DEPARTMENT OF FINANCE BILL ANALYSIS

AMENDMENT DATE: July 12, 2011
POSITION: Oppose

BILL NUMBER: AB 1423
AUTHOR: H. Perea

BILL SUMMARY: Conformity: Regulated Investment Companies/mutual funds

This bill, an urgency measure, would conform to several provisions of the federal Regulated Investment Company Modernization Act of 2010.

FISCAL SUMMARY

According to the Franchise Tax Board (FTB), this bill would result in revenue losses of $925,000 in 2011-12, $383,500 in 2012-13, and $73,500 in 2013-14 followed by revenue gains from 2014-15 to 2017-18. Beginning in 2018-19, this bill would result in ongoing revenue losses of about $10 million annually.

The FTB notes that this bill would not significantly impact its administrative costs.

COMMENTS

Close conformity with federal tax law has the benefit of reducing complexity in tax preparation and administration and Finance notes that conforming to the recasting of rules regarding the taxation of mutual funds has merit. However, the effect on the General Fund must also be considered.

Finance opposes this bill because it would result in a significant General Fund revenue loss of nearly $1 million in the current year and continued revenue losses, albeit of a significantly lower magnitude, in each of the following two fiscal years. Additionally, this bill is expected to generate ongoing revenue losses of about $10 million per year starting in 2018-19.

Note: Prior to passage of Proposition 26 in November 2010, significant conformity legislation typically bundled numerous provisions into one bill that was, on net, revenue neutral. This mitigated the negative impact on the General Fund and could also be passed by a majority vote. Since passage of Proposition 26, however, a revenue-neutral, majority-vote conformity bill is no longer an option. Proposition 26 would require a 2/3 vote for any conformity tax increase whereas conformity legislation that does not include any tax increases would still require only a simple majority to pass.

While most of the provisions of the bill result in revenue losses, the capital loss carryover provisions result in a revenue gain, thus for some taxpayers the bill would increase taxes and the Legislative Counsel has keyed the bill as a two-thirds vote.

From a policy perspective, conformity is desirable because of its tax simplification benefits. However, each conformity measure that results in a revenue loss adds additional pressure to the General Fund. For example, AB 242 as amended June 29, 2011, includes provisions that would conform to federal health care reform.

Analyst/Principal	Date	Program Budget Manager	Date
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Governor's Office:	By:	Date:	Position Approved_______
			Position Disapproved

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ANALYSIS

A. Programmatic Analysis

In general, a regulated investment company (RIC) is an electing domestic corporation that either meets certain registration requirements under the Investment Company Act of 1940, that derives at least 90 percent of its ordinary income from specified sources considered passive investment income, that has a portfolio of investments that meet certain diversification requirements, and meets certain other requirements. As long as a RIC pays out 90 percent of its dividends to its shareholders, no corporate tax is imposed on this distributed income.

Many RICs are open end companies (mutual funds) that have a continuously changing number of shares that can only be bought from and redeemed by the company. Shareholders redeem shares at the net asset value; shares are not available for purchase or sale in a secondary market. Closed end RICs have a fixed number of shares that are not directly redeemable from shareholders. They are traded on national security exchanges or in the over-the-counter market.

The RIC Modernization Act of 2010, signed into law in December 2010, made a number of changes intended to modernize tax laws governing RICs, including mutual funds.

This bill would conform California law to the RIC Modernization Act of 2010 (Public Law 111-325) by conforming state law to the following federal law changes:

- Capital Loss Carryover of RICs.
- Asset and Gross Income Tests.
- Modification of Dividend Designation Requirements and Allocation Rules for RICs.
- Earnings and Profits of RICs.
- Pass-Thru of Exempt-Interest Dividends and Foreign Tax Credits in Funds of Funds Structure.
- Modification of Rules for Spillover Dividends of a RIC.
- Return of Capital Distributions of RICs.
- Distributions in Redemption of Stock of a RIC.
- Repeal of Preferential Dividend Rule for Publicly Offered RICs.
- Elective Deferral of Certain Late-Year Losses of RICs.
- Exception to Holding Period Requirement for Certain Regularly Declared Exempt Interest Dividends.
- Modification of Sales Load Basis Deferral Rule for RICs.

This bill would take effect immediately as an urgency measure and be operative for taxable years beginning on or after December 23, 2010.

Discussion:

Proponents have noted that non-conformity will have a significant adverse affect on many California -based mutual funds and the shareholders in terms of costs and confusion how they are taxed on the distributions since recently enacted federal law restructured the tax laws governing mutual funds. Having one set of rules at the federal level and a materially different set at the state level imposes an onerous burden on mutual funds and the shareholders in terms of tax preparation, as well general confusion about the tax treatment of the same investment.

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B. Fiscal Analysis

According to the FTB, this bill would result in revenue losses of $925,000 in 2011-12, $383,500 in 2012-13, and $73,500 in 2013-14 followed by revenue gains from 2014-15 to 2017-18. Beginning in 2018-19, this bill would result in ongoing revenue losses of about $10 million annually.

The revenue impact of conforming is listed below by provision and fiscal year:

Act Section	Provision	2011-12	2012-13	2013-14
101	Capital Loss Carryover	$0	$250,000	$450,000
201	Savings Provisions/Regulation/Tests	Negligible	Negligible	Negligible
301	Modify Div Designation/RIC req/Allocation	-$1,000	-$500	-$500
302	Earnings and Profits of RICs	-$3,000	-$2,000	-$2,000
303	Pass thru/Exempts/Foreign Tax Credits	-$100,000	-$80,000	-$70,000
304	Modify Spillover Dividends of RICs	Negligible	Negligible	Negligible
305	Return of Capital Distributions RICs	Negligible	Negligible	Negligible
306	Distribution in Redemption RIC stocks	-$450,000	-$350,000	-$350,000
307	Repeal Preferential Dividend Rule RICs	Negligible	Negligible	Negligible
308	Elective Deferral of Certain Late-Year	-$1,000	-$1,000	-$1,000
309	Exception to Holding Period Requirement	Negligible	Negligible	Negligible
502	Modification of Sales Load Basis Def.	-$370,000	-$200,000	-$100,000
Total Impact		**-$925,000**	**-$383,500**	**-$73,500**

According to the FTB, this bill does not significantly impact department costs.

Code/Department Agency or Revenue Type	SO LA CO RV	PROP 98	FC	(Fiscal Impact by Fiscal Year) (Dollars in Thousands) 2011-2012	FC	2012-2013	FC	2013-2014	Fund Code
1147/Pers Inc Tax	RV	Yes	U	-$925	U	-$384	U	-$74	0001
1730/FTB	SO	No		------------------- No/Minor Fiscal Impact -------------------					0001