the taxpayer, which lists the investments by security, and attributes specific securities to foreign countries. 69% of the taxpayer's total income was derived from those four mutual fund clients in 2012.

Based on the taxpayer's Exhibit A, approximately 47% of the taxpayer's income came from management fees for the five accounts in 2012. Approximately 22% came from 12b-1 fees. The taxpayer totaled management fees, 12b-1 income, transfer fees, underwriting commissions, C share CDSC income, and accounting fees from the four funds where the taxpayer's clients had at least 10% of their investments located outside of the United States. The taxpayer concluded that over 50% of its total income for 2012, or 69%, was qualifying income.

³ Form ADV is the uniform form used by investment advisers to register with both the SEC and state securities authorities.

ANALYSIS

Washington imposes a B&O tax “for the act or privilege of engaging in business” in the State of Washington. RCW 82.04.220. Different B&O tax rates apply, depending on the activity. The taxpayer seeks a preferential B&O tax rate under RCW 82.04.290, which provides in subsection (1):

Upon every person engaging within this state in the business of providing international investment management services, as to such persons, the amount of tax with respect to such business shall be equal to the gross income or gross proceeds of sales of the business multiplied by a rate of 0.275 percent.

If we find that the taxpayer is engaged in the business of providing international investment management services, the taxpayer’s B&O tax would be computed by multiplying gross income from that business by .00275. RCW 82.04.293(1) explains when a person provides qualifying international investment management services:

A person is engaged in the business of providing international investment management services, if:

- (a) Such person is engaged primarily in the business of providing investment management services; and
- (b) At least ten percent of the gross income of such person is derived from providing investment management services to any of the following: (i) Persons or collective investment funds residing outside the United States; or (ii) persons or collective investment funds with at least ten percent of their investments located outside the United States.

RCW 82.04.293(2) defines “Investment management services” to mean, “investment research, investment consulting, portfolio management, fund administration, fund distribution, investment transactions, or related investment services.” Because the activity being taxed is “investment management services,” this definition requires some management component in each of the enumerated services. ETA 3183.2014.

According to its filings with the SEC, the taxpayer’s investment advisory agreements give the taxpayer discretionary authority to invest for mutual fund clients under Section 2(a)(20)(A) of the Investment Company Act of 1940 (15 U.S.C. § 80-b-1). The taxpayer is contractually empowered to exercise investment discretion and determine what securities it purchases and sells for the funds.⁴ The taxpayer actually uses its discretionary powers to trade the funds’ securities.

⁴ We only have information about this contractual authority for three of the five contracts. We assume, for purposes of this determination, that the taxpayer has this same authority in its other two contracts with mutual funds. Whether the taxpayer has such authority in each of the five contracts is subject to verification by the Department.

Therefore, the taxpayer is engaged in investment management services under RCW 82.04.293(2).

Under RCW 82.04.293(1)(a), a person must be primarily engaged in the business of providing investment management services to receive the preferential B&O tax rate. A person is “primarily” engaged in the business of providing investment management services when more than fifty percent (50%) of that person’s activities are investment management services. ETA 3183.2014. If a person’s activities are not primarily investment management services, then they cannot qualify for the international investment management services B&O tax rate. *Id.*

The taxpayer contends that over 50% (69%) of its worldwide service income came from investment management services, representing its charges to four of the five mutual funds. In arriving at that figure, the taxpayer included not only management fees on its Exhibit A, but it also includes amounts designated as 12b-1 fees in Exhibit A. “12b-1 fees” are fees paid by the fund out of fund assets to cover distribution expenses and sometimes shareholder service expenses. “12b-1 fees” get their name from the SEC rule that authorizes a fund to pay them. The rule permits a fund to pay distribution fees out of fund assets only if the fund has adopted a plan (12b-1 plan) authorizing their payment. “Distribution fees” include fees paid for marketing and selling fund shares, such as compensating brokers and others who sell fund shares, and paying for advertising, the printing and mailing of prospectuses to new investors, and the printing and mailing of sales literature. See <http://www.sec.gov/answers/mffees.htm> (last visited May 1, 2014).

The amount of 12b-1 fees are relevant to the outcome in the taxpayer’s situation because without 12b-1 fees considered to be investment management services, the taxpayer would not qualify as a person engaged primarily (over 50%) in the business of providing investment management services based on its income. The management fees constituted only 47% of the taxpayer’s income and the 12b-1 fees represented another 22%. The amount of accounting fees, underwriting commissions, and transfer agent fees were not sufficient when added to the management fees to total over 50% of the taxpayer’s income. Therefore, the taxpayer would need to include both the management fees and 12b-1 income as investment management services to exceed 50% of its income to qualify for the preferential rate.⁵

The funds pay the taxpayer to manage their assets. 12b-1 fees are fees paid by the fund out of fund assets to cover distribution expenses and sometimes shareholder service expenses.⁶ Because the taxpayer’s 12b-1 activities are part of the overall management that the taxpayer performs for the funds, we conclude that the taxpayer’s 12b-1 fees are included in the taxpayer’s investment management service income. See RCW 82.04.293(2). When over 50% of the taxpayer’s income is derived from investment management services, the taxpayer is primarily engaged in investment management services under RCW 82.04.293(2)(a).

⁵ 12b-1 fees are not always for investment management services and, if not, they would not be added as investment management services in the computation. 12b-1 activities must be an extension of management services to be included as investment management services.

⁶ <http://www.sec.gov/answers/mffees.htm> (last visited May 1, 2014).

We will next consider whether the taxpayer derives at least 10% of its gross income from investment management services from collective investment funds with at least ten percent of their investments located outside the United States under RCW 82.04.293(2)(b)(ii). Collective investment funds include a mutual fund or other regulated investment company. RCW 82.04.293(3)(a). “Investments are located outside the United States if the underlying assets in which the investment constitutes a beneficial interest reside or are created, issued or held outside the United States.” RCW 82.04.293(4). According to the taxpayer’s schedules of 2012 investments for four of the mutual fund clients, over 10% of the value of those funds were comprised of specific securities issued in foreign countries. Because 69% of the taxpayer’s 2012 income was derived from those four mutual fund clients, over 10% of the taxpayer’s income was derived from rendering investment management services to qualifying clients.

A taxpayer must periodically review the source of its income to determine whether it continues to meet the necessary criteria to report income under the international investment management services B&O tax classification, which may be subject to future audit verification. ETA 3183. Since the taxpayer has a long term relationship with the five mutual funds, it has a very consistent client base that does not vary or fluctuate significantly. For such a taxpayer, a single verification date each year may be appropriate. *Id.* The taxpayer must verify at least annually, that its source of income still meets the requirements to qualify for the international investment management services preferential rate classification under RCW 82.04.290(1). From the additional information that the taxpayer provided with its petition, it appears the taxpayer qualified for the preferential international investment management services preferential rate classification under RCW 82.04.290(1), subject to verification.

In conclusion, the taxpayer is entitled to the preferential B&O tax rate only for income earned from investment management services under RCW 82.04.290. Other service income and income taxable under different classifications, such as retailing, earned by the taxpayer is taxable at the rates for those classifications, not at the preferential B&O tax rate under RCW 82.04.290(1).

This conclusion is based on the taxpayer’s representations to us and figures provided for 2012. We do not know whether the taxpayer meets the requirements for the preferential rate in other years. When the taxpayer’s income from investment management services exceeds 50% of its income, and at least ten percent of the gross income of the taxpayer is derived from providing investment management services to mutual funds with at least ten percent of their investments located outside the United States, the taxpayer may apply the rate under RCW 82.04.290(1) to its income from investment research, investment consulting, portfolio management, fund administration, fund distribution, investment transactions, or related investment services in accordance with ETA 3183.2014.⁷

⁷ [The conclusion reached in this determination is based upon the taxpayer’s representation of the facts. We did not receive the documentation necessary to independently verify the facts provided by the taxpayer. Therefore, the result remains subject to future audit verification.]

DECISION AND DISPOSITION

We grant the taxpayer's petition in part. We revise the ruling as discussed above subject to verification.

Dated this 4th day of June 2014.