

*By Electronic Delivery*

September 9, 2009

Mr. Gerald Parsky, Chairman  
Commission on the 21st Century Economy  
c/o State of California Department of Finance  
915 L Street, 8th Floor  
Sacramento, CA 95814

Re: *Business Net Receipts Tax (“BNRT”)*  
*Exemption for Investment Companies*

Dear Mr. Parsky:

The Investment Company Institute (“ICI”)<sup>1</sup>, on behalf of regulated investment companies (e.g., mutual funds) advised by California-based advisors and the shareholders in those funds, urges the Commission on the 21<sup>st</sup> Century Committee to clarify that funds will be exempt from any business net receipts tax (“BNRT”) proposal. Imposition of an entity-level state tax on the funds, for the reasons discussed below, would have significant negative consequences for investors (regardless of residence) in California-based funds and for the viability of California as a fund domicile.

Background

Mutual funds are the investment vehicle of choice for moderate-income investors saving for retirement and other long-term needs. A fund is a quasi-pass-through investment vehicle; money from investors is pooled and invested in a diversified portfolio of securities. The typical fund issues its shares to investors pursuant to a continuous public offering. Each shareholder owns a proportionate interest in the fund’s underlying securities. More than half of all American households invest in mutual funds.

The quasi-pass-through nature of funds is well recognized under federal and state tax laws. The Internal Revenue Code and the laws of every state provide funds with a deduction for the dividends that they pay to their shareholders. Because funds suffer a competitive disadvantage if they

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$11.02 trillion and serve over 93 million shareholders.

pay tax, funds typically distribute all of their income each year. The result is that funds have no net taxable income and pay no income tax.

Mutual fund advisers, who select the securities for the funds, can be (and in fact are) located virtually anywhere. Several of the largest advisers, and many smaller ones as well, are located in California. The two most important requirements for managing a mutual fund are well-educated employees and ready access to modern technology. Physical plant requirements are minimal. The jobs created by these companies are precisely the type of jobs that all states seek to attract.

The potential market for a fund manager’s products is nationwide in scope. Because investors can communicate with a mutual fund manager through the mail, over the phone, or electronically, a mutual fund’s shareholders can be (and generally are) located in all 50 states. A “local” mutual fund manager has no inherent advantage over “non-local” managers in attracting new investor dollars.

#### Proposed Application of BNRT

The Commission’s document entitled “Preliminary Overview of the Business Net Receipts Tax” states that the BNRT proposal “is intended to reflect a value-added concept” and “improve tax competitiveness.” The overview sets forth various options for how a financial institution would be defined and the basis on which the institution would be taxed. No exception for funds – such as one that effectively replaces the dividends paid deduction provided by California currently – is discussed.

#### BNRT Should Not Be Imposed on Investment Activity Conducted Through a Mutual Fund

The BNRT appears designed to apply to commercial activities. In the mutual fund context, the commercial activity is performed by the fund’s adviser. The fund is not in a trade or business; the fund merely is an investment pool created by the adviser to allow efficient investment by a large group of investors.

If the BNRT were applied to a mutual fund, the tax effectively would be paid by the fund’s shareholders. Consequently, shareholders in California-based funds (whether or not they are California residents) would be taxed twice at the state level on the fund’s return because tax would be imposed both at the fund level (under the BNRT) and then again at the shareholder level (under the income tax regime of the state in which the investor resides). In contrast, California investors who buy funds advised outside of California would *not* have their returns taxed under the BNRT; their returns would continue to be taxed only once -- under California’s income tax.

Were personal investment activity taxed more harshly when it occurs through a California-based fund, the BNRT would impose an unfair burden on the savings incentives for moderate income investors who have the greatest need to save. Given the increased responsibility that individuals have for ensuring their own retirement security, the Commission should be proposing incentives to *encourage* rather than *discourage* saving.

California-Based Fund Managers Should Not Be Placed at a Competitive Disadvantage

If the BNRT were applied to funds, California-based fund managers would be placed at a distinct competitive disadvantage relative to fund managers located throughout the rest of the United States. Because the BNRT would not be limited to the receipts of California-based firms with respect to their California-resident investors, the BNRT effectively would be paid by all shareholders in a California-based fund.

The mutual fund industry is a highly competitive market in which fund returns are measured constantly against benchmarks and peers over short and long periods. Very small differences in investment returns can have a significant impact on a fund’s widely-reported relative performance. These relative performance rankings (*e.g.*, top 10%, top 25%) can have a pronounced effect on investor interest in a fund; a drop from top 24% to top 26%, for example, can cause a sharp drop in new share purchases. An additional expense attributable to a California-based fund’s net receipts could impact significantly a fund’s return relative to funds located outside of California that would not subject to the tax.

As California-based fund managers in this highly mobile business provide exactly the kind of good jobs that states covet, the Commission should be creating incentives to *encourage* fund managers to locate in California. Applying the BNRT to mutual funds would have the opposite effect. Any short-term revenue benefit from the BNRT would be outweighed by the significant long-term harm to California and its residents caused by the potential loss of other revenue and jobs if companies can’t afford to operate in the state or compete with non-California companies in a national market.

Recommendation

ICI strongly urges, on behalf of California-based advisers and the shareholders in the funds they advise, that the Commission clarify that any BNRT will not apply to funds.

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The Institute appreciates your consideration of our concerns. Please do not hesitate to contact the undersigned at (202) 326-5832 if you have any questions regarding this letter or would like any additional information regarding the organization, operation, or taxation of investment companies and/or their shareholders.

Sincerely,

*/s/ Keith Lawson*

Keith Lawson  
Senior Counsel – Tax Law