



June 28, 2011

The Honorable Henry Perea
California State Assembly
State Capitol, Room 4112
Sacramento, CA 95814

Re: SUPPORT for AB 1423 (Perea), amended June 16, 2011

The above-named organizations and businesses support AB 1423, a measure that would conform specified California tax provisions to the relevant provisions of the federal Regulated Investment Company (RIC) Modernization Act (P.L. 111-325), which passed Congress without objection last December. The federal act made a number of changes to technical rules that govern the tax treatment of RICs, most of which are more commonly known as mutual funds. Most mutual funds and similar investment companies seek to qualify as RICs under the tax law because of the benefits for their shareholder-investors.

Qualifying RICs may deduct from their taxable income amounts distributed to their shareholders. The character of certain types of income, such as long-term capital gains and tax-exempt interest, flows through from a RIC to its shareholders. As a result, capital gains, dividend and interest income earned by the RIC and distributed to shareholders, assuming certain other requirements are met, are only taxed at the shareholder level. These rules provide RIC shareholders with tax treatment comparable to that received by a direct investor in the RIC's portfolio securities. Note that, for California purposes, RICs are subject to the minimum franchise tax.

The advantages RICs offer shareholders go far beyond the tax consequences. RICs enable average households to obtain access to a diversified portfolio and professional investment management of their savings for retirement, college, and other purposes. Approximately 5.9 million California households own at least one fund, and the 24 fund management companies headquartered in California have more than \$3 trillion in assets under management and employ more than 15,000 workers.

Without conformity to the federal rules this year, California RICs and their California shareholder-investors would be subject to materially different federal and California tax rules governing the same investment. The discrepancies would relate to, among other things, the calculation of RIC-level income, the amounts RICs must distribute to shareholders, the tax treatment of the distributions in the hands of shareholders, and the timing/character of shareholder gain/loss on the disposition of RIC shares. In the worst case scenario, lack of conformity would cause a California fund to be disqualified for California purposes while remaining a RIC for federal purposes.

The burdens of nonconformity would fall not only on RICs, but also on their investors and the Franchise Tax Board. Without conformity, RICs would suffer major financial and operational burdens. Unlike most regular corporations, RICs must be able to conclude and demonstrate annually, based on the existing law at the time, that they satisfy various tax-related tests in order to avoid double taxation on distributions made to investors. For RIC shareholders, the taxable portions of distributions they receive likewise depend directly on application of RIC tax rules in effect for the relevant tax year. The FTB would face extra burdens and costs associated with providing guidance about operating under materially different tax regimes.

The complexity associated with maintaining compliance with materially different requirements at the state and federal levels (to avoid the possibility of disqualification at either level) would negatively impact the investment performance of California's RICs and would certainly place California's RICs at a competitive disadvantage vis-à-vis their counterparts in other states. Investors in California RICs would face confusion and increased tax preparation costs.

In the Franchise Tax Board's 2010 Taxpayers' Bill of Rights Annual Report to the Legislature, the taxpayers' rights advocate states, " For the last two years, I raised concerns about how the lack of conformity to the Internal Revenue Code (IRC) increases the complexity for the taxpayer. This leads to low taxpayer self-compliance and greater costs of administering and enforcing income tax laws. We believe the lower taxpayer self-compliance, in many cases, is the result of unawareness of the state and federal differences that exist in income tax law...Full conformity helps:

- Simplify the taxpayer's ability to self-comply.
- Decrease unintentional taxpayer error.
- Decrease the burden of preparing tax returns for most taxpayers.
- Decrease the cost for taxpayers to prepare their tax returns.
- Decrease administrative costs to the state.

“So, I reprise my call for simplification through conformity, and I encourage you to continue your efforts to pass a full conformity bill. As you are aware, getting a conformity bill passed is time intensive. The growing disparity between the federal and California tax laws makes the lack of conformity one of the biggest areas of concern for California taxpayers. Without conformity, complex tax law continues to place burdens on taxpayers, and these burdens lead to increased errors, penalties, and tax return preparation costs.”

For the reasons stated above, AB 1423 is very important both to RICs based in California and to their California shareholder-investors. Several of the most important changes include:

- **Capital Loss Carryovers** — Under current law, a RIC may carry forward its capital losses for up to eight years. Should a RIC fail to generate enough capital gains over the eight-year period to offset its capital loss carry-forwards, gains of the RIC are still required to be distributed to shareholders, even though the RIC may have a cumulative net loss. If the same capital loss carryover were in the hands of an individual shareholder, the carryover would not be subject to expiration. This bill would allow RICs unlimited carry- forwards of their net capital losses in the same manner as individual taxpayers.
- **Savings Provisions for Failure to Satisfy Gross Income and Asset Tests** — The bill would allow RICs to fix inadvertent failures to comply with either the gross income or asset test rather than cause them to lose their status as RICs. Without conformity, a RIC that fails to comply with the gross income or asset test could lose its eligibility for the integrated tax treatment provided under Subchapter M of the Internal Revenue Code. Failure to comply with either test would result in the RIC's net taxable income being subject to tax at the corporate level at the 8.84% rate (35% at the federal level).
- **Dividend Designation Rules** — Under the federal law in effect before enactment of the RIC Modernization Act, a RIC was required to send a notice to shareholders within 60 days of the end of the RIC's taxable year to notify shareholders of the tax treatment of various distributions made during the course of the year. Under the bill, RICs would still be required to notify shareholders of distributions in a written statement, but AB 1423 would eliminate the 60-day requirement, providing consistency with California and federal reporting.
- **Elective Deferral of Late Year Losses** — A RIC generally must distribute all of its calendar-year income (pre-November 1 income in the case of gains) by December 31 of each calendar year. Before the federal RIC Modernization Act, a RIC that suffered losses after December 31st (or, in some cases, after October 31st) might have been required to amend information that was previously reported on a shareholder's information return (Form 1099-DIV, for example) to reflect the tax effects of the losses. AB 1423 would conform California to the federal rule (thereby reducing the number of amended returns) by allowing a RIC to generally treat a loss arising late in its taxable year as a loss arising instead on the first day of the RIC's next taxable year.

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For the foregoing reasons, it is critical that California conform to the federal RIC rules this year to avoid these consequences.

Sincerely,

A handwritten signature in cursive script that reads "Gina Rodriguez".

Gina Rodriguez
Vice President of State Tax Policy

Also on Behalf of:

BlackRock
California Bankers Association
California Chamber of Commerce
California Retailers Association
California Society of Enrolled Agents
Capital Group Companies
Charles Schwab and Company
Dodge and Cox
Fireman's Fund Insurance Company
Franklin Templeton Investments
Investment Company Institute
Pacific Life Insurance Company
PIMCO
Securities Industry and Financial Markets
Association
Spidell Publishing, Inc.

cc: Members, Senate Governance and Finance Committee
Oksana Jaffe, Consultant, Assembly Revenue and Taxation Committee
Colin Grinnell, Consultant, Senate Governance and Finance Committee