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International Investment Management Services

Purpose

The purpose of this Excise Tax Advisory is to clarify for taxpayers the qualifications and application of the lower tax rate (RCW 82.04.290(1)) for international investment management services defined in RCW 82.04.293.

Investment Management Services

When is a person engaged in the business of providing investment management services?

RCW 82.04.293(2) states that “investment management services” means 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,” the Department interprets this definition to require some management component in each of the enumerated services.

- For example, a broker-dealer transaction may incidentally involve investment research or investment consulting, but such transactions are not considered “investment management services” because they lack the requisite management component.

Also helpful in illustrating this distinction:

- Part 1A, Item 5(G) when compared to Item 6(A) of the Securities and Exchange Commissions’ uniform form (Form ADV) that investment advisers use to register.
 - “Investment management services” does not include “impersonal investment advice” which is defined in the Form ADV glossary as investment advisory services that do not purport to meet the objectives or needs of specific individuals or accounts.
- The description of an investment adviser in Section 2(a)(20)(A) of the Investment Company Act of 1940. The term

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- includes a person who:
 - regularly furnishes advice with respect to the desirability of investing in, purchasing or selling securities or other property; or
 - is empowered to determine what securities or other property shall be purchased or sold.
 - but does not include a person:
 - whose advice is furnished solely through uniform publications distributed to subscribers thereto, or
 - who furnishes only
 - statistical and other factual information,
 - advice regarding economic factors and trends, or
 - advice as to occasional transactions in specific securities, but without generally furnishing advice or making recommendations regarding the purchase or sale of securities.
 - The description of investment discretion in Section 3(a)(35) of the Securities Exchange Act of 1934.
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“Primarily”

When is a person engaged “primarily” in the business of providing investment management services?

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. 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.

Activities can be characterized either by income earned or by expenses incurred. Therefore, a taxpayer must show that more than 50 percent of either (1) its gross income is from investment management services or (2) its total expenditures are incurred in support of its investment management services.

10% of Gross Income

What percent of gross income for a person engaged primarily in the business of providing investment management services must be derived from rendering those services to qualified clients?

At least ten percent of the person’s total gross income from investment management services must be from those investment management services provided to qualifying clients. RCW 82.04.293(1)(b)

Taxpayers must determine whether each client individually is a qualified client, not collectively. Income from those clients that individually qualify must make up at least ten percent of the taxpayer’s gross income. Form ADV, Part 1A, Item 5(C) and (D) provide an example of how to determine who each client is.

**Qualifying
Client**

Who is a qualifying client?

RCW 82.04.293(1)(b) identifies two types of qualifying clients. Both types of qualifying clients consist of persons or collective investment funds.

- The first type of qualifying clients reside outside the United States.
 - The second type of qualifying clients reside in the United States and have at least ten percent of their investments located outside the United States.
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**Income and
Clients**

What is the relationship between income and client requirements?

The ten percent of taxpayer's total gross income may come from one type of qualifying client or the other or any combination of the two types of clients.

- For example, a taxpayer would meet this requirement of the statute if ten percent of its gross income comes only from the first type of qualifying clients (those who reside outside the United States).
 - Another taxpayer would meet this requirement if ten percent of its income was generated from the second type of qualifying clients (those who reside in the United States and have at least ten percent of their investments located outside the United States).
 - Another taxpayer would meet this requirement if five percent of its income was generated from the first type of qualifying clients and five percent of its income was generated from the second type of qualifying clients for a total of 10% of its income being generated from qualifying clients.
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**Type 1 – Reside
Outside the
U.S.**

When is a client residing outside the United States (the first type)?

Individuals establish residence by physical presence and intent to make a particular place a home. A corporation or other legal entity may be a resident of multiple places dependent on where it transacts business.

Not every individual or legal entity with a foreign mailing address is a foreign resident. A foreign mailing address alone does not provide proof of the requisite degree of permanent attachment to a foreign location. Records showing a foreign mailing address provide some evidence of residency, but are independently insufficient to prove foreign residency.

The Department will not attempt to detail an exclusive list of documentation or means by which a taxpayer could corroborate the mailing address as the client's residence. Taxpayers must provide information to show residency outside the United States. Examples of corroborating evidence of residency can be found in the US Patriot Act and federal income tax regulations. However, these examples are by no means exclusive standards by which a taxpayer must establish residency of clients. Item 5(C)(2) of Form ADV, Part 1A is also an indicator of Type 1 clients as it uses the definition of "U.S. person" found in Rule 902(k) or Regulation S under the

Securities Act, but the Department may request further information to verify non-United States persons' residence outside the United States.

**Type 2 – 10%
Outside the
U.S.**

When does a client have at least ten percent of their investments located outside the United States (the second type)?

To determine if a client has at least ten percent of their investments outside the United States, the taxpayer must determine: (1) the client's total investments and (2) the client's total qualified investments. Then simply divide the client's total qualified investments by the client's total investments. If the result is 10% or more, then the client is a Type 2 client.

**“Their
Investments”**

What are “their investments”?

“Their” refers to the client. “Their investments” means the assets of the taxpayer's clients managed by the investment manager on a discretionary basis. For example, the methodologies used to determine the taxpayer's discretionary regulatory assets under management for purposes of reporting on Form ADV, Part 1A, Item (5)(F)(2) would be acceptable for determining “their investments.”

**Qualified
Investment of
Persons or
Collective
Investment
Funds**

How do you determine a client's investments qualify as outside the United States?

RCW 82.04.293(4) states: “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.” Here the statute essentially requires that investment be assigned a residence, parallel to determining the residence of individual qualifying clients in the first type.

1. If the investment is an individual security (i.e. stock, bond, etc.), then the location of the investment is determined by where the security is issued.
 2. If the investment is a collective investment fund, then the location of the investment is determined by where the underlying securities held by the collective investment fund are issued.
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**Individual
Investment
Location
Example**

Where are individual securities located?

For individual securities, determining where the underlying asset in which the investment constitutes a beneficial interest is located is a simple inquiry. For example, shares in US Company X are located or reside in the US because that is where the shares were issued regardless of where purchased or what assets US Company X owns. Correspondingly shares of Foreign Company Y are located or reside outside the US even if purchased on an American exchange (for example as an

American Depository Receipt).

**Collective
Investment
Fund
Investment
Location
Example**

Where are collective investment funds located?

For collective investment funds, determining where the underlying asset in which the investment constitutes a beneficial interest is located is also a simple inquiry. For example, Z International Mutual Fund is located or resides outside the US because the individual securities held by Z International Mutual Fund were issued outside the US. The fact that Z International Mutual Fund shares are issued in the US (or even if the shares were issued outside the US) does not determine where the investment is located.

**Collective
Investment
Fund Client
Example**

The International Small Sector Fund (ISSF) invests in small companies around that world that specialize in cheese making. ISSF hires Spork Investments (Spork) as its investment manager to pick which small cheese making companies outside the United States it will invest in per its investment goals. ISSF is registered and issued in the United States. Spork is the taxpayer and believes it qualifies for the IIMS classification. ISSF is one of four clients, but provides 30% of Spork's income. ISSF is not a Type 1 client because it is a collective investment fund residing in the United States. However, ISSF is a qualified Type 2 client because it is a collective investment fund with over 10% of its money invested in cheese making company stock issued outside the United States.

Verification

How often should a taxpayer verify that it still qualifies for the international investment management services lower tax rate?

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.

For example, a particular taxpayer may have 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. Conversely, a taxpayer's client base may fluctuate significantly, which would render a single verification date inaccurate for their regular business practices. For example, if a taxpayer is filing an amendment to its Form ADV, it may also be appropriate to review the source of its income for B&O tax purposes. Therefore, taxpayers must review the source of their income annually, but the Department may require more frequent review.
