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Calif. Ruling May Hike PE Fund Founders' Tax Liabilities

Law360, New York (April 14, 2014, 12:35 PM ET) -- A release by the California Franchise Tax Board in March 2014 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 limited partnership and a management limited liability company, both located in California and both founded by a nonresident of California. While the private equity fund itself operated from a principal office located in California, it invested mainly in portfolio companies that were neither incorporated nor headquartered in California.

The private equity fund was managed by the separate management company, which also had its principal administrative office in California. As is common in many private equity fund structures, the management company's principal business was providing services to the private equity fund and its portfolio companies. The management company received fees for these services. It is not clear from the facts in the ruling whether it also received a carry.

The nonresident founder earned income both as a member of the management company 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." An exception is provided, however, for income earned by qualified "investment partnerships," including many private equity funds.

Dividends, interest and gains earned through an investment partnership are not subject to California income tax even if the partnership itself has an office in California. An investment partnership generally includes a partnership with at least 90 percent of its assets invested in "qualifying investment securities" and that earns at least 90 percent of its gross income from interest, dividends and gain from the sale or exchange of those securities. A partnership interest can be a qualifying investment security as long as the underlying partnership is itself an investment partnership.

The private equity fund in the letter ruling operated as a qualified investment partnership, and so the nonresident founder was not subject to California income tax on his share of income from the fund. The management company, however, was not an investment partnership. The management company had no substantial assets and almost no capital investment by its owners.

The management company's entire business was conducted in California, and the founder only provided services for the management company in California. As a result, the nonresident founder was subject to California income tax on his entire allocable share of the management company's income.

Importantly, the letter ruling views the taxpayer's two income streams (from the management company and from the private equity fund) as separate. Each is analyzed separately and one does not taint the other.

The nonresident founder was considered to have income taxable in California from the trade or business conducted by the management company not qualified for the investment partnership exception, and a separate pool of income from his interest in the private equity fund, which was a qualified investment partnership. The fact that the founder had California-sourced income from the management company did not taint the founder's income from the private equity fund.

The holding of the ruling is not surprising and may not have a large practical impact 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 general partner structure and carry as well.

Although the ruling does not discuss the general partner or whether there was a carry, under the principles followed in the ruling, the general partner should be analyzed separately from the management company. If the general partner separately qualifies as an investment partnership, a carry earned by the general partner should not be subject to California tax under the investment partnership exception.

Funds that operate in California but have founders outside of California, should closely evaluate their general partner structures to determine whether the general partner qualifies as an "investment partnership." The general partner's main or only asset may be the carry it owns in the fund. As noted above, if the fund is itself an investment partnership, the general partner's carry can be considered a qualifying investment security.

If the general partner qualifies as an investment partnership, the nonresident founders would not be subject to California income tax on their share of the carry. If the general partner does not qualify as an investment partnership and operates in California, presumably the nonresident founders would be subject to California income tax on their share of the carry earned through the general partner, under the same reasoning as applied to the management company in the ruling.

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

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