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CLIENT ALERT

New California Tax Ruling Impacts Private Equity Fund Founders

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A new ruling released by the California Franchise Tax Board may impact private equity fund structuring for funds and management companies that do business in California but have founders resident outside of California.

Often, private equity funds are formed as a Delaware limited partnership, with separate management companies and general partners also formed in Delaware. Each entity then qualifies to do business in the primary jurisdiction of the main officer of the fund.

The California ruling involved a private equity fund and management LLC both located in California and both founded by a nonresident of California. The management LLC received fees for providing services to the private equity fund and its portfolio companies. It is not clear from the facts in the ruling whether the management LLC received only a management fee or also received a carry.

The nonresident taxpayer earned income both as a member of the management LLC and as a partner in the private equity fund. At issue in the letter ruling was whether any of this income would be subject to California income tax.

Generally, as most states do, California imposes income tax on a nonresident on income from "sources within California." There is an exception, however, for income earned by qualified "investment partnerships," including many private equity funds.

The private equity fund in the letter ruling operated as a qualified investment partnership, but the management LLC did not. Furthermore, the management LLC's entire business was conducted in California. Thus, the nonresident taxpayer was subject to California income tax on his entire allocable share of the management LLC's income.

The holding of the ruling is not surprising and may not have a large practical impact especially where the management company receives only the management fee and not the carry. A much larger impact may occur if the same logic applies to the GP structuring as well. Funds that operate in California but have founders outside of California, should closely evaluate their GP structures to determine whether the GP qualifies as an "investment partnership" such that the nonresident founders are not subject to California income tax on the carry.

Importantly, for this purpose, the letter ruling views the taxpayer's two income streams (from the management LLC and from the private equity fund) as separate so that each is analyzed separately and one does not taint the other. That is, the fact that the taxpayer had California-source income from the management LLC did not appear to taint the taxpayer's income from the private equity fund.

Finally, the ruling does not impact the choice of Delaware as a state of organization for the fund or associated companies. In determining whether California income tax applies to income arising from the management LLC or fund, the important question is where the employees and offices of the entity are located.

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