INVESTMENT COMPANY INSTITUTE

Keith Lawson
SENIOR COUNSEL – TAX LAW

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

202/326-5832 FAX: 202/326-5841
lawson@ici.org

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The Honorable Rene Oliveira
Chair, Ways and Means Committee
Texas House of Representatives
Room CAP 4N.10
Austin, TX 78768

The Honorable John Otto
Vice Chair, Ways and Means Committee
Texas House of Representatives
Room EXT E2.906
Austin, TX 78768

RE: *Preserving Mutual Fund Exemption from Franchise Tax*

Dear Representatives Oliveira and Otto:

On behalf of its Texas-based members, the Investment Company Institute[1] strongly urges that open-ended investment companies (commonly known as mutual funds) remain exempt from the franchise tax.[2] We understand that the mutual fund exemption, like all others in the Texas Franchise Tax Code, is being reviewed by your Committee to determine whether it continues to serve important policy purposes and should be retained.

If this exemption were eliminated, Texas-based mutual fund managers would be placed at a significant competitive disadvantage in the nationwide market for mutual fund shareholders because of the tax' negative impact on the investment returns of the funds they manage. Specifically, the tax would fall directly on all investors who save for retirement and other long-term needs (as well as for shorter-term needs) through Texas-based mutual funds.

Background on the Mutual Fund Industry

A mutual fund is an investment pool that holds a diversified portfolio of stocks, bonds, and/or other securities; these securities may be issued by companies located in the United States or abroad. Funds do not operate active businesses. The mutual fund's owners are its shareholders, who

[1] 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 $11.42 trillion and serve almost 90 million shareholders.

[2] This exemption is provided today by Section 171.055 of the Texas Franchise Tax Code.

invest in the fund to achieve their savings objectives. The typical fund will have investors resident in most or all of the 50 states.

A mutual fund generally does not have employees of its own. Instead, the fund's activities are performed by third-party service providers. Funds with a common investment adviser (sometimes called a "manager") are often referred to as a mutual fund "family" or "complex."

Mutual fund complexes can be located virtually anywhere because of the minimal need for permanent physical equipment. Additionally, there is little added advantage for a fund manager to be located near the shareholders because investors typically communicate with the manager electronically, over the phone, or through the mail. As a result, the mutual fund industry's employees tend to be highly mobile when faced with a disadvantaged situation.

Competition between mutual fund complexes is intense. One important factor in a fund's success is its investment return relative to that of its competitors. Anything that affects a fund's return can affect its success and that of the adviser that manages the fund.

Current Federal and State Taxation of Mutual Funds and Their Advisers

While mutual funds are corporations for federal income tax purposes, they typically incur no federal tax liability. Pursuant to federal tax rules designed to provide investors with a highly regulated, widely diversified, publicly-offered investment vehicle that is not tax-disadvantaged, funds that meet certain qualification tests receive a deduction for the income that they distribute to their shareholders.[3] This dividends paid deduction allows funds to eliminate their federal income tax liability and provide fund shareholders with tax treatment comparable to that received by direct investors in securities. This important policy objective of providing comparable tax treatment has been a feature of the Internal Revenue Code since 1936.

Mutual funds likewise effectively are exempt from tax at the state level. Because the imposition on any fund of any state tax would reduce the fund's income distributable to its shareholders, these taxes (like other fund expenses) would fall on all of the fund's shareholders. Thus, a State X tax on funds located in that state would reduce the investment return of its shareholders resident in State X as well as its shareholders resident in every other state. Conversely, the State X resident shareholders investing in non-State X funds would not incur the tax. This adverse impact of state-level taxes to in-state fund complexes is one very important reason why states do not tax mutual funds.

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[3] In many respects, this deduction for dividends paid is the equivalent, for pass-through investment vehicles, to the deduction that operating companies receive for the cost of goods sold.

Advisers to mutual funds are taxed like other similarly organized businesses at both the federal and state level. The effective tax exemption provided for sound policy reasons to funds has no impact on the tax treatment of the funds' advisers and other service providers.

Texas-Based Fund Industry Would Be Taxed Twice if the Mutual Fund Exemption Were Repealed

Texas-based fund managers pay the franchise tax today. Thus, the mutual fund industry already pays franchise tax on all of its activities within Texas. Imposing the franchise tax on the income of the funds the industry manages would result, in essence, in double taxation: a franchise tax on the fund manager and an income tax on the fund shareholders. This double taxation would be even more inappropriate if the franchise tax exemption for mutual funds were repealed while the exemption for passive entities[4] were retained.

Texas-Based Fund Managers Would Be Disadvantaged If the Franchise Tax Applied to Their Funds

Eliminating the mutual fund exemption from the franchise tax would place Texas-based fund managers at a competitive disadvantage to fund managers located throughout the rest of the United States. Because of the competitive nature of the industry, this disadvantage may cause them to move their business and employees elsewhere due to the low cost of relocation. Additionally, taxing mutual funds may prevent fund managers from choosing to move to Texas in the future.

The Tax Burden on Savings Should Not be Increased

Mutual funds have become an important investment vehicle for moderate-income households. Over half of all American households invest in mutual funds and often depend on this form of saving to buy a home, finance their children's education, support aging parents or extended family, and prepare for retirement. Repealing the franchise tax exemption for these investments would make it more difficult for investors to meet their long-term goals and may also discourage savings.

Recommendation

The Investment Company Institute recommends that the franchise tax exemption for open-ended mutual funds in Section 171.005 *not* be eliminated. Imposing franchise tax on mutual funds managed by Texas-based fund managers would harm the shareholders in these funds and place the

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[4] The franchise tax exemption for passive entities is provided by Section 171.001(c). Because the character of a mutual fund's income is essentially the same as the income of entities that qualify for the passive entity exemption, funds effectively are precluded from this passive entity exemption only because of the requirement that the passive entity be a partnership or trust (other than a business trust). Funds are organized either as business trusts or corporations.

managers of these funds at a competitive disadvantage relative to managers located in every other state.

The Institute appreciates your consideration of our concerns. Please do not hesitate to contact the undersigned at (202) 326-5832, or lawson@ici.org, if you have any questions regarding this letter or would like any additional information regarding the organization, operation, or taxation of mutual funds, their shareholders, and/or their third-party service providers.

Sincerely,

/s/ Keith Lawson

Keith Lawson
Senior Counsel – Tax Law