STAFF REPORT, STAFF RECOMMENDATION, AND REQUEST FOR ADOPTION OF PROPOSED REGULATION SECTION 25137-14, SPECIAL INDUSTRY REGULATION FOR MUTUAL FUND SERVICE PROVIDERS, AS AN ADDITION TO CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 25137, RELATING TO EQUITABLE ADJUSTMENT OF THE STANDARD ALLOCATION AND APPORTIONMENT PROVISIONS

On September 21, 2005, staff issued FTB Notice 2005-3, requesting public input regarding the need for a special industry regulation for mutual fund service providers (MFSPs). Staff did not provide language at that time, but rather sought to elicit input regarding the methods used in other states and what a California regulation should look like if one were to be proposed. A symposium was held on October 28, 2005. Considerable information was gathered and staff began working on a regulation with the help of interested parties who participated in the symposium. Once language was developed, staff asked the Franchise Tax Board, at its June 19, 2006, meeting, to allow staff to move into the formal regulatory process to adopt a regulation to address the needs of MFSPs. The Board approved staff's request to move forward, and a formal Notice of Hearing was published on October 27, 2006.

On December 18, 2006, Carl Joseph of the department's Legal staff held the required public hearing at the Franchise Tax Board's central office to receive public comments on the proposed Regulation Section 25137-14. There were 14 attendees at the hearing. 5 persons, who each submitted written comments, also presented comments orally at the hearing. In addition there was an attendee who, while not providing specific oral comments, asked for an extension of time to provide written comments regarding the regulation. This request was granted, with the comment period for written comments being extended until January 15, 2007. In total, during the formal regulatory process there were comments received from 9 different commentators who submitted approximately 45 comments in total, orally and in writing.

In response to the comments raised, staff published a 15-day Notice setting forth certain "sufficiently related changes" within the meaning of Government Code section 11346.8, subdivision (c). The Notice was mailed on February 21, 2007, with comments due no later than March 12, 2007. A total of 4 comments were received in response to the 15-day Notice.

The comments received during the formal regulatory process generally fell into four categories:

1. MFSPs based outside of California submitted comments asking that the Finnigan approach be removed from the proposed regulation.
2. MFSPs based in California submitted comments requesting that the throwback provision of the proposed regulation be removed.
3. Comments that the staff had not met its burden of proof to show the need for the proposed regulation.
4. Comments regarding the actual language of the proposed regulation that requested changes, for clarification and other reasons.

Included, as Exhibit A to this report, is a global response to the concerns of commentators raising issues in categories 1 and 2 above. Category 3 is addressed, in detail, in the responses to comments, included as Exhibit B. Most of the items raised in comments falling into category 4 were addressed in the changes that led to the 15-day Notice, which changes were accepted without the need for further revision by the commentators. The 15-day changes and explanations for the changes are also included as Exhibit C to this report. The comments received during the formal regulatory process and during the 15-Day comment period are attached as Exhibit D to this Report. The transcript of the Regulatory Hearing is included as Exhibit E. The final version of the regulation is included as Exhibit F to this Report, and the Supplemental Analysis of the Revenue Impact for Proposed Regulation Section 25137-14 is included as Exhibit G.

Staff recommends that the Board authorize the Executive Officer to proceed with the final requirements for the adoption of proposed Regulation Section 25137-14, the language of which is set forth in Exhibit F of this package.

Hearing Officer's Response to Primary Objections to Proposed Regulation Section 25137-14

The Mutual Fund Service Provider (MFSP) regulation came about as a result of past petitions by MFSPs to utilize an alternative apportionment formula under the authority of section 25137 of the Revenue and Taxation Code (RTC). These petitions made a compelling argument that the normal apportionment formula rules for the sales factor simply do not work for members of this industry. The MFSPs argued that the standard apportionment rules for the sales factor do not reflect the market for their services, but simply assign most of their receipts to their home state based on the activities of their employees. Because market reflection is the underlying reason for the inclusion of the sales factor in the apportionment formula, FTB staff agreed with this argument and granted these petitions without objection from the three-member Franchise Tax Board.

The proposed regulation now seeks to consistently apply this alternative methodology to all members of the industry. The alternative method assigns these services receipts to the location of the underlying shareholders in the mutual funds. The methodology is consistent with the laws of at least twelve other states who have specifically addressed the apportionment formula for MFSPs. Input received during the regulatory process has been generally quite favorable. MFSPs located in other states have objected to some of the provisions in the proposed California regulation that would increase their sales factors in California. Their primary objection relates to the use of a so-called "Finnigan"[1] methodology in determining the sales factor numerator of a MFSP unitary group. This methodology treats the unitary group as one taxpayer for purposes of determining taxability. Therefore, as long as there are members of the unitary group that are taxpayers in this State, all of the receipts assignable to this State through the shareholder ratio calculation will be included in the California numerator, regardless of whether the specific entity in the unitary group that is receiving the receipts is itself a California taxpayer. This methodology is legally permissible[2] and is necessary for two main reasons:

1. MFSPs are frequently set up as a group of separate entities that are highly interdependent. This is done in order to meet regulatory requirements imposed by the SEC and other agencies. Because of this, the use of the Finnigan method works better for this industry. In addition, the use of Finnigan has been endorsed by the in-state MFSP's. As described by one of the MFSPs:

> In a highly regulated enterprise, such as is found among Mutual Fund Service Companies, companies operate in a manner that is inconsistent with the separate company apportionment

[1] Appeal of Finnigan Corporation, Cal. St. Bd. of Equal., August 25, 1988 [88-SBE-022] ("Finnigan I") and January 24, 1990 [88-SBE-022-A] ("Finnigan II")

[2] See Citicorp North America, Inc v. Franchise Tax Board (1st Appellate Dist., 2000) 100 Cal Rptr. 2d 509.

methodology of *Joyce*, and in a manner that is far more consistent with the unitary apportionment methodology of *Finnigan*.[3]

2. The use of Finnigan will allow California to pick up the receipts that are assigned here by other states that have a similar shareholder location methodology.[4] MFSPs based in these states are receiving a denominator inclusion for receipts derived from investments by shareholders located in California. Without using the Finnigan methodology, California will not include these denominator amounts in the California numerator. Instead, the receipts simply are never counted anywhere. This will put out-of-state businesses at a competitive advantage over in-state companies due to their lower overall state tax burden. Obviously this should not happen. Similarly situated taxpayers should be treated the same for tax purposes, and use of the Finnigan methodology is necessary to accomplish this goal.

In-state taxpayers have raised one primary concern with the proposed regulation that staff was unable to resolve during the regulatory process. This issue is the inclusion of a throwback provision in the regulation. A throwback provision serves to include receipts in the California sales factor numerator that would otherwise be assigned to a state where the taxpayer is not taxable.[5] The standard apportionment rules provide for throwback in RTC section 25135(b), which deals with assigning receipts from sales of tangible personal property. There is no throwback provision contained in RTC section 25136, which addresses all other sales receipts, including services receipts. In-state MFSPs argue that because the normal rule for services receipts does not contain a throwback, that no throwback rule should be included in the special industry regulation. This argument is not persuasive for three reasons:

1. The inclusion of a throwback rule is not precluded because the standard formula for these receipts does not contain such a provision. The argument made by the in-state MFSPs seems to suggest that there should be linkage between the standard apportionment formula rule of RTC section 25136 and the special industry regulation under RTC section 25137. Clearly there is no such requirement. The FTB has adopted three regulations under the authority of RTC section 25137 that include a throwback rule, despite addressing receipts that would have been

[3] This quote is part of a submittal made by Franklin Templeton Investments to the Franchise Tax Board at its June 19, 2006 meeting. The submittal was made in support of the regulation project proceeding to the formal regulatory stage.
[4] A large portion of the mutual fund industry is located in states that already utilize the shareholder location method of this regulation. This includes the states of New York, Massachusetts, New Jersey, Connecticut, Rhode Island, Missouri, Texas, Kansas, Utah, Kentucky, Maryland, and Maine.
[5] The regulation uses RTC section 25122 for the definition of "taxable in another state." That section provides that a taxpayer is taxable in a state if it is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax. In addition, a taxpayer is taxable in a state if that state has the jurisdiction to subject the taxpayer to a net income tax, regardless of whether, in fact, the state does or does not subject that taxpayer to their tax.

assigned by RTC section 25136 prior to the adoption of the special industry regulation.[6]

2. The change from an "income producing activity" approach under RTC section 25136 to a market approach based on location of shareholders gives rise to the need for a throwback rule. Under the standard apportionment formula rule, receipts from services would generally be assigned to the location where the employees who performed the services were located, as these employees would be performing the income producing activity. Nexus is not an issue in most of these cases, as employee presence would create nexus. This is not the case when you go to a customer location approach. Just as the customer location approach under RTC section 25135 needed a throwback provision, it is also necessary in this proposed regulation. Without such a rule, is it highly likely that income will be assigned to a location that cannot impose a tax upon it.
3. The inclusion of the throwback provision is necessary to prevent income from escaping taxation. It is a core principle of UDITPA that 100 percent of the taxpayer's income (no more or less) should be assigned to jurisdictions where the taxpayer is taxable, whether that jurisdiction chooses to tax the income or not. That is why throwback is included in RTC section 25135. This principle is concerned with providing a level playing field between apportioning and non-apportioning taxpayers. Without a throwback rule, a taxpayer who makes sales to customers outside of the state would have a lower tax liability than a solely in-state competitor because of the ability to apportion income to locations where the taxpayer pays no tax. These concerns are not limited to the corporate franchise tax. In the personal income tax arena, a resident is subject to tax in their home state on all of his/her income and only receives a reduction for activities in other states (often through a credit for taxes paid to another state) if they show that they had nexus and paid tax in other states. This methodology assures that 100 percent of the resident's income is taxed, which addresses the same underlying concerns as throwback.

[6] Regulation § 25137-3, dealing with franchisors, contains such a rule for royalty receipts in § 25137-3(b)(2)(B); Regulation § 25137-4.2, for banks and financials, contains such a rule in § 25137-4.2 (c)(2)(N); Regulation § 25137-12, for print media companies, adopts such a rule for advertising services in § 25137-12 (c)(4).

SUMMARY OF COMMENTS, RESPONSES AND RECOMMENDATIONS
Proposed Regulation Section 25137-14

Comments from Federated Investors dated December 14, 2006 (also submitted orally at the December 18th hearing).

1. FTB's proposal is inconsistent with the provisions of the standard apportionment formula sales factor concerning the treatment of sales of other than tangible personal property (i.e. intangibles and personal services).

Response:

The comment is correct; however, the proposed regulation is not promulgated under section 25136 of the Revenue and Taxation Code (RTC), which deals with the sales factor numerator assignment for sales other than sales of tangible property. Rather, the proposed regulation is promulgated under R TC section 25137, which specifically allows for deviations from the standard formula rules, such as RTC section 25136. There are numerous other special industry regulations that have been promulgated under RTC section 25137, all of which provide rules that are inconsistent with the standard formula.

In regards to the market state approach, the commentator argues that the standard rules for sales of intangibles and services are not meant to reflect the market. Respectfully, this is not supported by the history of UDITPA. The intention of the drafters of UDITPA was to provide a counterbalance to the payroll and property factors through the inclusion of a sales factor. The payroll and property factors do not reflect market state activities that contribute to the production of apportionable business income. The sales factor was designed to remedy this problem. The commentator quotes from the William Pierce article[1] on UDITPA to show that section 17 (RTC Section 25136) is not a market approach, yet does not quote sections from the article that suggest that the sales factor was designed to provide market reflection. The Pierce article states:

> Sections 15 through 17 of the act provide for the computation of the sales factor. Two major problems are encountered in respect to these provisions. The first problem arises because, with two exceptions, sales are attributed to the consumer state rather than to the state of sales activity or the place where the goods are appropriated to the orders. If the taxpayer is not taxable in the state to which the goods are shipped or if the purchaser is the United States Government, the sales are attributed to the state from which the goods are shipped. Manufacturing states probably

[1] Pierce, *The Uniform Division of Income for State Tax Purposes* (October, 1957) Taxes, The Tax Magazine, at 747.

> would prefer a system attributing sales to the place from which goods are shipped in every case. However, the national conference was of the opinion that such a system would merely duplicate the property and payroll factors which emphasize the activity of the manufacturing state, so that there would tend to be a duplication by such a sales factor. <u>Moreover, it is believed that the contribution of the consumer states toward the production of the income should be recognized by attributing the sales to those states.</u>
>
> <u>(emphasis added)</u>

Then, in discussing section 17, the Pierce article provides the following:

> Another problem arises in conjunction with sales other than sales of tangible personal property. Section 17 of the uniform act attributes these sales to the state in which the income-producing activity is performed. If the activity is performed in more than one state, the sales are attributed to the state in which the greater proportion of the activity was performed, based upon costs of performance. In many types of service functions, this approach appears adequate. However, there are many unusual fact situations connected with this type of income and probably the general provisions of Section 18 should be utilized for these cases.

Section 18 of UDITPA is RTC section 25137, the section under which this regulation is promulgated. Clearly, even at the time UDITPA was written, it was acknowledged that to achieve fair apportionment, the standard formula would need to be altered to address the needs of specific industries, and that section 17 (RTC section 25136) would be a major source of the need for such alterations.

2. The sales "throwback rule" provision in the proposed regulation is not consistent with California law.

Response:

It is not necessary that a regulation promulgated under RTC section 25137 be consistent with normal rules of apportionment. What is necessary is that the rule that is promulgated is designed to address the specific issues of the industry and provides a set of rules that fairly represent the activities of the taxpayers in the state. That being said, it is true that the Board of Equalization, in <u>Appeal of Huffy</u>, 99-SBE-005 (1999), did decide to move California back to the <u>Joyce</u> rule concerning sales factor throwback; however, this does not prevent the use of the <u>Finnigan</u> methodology in a regulation promulgated under RTC section 25137. As has been demonstrated by FTB, and agreed with by several commenting parties during this regulatory process, the standard formula does not fairly represent the activities of mutual fund service providers. Therefore the FTB is authorized to promulgate rules under RTC section 25137 to remedy this problem. This includes the use of a Finnigan throwback rule.

Further support for this position can be found in the legislative regulations adopted under RTC section 25106.5, which specifically provide that while Joyce is the standard throwback approach, the FTB may adopt an alternative approach (Finnigan) under RTC section 25137. Regulation section 25106.5(c)(7)(B) specifically provides that:

> B) Taxpayer Member's Property, Payroll, and Sales Factors. In the application of subsection (c)(7) of this regulation*, except as modified under Section 25137 of the Revenue and Taxation Code:*
>
> …
>
> (emphasis added)

This clearly demonstrates that RTC section 25137 can be used to apply different rules for determining each taxpayer member's sales factor. This would include a throwback rule.

3. The FTB has not met its heavy burden to prove by clear and convincing evidence that a variation from the standard apportionment formula rules, regulations and case law regarding sales of other than tangible personal property is warranted.

Response:

The reason that the commentator finds the evidence lacking is because the commentator applies an incorrect standard (clear and convincing evidence). The standard by which a regulation is judged to be valid requires that the regulation be consistent with the statute and reasonably necessary to effectuate the purpose of the statute. (Government Code section 11342.2.) Government Code section 11349 defines necessity in subdivision (a) as follows:

> (a) "Necessity" means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record. For purposes of this standard, evidence includes, but is not limited to, facts, studies, and expert opinion.

Clearly this is not the "clear and convincing" standard that the commentator is using to judge what is in the record. The FTB has met the proper standard of showing necessity. Staff of the Franchise Tax Board has received input from industry demonstrating the need for the regulation through a symposium process that began well before the regulation currently in issue was developed. This process is documented in the regulatory record. The facts that were developed make it clear that, for California based service providers, the inclusion of almost all of the receipts of these companies in the California sales factor numerator distorts the California apportionment factor. There is no market reflection and the formula fails to fairly represent the activities of the taxpayer in the state because of this. Similarly, for out of state service providers, an apportionment factor in California that contains almost no receipts results in an apportionment factor that clearly understates the activities of the providers in the state.[2]

The need for the regulation is further made clear by the numerous comments received from some of the leading companies in the industry during this process. These comments have included substantial evidence that the normal apportionment formula rules seriously distort the activities of this industry. Also, the Franchise Tax Board has reviewed these facts and has allowed variations from the standard apportionment formula for individual members of this industry, which shows that there is a necessity to regulate in order to provide similarly situated taxpayers with the same method of apportionment. Finally, the evidence provided by Federated's own expert, Dr. Hamm, supports a finding that the regulation is necessary. In his report he shows that under the standard apportionment formula rules, California based mutual fund service providers (which service 24% of all mutual fund shares) assign 100% of these sales to California, even though Californians only own 11.7% of *all* mutual fund shares. Therefore, the normal formula, even when looking at only the California based companies, assigns more than double the amount of shares to California (24%) than are actually owned by shareholders located in the state (11.7%).

All of this evidence supports the regulation's validity. As has been demonstrated by FTB, and agreed with by other commenting parties during this regulatory process, the standard formula does not fairly represent the activities of mutual fund service providers. Therefore the FTB is authorized to promulgate a regulation under RTC section 25137 to remedy this problem. Even if the commenter were correct, and a clear and convincing evidence standard was applicable, the evidence provided is more than enough to meet this standard. This includes the submittals from taxpayers that would be affected by the regulation, as well as the laws of other states where mutual fund service providers are located. The evidence clearly shows that the standard apportionment formula does not fairly represent the activities of this industry and should be adjusted under the authority of RTC section 25137.

4. The use of <u>Finnigan</u> throwback is inconsistent with concepts of uniformity under UDITPA.

Response:

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[2] In a comment received on January 12, 2007, from Manatt, Phelps and Phillips, it is stated that the average apportionment percentage for these types of entities is approximately 0.80%.

The shareholder location rules contained in the proposed regulation are consistent with the approach taken in at least twelve other states. This promotes uniformity rather than discourages it. In regards to the throwback issue, while it is true that other states have not adopted throwback as part of their mutual fund regulations, there is a clear need for throwback in the regulation in order to meet another goal of UDITPA, that 100 percent of the taxpayer's income (no more or less) is assigned to jurisdictions where the taxpayer is taxable, whether a jurisdiction chooses to tax the income or not. Throwback is therefore found in UDITPA itself (RTC section 25135) as well as numerous special industry regulations promulgated under RTC section 25137.[3] The use of Finnigan throwback was requested by the mutual fund service providers themselves as can be seen in numerous comments to this regulation. This is because these businesses, for regulatory and business purposes, usually operate as a tightly knit unitary group rather than as single stand alone entities. The use of Finnigan throwback more accurately reflects the taxable presence of such a business structure and will result in much less throwback to California than a Joyce type approach would provide. Therefore, in-state business will have better market reflection, and out of state businesses will pay tax based on their unitary presence in the state, which is precisely how their liability should be determined.

5. Franchise Tax Board should go the legislature to change the standard formula rule under section 25136 rather than promulgate this regulation.

Response:

While this could be done, it is well in excess of what is necessary to address the needs of this specific industry. RTC section 25137 regulations provide a better approach because the regulation can be specifically targeted to the industry. In any event, the regulation is not in any way invalidated because there may be a legislative solution that could also be proposed.

Comments from Federated Investors Post-hearing (January 15, 2007)

In comments submitted post-hearing, Federated Investors reiterated its comments set forth above. These comments are responded to below only to the extent they raise new issues.

1. There is no basis for the application of the Finnigan sales throw back rule provided for in the Proposed Regulation. Joyce is the law in California as it is in almost every state that uses an apportionment of income scheme. Finnigan is not the law in California. Even if the FTB wants to use Finnigan they must prove

[3] Regulation § 25137-3, dealing with franchisors, contains such a rule for royalty receipts in § 25137-3(b)(2)(B); Regulation § 25137-4.2, for banks and financials, contains such a rule in § 25137-4.2 (c)(2)(N); Regulation § 25137-12, for print media companies, adopts such a rule for advertising services in § 25137-12 (c)(4).

by clear and convincing evidence that this deviation is appropriate and they have not done so.

Response:

Joyce is the correct method under RTC section 25135, but this does not mean that Finnigan cannot be utilized under the authority of RTC section 25137, especially when the activity at issue is not normally assigned under RTC section 25135. In fact, as many commentators have argued, the use of Joyce throwback would exacerbate the distortion problem rather than solve the problem. This is because the companies in this industry are frequently separated into various subsidiaries for regulatory purposes. While in the aggregate they have nexus in many states, the main service provider may have nexus in only a few states. If Joyce is utilized, all of the sales assigned to the states where the main provider does not have nexus will simply come back to the state where the provider is located. This puts the companies back in the same position they were in prior to the regulation, namely, a vast overstatement of sales in the home state. Furthermore, as stated in responses to the earlier comment by Federated, throwback has been required in other special industry regulations not involving RTC section 25135 type sales, and the use of Finnigan is specifically contemplated under (legislative) Regulation section 25106.5(c)(7)(B).

There is no reason to not use Finnigan. It is the better rule for this industry and its use is not prohibited by RTC section 25137 or by the case law.

As far as the burden of proof is concerned, there is adequate evidence on the record to support the use of Finnigan. Comments received during this regulatory process, as well as statements by the hearing officer, have explained why the use of Finnigan is necessary. Furthermore, the "clear and convincing evidence" standard is not the right standard to apply to the validity of a regulation as set forth in detail in response to earlier comments by this party.

Comments by Manatt, Phelps & Phillips received December 15, 2006 (also submitted orally at the December 18 hearing).

1. While the coalition of companies represented by Manatt does not disagree with the main thrust of the regulation (shareholder location sales factor assignment), they do not support the use of the Finnigan methodology contained in [sub]section (b)(1)(C). The use of Finnigan makes no sense as a matter of tax policy or fundamental fairness and will unreasonably apportion sales to California. Furthermore, the use of Finnigan flies in the face of judicial and Board of Equalization decisions and has not been demonstrated to meet the standards of Government Code section 11349.1.

Response:

Mutual Fund Service Providers are frequently set up as a group of separate entities that are highly interdependent. This is done in order to meet regulatory requirements imposed by the SEC and other agencies. Because of this, the use of the Finnigan method works better for this industry. Many service providers have endorsed the use of Finnigan. As described by one these companies:

> In a highly regulated enterprise, such as is found in among Mutual Fund Service Companies, companies operate in a manner that is inconsistent with the separate company apportionment methodology of *Joyce*, and in a manner that is far more consistent with the unitary apportionment methodology of *Finnigan*.[4]

The use of Finnigan will allow California to pick up the receipts that are assigned here by other states that have a similar shareholder location methodology.[5] Companies based in these states are receiving a denominator inclusion for receipts derived from investments by shareholders located in California. Without the Finnigan methodology, California will not include these denominator amounts in the California numerator. Instead, the receipts simply are never counted anywhere. This will put out-of-state businesses at a competitive advantage over in-state companies due to their lower tax burden. Obviously this should not happen. Similarly situated taxpayers should be treated the same for tax purposes, and Finnigan is necessary to accomplish this goal.

For in-state mutual fund service companies, the use of Finnigan is necessary in order for the throwback provision of the regulation to function as intended. In fact, as many commentators have argued, the use of Joyce throwback would exacerbate the distortion problems addressed by the regulation rather than solve these problems. This is because the companies in this industry are frequently separated into various subsidiaries for regulatory purposes. While in the aggregate they have nexus in many states, the main service provider may have nexus in only a few states. If Joyce is utilized, all of the sales assigned to the states where the main provider does not have nexus will simply come back to the state where the provider is located. This puts the companies back in the same position they were in prior to the regulation, namely, a vast overstatement of sales in the home state.

Regarding the state of the law in this area, the comment is premised upon an inconsistency between the throwback provision in the proposed regulation and existing case law. However, this premise is incorrect. The case law that is cited by the commentator all interprets the throwback rule contained in RTC section 25135. This section deals with sales of tangible property. The regulation does not deal with

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[4] This quote is part of a submittal made by Franklin Templeton Investments to the Franchise Tax Board at its June 19, 2006 meeting. The submittal was made in support of the regulation project proceeding to the formal regulatory stage.

[5] A large portion of the mutual fund industry is located in states that already utilize the shareholder location method of this regulation. This includes the states of New York, Massachusetts, New Jersey, Connecticut, Rhode Island, Missouri, Texas, Kansas, Utah, Kentucky, Maryland and Maine.

sales of tangible property, but instead deals with services. Therefore the case law is not directly applicable. Even if the case law is taken into consideration, the regulation is promulgated under the authority of RTC section 25137, which specifically allows for variations from the standard formula. By its very nature, the regulations contained in RTC section 25137 are therefore inconsistent with the standard formula.

2. The FTB does not have the legal authority to adopt throwback in this context. Throwback is intended to throwback only sales of tangible property to California when the taxpayer is not taxable in the state of delivery. Section 25136 does not contain a throwback provision and the legislature clearly could have done so if it had intended throwback to apply to services sales under 25136.

Response:

While RTC section 25136, the standard rule for the numerator assignment of sales of other than tangible property, does not contain a throwback provision, this does not preclude a regulation under RTC section 25137 from containing such a provision. RTC section 25137 authorizes the Franchise Tax Board to utilize "any other method to effectuate an equitable allocation and apportionment of the taxpayer's income" (RTC § 25137(d)). In fact, there are other regulations adopted under RTC section 25137 that deal with sales of other than tangible property and contain a throwback provision. Regulation section 25137-3, dealing with franchisors, contains such a rule for royalty receipts in § 25137-3(b)(2)(B); Regulation section 25137-4.2, for banks and financials, contains such a rule in § 25137-4.2 (c)(2)(N); and Regulation section 25137-12, for print media companies, adopts such a rule for advertising services in § 25137-12 (c)(4). This approach is also warranted in this regulation.

The use of throwback is believed to be necessary because the taxpayer, even under a <u>Finnigan</u> approach, may not be taxable in all of the locations where its shareholders are located. Without the inclusion of the throwback rule, a core principle of UDITPA, that 100 percent of the taxpayer's income (no more or less) is assigned to jurisdictions where the taxpayer is taxable (whether a jurisdiction chooses to tax the income or not), would not be implemented.

3. Franchise Tax Board has not shown that the regulation is necessary and has not met its high burden of proof to clear and convincing evidence why there is a need to deviate from <u>Joyce</u> for purposes of nexus or throwback.

Response:

The standard by which a regulation is judged to be valid requires that the regulation be consistent with the statute and reasonably necessary to effectuate the purpose of the statute. (Government Code section 11342.2.) Government Code section 11349 defines necessity in subdivision (a) as follows:

> (a) "Necessity" means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record. For purposes of this standard, evidence includes, but is not limited to, facts, studies, and expert opinion.

Clearly this is not the "clear and convincing" standard that the commentator is using to judge what is in the record. The Franchise Tax Board has met the proper standard of showing necessity. Staff of the Franchise Tax Board has received input from industry demonstrating the need for the regulation through a symposium process that began well before the regulation currently in issue was developed. This process is documented in the regulatory record. The facts that were developed make it clear that, for California based service providers, the inclusion of almost all of the receipts of these companies in the California sales factor numerator distorts the California apportionment factor. There is no market reflection and the formula fails to fairly represent the activities of the taxpayer in the state because of this. Similarly, for out of state service providers, an apportionment factor in California that contains almost no receipts results in an apportionment factor that clearly understates the activities of the providers in the state.[6]

The need for the regulation is further made clear by the numerous comments received from some of the leading companies in the industry during this process. These comments have included substantial evidence that the normal apportionment formula rules seriously distort the activities of this industry. Also, the Franchise Tax Board has reviewed these facts and has allowed variations from the standard formula for individual members of this industry, which shows that there is a necessity to regulate in order to provide similarly situated taxpayers with the same method of apportionment. Finally, the evidence provided by Federated's own expert, Dr. Hamm, supports a finding that the regulation is necessary. In his report he shows that under the standard apportionment formula rules, California based mutual fund service providers (which service 24% of all mutual fund shares) assign 100% of these sales to California, even though Californians only own 11.7% of *all* mutual fund shares. Therefore, the normal formula, even when looking at only the California based companies, assigns more than double the amount of shares to California (24%) than are actually owned by shareholders located in the state (11.7%).

All of this evidence supports the regulation's validity. As has been demonstrated by FTB, and agreed with by other commenting parties during this regulatory process, the standard formula does not fairly represent the activities of mutual fund service providers. Therefore the FTB is authorized to promulgate a regulation under RTC section 25137 to remedy this problem. Even if the commenter were correct, and a

[6] In a comment received on January 12, 2007 from Manatt, Phelps and Phillips, it is stated that the average apportionment percentage for these types of entities is approximately 0.80%.

clear and convincing evidence standard was applicable, the evidence provided is more than enough to meet this standard. The evidence clearly shows that the standard apportionment formula does not fairly represent the activities of this industry and should be adjusted under the authority of RTC section 25137.

Furthermore, as explained in the Initial Statement of Reasons, members of this industry have individually requested, and been granted, relief similar to that contained in the proposed regulation. Rather than continuing to grant petitions and attempt to enforce the variant on other members of the industry on a case-by-case basis, the staff seeks to adopt this approach as a rule of general application. All members of the industry should be treated equally for tax purposes, and a regulation is the best way to reach this goal. This approach has been endorsed by other members of the industry, and is, to a large degree, endorsed by this commentator. Also, as explained in the Notice of Hearing on this regulation:

> For mutual fund service providers, the income producing activity, and most of the cost of performance, relates to services provided by their employees. Because of this, the location of the employees is almost always the location where the receipts will be assigned under normal sales factor rules. The result is that the sales factor will essentially mirror the payroll factor. Similarly, the property factor also reflects the location of the employees, as the property factor is primarily composed of the offices and equipment used by the employees performing the services. However, in contrast to the carpet cleaning company example, the customers of these companies are the fund shareholders, who receive the benefit of the services in locations scattered amongst all fifty states. Because the services are concentrated to one location, the receipts follow, even though this is not indicative of the market.
>
> For this reason, many states have changed the sales factor rules for mutual fund service providers to allow them to assign their sales factor utilizing a ratio of shares owned by shareholders in this state to shares owned by shareholders located everywhere. This allows a reflection of the actual market and corrects the over-taxation of in-state mutual fund service providers by assigning receipts outside of the home state. Similarly, if the service provider were located outside of the state, rather than having a zero numerator in the California sales factor, they would have a factor based on the market through the reflection of shares owned by California shareholders.

Ample evidence exists in the record to show the necessity requirement of the Government Code has been met in this matter. The Joyce/Finnigan issue has already been addressed in response to the commentator's earlier comments so no further discussion is necessary.

4. The language contained in section (b)(1)(A)2 of the regulation should be amended to provide greater flexibility as to the year-end to be utilized in calculating the shareholder ratio for the state.

Response:

The regulation has been amended and a 15-day Notice was issued[7] setting forth a change to address this concern. The relevant amended portion of the regulation now reads:

> 2. The regulated investment company's taxable year for computing the shareholder ratio shall be <u>either</u> the taxable year that ends during the taxable year of the principal member of the mutual fund service provider's combined reporting group <u>or the taxable year of the principal member of the mutual fund service provider's combined reporting group. Once a method for computing the shareholder ratio is chosen, that methodology should be applied consistently in later years.</u>

5. The regulation should be amended to include a 50% gross income threshold before a taxpayer is required to utilize the method set forth in the regulation.

Response:

While some states have adopted such a limitation, others have not. Of the twelve states that have addressed special apportionment rules affecting this industry, eight have done so without utilizing a threshold based on income. This suggests that the threshold is not the preferred position from a uniformity perspective. Furthermore, the 50% threshold could result in similarly situated taxpayers using different apportionment methodologies based on small differences in income. This is not a desirable result. Whether a given entity earns 45% of its income from mutual fund activities or 51% of its income is not determinative of the best way to apportion that income. Rather it is recognition that it is *the activity itself* that needs to be reflected by an alternative method that gives rise to the use of the regulation. The amount should not matter, and thus no change to the regulation is necessary

<u>**Comments by Ameriprise Financial received December 15, 2006**</u>

1. The regulation should be made elective because some states, including the home state of Ameriprise, tax the income of a mutual fund service provider

[7] All of the changes shown in underline and strikethrough are changes to the original regulation language made public on October 27, 2006. The changes are all included in a 15-day Notice that was made public on February 21, 2007. A full updated version of the regulation, including the 15-day changes, was also made available at that time.

utilizing different rules from the shareholder location assignment mechanism. Therefore, if the regulation is not elective, this will result in double taxation.

Response:

The rules for mutual fund service providers in Minnesota are different from that in states that have adopted a shareholder location methodology. Unfortunately, this results in a possibility of double taxation for Minnesota based companies. The answer to this concern, however, is not to make the regulation elective. An elective regulation effectively would allow those that are benefited by the regulation to lower their taxes, while those not benefited would simply elect not to use the regulation. The result would be lower revenue to the State and inconsistent treatment of similarly situated taxpayers. Neither of these results is desirable.

It is the hope of the hearing officer that as more states adopt shareholder location apportionment, Minnesota will seek to change its laws to become uniform with those of other states who have a significant mutual fund industry presence.

2. Eliminate the provisions of the regulation dealing with asset management receipts or at least narrow this section such that asset management activities performed for insurance companies are assigned to the domicile of the insurance company, rather than its underlying beneficiaries.

Response:

Asset management services are very similar to mutual fund services. The same problems that arise under the standard apportionment rules for mutual fund services receipts also are problems for asset management services receipts. Under the standard formula, the sales factor simply restates the property and payroll factors rather than providing a reflection of the market for both kinds of services. A switch to a market rule is therefore equally necessary for both types of services performed by the mutual fund services company. No change to the regulation is necessary

The commentator's proposal to exclude insurance companies from the asset management scheme based on beneficial owners is inconsistent with the purpose of the regulation. The rules are designed to find the underlying owners who are receiving the benefit of the services performed. There is no reason to change this rule specifically for receipts derived from providing these services to insurance companies and not for other types of entities. The rules contain considerable flexibility in assigning these receipts and it should not be overly burdensome for taxpayers to comply.

3. The regulation should clarify that a taxpayer may continue to request relief under the general provisions of Section 25137.

Response: This is unnecessary to include in the regulation. The ability of a taxpayer to request relief under the statute (RTC section 25137) cannot be affected by this regulation. A taxpayer may continue to request relief, even from the provisions of the regulation, under the authority of RTC section 25137. This authority is reaffirmed in the decision of the Board of Equalization in Appeal of Fluor, 95-SBE-016 (December 12, 1995).

Comments from Pillsbury Winthrop/Franklin Resources dated November 14, 2006, (also consistent with comments made orally at the December 18 hearing).

This comment is largely in favor of the regulation. The comment provides that the regulation is necessary to correct distortion caused by the standard formula and explains in detail the unique nature of the industry and the need for a shareholder apportionment methodology. Despite this commentator's strong support of the regulation, there is one area where the commentator requested changes.

1. There should not be a throwback rule included. The throwback provision contained in section (b)(1)(D) should be removed. A throwback rule is inappropriate for services based business. Throwback is also inconsistent with a market-based apportionment approach. However, if throwback is included, it should done using the Finnigan methodology due to the unique nature of the mutual fund service provider industry.

Response:

RTC section 25136, the standard formula rule for all sales other than sales of tangible property, does not contain a throwback rule. However, this does not preclude the implementation of a throwback rule in a special industry regulation under RTC section 25137. The lack of a throwback rule under RTC section 25136, at least in the case of services, is understandable because when UDITPA was developed in the 1950s, most services were probably performed in proximity to the customer receiving the services. Therefore the service provider would have nexus in the location where the sales were assigned based on income producing activity.

However, when a special formula is adopted that assigns to customer location, or an industry changes over time to the point where all services are being performed remotely, the need for throwback increases. Throwback assures that all of the taxpayer's income is assigned to jurisdictions that have the ability to tax the income. It is simply designed to make sure that all of the taxpayer's income is subject to tax. This principle applies equally to services sales as well as sales of tangible personal property.

The Franchise Tax Board had adopted numerous special industry regulations that contain a throwback rule outside of the tangible personal property context. (Regulation section 25137-3, dealing with franchisors, contains such a rule for royalty receipts in 25137-3(b)(2)(B); Regulation section 25137-4.2, for banks and financials, contains such a rule 25137-4.2 (c)(2)(N); and Regulation section 25137-12, for print media companies, adopts such a rule for advertising services in 25137-12 (c)(4).) There is no reason to not do the same in this regulation.

In regards to the use of the Finnigan methodology, this is the method that is employed in the regulation. The hearing officer agrees with the comment that this method is much better suited to the needs of this particular industry.

Comment from Barclays Global Investors dated December 18, 2006

1. Subsection (b)(1)(A)1 should be revised to provide for the use of census data as a reasonable basis for assigning shares to a given location for purposes of the shareholder assignment ratio.

Response:

The regulation provides that the service provider may utilize "any reasonable basis" to determine the proper location for the assignment of the shares. This should allow the requisite level of flexibility to the service provider. The use of census data may or may not be reasonable given the facts of a given taxpayer. For instance, the use of census data would not be reasonable if there are other possible methods that would provide a better methodology for the given fund. Also, there are specialized funds, such as municipal bond tax-exempt funds, that are by their very nature state specific. For such funds, the use of census data appears inappropriate and potentially distortive.

No change to the regulation is necessary.

2. Subsection (b)(1)(B) should be further clarified as to what might constitute a reasonable method.

Response:

The regulation, as revised pursuant to the 15-day change Notice15-day change Notice, provides, in Regulation section (b)(1)(B)1:

> 1. In the case of asset management services directly or indirectly provided to a pension plan, retirement account or institutional investor, such as private banks, national and international private investors, international traders or insurance companies, receipts shall be assigned to this State to the extent the domicile of the beneficiaries of the plan, beneficiaries of the account or beneficiaries of the similar pool of assets held by the institutional

> investor, is in California. <u>If the individual domiciles of the beneficiaries are not available, a mutual fund service provider may utilize any reasonable basis in order to determine the domiciles of the individual beneficiaries, including information based on zip codes or other statistical data.</u>

Similar to the response to comment one, this provides flexibility to the taxpayer in assigning the receipts to a location. The regulation provides one example, zip codes, specifically. A list of examples is unnecessary and could be seen as limiting the possible options to the taxpayer, which may well differ from fund to fund. For instance, it may be reasonable to assign most of the receipts from managing a state pension fund to one state, if it can be shown that the pension fund's beneficiaries are located in that state. This may not work at all for another customer.

No further change to the regulation is required.

3. Please confirm that regulation 25137-14 would be applicable to a financial corporation.

Response:

If a financial corporation has receipts from activities that would fall under this regulation, then those receipts would be assigned through this regulation. RTC section 25137-4.2, the special industry regulation for banks and financial corporations, provides, in subsection (c)(3)(M), that "[t]he numerator of the receipts factor includes all other receipts pursuant to the rules set forth in sections 25135 and 25136 of the Revenue and Taxation Code and the regulations adopted pursuant to those sections and Section 25137 of the Revenue and Taxation Code." This would encompass the use of this new regulation, as it is a regulation under the authority of RTC section 25137.

<u>Comments from Silverstein and Pomerantz LLP dated December 15, 2006</u>

1. Regulation subsection (a)(3) should be clarified to provide that management services do not include the buying and selling of the mutual fund service providers own intangible assets, rather it is the regulated investment companies assets that should be addressed by the definition.

Response:

The regulation, as revised pursuant to the 15-day change Notice, includes this suggested change and provides:

> (3) "Management services" include, but are not limited to, the rendering of investment advice, directly or indirectly, to a regulated investment company, making determinations as to when sales and

purchases of securities are to be made on behalf of the regulated investment company or providing services related to the selling or purchasing of securities constituting assets of a regulated investment company, and related activities. Services qualify as management services only when such activity or activities are performed pursuant to a contract with the regulated investment company entered into pursuant to 15 United States Code, Section 80a-15(a), as amended, for a person that has entered into such a contract with the regulated investment company or for a person that is affiliated with a person that has entered into such a contract with a regulated investment company.

2. Subsection (b)(1)(B) should be clarified to emphasize that it is the domicile of the ultimate individual owner of the assets that is used to assign asset management receipts. This is not clear in the regulation because the regulation uses the term "individual" in addressing entities rather than people. The regulation should make clear that the intention is to look through to the ultimate owner of the assets.

Response:

The regulation, as revised pursuant to the 15-day change Notice, deletes the use of the term "individual" from subsection (b)(1)(B) and replaces it with "beneficial owner." It now reads:

> (B) If a mutual fund service provider has receipts from performing asset management services, in addition to performing services for regulated investment companies, these services shall be assigned to this state if the domicile of the ~~individual owning~~ beneficial owner of the assets is located in this state.

This should address the concern and confirms that it is the intention of the regulation to look through to the ultimate owner of the assets to assign the receipts.

3. The throw out rule contained in section (b)(1)(B)2 should be removed and replaced by a rule that uses section 25136 to assign any receipts from asset management services for which the provider cannot obtain a domicile.

Response:

Subsection (b)(1)(B)2, as revised pursuant to the 15-day change Notice, states:

> In the event the domicile of the beneficiaries is not or cannot be obtained, and the taxpayer cannot devise a reasonable method to approximate this information ~~statistically~~, the receipts shall be disregarded for purposes of the sales factor.

This subsection, when read in concert with subsection (b)(1)(B)1, provides taxpayers with considerable flexibility in the methodology utilized to assign these receipts to the location of the beneficial owner. It is not expected that there will be many occasions when the taxpayer would be unable to provide some statistical basis for the assignment of these receipts. Even when it is applied, it is not expected that the throw out will lead to a statistically significant change in the sales factor simply due to the rarity of its application. Most receipts will be assignable to a location. Also, the use of an alternative approach utilizing cost of performance may provide an incentive to reject an otherwise reasonable basis for assignment, if the RTC section 25136 alternative were found to have a better tax consequence. This sort of incentive should be avoided. The throw out rule is easy to apply and should not be implemented very often given the flexibility of the regulatory language.

No change in the regulation is necessary.

<u>Comments from Capital Group dated December 18, 2006</u>

The letter specifically references back to comments made prior to the beginning of the formal regulatory process and requests that those comments be included in the rulemaking file. Therefore, the comments received on June 16, 2006, are responded to at this time.

1. Section (b)(1)(A)2 which sets forth the taxable year for computing the shareholder ratio should be expanded to include not only the taxable year of the regulated investment company, but also the taxable year of the principal member of the mutual fund service provider's combined reporting group. This would provide greater flexibility for the service providers, which is necessary because the individual funds may have different year-ends and may also have different year-ends. Capital Group, for instance, has 29 RIC's which have 10 different year-ends.

Response:

In response to the comment, subsection (b)(1)(A)2, as revised pursuant to the 15-day change Notice, reads as follows:

> The regulated investment company's taxable year for computing the shareholder ratio shall be <u>either</u> the taxable year that ends during the taxable year of the principal member of the mutual fund service provider's combined reporting group <u>or the taxable year of the principal member of the mutual fund service provider's combined reporting group. Once a method for computing the shareholder ratio is chosen, that methodology should be applied consistently in later years.</u>

This will address the concerns raised by the comment.

2. Section (a)(4), which defines domicile, should apply to businesses and other entities when the ultimate beneficial owner is the registered legal owner. As written, the section only applies to individuals, and all other entities are addressed utilizing the special rule contained in section (b)(1)(A)1, even if the entity itself is the beneficial owner of the shares. This should be changed.

Response:

Subsection (a)(4), as revised pursuant to the 15-day change Notice, provides:

> (4) "Domicile" is defined as follows:
> (A) The domicile of a shareholder of a regulated investment company is presumed to be the shareholder's mailing address on the records of the regulated investment company or the mutual fund service provider. If the regulated investment company or the mutual fund service provider has actual knowledge that the shareholder's primary residence or principal place of business is different than the shareholder's mailing address, the presumption does not control. Shareholders of record that own shares for the benefit of others ~~are not individuals~~ are subject to the special rule contained in subsection(b)(1)(A)1 of this regulation.

This change will make it clear that entities other than individuals can have a domicile for shares they hold as the ultimate beneficial owner.

3. Section (b)(1)(B) relating to asset management services also has the same problem set forth in comment 2 and should be changed to recognize that there may not be underlying beneficiaries in regards to asset management services provided to a business entity. Furthermore, if there are underlying beneficiaries, the methodology for assigning the shares should provide for the use of any reasonable method, including census data and other statistical data, for determining the domicile of the beneficial owners for purposes of assigning the receipts derived from providing the asset management service. This should be clarified in the regulation.

Response:

The domicile issue is now addressed in amended subsection (a)(4) which, as revised pursuant to the 15-day change Notice, now includes subsection (a)(4)(B), which provides:

> The domicile of a beneficial owner of assets managed by a mutual fund service provider shall be presumed to be the beneficiary's mailing address on the records of the entity for whom the asset

> management services are rendered, or on the records of the mutual fund service provider. If the entity for whom the asset management services are rendered, or the mutual fund service provider, has actual knowledge that the beneficiary's primary residence or principal place of business is different than the beneficiary's mailing address, the presumption does not control. Owners of record that are not the beneficial owner are subject to the special rule contained in subsection (b)(1)(B)1 of this regulation.

By providing that only owners of record that are not the beneficial owner are subject to the rules contained in subsection (b)(1)(B)1 of the regulation, the problem of asset management services provided to a business entity for its own benefit is addressed. The receipts derived from providing such services would be presumed to be assignable to the business entity's mailing address, or its principal place of business if known to the service provider.

The problem of flexibility in assigning receipts derived from an entity that is not the beneficial owner is addressed in subsections (b)(1)(B)1 and (b)(1)(B)2, which have been revised to allow greater flexibility in the assignment of these receipts. Subsection (b)(1)(B)1, as revised pursuant to the 15-day change Notice, now reads:

> In the case of asset management services directly or indirectly provided to a pension plan, retirement account or institutional investor, such as private banks, national and international private investors, international traders or insurance companies, receipts shall be assigned to this State to the extent the domicile of the beneficiaries of the plan, beneficiaries of the account or beneficiaries of the similar pool of assets held by the institutional investor, is in California. If the individual domiciles of the beneficiaries are not available, a mutual fund service provider may utilize any reasonable basis in order to determine the domiciles of the individual beneficiaries, including information based on zip codes or other statistical data.

Subsection (b)(1)(B)2, as revised pursuant to the 15-day change Notice, also mirrors this change by striking the word "statistically", which could be seen as confusing and unnecessarily limiting the use of any reasonable method. Subsection (b)(1)(B)2 provides:

> In the event the domicile of the beneficiaries is not or cannot be obtained, and the taxpayer cannot devise a reasonable method to approximate this information ~~statistically~~, the receipts shall be disregarded for purposes of the sales factor.

This should provide the greater flexibility requested. No further changes are necessary.

4. Section (b)(1)(D), which addresses throwback, states that if receipts are assigned "to a state where no members of the mutual fund services provider's unitary group are taxable, these receipts shall not be assigned to that state". This should be clarified to define the term "taxable" to include states where the taxing jurisdiction has the ability to levy a tax but chooses not to do so. The term "taxable" should also include states that impose a franchise tax, such as Texas, capital taxes, such as Delaware, or gross receipts taxes, such as in Washington state.

Response:

This was always the intention of the regulation. To clarify this, the regulation, as revised pursuant to the 15-day change Notice, now reads:

> If the shareholder ratio calculated under section (b)(1)(A) <u>or asset management services assigned under (b)(1)(B</u>) of this regulation assigns receipts to a state where no members of the mutual fund service provider's unitary group are taxable <u>as defined in Section 25122</u>, these receipts shall not be assigned to that state. Instead, these receipts shall be assigned to the location of the income producing activity that gave rise to the receipts, as determined under Revenue and Taxation Code section 25136.

The new reference to RTC section 25122 will incorporate that section's definition of "taxable in another state," which would include, as taxable, all of the states where the state would have jurisdiction to subject a member of the unitary group to a net income tax, regardless of whether that state does or does not choose to do so.

5. The commentator requests language to allow an election such that, if an effective date is chosen, the regulation can still be applied to earlier years.

Response:

An effective date of January 1, 2007, is now included in new subsection (c) of the revised regulation. However, this does not make an election necessary. The taxpayer can still request relief under the authority of RTC section 25137 to address issues of distortion in their individual fact pattern. This should suffice. No further change is necessary.

<u>Comment by Allianz of America Corporation received January 12, 2007</u>

This comment is a general defense of the need for the regulation in issue and is primarily a response and rebuttal to the comments made by Federated Investors. As the position set forth in this comment is generally consistent with the position of the

Franchise Tax Board staff, there is no need to respond to the comment further. It is, however, extremely helpful to have third party input analyzing the comments of another third party, as it provides additional insight into the propriety of the comments received.

Comment by Silverstein and Pomerantz LLP dated January 16, 2007

1. Franchise Tax Board has the authority to promulgate a regulation under section 25137 that addresses the proper apportionment methodology for mutual fund service providers. There is no "clear and convincing" evidence standard that must be met by the Franchise Tax Board, and the evidence supporting the need for the regulation, that has been provided by the industry as well as developed by Franchise Tax Board, is more than adequate to support the need for the regulation.

   Response:

   This comment is generally consistent with the views of the hearing officer. No further comment is necessary.

2. The regulation should not be revised to include an income threshold. Currently, the regulation applies to all mutual fund service providers. There is no need to adjust this to include only mutual fund service providers who receive more than 50% of their gross income from providing these services. This suggestion, made by some parties at the hearing, should be rejected. The use of a 50% threshold is inconsistent with most other states that have gone to a shareholder location approach. Furthermore, such an approach is inconsistent with the goal of achieving the most accurate reflection of the taxpayer's activities in the state and could in fact lead to manipulation on the part of some taxpayers.

   Response:

   The regulation was not revised to include a 50% threshold for precisely the reasons stated in the comment. No further action is necessary.

Comment by Jeffrey Vesely of Pillsbury Winthrop Shaw Pittman for Franklin Resources Inc. dated January 16, 2007

1. The regulation is consistent with UDITPA and sections 25136 and 25137. The FTB is authorized under section 25137 to adopt an alternative apportionment methodology. The methodology chosen reflects the market and therefore is consistent with the purposes of the sales factor, to act as a counterbalance to the payroll and property factors and reflect the activity in the market states. The use of section 25137 to correct problems in the application of section 25136 was specifically endorsed by writers at the time that UDITPA was adopted.

Response: This comment is consistent with the position of the hearing officer. No further response is necessary.

2. The proposed regulation is not inconsistent with California law concerning sales throwback. The cases that reflect the use of the Joyce methodology all involved section 25135 and not section 25136 or 25137. Finnigan, the methodology applied in the regulation, is not overruled by the case law; rather a choice was made to use a different method going forward. In fact, the SBE and the courts have commented that Finnigan rests on "theoretically good reasons". Under section 25137, the Franchise Tax Board is free to adopt Finnigan, and in this regulation, the Finnigan methodology better suits the industry in question.

Response: This comment is consistent with the position of the hearing officer. No further response is necessary.

3. The FTB staff has satisfied the requisite evidentiary standards under section 25137. The staff's qualitative review of the industry, as well as the actions of many other states in changing the rules for this industry, demonstrate that an unusual fact situation exists such that the FTB can regulate under section 25137.

Response: This comment is consistent with the position of the hearing officer. No further response is necessary.

4. The proposed regulation fosters uniformity. The trend in the other states is to move towards a market approach. This is precisely what the regulation provides.

Response: This comment is consistent with the position of the hearing officer. No further response is necessary.

Comment from Joanne Garvey of HellerEhrman LLP on behalf of Barclays Global Investors, dated January 16, 2007.

This comment contains responses to comments made by other commentators at the regulatory hearing. As such it provides useful perspective to the hearing officer regarding the proper weight to be placed on the various comments made by the parties. However, these comments do not directly address the regulation and therefore no response is necessary. There are other specific comments that do require a response.

1. The definition of "domicile" contained in subsection (a)(4) should be amended to specifically address asset management services.

Response:

The domicile issue is now addressed in amended subsection (a)(4), as revised pursuant to the 15-day change Notice, which now includes subsection (a)(4)(B), which provides:

> The domicile of a beneficial owner of assets managed by a mutual fund service provider shall be presumed to be the beneficiary's mailing address on the records of the entity for whom the asset management services are rendered, or on the records of the mutual fund service provider. If the entity for whom the asset management services are rendered, or the mutual fund service provider, has actual knowledge that the beneficiary's primary residence or principal place of business is different than the beneficiary's mailing address, the presumption does not control. Owners of record that are not the beneficial owner are subject to the special rule contained in subsection (b)(1)(B)1 of this regulation.

2. Regulation section (a)(7), which defines asset management services, should be amended to make clear that the definitions of "administrative services", Distribution services" and Management services" contained in (a)(1), (a)(2) and (a)(3) are applicable to asset management activities.

Response:

Subsection (a)(7), as revised pursuant to the 15-day change Notice, is amended to read:

> (7) "Asset management services" means the direct or indirect provision of management, distribution or administrative services to entities other than regulated investment companies, if those services would be management, distribution or administrative services within the meaning of subparagraphs (a)(1), (a)(2), or (a)(3) of this regulation, if provided directly or indirectly to a regulated investment company.

No additional changes are required.

3. Section (b)(1)(A)1 should be revised to allow for greater flexibility. The rule should allow for the use of any reasonable method for determining the domicile of the underlying beneficial owners.

Response:

This section, as revised pursuant to the 15-day change Notice, now provides:

> If the domicile of a ~~given individual~~ shareholder is unknown to the mutual fund service provider because the shareholder of record is a

> person that holds the shares of a regulated investment company as depositor for the benefit of ~~a separate account~~ others, the mutual fund service provider may utilize any reasonable basis ~~derived from information that it receives from the shareholder of record~~, such as the zip codes of underlying shareholders, in order to determine the proper location for the assignment of these shares. If no information is ~~available~~ obtained such that a reasonable basis can be developed to determine the proper location for the assignment of these shares, ~~from the shareholder of record~~, then all of the shares held by the shareholder of record shall be disregarded in computing the shareholder ratio for the fund in issue.

This should provide the requisite level of flexibility to the services providers. No further change is necessary.

4. Subsection (b)(1)(A)2 should be amended to provide greater flexibility for the taxable year used in computing the shareholder ratio. The taxable year of the mutual fund service provider should be an allowable alternative.

Response:

The regulation, as revised pursuant to the 15-day change Notice, provides this additional flexibility and now states:

> The regulated investment company's taxable year for computing the shareholder ratio shall be either the taxable year that ends during the taxable year of the principal member of the mutual fund service provider's combined reporting group or the taxable year of the principal member of the mutual fund service provider's combined reporting group. Once a method for computing the shareholder ratio is chosen, that methodology should be applied consistently in later years.

No further change is necessary.

5. Revise section (b)(1(B) to provide great flexibility in the method of determining the domiciles of beneficial owners of the assets held by entities receiving services form the asset managers. The comment suggests its own language for accomplishing this greater flexibility.

Response:

The flexibility sought is found in the revised regulation. The subsection, as revised pursuant to the 15-day change Notice, now reads:

> In the case of asset management services directly or indirectly provided to a pension plan, retirement account or institutional investor, such as private banks, national and international private investors, international traders or insurance companies, receipts shall be assigned to this State to the extent the domicile of the beneficiaries of the plan, beneficiaries of the account or beneficiaries of the similar pool of assets held by the institutional investor, is in California. <u>If the individual domiciles of the beneficiaries are not available, a mutual fund service provider may utilize any reasonable basis in order to determine the domiciles of the individual beneficiaries, including information based on zip codes or other statistical data.</u>

This should provide all of the flexibility needed to comply with the requirements of the subsection.

6. Expand subsection (b)(1)(C) to make clear that the Finnigan methodology will be applied to asset management services receipts as well as mutual fund services receipts.

Response:

The subsection, as revised pursuant to the 15-day change Notice, is amended to address the comment. As revised, the subsection now reads:

> If a mutual fund service provider has non-taxpayer members that are providing management, distribution or administration services to or on behalf of a regulated investment company with shareholders in this State, <u>or that are providing asset management services directly or indirectly for beneficiaries who are domiciled in this State</u>, the receipts from these activities that are assigned to the numerator of the sales factor by virtue of this regulation shall be included in the numerator of the sales factor in determining the unitary group's business income apportionable to this State, even though the specific entity that performed the services in not a taxpayer in this State.

No further changes to the regulation are necessary.

7. Clarify subsection (b)(1)(C)1d to provide that the normal sales factor rules will apply to sales not addressed by the regulation and that these sales will be included in the sales factor.

Response:

This change has been incorporated into the regulation, as revised pursuant to the 15-day change Notice, as follows:

> d. The taxpayer member's California sales factor is a fraction, the numerator of which is the California sales of that taxpayer member, determined under <u>sections 25133 through 25137 of the Revenue and Taxation Code and the regulations adopted pursuant thereto and as modified by</u> this regulation, and the denominator of which is the total sales of the group everywhere.

8. The throwback provision in section (b)(1)(D) runs counter to the purpose of adopting a market-based approach to assigning receipts and should be deleted. If it is not deleted, it needs to be revised to explicitly contemplate other states where shareholder ratio is assigning receipts.

Response:

The regulation, as revised pursuant to the 15-day change Notice, addresses this comment. Subsection (b)(1)(A) now requires that the ratio be developed for all states, not just California, and now reads:

> Sales Factor. For purposes of determining the numerator of the sales factor:
> (A) Receipts from the direct or indirect provision of management, distribution or administration services to or on behalf of a regulated investment company are assigned by the use of a shareholder ratio. This ratio is calculated by multiplying total receipts for the taxable year from each separate regulated investment company for which the mutual fund service provider performs management, distribution or administration services by a fraction, the numerator of which is the average of the number of shares owned by the regulated investment company's shareholders domiciled in ~~this~~ <u>the</u> State at the beginning of and at the end of the regulated investment company's taxable year, and the denominator of which is the average of the number of the shares owned by the regulated investment company's shareholders everywhere at the beginning of and at the end of the regulated investment company's taxable year.

This change, coupled with the language of subsection (b)(1)(D) which, as revised pursuant to the 15-day change Notice, states:

> If the shareholder ratio calculated under section (b)(1)(A) <u>or asset management services assigned under (b)(1)(B)</u> of this regulation assigns receipts to a state where no members of the mutual fund service provider's unitary group are taxable <u>as defined in Section 25122</u>, these receipts shall not be assigned to that state. Instead,

> these receipts shall be assigned to the location of the income producing activity that gave rise to the receipts, as determined under Revenue and Taxation Code section 25136.

should make it clear that the ratio in subsection (b)(1)(A) is calculated for all states in order for the throwback rule to function properly.

The comment also states that the throwback rule should be eliminated. This comment is rejected. There is a clear need for throwback in the regulation in order to meet another goal of the UDITPA, that 100 percent of the taxpayer's income (no more or less) is assigned to jurisdictions where the taxpayer is taxable, whether a jurisdiction chooses to tax the income or not. Throwback is therefore found in UDITPA itself (RTC section 25135) as well as numerous special industry regulations promulgated under RTC section 25137.

Comments by Dr. William G. Hamm of LECG Corporation received on December 14, 2006 and January 15, 2006, also submitted orally at the December 18 hearing.
(Included in Comments made by Federated Investors on these dates.)

Dr. Hamm provided a comment that did not directly relate to language of the proposed regulation, but rather questioned the revenue estimate of the regulation. His initial analysis was that the regulation would cause an annual $370 million loss to the state if it were to be adopted. This effect is at odds with FTB's analysis that the regulation would produce a $10 million annual gain for the state. Phil Spilberg, of the FTB Economic and Statistical Research Bureau, responded to this comment during the regulation hearing. After the hearing, and after considering Mr. Spilberg's comments, Dr. Hamm submitted a revised report in which he changed his revenue effect to an annual loss of $107 million.

As this comment does not address the regulation itself, the hearing officer has no response to the comment beyond what was provided orally by Mr. Spilberg at the hearing.

Comment by Forward Observer dated January 16, 2007

Allianz of America, Barclays Global Investors, Capital Group, and Franklin Templeton (four California-based MFSPs) hired Dr. Philip Romero of Forward Observer to provide an estimate of the fiscal impact of this regulation. This was done in response to a fiscal impact analysis performed by Dr. William Hamm of LECG Corporation. Dr. Hamm was hired by Federated Investors to perform an analysis of the regulation's impact on the state's general fund revenues.

The analysis performed by Forward Observer is consistent with the revenue estimate performed by the Franchise Tax Board and refutes the estimate of LECG that the regulation will result in a large revenue loss.

As there is no specific comment regarding the regulation itself, there is no need to respond to the comment or its analysis.

<u>Comments by John McBeth, Senior Tax Counsel for Franklin Templeton Investments dated January 16, 2007</u>

This comment is a response to the economic analysis performed by Dr. Hamm of LECG for Federated Investors. The comment refutes many of the underlying assumptions made in the calculation of the economic effect of the regulation in regards to state general fund revenues. The commentator urges that the Franchise Tax Board's economic analysis be relied upon as a better measure of the impact of the regulation.

Response:

While the comments provide helpful information to the hearing officer in regards to the validity of the methodology utilized by Dr. Hamm, they do not address the regulation itself; therefore no response to the comment is necessary.

<u>Comments By Julie Coleman Manth, Vice President of Treasury Operations for Capital Group Companies, dated January 16, 2007</u>.

This comment is also in response to the economic impact analysis performed by Dr. Hamm. The commentator states that Dr. Hamm's analysis used assumptions that are inaccurate. This leads to a vast overstatement of the effect of the regulation. The economic analysis of the Franchise Tax Board should be the one relied upon in assessing the impact of the regulation.

Response:

This comment is not directed to the regulation itself and therefore there is no need for a response.

<u>Comments received in response to the 15-day Notice</u>

There were four comments received in response to the changes made in the 15-day Notice mailed on February 21, 2007. Of those four comments, the comments from Barclays Global Investors, Franklin Templeton Investments and The Capital Group were all positive responses and made no comments regarding any of the changes. The fourth comment received was from Investment Company Institute (ICI), which maintained its opposition to the throwback rule contained in the regulation. There was also one additional comment in ICI's response:

1. The FTB should clarify that the throwback rule does not apply in situations where a taxpayer is subject to a state's taxing jurisdiction, regardless of whether a state chooses to impose a tax.

Response:

The regulation, as revised pursuant to the 15-day change Notice, contains such clarification in subsection (b)(1)(D), which provides:

> If the shareholder ratio calculated under subsection (b)(1)(A) <u>or asset management services assigned under (b)(1)(B)</u> of this regulation assigns receipts to a state where no members of the mutual fund service provider's unitary group are taxable <u>as defined in Section 25122</u>, these receipts shall not be assigned to that state. Instead, these receipts shall be assigned to the location of the income producing activity that gave rise to the receipts, as determined under Revenue and Taxation Code section 25136.

The new reference to RTC section 25122 will incorporate that section's definition of "taxable in another state," which would include, as taxable, all of the states where the state would have jurisdiction to subject a member of the unitary group to a net income tax, regardless of whether the state does or does not choose to do so.

TITLE 18. FRANCHISE TAX BOARD
AMENDMENTS TO PROPOSED
REGULATION SECTION 25137-14, RELATING TO
MUTUAL FUND SERVICE PROVIDERS

A hearing was held on December 18, 2006, by Carl A. Joseph of the Franchise Tax Board Legal Department, the "hearing officer," on proposed new Regulation Section 25137-14, which was noticed in the California Regulatory Notice Register on October 27, 2006. Section 25137 of the Revenue and Taxation Code authorizes the Franchise Tax Board to promulgate regulations regarding alternative apportionment methodologies. The indicated regulations, if adopted, would provide rules for the apportionment of income of mutual fund service providers.

After department staff reviewed the regulations and considered the comments submitted at and before the hearing, the hearing officer recommends that certain amendments to the proposed regulations be made for purposes of clarity and to insert clear language regarding the effective date of the regulation. These nonsubstantial changes (within the meaning of Govt. Code Section 11346.8) and sufficiently related changes (within the meaning of Govt. Code Section 11346.8) recommended by the hearing officer are reflected in the attachment hereto. Deletions to the indicated regulations are reflected by strikeout, and additions to the regulations are reflected by underscore. The proposed changes are summarized below:

1. Subsection (a)(3), the definition of management services, is revised to clarify that the mutual fund service provider is providing the service of selling or purchasing assets for the RIC rather than buying and selling for its own account. Comments were received that this needed clarification.

> (3) "Management services" include, but are not limited to, the rendering of investment advice, directly or indirectly, to a regulated investment company, making determinations as to when sales and purchases of securities are to be made on behalf of the regulated investment company or <u>providing services related to</u> the selling or purchasing of securities constituting assets of a regulated investment company, and related activities. Services qualify as management services only when such activity or activities are performed pursuant to a contract with the regulated investment company entered into pursuant to 15 United States Code, Section 80a-15(a), as amended, for a person that has entered into such a contract with the regulated investment company or for a person that is affiliated with a person that has entered into such a contract with a regulated investment company.

2. The definition of "domicile" contained in subsection (a)(4) was not clear in how it would apply to customers who were being provided asset management services. Therefore, the definition of "domicile" contained in subsection (a)(4) is split into two sections; one for shareholders in a RIC, and the other for beneficiaries who are receiving asset management services. Prior to the change, there was no clear

definition of domicile for asset management services. The sales factor assignment section for asset management did not speak in terms of domicile. This was seen as confusing. Comments were also received that the two sales factor sections should parallel each other.

Also, a change is being made in the subsection (a)(4)(A) definition of domicile to expand the scope of possible shareholders subject to the rules contained in subsection (b)(1)(A)1. This change was requested because it was pointed out that some corporate entities own shares for themselves, and not for the benefit of others, and therefore could be assigned to a principal place of business address rather than under the special rules.

(4) "Domicile" is defined as follows:

> <u>(A) The domicile</u> of a shareholder of a regulated investment company is presumed to be the shareholder's mailing address on the records of the regulated investment company or the mutual fund service provider. If the regulated investment company or the mutual fund service provider has actual knowledge that the shareholder's primary residence or principal place of business is different than the shareholder's mailing address, the presumption does not control. Shareholders of record that <u>own shares for the benefit of others</u> ~~are not individuals~~ are subject to the special rule contained in subsection (b)(1)(A)1. of this regulation.
>
> <u>(B) The domicile of a beneficial owner of assets managed by a mutual fund service provider shall be presumed to be the beneficiary's mailing address on the records of the entity for whom the asset management services are rendered, or the records of the mutual fund service provider. If the entity for whom the asset management services are rendered, or the mutual fund service provider, has actual knowledge that the beneficiary's primary residence or principal place of business is different than the beneficiary's mailing address, the presumption does not control. Owners of record that are not the beneficial owner are subject to the special rule contained in subsection (b)(1)(B)1 of this regulation.</u>

3. Subsection (a)(7) changed to make it clear that the definitions of management, distribution or administrative services contained in subsections (a)(1), (a)(2) and (a)(3) also apply to asset management services. Before this change, it was not clear that the same definitions applied.

(7) "Asset management services" means the direct or indirect provision of management, distribution or administrative services to entities other than regulated investment companies, <u>if those services would be management, distribution or administrative services within the meaning of subsections</u>

(a)(1), (a)(2), or (a)(3) of this regulation, if provided directly or indirectly to a regulated investment company.

4. Subsection (b)(1)(A) is modified in order to clarify that the ratio calculation should be performed for *all* states and not just California. It is necessary to clarify this because the throwback provision in subsection (b)(1)(D) only applies to states where the ratio is assigning receipts. If the ratio only were calculated for California, this section would never apply.

(A) Receipts from the direct or indirect provision of management, distribution or administration services to or on behalf of a regulated investment company are assigned by the use of a shareholder ratio. This ratio is calculated by multiplying total receipts for the taxable year from each separate regulated investment company for which the mutual fund service provider performs management, distribution or administration services by a fraction, the numerator of which is the average of the number of shares owned by the regulated investment company's shareholders domiciled in ~~this~~ the State at the beginning of and at the end of the regulated investment company's taxable year, and the denominator of which is the average of the number of the shares owned by the regulated investment company's shareholders everywhere at the beginning of and at the end of the regulated investment company's taxable year.

5. Subsection (b)(1)(A)1 is modified to make it apply to all shareholders and not just individuals. Comments were received that this subsection was confusing because the term "individual shareholder" was used to mean "a single shareholder" when the term "individual" is later used to describe a human being, as opposed to a corporation. Also the term "benefit of others" is included to replace "benefit of a separate account". This was done to be consistent with the change in subsection (a)(4)(A) set forth above. This subsection is further modified to take out the limitation that information used to develop a reasonable assignment mechanism must come from the shareholder of record. It was suggested that this was too limiting and that information may come from sources other than the shareholder of record. Also, an additional change was made to remove the term "available" and replace it with "obtained". Available, it was argued, is too subjective.

1. If the domicile of a ~~given individual~~ shareholder is unknown to the mutual fund service provider because the shareholder of record is a person that holds the shares of a regulated investment company as depositor for the benefit of ~~a separate account~~ others, the mutual fund service provider may utilize any reasonable basis ~~derived from information that it receives from the shareholder of record~~, such as the zip codes of underlying shareholders, in order to determine the proper location for the assignment of these shares. If no information is ~~available~~ obtained such that a reasonable basis can be developed to determine the proper location for the assignment of these shares ~~from the shareholder of record~~, then all of the shares held by the

shareholder of record shall be disregarded in computing the shareholder ratio for the fund in issue.

6. Subsection (b)(1)(A)2 is modified to allow greater flexibility, as requested by commenters, such that the ratio can be calculated either on the RIC's year end or the mutual fund service provider's year end. In addition, language is added to require that the chosen method be consistently applied in subsequent years.

2. The regulated investment company's taxable year for computing the shareholder ratio shall be either the taxable year that ends during the taxable year of the principal member of the mutual fund service provider's combined reporting group or the taxable year of the principal member of the mutual fund service provider's combined reporting group. Once a method for computing the shareholder ratio is chosen, that methodology should be applied consistently in later years.

7. Subsection (b)(1)(B) is modified to be consistent with the new definition of domicile, which uses the term "beneficial owner" instead of "individual."

(B) If a mutual fund service provider has receipts from performing asset management services, in addition to performing services for regulated investment companies, these services shall be assigned to this state if the domicile of the ~~individual owning~~ beneficial owner of the assets is located in this state.

8. Subsection (b)(1)(B)1. is modified to be consistent with the change made in (b)(1)(A)1.

1. In the case of asset management services directly or indirectly provided to a pension plan, retirement account or institutional investor, such as private banks, national and international private investors, international traders or insurance companies, receipts shall be assigned to this State to the extent the domicile of the beneficiaries of the plan, beneficiaries of the account or beneficiaries of the similar pool of assets held by the institutional investor, is in California. If the domiciles of the beneficiaries are not available, a mutual fund service provider may utilize any reasonable basis in order to determine the domiciles of the individual beneficiaries, including information based on zip codes or other statistical data.

9. Subsection (b)(1)(B)2 is modified because input was received that the term "statistically" was confusing and unnecessary, so the term is being deleted.

2. In the event the domicile of the beneficiaries is not or cannot be obtained, and the taxpayer cannot devise a reasonable method to approximate this information ~~statistically~~, the receipts shall be disregarded for purposes of the sales factor.

10. Subsection (b)(1)(C) is modified to make it clear that the section applies to both services provided to RICs and asset management services provided by the mutual fund service providers.

> (C) If a mutual fund service provider has non-taxpayer members that are providing management, distribution or administration services to or on behalf of a regulated investment company with shareholders in this State, or that are providing asset management services directly or indirectly for beneficiaries who are domiciled in this State, the receipts from these activities that are assigned to the numerator of the sales factor by virtue of this regulation shall be included in the numerator of the sales factor in determining the unitary group's business income apportionable to this State, even though the specific entity that performed the services in not a taxpayer in this State.

11. Subsection (b)(1)(C)1(d) is clarified pursuant to a comment that this section was unclear regarding whether sales made by a mutual fund service provider that were not addressed under the regulation could still be included in the sales factor of the mutual fund service provider. This was always staff's intention, as set forth in subsection (b), but staff agrees that this change provides greater clarity.

> The taxpayer member's California sales factor is a fraction, the numerator of which is the California sales of that taxpayer member, determined under Sections 25133 through 25137 of the Revenue and Taxation Code and the regulations adopted pursuant thereto and as modified by this regulation, and the denominator of which is the total sales of the group everywhere.

12. Subsection (b)(1)(D) is modified to match the addition made in subsection (b)(1)(C) to insert asset management services into the section.

> (D) If the shareholder ratio calculated under section (b)(1)(A) or asset management services assigned under (b)(1)(B) of this regulation assign~~s~~ receipts to a state where no members of the mutual fund service provider's unitary group are taxable, these receipts shall not be assigned to that state. Instead, these receipts shall be assigned to the location of the income producing activity that gave rise to the receipts, as determined under Revenue and Taxation Code section 25136.

13. In addition, subsection (b)(1)(D) is further modified to tie the definition of "taxable" to the definition found in Revenue and Taxation Code section 25122. This was requested by comment in order to clarify the term. This was already staff's interpretation of the regulation, under the language in subsection (b), and this simply provides clarity.

> (C) If the shareholder ratio calculated under subsection (b)(1)(A) or asset management services assigned under (b)(1)(B) of this regulation assign~~s~~ receipts to a state where no members of the

mutual fund service provider's unitary group are taxable as defined in Revenue and Taxation Code section 25122, these receipts shall not be assigned to that state. Instead, these receipts shall be assigned to the location of the income producing activity that gave rise to the receipts, as determined under Revenue and Taxation Code section 25136.

14. Section (c) is added to set forth that the regulation is applicable to taxable years beginning on or after January 1, 2007. It was requested that staff include an effective date in the regulation and the January 1, 2007 date is reasonable as the process of regulating was well under way by this date.

(c) This regulation is applicable to taxable years beginning on or after January 1, 2007

These nonsubstantial and sufficiently related changes are being made available to the public for the 15-day period required by Government Code section 11346.8(c) and Section 44 of Title 1 of the California Code of Regulations. Written comments regarding theses changes will be accepted until 5:00 p.m. on March 12, 2007.

A copy of the proposed amendments is being sent to all individuals who requested notification of such changes, as well as those who attended the hearing and those who commented orally or in writing, and will be available to other persons upon request. All inquiries and written comments concerning this notice should be directed to Colleen Berwick (916) 845-3306, FAX (916) 845-3648, E-Mail: colleen.berwick@ftb.ca.gov, or by mail to the Legal Department, Attn: Colleen Berwick, P.O. Box 1720, Rancho Cordova, CA 95741-1720. This notice and the proposed amendment and adoption will also be made available at the Franchise Tax Board's website at http://www.ftb.ca.gov/.

Section 25137-14 is adopted to read:

§ 25137-14. Mutual Fund Service Providers and Asset Management Service Providers.

NOTE: The 15-day changes are shown in underscore for additions and strikeout for deletions.

(a) Definitions.

As used in this section, unless the context otherwise indicates, the following terms have the following meanings:

(1) "Administration services" include, but are not limited to, clerical, fund or shareholder accounting; participant record-keeping, transfer agency, bookkeeping, data processing, custodial, internal auditing, legal, and tax services performed for a regulated investment company. Services qualify as administration services only if the provider of such service or services during the taxable year also provides, or is affiliated with a person that provides, management or distribution services to the same regulated investment company during the same taxable year.

(2) "Distribution services" include, but are not limited to, the services of advertising, servicing, marketing or selling shares of a regulated investment company. The services of advertising, servicing or marketing shares qualify as distribution services only when the service is performed by a person who is, or in the case of a closed-end company was, either engaged in the business of selling regulated investment company shares or affiliated with a person that is engaged in the service of selling regulated investment company shares. In the case of an open-end company, such service of selling shares must be performed pursuant to a contract entered into pursuant to 15 United States Code, Section 80a-15(b), as amended.

(3) "Management services" include, but are not limited to, the rendering of investment advice, directly or indirectly, to a regulated investment company, making determinations as to when sales and purchases of securities are to be made on behalf of the regulated investment company or providing services related to the selling or purchasing of securities constituting assets of a regulated investment company, and related activities. Services qualify as management services only when such activity or activities are performed pursuant to a contract with the regulated investment company entered into pursuant to 15 United States Code, Section 80a-15(a), as amended, for a person that has entered into such a contract with the regulated investment company or for a person that is affiliated with a person that has entered into such a contract with a regulated investment company.

(4) "Domicile" is defined as follows:

(A) The domicile of a shareholder of a regulated investment company is presumed to be the shareholder's mailing address on the records of the regulated investment company or the mutual fund service provider. If the regulated investment company or the mutual fund service provider has actual knowledge that the shareholder's primary residence or principal place of business is different than the shareholder's mailing address, the presumption does not control. Shareholders of record that own shares for the benefit of others ~~are not individuals~~ are subject to the special rule contained in subsection (b)(1)(A)1 of this regulation.

(B) The domicile of a beneficial owner of assets managed by a mutual fund service provider shall be presumed to be the beneficiary's mailing address on the records of the entity for whom the asset management services are rendered, or on the records of the mutual fund service provider. If the entity for whom the asset management services are rendered, or the mutual fund service provider, has actual knowledge that the beneficiary's primary residence or principal place of business is different than the beneficiary's mailing address, the presumption does not control. Owners of record that are not the beneficial owner are subject to the special rule contained in subsection (b)(1)(B)1 of this regulation.

(5) "Mutual fund service provider" means any unitary business that derives income from the direct or indirect provision of management, distribution or administration services to or on behalf of a regulated investment company.

(6) "Regulated Investment Company" means a regulated investment company as defined in Section 851 of the Internal Revenue Code.

(7) "Asset management services" means the direct or indirect provision of management, distribution or administrative services to entities other than regulated investment companies, if those services would be management, distribution or administrative services within the meaning of subparagraphs (a)(1), (a)(2), or (a)(3) of this regulation, if provided directly or indirectly to a regulated investment company.

(b) Apportionment of Business Income. The property, payroll and sales factors of the apportionment formula for mutual fund service providers shall be computed pursuant to Sections 25128 through 25137 of the Revenue and Taxation Code and the regulations adopted pursuant thereto, except as provided in this regulation:

(1) Sales Factor. For purposes of determining the numerator of the sales factor:

(A) Receipts from the direct or indirect provision of management, distribution or administration services to or on behalf of a regulated investment company are assigned by the use of a shareholder ratio. This ratio is calculated by multiplying total receipts for the taxable year from each separate regulated investment company for which the mutual fund service provider performs management, distribution or administration services by a fraction, the numerator of which is the average of the number of shares owned by the regulated investment company's shareholders domiciled in ~~this~~ the State at the beginning of and at the end of the regulated investment company's taxable year, and the denominator of which is the average of the number of the shares owned by the regulated investment company's shareholders everywhere at the beginning of and at the end of the regulated investment company's taxable year.

1. If the domicile of a ~~given individual~~ shareholder is unknown to the mutual fund service provider because the shareholder of record is a person that holds the shares of a regulated investment company as depositor for the benefit of ~~a separate account~~ others, the mutual fund service provider may utilize any reasonable basis ~~derived from information that it receives from the shareholder of record~~, such as the zip codes of underlying shareholders, in order to determine the proper location for the assignment of these shares. If no information is ~~available~~ obtained such that a reasonable basis can be developed to determine the proper location for the assignment of these shares, ~~from the shareholder of record~~, then all of the shares held by the shareholder of record shall be disregarded in computing the shareholder ratio for the fund in issue.

2. The regulated investment company's taxable year for computing the shareholder ratio shall be either the taxable year that ends during the taxable year of the principal member of the mutual fund service provider's combined reporting group or the taxable year of the principal member of the mutual fund service provider's combined reporting group. Once a method for computing the shareholder ratio is chosen, that methodology should be applied consistently in later years.

(B) If a mutual fund service provider has receipts from performing asset management services, in addition to performing services for regulated investment companies, these services shall be assigned to this state if the domicile of the ~~individual owning~~ beneficial owner of the assets is located in this state.

1. In the case of asset management services directly or indirectly provided to a pension plan, retirement account or institutional investor, such as private banks, national and international private investors, international traders or insurance companies, receipts shall be assigned to this State to the extent the domicile of the beneficiaries of the plan, beneficiaries of the account or beneficiaries of the similar pool of assets held by the institutional investor, is in California. If the individual domiciles of the beneficiaries are not available, a mutual fund service provider may utilize any reasonable basis in order to determine the domiciles of the individual beneficiaries, including information based on zip codes or other statistical data.

2. In the event the domicile of the beneficiaries is not or cannot be obtained, and the taxpayer cannot devise a reasonable method to approximate this information ~~statistically~~, the receipts shall be disregarded for purposes of the sales factor.

(C) If a mutual fund service provider has non-taxpayer members that are providing management, distribution or administration services to or on behalf of a regulated investment company with shareholders in this State, or that are providing asset management services directly or indirectly for beneficiaries who are domiciled in this State, the receipts from these activities that are assigned to the numerator of the sales factor by virtue of this regulation shall be included in the numerator of the sales factor in determining the unitary group's business income apportionable to this State, even though the specific entity that performed the services in not a taxpayer in this State.

1. In lieu of the provisions contained in Regulation section 25106.5(c)(7)(B), the taxpayer member's property, payroll and sales factors are calculated as follows:

a. Each taxpayer member of the combined reporting group (and only the taxpayer members) determines its California property factor, payroll factor and sales factor.

b. The taxpayer member's California property factor is a fraction, the numerator of which is the California property of that member, and the denominator of which is the total property of the group everywhere. Property values are determined in accordance with Sections 25130 and 25131 of the Revenue and Taxation Code.

c. The taxpayer member's California payroll factor is a fraction, the numerator of which is that member's California payroll, determined under Section 25133 of the Revenue and Taxation Code, and the denominator of which is the total payroll of the group everywhere.

d. The taxpayer member's California sales factor is a fraction, the numerator of which is the California sales of that taxpayer member, determined under sections 25133 through 25137 of the Revenue and Taxation Code and the regulations adopted pursuant thereto and as modified by this regulation, and the denominator of which is the total sales of the group everywhere.

2. In lieu of the provisions contained in Regulation section 25106.5(c)(7)(C), the taxpayer member's California source combined report business income is then calculated as follows:

a. First, the taxpayer's California apportionment percentage is determined. It is the sum of that member's California payroll, property, and a doubled weighted sales factor (or a single weighted sales factor, if applicable), with that sum divided by either four or three (as applicable).

b. Next, the taxpayer member determines its intrastate apportionment percentage. That percentage is the ratio of the taxpayer member's California apportionment percentage to the sum of all of the California taxpayer members' California apportionment percentages.

c. Finally, the taxpayer member multiplies the group's California source combined report business income by its intrastate apportionment percentage to arrive at the taxpayer member's California source combined report business income.

(D) If the shareholder ratio calculated under section (b)(1)(A) or asset management services assigned under (b)(1)(B) of this regulation assign~~s~~ receipts to a state where no members of the mutual fund service provider's unitary group are taxable as defined in Section 25122, these receipts shall not be assigned to that state. Instead, these receipts shall be assigned to the location of the income producing activity that gave rise to the receipts, as determined under Revenue and Taxation Code section 25136.

(c) This regulation is applicable to taxable years beginning on or after January 1, 2007.

Note: Authority cited: Section 19503, Revenue and Taxation Code.
Reference: Section 25137, Revenue and Taxation Code.

Capital Group
Companies

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June 16, 2006

Mr. Carl Joseph
Franchise Tax Board, Legal Department
P.O. Box 1720
Rancho Cordova, CA 95741-1720

RE: Request for Comments on Discussion Draft of Regulation 25137-14

Dear Mr. Joseph:

Thank you for the opportunity to comment on discussion draft 25137-14. As previously noted in our submission prior to the symposium, The Capital Group Companies, Inc. ("CGC") fully supports the Franchise Tax Board Legal Department's efforts to provide an apportionment method that is suitable for the business of mutual fund service providers. We are in agreement with the FTB Legal Staff that the highly integrated business model used by the mutual fund industry is ideally suited to the shareholder residency market-based apportionment methodology as provided in the draft regulations.

We believe that the current cost of performance method in Reg. Sec. 25136 is distortive. It causes the sales factor to essentially duplicate the payroll and property factors instead of reflecting the market for the provider's services. As such, it unfairly discriminates against in-state mutual fund service providers. Overall, we feel that the draft regulations adequately correct the distortion in the current California apportionment rules faced by the industry. Also, the adoption of the shareholder-residency apportionment method will align California with 12 other states that have previously adopted this method. This will foster consistency in the treatment of the mutual fund industry across the states where most of the large mutual fund complexes are headquartered.

We appreciate the opportunity to provide feedback related to specific sections of the draft regulation which are discussed below.

Specific Comments on the Draft Regulation

Section (b)(1)(A) states that the fraction shall be determined by using the number of shares owned at the beginning of and at the end of the regulated investment company's taxable year. Taxable year is further defined in (b)(1)(A)(ii) as the regulated investment company's taxable year that ends during the taxable year of the principal member of the mutual fund service provider's combined reporting group.

The American Funds group of mutual funds comprises 29 different regulated investment companies which in aggregate have 10 different year ends. We currently obtain shareholder information for each of these funds based on the mutual fund service provider's taxable year end (June 30). It would be much more onerous for us to obtain these percentages 10 different months for each of the separate funds. However, we do understand that other fund complexes may calculate their apportionment ratio based on the method currently outlined in (b)(1)(A). We would suggest that either method should be acceptable and not result in any substantive distortion so long as it is consistently followed.

Therefore, we would suggest that (b)(1)(A) simply state "at the beginning of and at the end of the taxable year". Then, in section (b)(1)(A)(ii), taxable year can be defined as either (a) the regulated investment company's taxable year that ends during the taxable year of the principal member of the mutual fund service provider's combined reporting group **or** (b) the taxable year of the principal member of the mutual fund service provider's combined reporting group. This should also include language to make the election apply to all funds managed by the provider and irrevocable without permission of the FTB.

In a mutual fund, shares are held in an account where the recordkeeping is performed either by the mutual fund service provider or by a third party administrator (TPA). If the registration on the account denotes that the owner is an individual, business or governmental agency, tax-exempt entity, IRA or other type of entity where the ultimate beneficial owner is the registered/legal owner, then these shares should be sourced to the address of record within the shareholder's account. Section (a)(4) should apply to all of these types of accounts, however, the section states that shareholders of record that are not individuals are subject to the special rule contained in (b)(1)(A)(i). The special rule only addresses the depositor relationship with the underlying beneficial owner. This causes a large number of accounts such as a corporation or charitable foundation to be excluded from both definitions/rules. Therefore, the definition in (a)(4) should be adapted to refer only shareholders of record that own shares for the benefit of others (such as omnibus/street accounts, TPA's, and retirement plans) to the special rule.

If the registration on the account is a pension plan/401(k) plan/variable insurance type of account, then we would suggest that it would be appropriate to use a hierarchical approach for sourcing. First, the mutual fund service provider would be required to look through the intermediate vehicle to the underlying beneficial owners of the funds shares. Second, if unknown or impracticable to determine, then the mutual fund service provider should revert back to allocating revenue based on sourcing to the domicile of the plan sponsor similar to Maryland. Maryland law gives an example of a 401(k) plan for a company located in Ohio. The plan participants are unknown to the mutual fund, therefore the "customer" and associated receipts would be domiciled in Ohio. Lastly, the mutual fund service provider should be allowed to utilize any reasonable method for determining the residence of the beneficial owner.

The shares held in accounts where the recordkeeping is performed by the broker/dealer (a third party) are often called omnibus or street accounts. Information provided by the broker/dealer recordkeeper (such as zip codes) is used to identify the location of the underlying beneficial owner and source the ownership of these shares accordingly. If the broker/dealer or other TPA does not provide the information on the underlying beneficial owners, then these shares would be excluded from the calculation. This appears to be the type of account that is addressed in (b)(1)(A)(i).

Section (b)(1)(B) relates to the sourcing of revenues from other asset management services. This section relates to the institutional management business which for The Capital Group Companies, Inc. consists of managing assets for pension plans, foundations, state and local governments, college endowment funds, high net worth individuals and various other entities. This type of revenue requires a slightly different approach. First, if the client is not a pension type fund and does not have "underlying beneficiaries", then it should be sourced to the state of domicile of the business entity or individual (currently the regulation just states the domicile of the individual). Second, if it is a pension fund, then there should be a tiered approach similar to these types of shareholders in the mutual funds. This would require the asset manager to first source the revenues based on the underlying beneficiary's address if it is known. If unknown or impracticable to obtain, then the service provider should be able to use another reasonable alternative as described earlier in the memo. Lastly, section (b)(1)(B)(ii) states that revenue will be disregarded if the taxpayer cannot devise a reasonable method to approximate this information statistically. It would be helpful if you could provide further guidance as to the circumstances that lead to this approach. Assuming use of census data would generally be a reasonable approach, under what circumstances would it not be reasonable?

Section (b)(1)(D) states that if receipts are assigned "to a state where no members of the mutual fund service provider's unitary group are taxable, these receipts shall not be assigned to that state." We request that the term taxable is further defined to include 1) states where a taxpayer is subject to a state's taxing jurisdiction regardless of whether a state chooses to impose a tax (i.e. Nevada or South Dakota) and 2) states that impose taxes other than income taxes such as franchise taxes (Texas), capital taxes (Delaware) or gross receipts taxes (Washington B&O).

Lastly, if a future effective date is chosen, we request that taxpayers be able to elect to apply the regulation to earlier years. For example, if the regulation states that it is effective for tax years beginning after December 31, 2006, we would like to be able to elect to follow this regulation in our tax year beginning July 1, 2006 and ending June 30, 2007.

Again, thank you very much for the opportunity to comment on the draft regulation. We are encouraged by the direction of the FTB on this issue and would be happy to meet with you to discuss any additional queries you might have.

Very truly yours,

Julie M. Coleman Marth

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November 14, 2006

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Re: FTB Proposed Regulation 25137-14 Regarding Apportionment for Mutual Fund Service Providers

Dear Mr. Joseph:

This letter is submitted on behalf of Franklin Resources, Inc. in support of Proposed Regulation 25137-14. An alternative apportionment formula, as provided under the proposed regulation, is necessary to address the special apportionment issues that are unique to the mutual fund industry. In particular, by looking to the location of mutual fund shareholders for purposes of assigning sales of mutual fund service providers, Proposed Regulation 25137-14 remedies the distortion that arises under California's standard apportionment provisions as applied to the mutual fund industry. Throwback provisions, however, should be removed from the proposed regulation because they undercut the very purpose for adopting a special apportionment formula for mutual fund service providers and are inconsistent with the market-based approach of the sales factor. If Proposed Regulation 25137-14 includes throwback provisions, then the approach under *Finnigan*, rather than *Joyce*, should be adopted.

A. Proposed Regulation 25137-14 is Necessary to Address the Unique Features of the Mutual Fund Industry and the Distortion that Arises under California's Standard Apportionment Provisions.

1. The mutual fund industry has unique features that are not addressed by California's standard apportionment formula.

In general, retail mutual funds are investment vehicles that permit investors to pool resources, diversify investments and obtain professional investment advisory services. Investors in a mutual fund are fund shareholders who receive dividends and capital gain distributions from the fund. For income tax purposes, the mutual fund is a "pass-through" entity under Subchapter M of the Internal Revenue Code, relating to the income tax treatment of regulated investment companies and other pass-through vehicles.

Mutual fund shareholders have specific voting rights that include the right to elect directors, to approve material changes in the terms of the fund's contract with the fund's investment manager, and the right to approve any changes in the fundamental investment objectives of the fund. Shareholders also elect the fund's board of directors, which oversees the management of the business of the fund. Thus, mutual funds are independent investment vehicles owned by their shareholders and not by the various companies that provide investment advisory, distribution and other services to the mutual fund.

The principal services provided to a mutual fund for the benefit of the fund's shareholders include investment advice, share distribution, custodial functions, transfer agent services and general business management. The investment advisor manages the shareholder investments consistent with the goals of each particular fund. The distributor markets the funds and acts as the distribution agent for fund shares. Custodians provide oversight and safeguard portfolio securities. The transfer agent maintains records of shareholder accounts, calculates and disburses all payments to shareholders, and prepares and mails shareholder account statements, tax information and other shareholder statements and notices, as required by law. Transfer agents also maintain customer service departments that are charged with providing telephonic, paper and electronic information to shareholders in response to their inquiries.

One of the most significant characteristics of the mutual fund industry is the high degree of government regulation. The Securities and Exchange Commission ("SEC") regulates mutual funds under rules promulgated in accordance with the Investment Company Act of 1940 (the "1940 Act"). The 1940 Act provides rules and regulations that guide mutual funds through their day-to-day operations and imposes restrictions not only on mutual funds, but also on investment advisors, underwriters, directors, officers and employees of service organizations. For example, all fees charged by fund service providers are charged in accordance with contracts that are subject to detailed regulation by the SEC and other federal agencies.

In addition to the 1940 Act, mutual funds are subject to further government regulation under Subchapter M of the Internal Revenue Code, the Securities Act of 1933, the Securities Exchange Act of 1934 and the Investment Advisors Act of 1940. The Investment Advisors Act of 1940 requires all investment advisors to mutual funds to register with the federal government. This Act contains many antifraud provisions and authorizes the SEC to establish detailed rules governing mutual fund service companies regarding the marketing and advertising of funds, communications with shareholders, record keeping, the privacy of client information, and disclosures to investors, regulators and the general public of fund and individual shareholder information.

As a result of such regulation, mutual fund service companies—which include investment advisors, mutual fund distributors, shareholder servicing agents and business managers—usually conduct their business through separate corporate entities to handle specific service functions. Mutual fund service providers generally operate as a highly integrated, single unitary business. The integrated nature of mutual fund service companies, coupled with the distinct relationship between mutual funds and their shareholders and service providers, as described above, makes the mutual fund industry a unique industry. Currently, neither California's standard apportionment provisions nor the regulations thereunder specifically address the unique features of the mutual fund industry.

2. The standard apportionment formula, as applied to the mutual fund industry, results in distortion.

Section 25136 of the Revenue and Taxation Code[1] sets forth California's general rule on where gross receipts from sales of other than tangible personal property are assigned for purposes of determining the numerator of the sales factor. In general, under California's standard apportionment formula, the gross receipts from such sales are assigned to California if the "income-producing activity" is performed in this State.[2] If the income-producing activity is performed both in and outside California, then sales are in California if a greater proportion of the income-producing activity is performed in California than in any other state, based on costs of performance.[3] Thus, under Section 25136, gross receipts from services provided by mutual fund service providers are assigned to a single location based on where the majority of income-producing activities occurred.

Section 25136 is identical to section 17 of the Uniform Division of Income for Tax Purposes Act ("UDITPA"), which California has adopted. Frank Keesling and John Warren, commentators on UDITPA, have noted that the income-producing activity

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[1] Unless otherwise indicated, all statutory references are to the California Revenue and Taxation Code, and all regulatory references are to the California Code of Regulations, Title 18.

[2] Section 25136(a).

[3] Section 25136(b).

provisions are seriously deficient. Not only is the phrase "income-producing activity" vague and ambiguous, but also the provisions of UDITPA section 17 relating to the apportionment of sales where the income-producing activities take place in two or more states are "arbitrary and capricious to the point of possibly being unconstitutional."[4] Keesling and Warren further note that apportionment under UDITPA section 17, where the income producing activities take place in two or more states, will result in serious distortions in the allocation of income in so many instances that such provisions should be ignored and a more reasonable method of apportioning sales should be devised under the authority of the relief provisions [i.e., Section 25137 or UDITPA section 18]."[5]

The cost of performance provisions under Section 25136, when applied to mutual fund service providers, usually result in most, if not all, of their receipts being assigned arbitrarily to one location. In particular, under the cost of performance rule, most of the receipts of mutual fund service providers are assigned to the service provider's location. Application of the cost of performance rule in this situation results in distortion, because such rule completely ignores the relationship between the service provider and the fund shareholders, upon which the service provider's earnings crucially depend. In addition, as described in more detail below, an apportionment formula that assigns sales without giving due weight to the taxpayer's marketplace for its goods and services is contrary to the original purpose behind the sales factor and, in effect, replicates the property and payroll factors which give disproportionate weight to the taxpayer's physical location. Thus, California's standard apportionment provisions, when applied to the mutual fund industry, do not fairly reflect where and how mutual fund service providers earn their income. Relief under Section 25137 is required.

3. Proposed Regulation 25137-14 remedies the distortion caused by the standard apportionment formula and is consistent with the trend in other states.

Proposed Regulation 25137-14 remedies the above-described distortion by overriding the standard apportionment formula and assigning receipts of mutual fund service providers to the numerator of the sales factor based upon the location of the underlying shareholders of the mutual funds. By assigning such receipts to the location of the fund's shareholders, Proposed Regulation 25137-14 provides a fairer method of apportionment

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4 See Frank M. Keesling & John S. Warren, "California's Uniform Division of Income for Tax Purposes Act, Part II," 15 *UCLA L. Rev.* 655, 673 (1968) (hereinafter, "Keesling & Warren").

5 Keesling & Warren, p. 675.

because it better reflects the market for the providers of mutual fund services, and thus captures how and where mutual fund service providers earn their income.

One of the principal goals of UDITPA is to create uniformity among similarly situated taxpayers. California Revenue and Taxation Code Section 38006 provides that one of the purposes of the Multistate Compact, to which California subscribes, is the promotion of uniformity. The distinct trend among states in which mutual fund service providers have a significant physical presence is towards a market-based apportionment rule for mutual fund receipts, and away from the application of the cost of performance rule.[6] In furtherance of uniformity, California similarly should adopt a market-based apportionment method based on shareholder residence.

The absence of uniformity among states creates a competitive imbalance between mutual fund service providers that must compute their apportionment percentages using cost of performance in California verses service providers that have successfully petitioned their home states for relief and now compute their apportionment percentages using a market-based shareholder-residency formula. Additionally, California-based service providers are faced with apportionment within California based on cost of performance and outside California based on shareholder residence, creating the very real possibility of double taxation of the same receipts. Adoption by California of an apportionment formula based on shareholder residency should minimize any competitive imbalance and the potential for double taxation.

Furthermore, the presence of distortion in the calculation of sales receipts, coupled with both this competitive imbalance and the possibility of multiple taxation of receipts has convinced the Franchise Tax Board ("FTB") to grant a number of Section 25137 petitions in which the sales factor has been modified to use a market-based approach. Proposed Regulation 25137-14 would enable the FTB to take a more comprehensive and consistent approach to the mutual fund industry in the determination of sales apportionment for mutual fund service providers. In so doing, it will provide clear guidance to all mutual fund service providers on allowable apportionment methods, avoiding the difficulties that resulted in the issuance of FTB Notice 2004-5, relating to accuracy-related penalties

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[6] Currently 14 states have mutual fund apportionment rules that are based on the residence of fund shareholders: New York, Massachusetts, Missouri, New Jersey, Connecticut, Rhode Island, Kentucky, Maryland, Utah, Texas, Kansas, Maine, Georgia and Wisconsin. As a state with a significant mutual fund industry presence, California is alone in maintaining sales apportionment based on cost of performance.

arising from taxpayers' use of an alternative apportionment method pursuant to Section 25137.

In sum, Proposed Regulation 25137-14 should be adopted because it is necessary to remedy the distortion that arises when the standard apportionment formula is applied to the mutual fund industry, is consistent with the approach taken in major mutual fund states, promotes uniformity, avoids competitive imbalance and the potential for multiple taxation, and provides the clear guidance that is much needed in this area of California law.

B. Throwback Should Not be Applied.

As currently drafted, Proposed Regulation 25137-14 contains "throwback" provisions in which sales are assigned to the numerator of the California sales factor, depending on whether the entity making the sale, or any other member of the entity's unitary business, is taxable in a particular jurisdiction. Specifically, Subsection (b)(1)(C) of the proposed regulation provides that if a non-taxpayer member of a unitary business provides mutual fund services to a regulated investment company with California shareholders (e.g., "inbound sales"), the receipts from such services assigned to California by virtue of the regulation will be included in the sales factor numerator of the unitary business. Subsection (b)(1)(D) of Proposed Regulation 25137-14 provides that sales assigned, under the regulation, to a jurisdiction in which no member of the unitary business is taxable will be assigned on the basis of the standard apportionment rules under Section 25136 (e.g., "outbound sales").

The FTB, however, should not include any throwback rule in the proposed regulation. A throwback rule—whether for inbound or outbound sales—is inappropriate where income from services is involved. More importantly, such rule would undercut the very purpose for adopting a special apportionment formula for mutual fund service providers, since it is inconsistent with the market-based approach of the sales factor.

1. A throwback provision is inappropriate for the sale of services.

A throwback rule should not be applied to the sale of services. California's standard apportionment formula does not provide a throwback rule for services and the Revenue and Taxation Code does not support such a rule. As discussed above, Section 25136 sets forth the general rule that sales of services are assigned to a specific location based on where the income-producing activity occurred. Section 25136 plainly does not include a throwback provision, and no such provision is required.

By comparison, Section 25135 does include a throwback rule. However, Section 25135 applies specifically to the assignment of sales of tangible personal property—not services. Thus, even under the standard apportionment formula, a throwback rule does not apply to sales of services, such as those performed by mutual fund service providers.

2. A throwback rule thwarts the basic purpose of Proposed Regulation 25137-14, since it is inconsistent with a market-based approach.

Inclusion of a throwback rule in Proposed Regulation 25137-14 would undercut the basic purpose for adopting a special apportionment formula for the mutual fund industry. A throwback provision is distortive, because it essentially would restore a cost of performance rule and lead to the deficiencies described above. In particular, a throwback rule is fundamentally at odds with the purpose of the sales factor, which is to reflect the market for a taxpayer's goods and services.

California's allocation and apportionment provisions, Sections 25120 *et seq.*, are modeled after UDITPA. As such, it is helpful to review how commentators and courts in UDITPA jurisdictions have interpreted the pertinent statutory language and the general history of the inclusion of a sales factor in an apportionment formula.

A three-factor apportionment formula, comprised of property, payroll and sales, has been employed continuously in California since the inception of the corporate franchise tax measured by income in 1929.[7] In *Butler Brothers v. McColgan*, 17 Cal. 2d 664, 677 (1941), *aff'd*, 315 U.S. 501 (1942), the California Supreme Court upheld the use of the formula method and held that "allocation of income to the various states in which the business is done by means of a formula that gives weight to the various factors such as property, services of employees and sales, which are responsible for the earning of income, appears entirely reasonable." In 1966, California adopted UDITPA, which also used a three-factor apportionment formula.

In general, the property and payroll factors tend to be concentrated in the state or country where the taxpayer is based or where the business' principal facilities are located. As such, the primary reason for the sales factor "is to give weight to the obtaining of markets, thereby balancing to some extent the property and payroll factors which are apt to be heavily concentrated in the state or country where the production or manufacturing

[7] See Keesling & Warren, p. 655.

operations are located."[8] As noted by Professor Pierce, the principal draftsman of UDITPA, a sales factor that does not assign sales to the consumer state "would merely duplicate the property and payroll factors which emphasize the activity of the manufacturing states."[9]

Keesling and Warren have noted:

> [I]t may well be asked, why use the sales factor? The answer, which is, it is believed, adequate and even compelling, is that in many instances some factor such as sales is needed to balance the property and payroll factors. . . . If the reason for the use of the factor is to balance the other two factors, then obviously the sales should be apportioned in such a manner as to offset rather than aggravate the effects of the property and payroll factors. . . . [S]ales should, so far as possible, be apportioned to the state where the markets are found, from which the business is received, or where the customers are located. . . . Such an apportionment seems proper not only because that is the state where the services which result in the sales are performed, but also because that is the state where the customer is located and the business is obtained.[10]

California courts also have recognized the market-based approach to the sales factor. In *McDonnell Douglas Corporation v. Franchise Tax Board*, 26 Cal. App. 4th 1789 (1994), the California Court of Appeal considered the issue of which sales should be included in the sales factor.[11] Specifically, the Court considered whether the state should look to the place of delivery or the place of destination for purposes of the sales factor, where the goods are delivered to one state, but the buyer picks up the goods for destination in another state (*i.e.,* dock sales). After analyzing the origins of the sales factor and cases from various jurisdictions, the Court concluded that for purposes of computing the sales factor, the "destination" rule rather than the "place of delivery rule" should be applied.[12]

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[8] See *id.* at p. 670.

[9] William J. Pierce, "The Uniform Division of Income for State Tax Purposes," 35 *Taxes* 747, 780 (1957).

[10] George T. Altman and Frank M. Keesling, *Allocation of Income in State Taxation*, (New York: CCH, 1946), pp. 124, 126.

[11] Section 25135 of the California Revenue and Taxation Code contains the same language as UDITPA § 16(a).

[12] *McDonnell Douglas*, 26 Cal. App. 4th at 1796.

The Court explained that UDITPA has been interpreted to provide that sales "should be apportioned to the state or country of destination . . . ."[13] Furthermore, "the drafters . . . made a deliberate policy decision to recognize the contribution of the 'consumer' states to the production of income by allocating sales to those states that produce the buyer."[14]

In the present situation, inclusion of a throwback provision in Proposed Regulation 25137-14 would be contrary to the market-based approach of the sales factor. Indeed, a throwback rule would create the same distortion the proposed regulation is designed to correct, since it would fail to recognize the contribution of the consumer states that produced the buyers of mutual fund services. Finally, only a small minority of the states that have adopted a special apportionment method for mutual fund service providers have included a throwback provision. For all of the above reasons, the FTB should not adopt a throwback rule in the proposed regulation.

C. If Throwback is Adopted, *Finnigan*, not *Joyce*, Should be Applied.

If throwback provisions are to be included in Proposed Regulation 25137-14, then the approach in *Finnigan*,[15] and not *Joyce*,[16] should be adopted. In general, under a *Finnigan* approach, outbound sales into a destination state are thrown back to California if no member of the unitary business is taxable in that state; inbound sales are assigned to California so long as any member of the unitary business is taxable in this State. By comparison, under a *Joyce* approach, outbound sales are thrown back if the specific member making the sale is not taxable in the destination state; inbound sales are assigned to California only if the specific member is taxable in this State. Subsections (b)(1)(C) and (b)(1)(D) of the proposed regulation correctly adopt a *Finnigan* approach.

In contrast to *Joyce*, *Finnigan* furthers the fundamental purpose of the proposed regulation, is consistent with California's unitary business principle of income taxation and addresses the unique attributes of the mutual fund industry. Because the FTB is not bound to use a *Joyce* rule in fashioning a special industry apportionment regulation under

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[13] *Id.* (quoting Keesling & Warren, p. 671).

[14] *Id.* (quoting Reich, "Dock Sales—The New State Income Tax Battleground," 1 *J. St. Taxation* 42, 43 (1982)).

[15] *Appeal of Finnigan Corporation*, 88-SBE-022 (Aug. 25, 1988), *opinion on petition for rehearing*, 88-SBE-022A (Jan. 24, 1990).

[16] *Appeal of Joyce, Inc.*, 66-SBE-070 (Nov. 23, 1966).

Section 25137, a *Finnigan* approach should be used for both inbound and outbound sales if Proposed Regulation 25137-14 contains a throwback provision.

1. *Finnigan*, rather than *Joyce*, furthers the purpose of Proposed Regulation 25137-14.

Proposed Regulation 25137-14 has been drafted to address apportionment issues that are specific and unique to the mutual fund industry. As noted above, mutual fund service providers are heavily regulated. They usually conduct their business through separate corporate entities to perform specific fund services. Mutual fund service providers generally operate as a highly integrated, single unitary business. By looking to the activities of all mutual fund service providers, separately incorporated or not, that constitute a single unitary business, a *Finnigan* approach upholds the purpose for this proposed special industry regulation. On the other hand, a *Joyce* approach, which narrowly focuses on the activities of a single member of the unitary business, would ignore the special attributes of the mutual fund industry.

2. *Finnigan* is consistent with unitary principles.

In addition, *Finnigan* is consistent with the unitary business principle. In general, the unitary business principle applies to a taxpayer whose business activities are conducted as a unit or as a single whole in two or more states or taxing jurisdictions. *Handlery v. Franchise Tax Board*, 26 Cal. App. 3d 970, 975 (1972). The California Supreme Court held in *Butler Bros.*, 17 Cal. 2d at 673, "where a business is unitary in character, so that its separate parts cannot be fairly considered by themselves and the whole business in the several states derives a value from the unity of use, allocation of income upon a reasonable formula is properly sustained." In *Edison California Stores, Inc. v. McColgan*, 30 Cal. 2d 472 (1947), the Court extended the *Butler Bros.* rationale to separate corporate entities operating as a unitary business.

The unitary business principle essentially requires affiliates that are linked together as if they were a single entity engaged in an integrated line of business, to report their total California income and expense and then apportion the resulting income or loss to each of the members of the unitary group that are taxable in California. See *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 440 (1980). Unitary theory is intended to treat unitary groups of related companies as a single entity for purposes of calculating tax liability. *Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298, 312, n.10 (1994). The members of a unitary group should be "treated as units of a single business."

Colgate-Palmolive Co., Inc. v. Franchise Tax Board, 10 Cal. App. 4th 1768, 1774 (1992).

Unitary theory is premised on the idea that it is impossible to separately identify the true income and expenses for each entity within a particular unitary business. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 779 (1992). Neither items of income nor expenditures of the unitary group are traced to the particular unitary member from which they were generated. See *Appeal of The Signal Companies, Inc.*, 90-SBE-003 (Jan. 24, 1990).

The *Finnigan* rule is consistent with the foregoing unitary principles. Unlike *Joyce*, which narrowly focuses on a specific member of the unitary group, *Finnigan* looks to the entire unitary business for purposes of determining whether sales throwback applies. As the Board of Equalization ("SBE") stated in *Finnigan*, citing *Edison California Stores*, 30 Cal. 2d at 473, 480, "[t]he California Supreme Court has told us that as far as unitary theory is concerned the same rule should apply whether the integral parts of the unitary business are or are not separately incorporated."

In the context of mutual fund service providers, if throwback provisions are to be included in Proposed Regulation 25137-14, it is essential that the *Finnigan* rule be adopted in keeping with the unitary business principle. Again, a principal reason behind California's use of the unitary theory is to eliminate the impact that separate incorporations have on the state's tax base. As described above, one of the unique features of the mutual fund industry is that, due to the heavily regulated nature of the industry, mutual fund service providers generally conduct their unitary business operations through separate corporate entities. A *Finnigan* approach would consistently treat a mutual fund unitary business as an integrated whole, regardless of whether it is conducted through a single corporation with separate divisions or multiple corporations. On the other hand, a *Joyce* approach in this situation would create significantly different results in the mutual fund industry solely because of corporate structure. Thus, in contrast to *Joyce*, a *Finnigan* approach would be the more appropriate rule for the mutual fund industry due to the industry's unique characteristics.

3. *Joyce* is not the rule in California for any and all purposes.

It may be argued that if the proposed regulation includes throwback provisions, it should take a *Joyce* approach, because in 1999 the SBE in *Appeal of Huffy*[17] rejected *Finnigan* and readopted *Joyce*. However, such an argument is without merit, especially within the context of Section 25137 and this proposed regulation. First, *Huffy* did not overrule *Finnigan*. More importantly, there is no requirement that an alternative method of apportionment under Section 25137 must apply *Joyce* rather than *Finnigan* for sales factor purposes.

a. *Huffy* did not overrule *Finnigan*.

Although the SBE in *Huffy* did readopt the *Joyce* rule on a prospective basis, it did not overrule *Finnigan*. Indeed, the SBE applied *Finnigan* to the taxpayer at issue in *Huffy*. The taxpayer in *Huffy* was an Ohio corporation with two operating divisions and five subsidiaries, all of which constituted a single unitary business. While the taxpayer's retail services subsidiaries were subject to California tax, neither its two operating divisions nor its consumer product subsidiaries did any business in California. In *Huffy*, the SBE applied *Finnigan* to an inbound situation and concluded that sales made to California customers by the taxpayer's consumer products divisions/subsidiaries must be included in the numerator of the sales factor.

In contrast to *Finnigan*, which expressly overruled *Joyce*, the SBE in *Huffy* chose not to overrule *Finnigan*.[18] Instead, the SBE used *Huffy* as an opportunity to re-evaluate the continued application of the *Finnigan* rule in California. The SBE maintained that there were "theoretically good reasons" for the implementation of *Finnigan* in California. However, the SBE noted that, contrary to its initial expectations, other UDITPA states declined to follow California's lead in adopting a *Finnigan* interpretation of the sales factor numerator provisions. The SBE thus decided to readopt *Joyce* in an effort to

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[17] 99-SBE-005 (Apr. 22, 1999), as amended by 99-SBE-005-A (Sept. 1, 1999).

[18] In *Finnigan*, the SBE expressly overruled *Joyce* by holding that "[b]ased on all of these considerations, we have concluded that the apportionment rule announced in *Joyce* should be overruled." 88A-SBE-022-A (page 3). See *Appeal of The NutraSweet Company*, 92-SBE-024 (Oct. 29, 1992) ("Appellant's position in this case is based on our decision in the *Appeal of Joyce, Inc.*, which was decided by this board on November 23, 1966, but overruled, with respect to the issue now before us, on January 24, 1990, by our Opinion on Petition for Rehearing in the *Appeal of Finnigan Corporation*, 88-SBE-022-A.").

promote uniformity among UDITPA states— not because *Finnigan* was an erroneous decision.

The SBE's readoption of *Joyce* is not tantamount to a rejection of the underlying rationale of *Finnigan*. Indeed, the California Court of Appeal in *Citicorp North America, Inc. v. Franchise Tax Board*, 83 Cal. App. 4th 1403 (2000),[19] which was decided subsequent to *Huffy*, supports the *Finnigan* approach. At issue in *Citicorp*, an inbound case, was whether the California sales of the taxpayer's credit card affiliate in South Dakota, which was not taxable in California, should be included in the sales factor numerator of the taxpayer's unitary corporate group. The FTB contended that *Finnigan* should apply. The taxpayer argued that application of the *Finnigan* rule violated the UDITPA principle of uniformity and violated constitutional standards.

The *Citicorp* Court held in favor of the FTB and rejected the taxpayer's arguments. The Court affirmed the judgment of the trial court, which applied *Finnigan* and concluded that such sales should be included in the sales factor numerator of the taxpayer's combined report. The Court in *Citicorp*, 83 Cal. App. 4th at 1421, held:

> The Board [SBE] correctly stated that there were "theoretically good reasons for the initial implementation of the *Finnigan/NutraSweet* rule," but that the actual implementation did not result in the expected uniformity. Thus, after reviewing the state of the law in the years intervening between its decisions, the SBE returned to the *Joyce* rule without finding legal flaws in the *Finnigan* rule. *Finnigan* simply did not withstand the test of time.
>
> We find the SBE's decisions to be thorough and reasoned. The SBE launched the *Finnigan* rule in the expectation that it would be widely accepted. It adhered to the rule for over nine years, subsequently reevaluated its position in light of relevant intervening legal developments and changed its mind. All decisions were arrived at in an adversary forum, which presumes the existence of vigorous advocacy and careful consideration by a quasi-judicial decision-maker. There is no reason to reject the application of *Finnigan* merely because the SBE has recognized

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[19] On January 10, 2001, the California Supreme Court denied review of the Court of Appeal's decision in *Citicorp*.

> that the passage of time did not result in its expected acceptance by other states.

Thus, the Court held that "[m]erely pointing to the fact that the [SBE's] decision in *Finnigan* ultimately proved to be a minority position does not support Citicorp's challenge to the legality or constitutionality of the *Finnigan* interpretation of the relevant statute." *Id.* at 1418.[20]

The Court of Appeal confirmed the *Citicorp* decision in a subsequent unpublished decision in *Deluxe Corp. v. Franchise Tax Board*, Cal. Ct. App. Case No. A088142 (April 26, 2001). In *Deluxe*, also an inbound case, the Court held that the FTB properly applied *Finnigan* to include as California sales in the taxpayer's combined report the California sales of the taxpayer's wholly owned subsidiaries, even though they did not have taxable nexus to California. The Court reasoned that:

> Any need to analyze the myriad of arguments made by Deluxe in support of its position on appeal has been made unnecessary by [the Court's] recent decision in *Citicorp*, a case that mirrors the one before us. . . . In so ruling, the court considered and rejected the bulk of the arguments raised by Deluxe herein to the application of the *Finnigan* rule of apportionment. We hereby adopt the well-reasoned analysis of *Citicorp* and find that analysis effectively disposes of the arguments made by Deluxe on appeal.

The *Deluxe* court emphasized that the apportionment methodology under the *Finnigan* rule "was fairly calculated to assign to California that portion of the unitary enterprise's

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[20] The taxpayer in *Citicorp* argued that *Finnigan* resulted in unconstitutional exposure to multiple taxation of the income of the out-of-state credit card affiliate. The Court, in rejecting the taxpayer's argument, held:

> There is nothing arbitrary or unconstitutional about assigning Citibank's (South Dakota) credit card sales and transactions actually occurring in California to California. Such an assignment reasonably recognizes the contribution of the state in producing the income of the unitary group. Citicorp has not shown the allocation to California is "out of all appropriate proportions to the business transacted . . . in that State . . ." (*Container Corp. v. Franchise Tax Board*, 463 U.S. at 170).

83 Cal. App. 4th at 1426. In addition, the Court in *Citicorp* noted that the original decision in *Huffy* contained a footnote to the effect that California was "improperly" taxing some income under the *Finnigan* rule. *Id.* at 1421, n. 17. The Court pointed out that this footnote was deleted in the decision denying rehearing in that case. *Id.*

income reasonably attributable to the business done here. This conclusion remains true even in light of the fact that the FTB has abandoned the *Finnigan* approach and reverted to *Joyce*."

In sum, the SBE in *Huffy* did not overrule *Finnigan*. Rather, the SBE decided to readopt *Joyce* on a going-forward basis, while reaffirming the strong theoretical underpinnings of *Finnigan*. Subsequent to the SBE's decision in *Huffy*, the Court of Appeal in both *Citicorp* and *Deluxe* confirmed that *Finnigan* was theoretically sound and constitutionally permissible, whether applied to inbound or outbound sales. In short, the underlying reasons supporting a *Finnigan* approach remain valid post-*Huffy*.

b. The FTB is not bound to apply *Joyce* in the context of adopting a regulation under Section 25137.

Although *Huffy* signaled the readoption of *Joyce* for Section 25135 purposes, it does not follow that *Joyce* is the rule in California for all situations in which sales throwback is involved. First, the issue in *Joyce*, *Finnigan*, *Huffy* and *Citicorp* was whether certain sales of an entity in the taxpayer's unitary corporate group should be "thrown back" to California under Section 25135 and included in the sales factor numerator of such group. Section 25135, however, pertains specifically to the assignment of sales of tangible personal property. It does not address sales under Section 25136 of intangible personal property or services, such as those performed by mutual fund service providers.

Joyce also has no applicability under Section 25137. Section 25137 provides that if the standard apportionment formula does not fairly represent the extent of the taxpayer's business activity in this State, an alternative formula may be used. Section 25137(d) and Regulation 25137(a)(4) specifically provide that the "employment of <u>any other method</u> to effectuate an equitable allocation and apportionment of the taxpayer's income" may be used (emphasis added). The term "any other method" is broad and would include the adoption of *Finnigan* rather than *Joyce* for sales factor purposes, where such an approach more appropriately apportions the income of the mutual fund industry.

Conclusion

In sum, Proposed Regulation 25137-14 should be adopted because it provides for a fair and reasonable alternative apportionment methodology that specifically addresses the unique apportionment issues that confront mutual fund service providers. The proposed regulation should not include any throwback provisions, which undercut the basic purpose for adopting an alternative apportionment method. However, if the Board determines that throwback provisions are required to be included in the regulation, then a *Finnigan* approach should be adopted, as currently drafted in the proposed regulation.

Very truly yours,

Jeffrey M. Vesely

cc: John I. McBeth

Kerne H. O. Matsubara
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Federated
WORLD-CLASS INVESTMENT MANAGER®

December 14, 2006

VIA FAX (916-845-3648) AND U.S. MAIL

Mr. Carl Joseph
Franchise Tax Board
Legal Branch
P.O. Box 1720
Rancho Cordova, CA 95741-1720

Re: **Proposed Adoption of California Code of Regulations, Title 18, Section 25137-14**
Mutual Fund Service Providers and Asset Management Service Providers
Written Comments of Federated Investors, Inc.

Dear Mr. Joseph:

Pursuant to written notification of the Franchise Tax Board ("FTB") issued October 27, 2006, enclosed are the written comments of Federated Investors, Inc. ("Federated") concerning the provisions of FTB staff's proposed Mutual Fund Service Providers and Asset Management Service Providers regulation ("Proposed Regulation"). Also enclosed is an analysis of the impact of the Proposed Regulation on the State's General Fund.

Furthermore, at the hearing to be held before FTB staff on December 18, 2006, it is intended that William G. Hamm, representing Federated, will testify as to the impact of the Proposed Regulation on the State's General Fund. In addition, it is intended that Brian W. Toman, also representing Federated, will testify as to the legal merits of the Proposed Regulation.

Thank you for the opportunity to submit the enclosed written materials.

Very truly yours,

G. Andrew Bonnewell
Vice President
Senior Corporate Counsel

Enclosures

Cc: **Via Fax (916-845-3648) and U. S. Mail**
Ms. Colleen Berwick
Franchise Tax Board
Legal Branch
P.O. Box 1720
Rancho Cordova, CA 95741-1720

COMMENTS OF FEDERATED INVESTORS, INC. CONCERNING THE PROPOSED ADOPTION OF CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 25137-14 – MUTUAL FUND SERVICE PROVIDERS AND ASSET MANAGEMENT SERVICE PROVIDERS.

INTRODUCTION

In order for the staff of the Franchise Tax Board ("FTB") to properly submit a proposed regulation to the Office of Administrative Law ("OAL") for approval for submission to the Secretary of State (SOS") for adoption, the proposed regulation must be in compliance with Administrative Procedures Act ("APA") requirements. See Gov. Code § 11340.5 (a). One essential APA requirement for a proposed regulation to be approved by the OAL is "consistency with the law." See Gov. Code § 11349.1 and 11349.3. See also Donaldson v. Department of Real Estate of the State of California (2005) 134 Cal.App.4th 948 at 966 [36 Cal.Rptr.3d 577 at 591]. If a proposed regulation is not consistent with the law, the OAL will not approve it and submit it to the SOS for adoption.

For the four reasons discussed below, the proposed regulation concerning Mutual Fund Service Providers and Asset Management Service Providers ("Proposed Regulation") is not consistent with the law.

First, the Proposed Regulation is not consistent with the proper treatment of sales of other than tangible personal property (i.e., intangibles and personal services) in a state under the standard apportionment formula sales factor. That is, FTB staff is proposing a so-called "market state approach" where the law is clear that under the standard apportionment formula sales factor, only an "income producing activity approach" is appropriate.

Second, the "sales throw back rule" contained in the Proposed Regulation (i.e., the so-called Finnigan approach) is not consistent with well established present-day California law concerning the "sales throw back rule."

Third, FTB staff has not met its burden by clear and convincing evidence to prove that the variations it seeks, under the authority of section 25137, from the standard apportionment formula sales factor, set forth in the two preceding paragraphs, are appropriate. In essence, FTB staff has offered no significant evidence to meet its burden of proof to deviate from the standard apportionment sales factor rules set forth above.

Fourth, the "market state approach" and the "sales throw back rule" contained in the Proposed Regulation are not consistent with the concept of uniformity as that concept is interpreted by the California courts in reference to the Uniform Division of Income for Tax Purposes Act ("UDITPA").[1]

Lastly, as a policy matter, the FTB has a better solution if it seeks to accomplish deviations from the general rules of income apportionment under the Proposed Regulation – that is, it can seek legislation to change the old rules, and effect new rules, that apply the "market state approach" to sales of other than tangible personal property, and apply the Finnigan approach to throw back sales.

LEGAL ISSUES

I. FTB's proposal is inconsistent with the provisions of the standard apportionment formula sales factor concerning the treatment of sales of other than tangible personal property (i.e. intangibles and personal services).

From the time of UDITPA's enactment in California, Revenue and Taxation Code section 25136 has provided:[2]

> Sales, other than sales of tangible personal property, are in this state if:
>
> (a) The income-producing activity is performed in this state; or
>
> (b) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

Section 25136 concisely states that, for the purposes of the sales factor, the gross receipts from sales other than sales of tangible personal property are sourced to the state where the taxpayer incurs the bulk of its costs related to that sale. Section 25136 does not qualify this mandate. Nor does it offer any alternatives.

There are different rules for "sourcing" (i.e., attributing) sales of other than tangible personal property to the various states than there are for sourcing sales of tangible personal property under the standard apportionment formula.[3] The purpose of

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1 Sections 25120 through 25138 of the Revenue and Taxation Code (California's version of UDITPA)

2 All Code references are to the Revenue and Taxation Code unless otherwise stated.

3 Section 25136 sources sales of other than tangible personal property for sales factor purposes. There is no definition of the phrase "other than tangible personal property" in California's version of UDITPA; nor is there any definition of "intangible personal property" in that same law. However, it is generally understood that "other than tangible personal property" refers to income from (1) intangible personal property and (2)

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the standard apportionment formula sales factor regarding sales of other than tangible personal property is to represent the contributions of the state where the costs are incurred that produce income. Sales of other than tangible personal property are sourced to the state where all, or the greater proportion, of the "income-producing activities" are performed (i.e., where all or most of the costs that produced the income were incurred). [4] See section 25136; Appeals of Pacific Telephone & Telegraph Co. (5/4/78) 78-SBE-028 ("Pacific Telephone"). These income-producing activities include rendering personal services by employees and utilization of tangible and intangible property by a taxpayer in generating the sale. See regulation 25136 (b).[5] In this regulatory matter concerning the Proposed Regulation, it is undisputed that all, or the greater proportion, of the income-producing activities giving rise to the sales in question of the mutual fund service providers took place at the mutual fund service providers' headquarters.

On the other hand, sales of tangible personal property are generally sourced to the state of "ultimate destination" of the sale under the standard apportionment formula.[6] See section 25135. McDonnell Douglas Corporation v. Franchise Tax Board (1994) 26 Cal.App.4th 1789 [33 Cal.Rptr.2d 129]. This rule does not look to income-producing activities for sourcing sales; it looks to the ultimate destination of the sale. See regulation 25135 (a). This rule sourcing sales of tangible personal property to the state of ultimate destination is known as the "market state approach." The market state approach only applies to sales of tangible personal property; it has no application whatsoever to sales of intangible personal property. Thus, FTB staff is focusing on the wrong statute in the proposed regulation.

FTB staff is in essence proposing to adopt a rule for intangibles that properly applies only to the sales of tangible personal property. However, as explained above, the purpose of the sales factor regarding sales other than sales of tangible personal property is to represent the contributions of the state where the costs are incurred that produce income.

Continued from previous page
personal services. See Appeal of PacifiCorp. (9/12/02) 2002-SBE-005. The phrases "sales of other than tangible personal property" and "sales of intangible personal property and services" will be used interchangeably herein.

4 Where income-producing activities take place in more than one state, "costs of performance" are used to ascertain where the greater proportion of activities that produce income are performed. See section 25136.

5 All Regulation references are to Cal. Code Regs., tit. 18.

6 Sales of tangible personal property to the United States Government are sourced to the state of "origination' of the sale (i.e., the state where the tangible personal property is shipped from). See regulation 25135(b). Sales into states where the taxpayer is not taxable are "thrown back" to either the state of origin or the state where the salesperson's office was located. See regulation 25135(a)(6) and (7).

The fact of the matter is, as provided in section 25136, in determining the state to which receipts from intangible personal property should be sourced for the purposes of the sales factor, UDITPA disregards the "market" or "destination" state, and includes receipts from other than intangible personal property in the numerator of the state where all or the greater proportion of the income-producing activities are performed.

The principal drafter of UDIPTA stated regarding sales other than sales of tangible personal property:

> Another problem arises in conjunction with sales other than sales of tangible personal property. Section 17 [section 25136] of the uniform act attributes these sales to the state in which the income-producing activity is performed. If the activity is performed in more than one state, the sales are attributed to the state in which the greater proportion of the activity was performed, based on costs of performance.

William J. Pierce, The Uniform Division of Income for State Tax Purposes, 35 Tax Magazine 747, 780.

Other well respected authorities on UDITPA (i.e., Keesling and Warren) have stated:

> The Act provides that sales, other than sales of tangible personal property, shall be apportioned to the state or country in which the income-producing activity is performed and if the income-producing activity is performed in two or more states, the sales shall be apportioned to the state in which the greatest proportion of such activity is performed, the proportion to be determined on the basis of cost of performance.

Keesling and Warren, California's Uniform Division of Income for Tax Purposes Act, (Part II) 15/16 UCLA L. Rev. 655, 672-73.

Furthermore, in Pacific Telephone, supra, the State Board of Equalization ("SBE") has stated:

> Under section 25136, which applies to all sales other than those of tangible personal property, sales are "in this state" if: (a) The income-producing activity is performed in this state; or (b) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state that any other state, based on costs of performance.

Pacific Telephone, supra, at 9.

Conclusion

Simply stated, the purpose of the sales factor under the standard apportionment formula is not the same for sales of intangible personal property and personal services and sales of tangible personal property. There are different statutes[7] and regulations[8] that address this different treatment. Yet FTB staff equates intangible personal property with tangible personal property in the Proposed Regulation. This treatment is inconsistent with the statute, regulations and case law addressing sales of other than tangible personal property.

II. The sales "throwback rule" provision in the proposed regulation is not consistent with California law.

FTB staff proposes to use a "sales throwback rule" for sales into a state where the taxpayer itself is not taxable which has long been overruled by the SBE and an appellate court in a published opinion in California. FTB staff's proposal is not consistent with present-day California law. Furthermore, FTB staff's proposal is illogical and contradictory. Staff argues for a "market state approach" regarding sales of intangibles and services similar to the approach taken with respect to sales of tangible personal property (section 25135), yet does not seek to apply the sales throw back rule presently applied to sales of tangible personal property – the Joyce rule.

In its INFORMATION DIGEST/PLAIN ENGLISH OVERVIEW of the Proposed Regulation, FTB staff, in addressing its proposed "sales throw back rule" states:

> Subsection (b)(1)(C) sets forth an approach to deal with the assignment of receipts to California when the underlying entity providing the services to California shareholders is not a California taxpayer. This section is included to make sure that there will be a market assignment of receipts based on the activities of the entire unitary group rather that on an entity-by-entity basis.

(Emphasis added.)

In 1966, in the Appeal of Joyce, Inc., (11/23/66) Cal. St. Bd. of Equal. ("Joyce"), the SBE held that the sales to California customers by an out-of-state seller which had no tax nexus with California in its individual capacity, but which was part of a unitary

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[7] Section 25136 for sales of intangible personal property and personal services and section 25135 for sales of tangible personal property.

[8] Regulation 25136 for sales of intangible personal property and personal services and regulation 25135 for sales of tangible personal property.

business group of which some other member had tax nexus with California, could not be included in the California sales factor of the combined franchise tax report. Since the out-of-state seller was immune from taxation in California pursuant to Public Law 86-272, the SBE concluded that the net income which the seller derived from sources in California was not includable in the measure of California tax (the sales factor), but the income of other members of the group, which were subject to California's taxing jurisdiction, were includable in the measure of tax.

The Joyce decision formed the basis of the "single-entity" sales throwback rule – namely, if the individual entity itself is not taxable in California, its sales into this state must be thrown back to the state of origination of the sale, or if the taxpayer is not taxable in that state, to the state where the office that made the sale was located. See regulation 25135 (6) and (7).

However, in 1988 the Joyce sales throwback rule was overturned. In the Appeal of Finnigan Corp. (8/25/88) 88-SBE-022 ("Finnigan I") and the Appeal of Finnigan Corp. Opinion on Petition for Rehearing (1/24/90) 88-SBE-A ("Finnigan II"), the SBE held that the term "taxpayer," as used in section 25135 (b)(2), meant all corporations within the combined unitary group.

Finnigan I and Finnigan II formed the basis for the "unitary business group" sales throwback rule – namely, if any member of the unitary business group had tax nexus with California, although the individual entity making the sale did not, the sale into this state would not be thrown back to another jurisdiction.

In 1999, the SBE decided the Appeal of Huffy Corporation (4/22/99) 99-SBE-005 ("Huffy"). In Huffy, the SBE overruled Finnigan I and Finnigan II and returned to the Joyce sales throw back rule.

In 2000, the Court of Appeal examined the approach taken by the SBE in Huffy in returning to the Joyce sales throw back rule. See Citicorp North America, Inc. v. Franchise Tax Board (2000) 83 Cal.App. 4th 1403 ("Citicorp"). The Citicorp Court found the Huffy decision to be "thorough and reasoned," and found that the SBE's decision in Huffy to apply the readopted Joyce sales throw back rule prospectively to be a "well-reasoned decision." See Citicorp, supra at 1421 through 1423.

Conclusion

Thus, since 2000, the Joyce sales throw back rule has been the law in California. In the Proposed Regulation, FTB staff seeks to revert to the Finnigan sales throw back rule; a rule rejected by California and a super majority of the states. Such action is not consistent with California law. Also, as alluded to above, FTB staff's position on the Finnigan sales throw back rule is illogical and contradictory. The Joyce sales throw back rule is used under California law for the "market state approach" of section 25135. FTB staff states no substantive reason why the Joyce sales throw back rule should not also work for section 25137.

III. The FTB has not met its heavy burden to prove by clear and convincing evidence that a variation from the standard apportionment formula rules, regulations and case law regarding sales of other than tangible personal property is warranted.

In this state, the California Supreme Court has recently made it abundantly clear that the party seeking to deviate from the standard apportionment formula has the burden to prove by clear and convincing evidence that such a deviation is warranted.[9] See Microsoft Corporation v. Franchise Tax Board (2006) 39 Cal.4th 750 at 765, [47 Cal. Rptr. 3d 216] ("Microsoft"). [10] In Microsoft, the Court stated:

> As the party invoking section 25137, the Board [FTB] has the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is reasonable (Citations).

Microsoft, supra at 765.[11] (Emphasis added.)

9 In a few situations, for reasons of policy of the substantive law, the ordinary preponderance of the evidence is not considered sufficient to establish the fact in issue, and instead the party must prove the fact in issue by a higher standard of clear and convincing evidence. See Witkin, California Evidence, 4th Ed., Burden of Proof and Presumptions, § 38. Clear and convincing evidence has been defined as "clear, explicit and unequivocal," "so clear as to leave no substantial doubt," and "sufficiently strong to command the unhesitating assent of every reasonable mind." Id.

10 At the administrative level, the SBE, since 1977 to present, has always consistently held that the party which seeks to deviate from the statutory formula, be it the taxpayer or the FTB, bears the burden to prove that deviation from the standard apportionment formula is warranted. See Appeal of Borden, Inc. (2/3/77) 77 SBE 007, Appeal of New York Football Giants, Inc. (2/3/77) 77 SBE 014, Appeals of Pacific Telephone & Telegraph Co., supra, Appeal of Kelsey-Hayes Co. (10/18/78) 78 SBE 096, Appeal of Aimor Corp. (10/16/83) 83 SBE 221, Appeal of California First Bank (6/25/85) 85 SBE 056, Appeal of Holiday Inns, Inc. (4/9/86) 86 SBE 074, Appeals of Sumitomo Bank of California et al. (5/7/87) 87SBE 041, Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc. (6/2/89) 89 SBE 017, Appeals of The Bank of Tokyo et al. (8/2/95) 95 SBE 006, Appeal of Fluor Corp. (12/12/95) 95 SBE 016, and Appeal of Crisa Corp. (6/20/02) 2002-SBE-004.

11 Prior to the Microsoft decision, the California Supreme Court had previously held that the evidentiary standard to satisfy the burden of proof to allow deviation from the standard apportionment formula was the clear and convincing evidence standard. McDonnell Douglas v. Franchise Tax Board (1968) 69 Cal.2d 506 at 512. The clear and convincing evidentiary standard has been applied in numerous California appellate cases,

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Furthermore, the California Supreme Court has not limited this burden of proof to ad hoc applications of section 25137. As the Court noted, some states may attempt to cure "distortions" by regulatory revision, other states may attempt to cure "distortions" on an ad hoc basis. See Microsoft, supra at 767, fn. 18. In either event, whether "distortion" is addressed by regulatory action or on an ad hoc basis, the party seeking to deviate from the standard apportionment formula has the burden to prove by clear and convincing evidence that such a deviation is warranted.

The cases of record that discuss burden of proof in the context of "distortion" and relate to the Proposed Regulation are the Appeal of Merrill, Lynch, Pierce, Fenner & Smith (6/2/89) 89-SBE-017 ("Merrill Lynch"), Pacific Telephone and Microsoft.

In Merrill Lynch, the taxpayer was incorporated in Delaware, headquartered in New York, and operated 20 branch offices in California. With its affiliates, it conducted a single worldwide unitary financial services business. In some of its securities transactions, Merrill Lynch acted as a broker, buying and selling securities in the open market for its customers and earning commission income. Merrill Lynch also traded in securities as a principal or underwriter purchasing securities for its own account and attempted to remarket them. In computing its sales factor, Merrill Lynch included its commission income from its brokerage activities and its gross receipts from its transactions as a principal in its sales factor. The FTB took the position that including the gross receipts from its transactions as a principal in its sales factor "distorted" Merrill Lynch's sales factor.

In a comparative analysis, the State Board of Equalization ("SBE") distinguished the investment activities as a principal in Merrill Lynch, which was a "fundamental segment" of its unitary business, from the investment activities of the taxpayer in Pacific Telephone, which was an "incidental" part of the unitary business.

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both to pre-UDITPA years (e.g., RKO Teleradio Pictures, Inc. v. Franchise Tax Board (1966) 246 Cal. App.2d 812 at 819; Montgomery Ward & Company v. Franchise Tax Board (1970) 6 Cal.App.3d 149 at 155; and Chase Brass v. Franchise Tax Board (1977) 70 Cal.App. 3d 457 at 471) and UDITPA years (e.g., Anaconda Company v. Franchise Tax Board (1982) 130 Cal.App. 3d 15 at 30; Colgate-Palmolive Company, Inc. v. Franchise Tax Board (1992) 10 Cal. App. 4th 1768 at 1786-87). One might quibble that the cases cited in this footnote dealt with "distortion" in the constitutional context and that a lesser burden of proof (i.e., preponderance of the evidence) would apply in the statutory context of section 25137. However, the California Supreme Court has now made it mandatory that the clear and convincing evidentiary standard also applies in the statutory context of section 25137.

Furthermore, the low level of "distortion" in Merrill Lynch, a change in the apportionment percentage of 23 to 36% from the treatment required by the standard apportionment formula sales factor to that asserted as proper by the FTB, was a "far cry" from the 250% change in the apportionment percentage in Hans Rees.

Additionally, the level of distortion in Merrill Lynch was much lower than in Pacific Telephone. In Pacific Telephone, the Treasury function investments produced less than 2% of the company's business income, but 34% of its gross receipts, and 11% of the unitary activities were assigned to one location.

The SBE held the FTB failed to meet its burden to prove "distortion" because Merrill Lynch bought and sold securities as its (1) principal business and (2) there was a low level of "distortion."

The Proposed Regulation clearly deals with a fundamental segment of the business operations of a mutual fund service provider (i.e., sales of mutual fund shares and services). Therefore, the analysis in Merrill Lynch is directly relevant. FTB staff has not presented any evidence of the change in the apportionment percentages from the treatment required by the standard apportionment formula sales factor to that asserted by FTB staff in the Proposed Regulation. Thus, FTB staff has failed to meet its burden to prove a deviation from the standard apportionment formula sales factor is warranted under Merrill Lynch.

Furthermore, even assuming the distortion analysis in Pacific Telephone is relevant to the Proposed Regulation (which it is not because Pacific Telephone dealt with an incidental, not fundamental, aspect of the taxpayer's unitary business operations), again FTB staff has not presented any evidence of the change in the apportionment percentages from the treatment required by the standard apportionment formula sales factor to that asserted by FTB staff in the Proposed Regulation. As such, FTB staff has failed to meet its burden to prove a deviation from standard is warranted under Pacific Telephone.

In Microsoft, the taxpayer was an international software company, headquartered in the state of Washington, with worldwide business operations. It and its subsidiaries conducted a single worldwide unitary business. Microsoft included the gross receipts from its Treasury operations (sales prior to maturity and dispositions on maturity of marketable securities) in its sales factor. The FTB only allowed the net income elements of the maturities to be included in the sales factor on the basis that "net" meant "gross" in the context of the facts and circumstances, and that even if "gross" meant "gross," the result caused "distortion" in the sales factor.

The California Supreme Court held that, under the standard apportionment formula sales factor, based on the plain language of the statute and regulations, the legislative history and the economic realities of sales verses maturities, "gross" meant "gross" (i.e., net income plus return of capital). However, the Court went on to hold that FTB had proven that this result under the standard apportionment formula sales factor caused "distortion" in Microsoft's sales factor based on functional separate accounting (i.e., Treasury function verses non-Treasury functions).

The factual basis for a finding of "distortion" was that (1) Microsoft's Treasury operation was a qualitatively different operation from its principal business, (2) Microsoft's investments produced less than 2% of its income but 73% of its gross receipts (Pacific Telephone's corresponding percentages, as noted above, were 2% and 34%), (3) Microsoft's profit margin (income/redemptions) was 0.2% for its Treasury operation compared to a profit margin (income/gross receipts) 31% for non-Treasury operations. Microsoft's non-Treasury operations were 155 times more profitable than its Treasury operations and (4) Microsoft's average worldwide margin was 8.6% - 43 times more profitable than Treasury.

The Court embraced the holding in Merrill Lynch based on (and in contrast to Microsoft) the facts that (1) Merrill Lynch bought and sold securities as its principal business, (2) Merrill Lynch's purchase and sale of securities on its own account was not qualitatively different from its main business and (3) the resulting quantitative difference between the standard formula and the FTB's proposed formula was only 23 to 36% (a "far cry" from 250%). See Microsoft, supra at 766.

The distortion analysis under the facts and circumstances in Microsoft, as the distortion analysis under the facts and circumstances in Pacific Telephone, is arguably not relevant to the treatment of sales of mutual fund shares and services in the Proposed Regulation. This is because Microsoft, as Pacific Telephone, dealt with an incidental, not fundamental, aspect of the taxpayer's unitary business operations. But even if Microsoft is to be considered in the analysis of whether FTB staff has met is burden to prove a deviation from the standard apportionment formula sales factor is warranted, for the following reasons FTB staff has failed to satisfy its burden of proof. First, FTB staff has not presented any evidence of the change in the apportionment percentages from the treatment required by the standard apportionment formula sales factor to that asserted by FTB staff in the Proposed Regulation. Second, FTB staff has presented no other numerical analysis demonstrating that the sales of mutual fund shares and services allegedly allocated to a single state should be spread among several states based on a market state approach. Thus, FTB staff has again failed to meet its burden to prove a deviation from standard is warranted.

The California and U.S. Supreme Courts have long recognized that it is impossible to measure with precision the exact amount of income attributable to a particular jurisdiction from a multistate business and consequently formulary apportionment was adopted as a way to produce a "rough approximation" of income, or rough justice. As the

California Supreme Court held in John Deere Plow Co. of Moline v. Franchise Tax Board (1951) 38 Cal.2d 214 at 229 ("John Deere"):

> A state in attempting to place upon a business extending into several states "its fair share of the burden of taxation" is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders" (Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 , 121), and as a matter of practical tax administration it has been "declared that 'rough approximation rather than precision' is sufficient." (International Harvester Co. v. Evatt, 329 U.S. 416, 422 .)

The California Supreme Court has clearly established the elements of what is required to invoke section 25137 to justify an alternative apportionment formula from the "rough approximation" result provided by the standard apportionment formula. FTB staff has failed to provide evidence to satisfy any of these elements.

First, the taxpayer's activities in California must be examined in relation to its activities everywhere. See Microsoft, supra at 768 through 769. In its INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW, apart from FTB staff stating that the income producing activity giving rise to sales of mutual fund shares and services takes place in one location, no other examination is offered regarding the mutual fund service providers' activities in California in relation to activities everywhere.

Second there must be a reasonable determination that there is a material deficiency in at least one of the factors. See Microsoft, supra at 765, 766, 770 and 771. In its INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW, FTB staff (1) alleges that attributing sales of mutual fund shares and services to one state causes the section 25136 rules to "break down" (whatever that phrase means in the context of fair apportionment), (2) alleges that such treatment is not indicative of the market, (3) and alleges that over-taxation can result. Such allegations are completely deficient to prove a material deficiency in the sales factor under the evidentiary standard set forth in Microsoft and under the facts and circumstances set forth in Merrill Lynch.

Third, that deficiency must be with respect to a function that is qualitatively different from the principal business of the taxpayer. See Microsoft, supra at 766 and 769. In its INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW, FTB staff makes no allegation whatsoever, or provides any evidence, that the particular sales it seeks to treat differently from the treatment afforded under the standard apportionment sales factor are qualitatively different from the principal business activity of the mutual fund service providers as required by Microsoft and Merrill Lynch.

Fourth, the qualitative deficiency must be sufficiently significant that application of the other factors in the multi-factor formula does not overcome it adequately to provide a rough approximation of the income apportioned to California. See Microsoft, supra at 769; John Deere, supra at 224 and 225. In its INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW, FTB staff makes no allegation whatsoever, or offers any evidence, that the deficiency it alleges exists in the standard apportionment formula sales factor is not overcome by the property and payroll factors to prevent a rough approximation of income of mutual fund services providers being apportioned to California.

Fifth, if the foregoing threshold requirements are met, then the test is whether any knowledgeable observer would concede that the result produced by the statutory formula cannot be defended as within the range of a reasonable result. See Microsoft, supra at 770. In its INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW, FTB staff offers no evidence that the application of the standard apportionment formula sales factor to the sales of mutual fund shares and services results in the sort of "serious" distortion required to warrant a deviation from the standard apportionment formula sales factor.

Conclusion

FTB staff has failed to provide any substantive evidence that is "clear, explicit and unequivocal", or evidence that is "so clear as to leave no substantial doubt," or evidence "sufficiently strong to command the unhesitating assent of every reasonable mind" that the use of the "market state approach" is appropriate with respect to mutual fund service providers.

Furthermore, FTB staff has failed to provide any substantial evidence as outlined above that use of the Finnigan sales throwback rule is appropriate with respect to mutual fund service providers. It is incomprehensible that the Joyce sales throw back rule would work under the "market state approach" of section 25135, but some how not work under the proposed "market state approach" proposed by FTB staff under section 25137 with respect to mutual fund service providers. FTB staff's illogical and contradictory postion on the use of the Finnigan approach is inexplicable.

UNIFORMITY ARGUMENTS

In its INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW, FTB staff alleges that the Proposed Regulation provides "a level of uniformity." However, a "level of uniformity" does not reflect the standard under which the California courts have found uniformity to be a convincing argument in upholding an approach sought by the FTB or the taxpayer. Arguments of uniformity have only been given credence in California in situations where there was almost complete uniformity already existing among the states.[12]

In Citicorp, supra at 1417, a total of 40 of the approximately 44 states had adopted the previously discussed Joyce sales throw back rule. The Court directed its attention to this super majority position to affirm the proper applicability of Joyce on a prospective basis in California under the concept of uniformity.

In Microsoft, supra at 766 and 767, the overwhelming majority of the states excluded from gross receipts the return of capital from short-term investment receipts from the sales factor, but did so in different ways. Some states excluded return of capital from the definition of gross receipts, other states did so by determining inclusion of return of capital resulted in "distortion" of the sales factor. The Court did not find uniformity among the states on the definition of gross receipts. Nevertheless, the super majority of the states did, however, come to the same "result" - exclusion of return of capital from gross receipts either by definition under the standard apportionment formula sales factor or by a finding of "distortion" under the deviation provision of UDITPA (i.e., section 18).

The California Supreme Court relied on this super majority in "result" to embrace the concept of uniformity in holding for the FTB on the "distortion" issue.

There is no super majority of the states adopting the same position FTB staff is proposing regarding the "market state approach" in the Proposed Regulation, either under the standard apportionment formula sales factor or under the deviation provision of section 18 of UDITPA, or a combination of both. As such, the argument that a "level of uniformity" will be effected under FTB staff's proposal should ring hollow, at least to the California courts. Whether or not FTB staff's position regarding the "market state approach" for sales in the Proposed Regulation is adopted by regulation under section 25137, uniformity by "result" or regulation will not be secured to any credible degree.

Furthermore, the Finnigan sales throw back approach is absolutely contrary to uniformity as over 90% of the states that have a sales throw back rule follow the Joyce approach.

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12 It could be argued that there is a "trend" in some states that are moving towards a "market state approach" regarding sales of mutual fund shares and services. However, the concept of uniformity is founded on the universe of states that have adopted UDITPA, or laws similar thereto, and the laws in those universe of states, not the laws in a handful of states following a "trend." See Hoechst Celanese Corporation v. Franchise Tax Board (2001) 25 Cal.4th 508 at 518 [22 P.3d 324].

As such, under the concept of uniformity as sanctioned by the California courts, both the "market state approach" to sourcing sales of other than tangible personal property and the use of the Finnigan approach to throw back sales are not consistent with California law

POLICY ARGUMENT

FTB staff seeks to impose the "market state approach" on sales of mutual fund shares and services by mutual fund service providers. As explained above, such an approach is not consistent with the standard apportionment formula sales factor regarding sales other than sales of tangible personal property. FTB staff admits this is true in its INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW. FTB staff has not met its burden to prove the deviation from standard is warranted. If FTB staff seeks to impose the "market state approach" on sales of other than tangible personal property, it has a better solution than attempting to do so by regulation – it should seek legislation to change the law to impose the market state approach on such sales.

The same holds true for attempting to impose the Finnigan approach on throw back sales to the sales in question. Finnigan is not consistent with the law in California (and 90% of the states). If FTB staff seeks to impose the Finnigan approach in contradiction of law under the guise of a regulation, it better serves the state by seeking legislation to change the law to effect the result it seeks, both under section 25135 as well as section 25137.

CONCLUSION

The purpose of the sales factor under the standard apportionment formula is not the same for sales of intangible personal property and personal services and sales of tangible personal property. Yet FTB staff equates sales of intangible personal property and personal services with sales of tangible personal property in the Proposed Regulation. This treatment is not consistent with the statute, regulations and case law addressing sales of other than tangible personal property.

Since 2000 the Joyce sales throw back rule has been the law in California. In the Proposed Regulation, FTB staff seeks to revert to the Finnigan sales throw back rule; a rule rejected by California and a super majority of the states. Such action is not consistent with California law and is contradictory to the "market state approach" treatment of throw back sales for purposes of section 25135.

FTB staff has failed to provide any substantive evidence that is "clear, explicit and unequivocal", or evidence that is "so clear as to leave no substantial doubt," or evidence "sufficiently strong to command the unhesitating assent of every reasonable mind" that the use of the "market state approach" and the use of the Finnigan sales throw back rule is appropriate with respect to mutual fund service providers. FTB staff has failed to carry its heavy burden to prove by clear and convincing evidence that the deviations it seeks from the standard apportionment formula sales factor are warranted.

No matter what approach is taken by California concerning treatment of the sales of other than tangible personal property in issue, no relevant degree of nationwide uniformity will be secured. Only non-uniformity will be effected by adopting the Finnigan sales throw back approach. The remedy for the results FTB staff desires under the Proposed Regulation should be found in the Legislature.

Testimony of William G. Hamm, Ph.D.
Proposed Regulation 25137-14
December 18, 2006 – Sacramento, CA

My name is William G. Hamm, and I am a managing director of the international consulting firm LECG, which is headquartered in Emeryville, California. I have considerable experience analyzing the fiscal consequences of proposed changes to tax and expenditure programs in California – a task I performed for the Legislature during the period 1977-86, when I was the State's Legislative Analyst. My *curriculum vitae* is attached as Exhibit 1.

Federated Investors, Inc. ("Federated") retained me to analyze the impact of Proposed Regulation 25137-14 on the State's General Fund. I conducted my analysis in a thoroughly objective manner, and my conclusions may not reflect Federated's views.

As I will explain, the available evidence indicates convincingly that the proposed regulation would significantly reduce General Fund revenue, relative to the revenue yielded by the standard method for determining the sales factor.

A. Overview

The proposed regulation would change the method used to determine a mutual fund service provider's ("MFSP's") sales factor in apportioning income to California for purposes of the State's Corporation Tax ("CT"). Currently, the Franchise Tax Board's ("FTB's") regulations require each MFSP to comply with the Uniform Division of Income for Tax Purposes Act ("UDITPA") and determine its sales factor using the costs-of-performance ("COP") method. FTB staff has proposed that the Board require MFSPs to allocate their sales based on each mutual fund shareholder's state of residence.

The residence method would have the effect of reducing the apportionment factor for MFSPs that incur a preponderance of their COP in California ("California MFSPs"), and increasing it for providers that primarily conduct servicing functions in other states ("out-of-state MFSPs"). In addition, the proposed regulation would subject an out-of-state MFSP's income to the CT even when the provider lacked income tax nexus, if it is part of a larger taxpayer group that includes a member with nexus. According to an Economic

Impact Statement dated October 4, 2006, FTB staff estimates that the proposed regulation would increase General Fund revenues by $10 million per year.

B. The Sales Component of the CT

California's CT can be thought of as three separate taxes: (1) a tax on property or business investment, (2) a tax on payroll or jobs, and (3) a tax on sales or gross receipts. In effect, the tax on sales is levied at the rate of 4.42 percent and applied to the product of the taxpayer's sales factor used for apportionment purposes and its worldwide taxable income. (Please see Exhibit 2.) Therefore, any change in the sales factor used to apportion income will change the amount of the taxpayer's California tax liability.

C. Key Variables Determining the Net Impact on General Fund Revenue

The proposed regulation would increase tax liabilities for some taxpayers and reduce them for others. The net impact would depend on the relative size of the reductions and increases. Five key variables would determine the impact on General Fund revenues.

1. The market share of California-based MFSPs

The COP method enables the State to apply the tax on sales to income from services that California MFSPs provide to both California and out-of-state mutual fund shareholders. Under the proposed regulation, the tax on sales would apply only to income earned from servicing shareholders who are California residents. Thus, the change would reduce tax liabilities for California MFSPs. The size of the reduction would depend on the number of out-of-state shareholders they serve. In my opinion, the number of shares owned by California MFSPs' out-of-state shareholders is likely to be highly correlated with the funds' market share.

2. The percentage of mutual fund shares held by California residents

Obviously, if a California MFSP had no customers outside California, it would not matter which of the two methods it used to determine its sales factor, and no revenue would be lost as a result of the proposed change. For California MFSPs, as the percent of the funds' shareholders residing in California goes down, their California tax liabilities will go down. For out-of-state MFSPs, the reverse is true: as the percent of the funds' shareholders residing in California goes up, their tax liabilities will go up.

3. The relative profitability of California-based and out-of-state MFSPs

Other things equal, if California MFSPs are more profitable than their out-of-state competitors, the proposed change in the apportionment method would bring about a relatively larger reduction in General Fund revenues. This is because the change would shift the tax burden from more profitable to less profitable firms.

4. The percentage of total mutual fund shareholders residing in California that are serviced by members of taxpaying groups lacking income tax nexus

Increasing the apportionment factor for out-of-state MFSPs that are not subject to the CT would not generate additional tax liabilities needed to "pay for" the tax reductions granted to providers favored by the proposed regulation.

5. The extent to which the FTB has allowed taxpayers to use alternatives to the UDITPA's COP method for determining their sales factor

I understand that FTB staff has granted tax relief to California MFSPs which have submitted petitions under Revenue and Tax Code 25137, requesting permission to depart from the apportionment method (COP) required by current regulations. The larger the amount of tax relief granted by FTB staff to date, the smaller the revenue loss resulting from the proposed regulation.

D. Data Sources

I have estimated the net impact of the proposed regulation on General Fund revenues, using publicly available information. Because I do not have access to tax returns, my estimate is illustrative, not definitive.

1. Market share of California MFSPs

The Investment Company Institute provides information on total mutual fund assets, by fund. Exhibit 3 shows the assets managed by the 50 largest funds. Together these companies account for 83.5 percent of total mutual funds assets in the United States.

Mutual fund companies headquartered in California account for 24 percent of the sample. I have assumed, as a first approximation, that California MFSPs also account for 24 percent of the mutual fund industry's servicing revenues and income.

2. Mutual fund shares held by California residents

There is no publicly available data on mutual fund shareholdings, by state.[1]

The U.S. Department of Commerce's Bureau of Economic Analysis ("BEA") reports income earned, by "industry," using the North American Industry Classification System ("NAICS"). The "industry" that includes mutual fund service providers is NAICS Code 523: "Securities, Commodity Contracts, and Other Financial Investments and Related Activities." In addition to MFSPs, this "industry" also includes securities underwriters and market makers, securities brokers, and asset managers.

According to the BEA, California-based revenue earned by firms in NAICS Code 523 represents 11.7 percent of the total.[2] This percentage is consistent with the assumption made by FTB staff in preparing its Economic Impact Statement, that California residents hold 12 percent of all mutual fund shares.

3. Relative profitability of California and foreign MFSPs

I obtained data from Fox-Pitt Kelton – a Global Investment Bank – on the operating margins achieved by public MFSPs and their parents. (The "operating margin" is the ratio of operating income to sales revenue, and is a frequently used indicator of profitability.) I supplemented this data with information on margins published by Thompson Financial, as well as with information derived from an analysis of Form 10-Ks filed by several out-of-state MFSPs or their parents. The firms for which I was able to obtain data on operating margins account for 14 percent of total mutual fund assets. This data appears in Exhibit 4.

[1] I am advised that IXI Corporation collects data from some mutual fund companies that, if representative of the industry as a whole, would show the distribution of mutual fund shareholders, by state. IXI maintains that its agreements with these companies prevent it from making the data available for purposes such as analyzing the effects of the proposed policy change.

[2] BEA reports that "Personal Income" for NAICS 523 in 2005 was $21 billion for California, $186 billion for all states. (http://www.bea.gov/bea/regional/statelocal.htm).

As Exhibit 4 shows, the one California-based MFSP for which profitability data is available (Franklin Templeton Investments – the fourth largest MFSP in the U.S.) achieved an operating margin of 50.5 percent in 2005. In contrast, the operating margins achieved by non-California MFSPs ranged from 19.4 percent to 42.8 percent, with a weighted average of 32.9 percent.

It is likely that the information on operating margins for public MFSPs understates the difference in profitability between California and out-of-state firms. The Pennsylvania-based Vanguard Group, which accounts for 12 percent of the mutual fund assets in my sample, is client-owned, rather than shareholder-owned, and seeks to keep its owners' investing costs as low as possible. Consequently, it is all but certain that Vanguard's operating margin and profitability are significantly below the industry average.

4. Worldwide taxable income

There is no reliable source of data on the worldwide taxable income of all MFSPs, public and private.

For illustrative purposes, I assumed that worldwide taxable income for all MFSPs is equal to the weighted average return on managed assets for the 11 publicly traded firms (0.7 percent) multiplied by total managed assets ($9,722,162 million). This yields an estimate of $68 billion.

5. Out-of-state MFSPs without nexus

I was not able to find any data that could be used to determine which, if any, out-of-state MFSPs would not be subject to the CT if the proposed regulation is adopted, because they are not part of a taxpayer group with nexus to California.

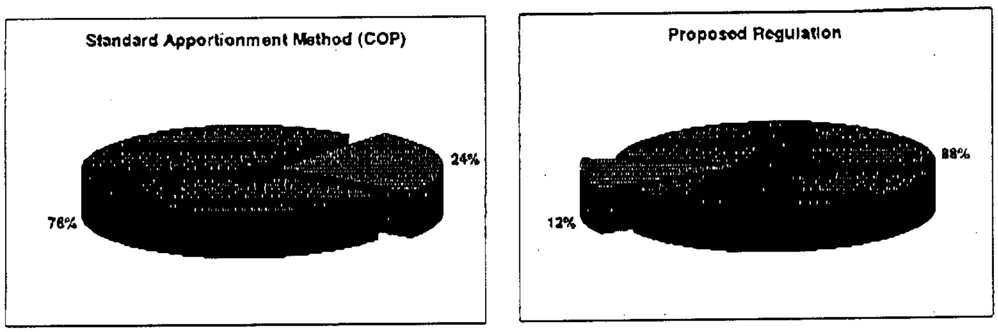
E. Impact of the Proposed Regulation on General Fund Revenues

Relative to the tax liabilities generated by the standard method for determining an MFSP's sales factor, the proposed regulation would significantly reduce General Fund revenues. The reason for the reduction is simple. Currently, the standard apportionment method (COP), in effect, reflects the revenues generated from servicing 24 percent of all mutual fund shares (the estimated percentage of all shares serviced by California MFSPs).

The proposed regulation would reduce the revenues reflected in the sales factor by more than 50 percent, to 11.7 percent (the estimated percentage of all mutual fund shares held by California residents). Chart 1 illustrates this comparison.

Chart 1

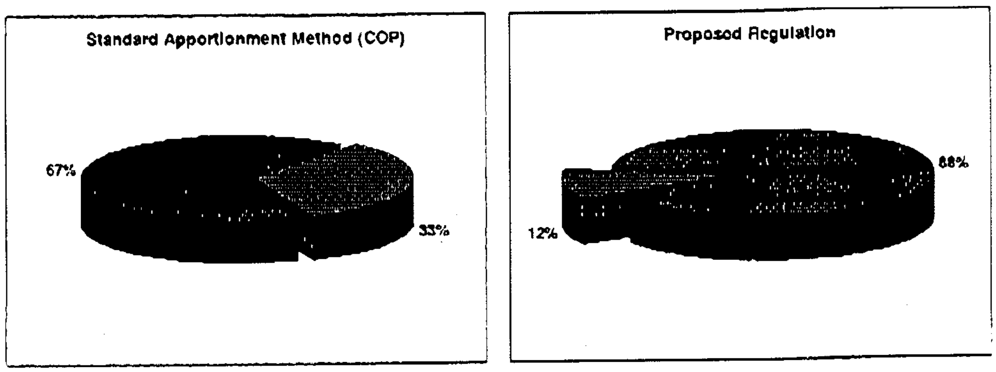
Impact of the Proposed Regulation on Servicing Revenues Reflected in the Sales Factor Used to Apportion Income Under the California Corporation Tax (No Difference in Profitability)



As noted earlier, the available data on operating margins indicates that California MFSPs are able to convert a relatively larger percentage of their sales revenues to pre-tax income. Assuming that the average operating margins for California and non-California MFSPs are 50.5 percent and 32.9 percent, respectively, the change in apportionment method would reduce the percentage of pre-tax income for all MFSPs subject to the sales component of the CT, from 33 percent to 11.7 percent. Chart 2 illustrates the reduction.

Chart 2

Impact of the Proposed Regulation on Servicing Revenues Subject to the California Corporation Tax (California MFSPs are More Profitable)



How much revenue would the change in apportionment method cost the State's General Fund? Assuming that (1) worldwide income from mutual fund servicing is $68 billion, and (2) no out-of-state MFSP would be able to escape the CT due to the absence of income tax nexus, I estimate that the annual revenue loss relative to the standard apportionment method would be $370 million. The basis for my estimate is summarized in Exhibit 5. Clearly, if an analysis of tax returns showed that worldwide income from servicing is more or less than $68 billion, the General Fund revenue loss would be higher or lower.

As I noted earlier, the FTB staff estimates that, instead of causing a revenue loss, adoption of the proposed regulation would generate an additional $10 million for the General Fund. Without access to the tax returns of all MFSPs (including those with no income tax nexus in California), I cannot reconcile the staff's estimate with mine.

Exhibit 1

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EDUCATION

Ph.D., Economics, UNIVERSITY OF MICHIGAN

Fields of Emphasis: Industrial Organization and Labor Economics

M.A., Economics, UNIVERSITY OF MICHIGAN

A.B., Government, DARTMOUTH COLLEGE

PRESENT POSITION

Managing Director
LECG, LLC, Emeryville, CA

PROFESSIONAL EXPERIENCE

Economics Consultant, 1995 - present

Business Executive, 1986 - 1995

Government Official, 1969 - 1986

ACCOMPLISHMENTS

Consulting

Coalition to Protect California: Analyzed the economic and fiscal impact of an initiative limiting the use of eminent domain and increasing the number of regulatory takings that are compensable.

Californians Against Higher Taxes: Analyzed the economic and fiscal impact of an initiative imposing a severance tax on California oil production.

Pacific Gas and Electric: Analyzed the likely impact on consumers if a municipal utility annexes a portion of PG&E's service area.

Stop the Reiner Initiative Coalition: Analyzed the fiscal impact of an initiative to create a preschool entitlement in California, and evaluated the program's design.

Exhibit 1
Page 2

Californians for Affordable Prescriptions: Analyzed the fiscal and economic impact of two ballot propositions that would establish prescription drug discount programs for certain California residents.

Californians Allied for Patient Protection: Tested the claim that regulation of insurance rates (Proposition 103), rather than tort reform, is responsible for limiting the growth in medical malpractice insurance premiums.

Californians for Public Safety and Education: Analyzed the fiscal impact of a proposed citizen initiative that would increase revenue to the state and local governments from legalized gambling.

A coalition of health care providers: Analyzed the impact of proposed reforms to Nevada's medical malpractice tort system on the cost of, and access to, healthcare.

Committee for Workers Compensation Reform and Accountability: Analyzed the economic and fiscal consequences of proposed changes to California's Workers Compensation system.

California Scholarship Opportunity Act: Analyzed the fiscal impact of a proposed constitutional amendment that would authorize use of public funds for scholarships to students in underperforming schools.

California Association of Marriage & Family Therapists: Analyzed the cost effectiveness of expanding the list of providers eligible to offer counseling to Medi-Cal participants.

Nutritional Grocers Association of California: Analyzed the impact of a proposed methodology for limiting redemption prices under the Women, Infants and Children Program ("WIC").

American Liver Foundation: Analyzed the fiscal impact on California's General Fund of proposed legislation establishing a statewide inoculation program for Hepatitis A.

Business for Economic Growth in California: Analyzed the economic and revenue impact of adopting a single-factor (sales) income apportionment formula under the state's corporate income tax program.

Association of California Insurance Companies: Analyzed workers' compensation benefits paid in California, relative to the benefit levels in other states.

Californians Against Fraud and Higher Insurance Costs: Analyzed the impact of proposed legislation on automobile insurance premiums, incentives to combat fraud, and number of lawsuits.

Consulting Engineers and Land Surveyors of California: Analyzed the economic and public policy consequences of a proposed constitutional amendment that would prevent the State of California from contracting-out certain professional services.

Coalition for Fair Liability Laws: Analyzed the economic impact of replacing joint-and-several liability with proportional liability for professional service providers.

Californians Allied for Patient Protection: Analyzed the economic and public policy consequences of legislative proposals to weaken medical malpractice insurance reforms in California.

Car and Truck Renting and Leasing Association: Analyzed the economic rationale for state controls on the prices that rental car companies may charge.

International Game Technology: Analyzed the economic impact of legislation to regulate business relationships, and testified before a committee of the Nevada Legislature.

Coalition of Investor-Owned Utilities: Analyzed the effects of the proposed Utility Rate Reduction Act on rate-payers, the state and local governments, and consumers.

Coalition Against Unregulated Gambling: Analyzed the impact on state and local governments of a proposed ballot proposition expanding Indian casino gambling.

Major commercial bank: Analyzed the issues raised, and conditions imposed, by regulators in connection with bank merger applications in six countries.

Yolo County, California: Analyzed the impact on county revenues of a recent change in state law.

Major technology corporation: Helped client identify probable impact of network-centric computing on competition, products, and business organization within a key customer segment (insurance).

GTECH Corporation: Identified opportunities for improving the management, organization, and effectiveness of the California State Lottery.

Expert Witness

Banking/Financial Services

Granite Management Corporation v. United States (Court of Federal Claims: 95-515C): Provided expert testimony at trial re: plaintiff's $137 million damages claim.

Bank of America, et al., v. United States (Court of Federal Claims: 95-660C; 95-7971C): Provided expert testimony at trial re: plaintiffs' $89 million damages claim.

American Capital Corporation, et al., v. United States (United States Court of Federal Claims: 95-523C): provided expert testimony at trial re: plaintiffs' $216 million damages claim.

Frank P. Slattery, Jr., et al. v. United States (Court of Federal Claims: 93-280C): Provided expert testimony at trial re: plaintiff's $3 billion damages claim.

WestFed Holdings, Inc., et al., v. United States (Court of Federal Claims: 92-820C, 95-731C, 95-797C, 95-803C (Consolidated)): Provided expert testimony at trial re: plaintiffs' $480 million damages claim.

California Federal Bank, FSB v. United States II (Court of Federal Claims: 92-138C): Provided expert testimony at trial re: plaintiffs' $600 million damages claim.

Southern California Federal Savings and Loan Association, et al., v. United States (Court of Federal Claims: 93-52C): Provided expert testimony at trial re: plaintiffs' $400 million damages claim.

John K. Castle, et al. v. United States (Court of Federal Claims: 90-1291C): Provided expert testimony at trial re: plaintiffs' $250 million damages claim.

C. Robert Suess, et al. v. United States (Court of Federal Claims: 90-981C): Provided expert testimony at trial re: plaintiffs' $1.1 billion damages claim.

California Federal Bank, FSB v. United States I (Court of Federal Claims: 92-138C): Provided expert testimony at trial re: plaintiffs' $1.7 billion damages claim.

Glendale Federal Bank v. United States (Court of Federal Claims: 90-772C): Provided expert testimony at trial re: plaintiffs' $2 billion damages claim; eighteen days on the witness stand.

American Savings Bank, FA, et al., v. United States (Court of Federal Claims: 92-872C): Filed expert report re: plaintiffs' $800 million damages claim; deposed. (Trial pending.)

Home Savings of America FSB, et al., v. United States (Court of Federal Claims: 92-620C): Filed expert report re: plaintiffs' $940 million damages claim; deposed. (Plaintiff withdrew claims addressed in expert report.)

Coast Federal Bank, FSB, v. United States (Court of Federal Claims: 92-466C): Filed two expert reports re: plaintiff's $1.4 billion damages claim; deposed. (Court granted summary judgment.)

Sterling Savings Association, et al., v. United States (Court of Federal Claims: 95-829-C): Filed expert report re: plaintiffs' $102 million damages claim; deposed. (Trial pending.)

Maco Bancorp, Inc. v. United States (Court of Federal Claims: 94-625C): Filed expert report re: plaintiffs' $300 million damages claim; deposed. (Case settled prior to trial.)

Housing/Mortgage Lending

Chancellor Manor, et. al., v. United States (Court of Federal Claims: 98-39C): Provided expert testimony at trial re: plaintiffs' $25 million damages claim (combined with CFC 94-1C).

Cienega Gardens, et al., v. United States (Court of Federal Claims: 94-1C): Provided expert testimony at trial re: plaintiffs' $41 million damages claim (combined with CFC 98-39C).

Carabetta Enterprises, et. al., v. United States (Court of Federal Claims: 02-1134C): Provided expert testimony at trial re: plaintiffs' $53 million damages claim.

Independence Park, et al., v. United States (Court of Federal Claims: 94-1AC): Provided expert testimony at trial re: plaintiffs' $3.4 million damages claim.

Franconia Associates, et al., v. United States (Court of Federal Claims: 97-381C): Provided expert testimony at trial re: plaintiffs' claims for damages.

Claremont village Commons, et al., v. United States (Court of Federal Claims: 94-1): Filed expert report re: plaintiffs' $101 million damages claim.

Grass Valley Terrace, et al. v. United States (Court of Federal Claims: 98-726C): Filed expert report re: plaintiffs' $20 million damages claim; deposed. (Trial pending.)

Pierceall v. Ameriquest Mortgage Company and Ameriquest Capital Corporation: (Superior Court of California, County of San Mateo: 415620): Designated testifying expert re: economic damages experienced by members of a class of borrowers. (Case settled prior to trial; adopted my methodology for calculating losses.)

Public Finance/Government Policy

County of San Diego & County of Orange v. State of California, et al. (Superior Court of California, County of San Diego, GIC 825109): Provided expert testimony at trial re: the State's ability to honor claims for reimbursement totaling $155 million.

US West Communications, Inc., et al. v. City of Coralville (Iowa District Court for Johnson County: LA CV-058956): Provided expert testimony at trial re: the economic and public policy consequences of a municipal ordinance.

United States v. Anne (Sandy) Batchelor-Robjohns, et al. (United States District Court, Southern District of Florida, Miami Division, 03-20164). Filed expert report re: complex financial transaction between a multinational bank and a U.S. corporation; deposed. (Court granted summary judgment.)

Qwest Corporation v. Central Puget Sound Regional Transit Authority, et al. (United States District Court for the Western District of Washington at Seattle: CO2-0155P): Filed declaration re: cost of protecting and relocating Plaintiff's facilities.

Alliance of American Insurers, et al. v. California Department of Motor Vehicles (Superior Court of the State of California: 02CS00702): Filed declaration re: cost of responding to electronic requests for information on licensed drivers and registered vehicles.

U.S. West Communications, Inc., v. City of Santa Fe, New Mexico (United States District Court, New Mexico: CIV 00-795 LH): Submitted expert report re: the economic and public policy consequences of a municipal ordinance.

County of Orange v. Merrill Lynch & Company, Inc. (United States District Court, Central District of California: CV-95-0037 GLT): Filed expert report re: plaintiff's $2 billion damages claim. (Case settled prior to trial.)

Irvine Ranch Water District v. Merrill Lynch & Company, Inc. (United States District Court, Central District of California: SA CV-97-254 GLT): Filed expert report re: plaintiff's $100 million damages claim. (Case settled prior to trial.)

Qwest Corporation v. City of Portland (United States District Court, District of Oregon: 01-CV-1005-JE): Submitted expert declaration regarding information needed to assess the City's right-of-way management needs.

Markieta Malory, et al., v. University of Maryland Medical System Corporation (Circuit Court for Baltimore City: 24-C-98410624): Submitted expert affidavit re: economic impact of medical malpractice insurance reforms.

The Arc of Washington State, Inc., et al., v. Lyle Quasim, et al. (United States District Court, State of Washington: C99-5577FDB): Designated testifying expert re: economic and budgetary consequences of relief sought by plaintiff; deposed.

Washington Federation of State Employees, et al., v. State of Washington (Superior Court of the State of Washington: 98-2-02432-9): Designated testifying expert re: economics of public retirement systems. (Court granted summary judgment.)

Washington Federation of State Employees, et al., v. State of Washington (Superior Court of the State of Washington: 98-2-00100-1): Designated testifying expert re: economics of public retirement systems. (Court granted summary judgment.)

Levi Townsend v. Lyle Quasim (United States District Court, Western District of Washington at Seattle: C00-0944Z): Filed expert report re: economic and budgetary consequences of relief sought by Plaintiff.

Business

FEDERAL HOME LOAN BANK OF SAN FRANCISCO, 1991 - 1995.

Executive Vice President - Chief Operating Officer

Responsibilities: Accountable to the CEO for all business and financial operations of this $50 billion bank, including:

- Finance
- Sales/Marketing
- Strategic planning
- Customer service
- Information systems
- Accounting/Budgeting
- Corporate communications
- Corporate facilities
- Financial reporting
- Credit underwriting
- Affordable housing
- Administration

Accomplishments:

- Increased assets by $9 billion.
- Increased annual net income by $53 million.

- Implemented comprehensive risk management policies that increased income stability and reduced risk.
- Reduced operating expenses by 14%.
- Developed customer/product/business unit profitability system.
- Won support for the bank's legislative priorities from key federal agencies.
- Led the shift to a customer- and market-oriented corporate culture.
- Supervised preparation of two award-winning reports on affordable housing.

Senior Vice President - Sales & Marketing

Responsibilities: Accountable to the CEO for strategic planning, marketing, and sales.

Accomplishments:

- Reversed the downward trend in business.
- Implemented a segmented pricing strategy that generated $3 billion in new business within 3 months.

Senior Vice President - Administration

Responsibilities: Accountable to the CEO for strategic planning, budgeting, information systems, and real estate.

- Reduced operating expenses by 42%.
- Initiated strategies that helped bring occupancy in the Bank's 320,000 square foot headquarters building from 28% to 90% within 2 years.

WORLD SAVINGS AND LOAN ASSOCIATION, Oakland, CA, 1986 - 1991.

Vice President - Loan Service

Responsibilities: Accountable to SVP for providing quality service to 155,000 real estate loan customers and collecting $1.5 billion in payments annually. Managed 12 departments.

Accomplishments:

- Raised customer satisfaction by reducing telephone wait times 80% and error rates 50%.
- Instrumental in developing a product that, at one time, accounted for 10% of World's new business.

Vice President - Operations Analysis

Responsibilities: Accountable to EVP for corporate budgeting ($200 million/year) and operations improvement programs. Also supported strategic planning and business analysis.

Government

STATE OF CALIFORNIA, OFFICE OF THE LEGISLATIVE ANALYST, Sacramento, CA, 1977 - 1986.

Director (Legislative Analyst)

Responsibilities: Led a 95-person office that provided the Legislature and the public with objective analyses and recommendations on all aspects of state government. Testified before legislative committees on hundreds of occasions, and delivered more than 100 speeches on complex policy issues to civic and other groups.

Accomplishments:

- Prepared objective analyses of all Constitutional amendments, bond measures, citizen initiatives and other ballot propositions submitted to the voters.
- Published annual analyses of the Governor's Budget that recommended spending reductions totaling more than $1 billion.
- Prepared analyses of all bills affecting state expenditures or revenues, prompting thousands of perfecting amendments.
- Published analyses of key public policy issues, such as Proposition 13, rapid transit, health care, tax incentives, the environment, education, and corrections.
- Conceived and published a highly acclaimed annual report on strategic issues facing the state of California.

EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF MANAGEMENT AND BUDGET, Washington, D.C., 1969 - 1977.

<u>Division Director</u>

Responsibilities: Analyzed and made recommendations to the President on the programs/budgets of 3 cabinet-level agencies with $60 billion in spending authority. Previously served as a budget analyst and Branch Chief.

Accomplishments:

- Spearheaded the most extensive revision of subsidized housing and urban development programs ever undertaken.
- Prepared the analyses that helped convince the President to suspend or terminate nearly two dozen ineffective federal programs.
- Devised and won approval for new scorekeeping techniques that significantly increased the President's ability to control spending.
- Earned two Presidential citations.

ACADEMIC HONORS AND AWARDS

Phi Beta Kappa
Graduated magna cum laude, with high distinction
William A. Jump Memorial Foundation Meritorious Award for Exemplary Achievement in Public Administration
National Science Foundation Fellowship
Phi Kappa Psi (honorary fraternity for scholars)
Colby Prize (shared)
Institute for Labor and Industrial Relations Fellowship
Institute for Public Utilities Fellowship

OTHER APPOINTMENTS/AFFILIATIONS

Member, Board of Trustees, Freedom From Hunger, 2004-present
Fellow, National Academy of Public Administration, 1983-present
Founding Principal, Council on Excellence in Government, 1986-present
Member, American Economics Association, 1964-present
Member, American Law and Economics Association, 1996-present
Member, Commonwealth Club, 1990-present
Member, Governing Board of the California Institute for County Government, 1999-2005
Member, Advisory Panel of the California Earthquake Authority, 1998-2004
Member, California Citizens Budget Commission, 1993-2000
Member, Board of Directors - PrimeTech, Inc., 1997-2000
Member, Dean's Advisory Council, San Francisco State University, 1995-1998
Founding Member, Dean's Advisory Council, Graduate School of Management, University of California/Davis, 1984-1993
Member, Board of Visitors, Institute for Public Policy, Duke University, 1986-1989
President, Western Legislative Fiscal Officers Association, 1983-1985

December 2006

Exhibit 2

The "Sales" Component of California's Corporation Tax

Notation

A_t - Apportionment factor

A_p - Property factor

A_l - Payroll factor

A_s - Sales factor

Y - Worldwide income

R - Tax Revenue

T - Corporation Tax rate (8.84%)

Contribution of the sales factor to tax liabilities

$R = (A_t * Y) * T$

$$A_t = \frac{A_p + A_l + 2A_s}{4} = \frac{A_p}{4} + \frac{A_l}{4} + \frac{A_s}{2}$$

$R = [.25T * (A_p * Y)] + [.25T * (A_l * Y)] + [.5T * (A_s * Y)]$

Implicit tax on sales $= .5 * .0884 * (A_s * Y)$

$= .0442 * (A_s * Y)$

Exhibit 3

Mutual Fund Assets Managed, By Firm
50 Largest Mutual Fund Companies
(Dollars in Millions)

Rank	Ticker	Firm	Public / Private	Headquarters State	Total Assets	Assets Share of Total
[1]	[2]	[3]	[4]	[5]	[6]	[7]
		California Based MFSPs				
3		Capital Research & Management	Private	California	$993,660	12%
4	BEN	Franklin Templeton Investments	Public	California	$309,825	4%
14		PIMCO Funds	Private	California	$182,570	2%
32		Dimensional Fund Advisors Inc.	Private	California	$78,772	1%
45		Pacific Life Insurance Company	Private	California	$44,296	1%
		California Based Conglomerates with MFSP Operations				
12	SCHW	SchwabFunds/U.S. Trust	Public	California	$190,800	2%
19	WFC	Wells Fargo	Public	California	$116,700	1%
		Non California Based MFSPs				
1		Fidelity Investments	Private	Massachusetts	$1,100,455	14%
2		Vanguard Group	Private	Pennsylvania	$1,014,208	12%
5		Columbia Management Group	Private	Massachusetts	$228,763	3%
8		OppenheimerFunds/MassMutual	Private	New York	$212,786	3%
9		TIAA-CREF	Private	New York	$201,783	2%
10	FII	Federated Investors	Public	Pennsylvania	$195,513	2%
11	TROW	T. Rowe Price	Public	Maryland	$193,259	2%
13	LM	Legg Mason	Public	Maryland	$189,202	2%
15		Dreyfus Corporation	Private	New York	$175,961	2%
18		Dodge & Cox	Private	New York	$122,528	2%
21		Putnam Funds	Private	Massachusetts	$114,194	1%
22		AIM Investments	Private	Texas	$113,529	1%
26		MFS Investment Management	Private	Massachusetts	$96,873	1%
27		Hartford Mutual Funds	Private	Connecticut	$96,625	1%
28	JNS	Janus	Public	Colorado	$88,903	1%
29		Evergreen Funds	Private	Massachusetts	$88,654	1%
30		American Century Investments	Private	Missouri	$88,608	1%
31	SEIC	SEI	Public	Pennsylvania	$83,048	1%
34		RiverSource Investments, LLC	Private	Minnesota	$78,178	1%
35	AB	AllianceBernstein	Public	New York	$77,207	1%
36		First American Funds	Private	Minnesota	$61,416	1%
39		Lord, Abbett & Co. LLC	Private	New Jersey	$61,064	1%
41		Davis Selected Advisers, L.P.	Private	Arizona	$58,750	1%
46	EV	Eaton Vance	Public	Massachusetts	$43,365	1%
47	AMG	Affiliated Managers Group	Public	Massachusetts	$41,443	1%
48		Pioneer Investment Management USA	Private	Massachusetts	$38,176	0%
49	WDR	Waddell & Reed Funds	Public	Kansas	$38,050	0%
50	DGF/DDF	Delaware Investments / Lincoln Financial Group	Public	Pennsylvania	$37,823	0%
		Non California Based Conglomerates with MFSP Operations				
6	JPM	J.P. Morgan Chase & Co.	Public	New York	$219,024	3%
7	MS	Morgan Stanley	Public	New York	$216,973	3%
16	MER	Merrill Lynch Investment Managers	Public	New York	$151,044	2%
17	GS	Goldman Sachs & Co.	Public	New York	$126,957	2%
23		Prudential Mutual Funds	Private	New Jersey	$111,839	1%
24	BLK	PNC Financial Services Grp (BlackRock)	Public	Pennsylvania	$103,315	1%
25		John Hancock Financial Services	Private	Massachusetts	$99,982	1%
37	MET	MetLife	Public	New York	$64,336	1%
44	AIG	AIG SunAmerica Group	Public	New York	$48,832	1%
40	NTRS	Northern Trust Mutual Funds	Public	Illinois	$59,774	1%
42	BSG	BISYS Fund Services Group	Public	New Jersey	$54,834	1%
		Total			$8,113,805	100%
		Sample Distribution:	California based companies		24%	
			Non California based companies		76%	

Sources and Notes:

[1] Ranking based on assets under management as of 9/30/06, as reported by Investment Company Institute, www.ici.org.
[2] Company Ticker (applies to publicly traded firms only).
[3] Firms in the sample include Top 50 as ranked by assets under management, based on data from Investment Company Institute, 2006.
[4] "Public" and "Private" identifies publicly traded companies and privately held companies.
[5] State of Company Headquarter offices.
[6] Total Assets as of 9/30/06, as reported by the Investment Company Institute. Represents 84% of total industry assets ($9,722,162 million).
[7] Percentage of assets within the sample.

Exhibit 4

Operating Margins Achieved By Selected Publicly Held Mutual Fund Service Providers

(Dollars in Millions)

Ticker	Firm	Managed Assets [3]	Assets Share of Subset [4]	Revenue [5]	Operating Profits [6]	Operating Margin [7]	Return on Managed Assets [8]
California Based MFSPs [1]							
BEN	Franklin Templeton Investments	$309,825	12%	$4,310.1	$2,176.6	50.5%	0.70%
California Based Conglomerates with MFSP Operations [1],[2]							
SCHW	SchwabFunds/U.S. Trust	$190,800	7%	$3,685.0	$978.2		
WFC	Wells Fargo	$118,700	5%	$30,566.0	$11,548.0		
Non California Based MFSPs							
FII	Federated Investors	$185,513	8%	$909.2	$328.2	36.1%	0.17%
TROW	T. Rowe Price	$193,259	8%	$1,515.8	$648.8	42.8%	0.34%
LM	Legg Mason	$189,202	7%	$2,645.2	$648.1	24.5%	0.34%
BLK	PNC Financial Services Grp (BlackRock)	$103,315	4%	$1,191.4	$415.8	34.9%	0.40%
JNS	Janus	$88,903	3%	$953.1	$299.3	31.4%	0.34%
SEIC	SEI	$83,048	3%	$773.0	$220.3	28.5%	0.27%
AB	AllianceBernstein	$77,207	3%	$3,250.7	$1,228.8	37.8%	1.59%
EV	Eaton Vance	$43,355	2%	$753.2	$242.5	32.2%	0.56%
AMG	Affiliated Managers Group	$41,443	2%	$918.5	$381.3	41.8%	0.92%
WDR	Waddell & Reed Funds	$38,050	1%	$622.1	$120.7	19.4%	0.32%
Non California Based Conglomerates with MFSP Operations [2]							
JPM	J.P. Morgan Chase & Co.	$219,024	9%	$5,004.0	$1,860.0		
MS	Morgan Stanley	$216,973	8%	$2,907.0	$1,007.0		
MER	Merrill Lynch Investment Managers	$151,044	6%	$1,807.0	$586.0		
GS	Goldman Sachs & Co.	$126,957	5%	$4,749.0	$1,679.0		
AIG	AIG SunAmerica Group	$48,832	2%	$5,325.0	$2,253.0		
NTRS	Northern Trust Mutual Funds	$59,774	2%	$2,886.1	$948.7		
BSG	BISYS Fund Services Group	$54,834	2%	$619.5	$86.4		
	California based MFSPs Average Operating Margin					50.5%	
	Non-California based MFSPs Average Operating Margin					32.9%	
	Weighted Average Return on Managed Assets						0.7%

Sources and Notes:

[1] California-based firms designated based on Headquarters location.
[2] Financial Data for Conglomerates reflects closest available business segment with MFSP operations.
[3] Total Assets as of 9/30/06, as reported by the Investment Company Institute.
[4] Subset represents $2.5 trillion, or 26.2% of total U.S. MFSP Managed Assets.
[5] Thomson Financial Data for Fiscal Year 2005.
Pre-tax operating profits and margin figures from Fox-Pitt, Kelton Group US Equity Research (10/24/06) (P. 9),
[6] except SEI figure from Thomson Financial and All Conglomerates' figures from 10-Ks, estimated by LECG.
[7] = [6] / [5].
[8] = [6] / [3].

Exhibit 5

Calculation of California Income Apportionment

Difference Between Current and Proposed Systems

(Dollars in Millions)

	California Income Apportionment	
	Current System	**Proposed System**
Total Managed Assets [1]	$9,722,162	
Estimated Return on Managed Assets [2]	0.7%	
Estimated World Wide Taxable Income [3]	$68,055	
California Tax Portion [4]	4.42%	4.42%
California Percentage Apportionment [5]	24.0%	11.7%
Total California Income [6]	**$722**	**$352**
Difference [7]	**$370**	

Notes:
[1] Total assets under management as of 9/30/06, as reported by the Investment Company Institute, ww.ici.org.
[2] Estimated ratio of pre-tax profits to managed assets, based on publicly traded MFSPs.
[3] = [1] * [2]
[4] Implicit tax on sales.
[5] California apportionment. In the current system based on the percentage of California-based assets under management. In the proposed system, based on the percentage of California-based income for NAICS 523 (as reported by BEA).
[6] = [3] * [4] * [5].
[6] = [3] * [4] * [5].
[7] = Difference in California Income between current system and proposed system.
Estimated income apportionment figures do not incorporate any tax relief that may have been granted to California MFSPs.

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December 15, 2006

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By Facsimile & U.S. Mail

Colleen Berwick
Franchise Tax Board
Legal Branch
P.O. Box 1720
Rancho Cordova, CA 95741-1720

Re: Proposed Regulation 25137-14—Mutual Fund Service <u>Providers and Asset Management Service Providers</u>

Dear Ms. Berwick:

Please accept the following submission as our comments regarding Proposed Regulation 25137-14.

1. We understand that the proposed regulation's concept of receipts from the provision of management services is not intended to encompass receipts from sales of the taxpayer's own intangible assets to regulated investment companies ("RICs") or other entities. However, we believe the current form of the proposed regulation may result in some confusion about this because it defines management services to include "the selling or purchasing of securities constituting assets of a regulated investment company."

We believe that the intent not to include receipts from sales of the taxpayer's own intangible assets would be substantially more clear if the first sentence of subsection (a)(3) were amended to read as follows:

> "Management services" includes, but is not limited to, the rendering of investment advice directly or indirectly to a regulated investment company, making determinations as to when sales and purchases of securities are to be made on behalf of the regulated investment company, or **providing services related to** the selling or purchasing of securities constituting assets of a regulated investment company, and all related activities.

Silverstein & Pomerantz LLP

ATTORNEYS AT LAW

If you decline to amend the proposed regulation in this manner, we would appreciate confirmation of the reason(s) you believe the regulation already clearly does not apply to receipts from sales of the taxpayer's own intangible assets.

2. We find the use of the term "individual: in subsection (b)(1)(B), which provides the rule for sourcing receipts from asset management services, to be confusing for at least two reasons. First, according to the definition of in subsection (a)(7), "asset management services" includes only services provided to *entities*. Second, subsection (b)(1)(B)(1 and 2) also relate to services provided to *entities*.

Because we understand the intent of subsection (b)(1)(B) is to assign receipts from the provision of asset management services to the domicile of the ultimate (individual) owner of the assets held and managed by the above-referenced entity, we recommend the following clarification to that subsection:

> If a mutual fund service provider has receipts from performing asset management services, in addition to performing services for regulated investment companies, these services shall be assigned to this state if the domicile of the **ultimate owner or beneficiary of the entity receiving the services** is located in this state.

If you decline to amend the proposed regulation in this manner, we would appreciate confirmation of the regulation's intent to source receipts from the provision of asset management services to domicile of ultimate individual owner of the assets, *i.e.*, to source the receipts in question on a look-through basis.

3. Our final comment relates to subsection (b)(1)(B)(2)'s throw-out approach in the event the domicile of the ultimate owners or beneficiaries of the entity receiving asset management services could not be obtained. We believe a throw-out rule in this context would be distortive. In the event the domicile of the ultimate owners or beneficiaries of the entity receiving the asset management services could not be obtained, it is unlikely the receipts of only a small number of ultimate owners or beneficiaries will be affected. It is much more likely that the inability to obtain the appropriate domiciles will extend to *all* of the ultimate owners or beneficiaries of a single fund or even multiple funds. In this way, we believe the facts surrounding RICs and other types of funds (*e.g.*, pension funds) are materially distinguishable. Whether the assumption is correct that a throw-out rule in the RIC context will not have a material impact on the outcome, we do not believe the same assumption can be made in the context of other types of funds. Accordingly, we urge you to consider amending subsection (b)(1)(B)(2) to provide that if the domicile of

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the ultimate owners or beneficiaries of the entity receiving the asset management services could not be obtained, the receipts in question would be sourced on the basis of Rev. & Tax. Code § 25136. We note that this would be consistent with the regulation's approach to avoiding no-where income in subsection (b)(1)(D) of the proposed regulation. In both cases, we feel that sourcing receipts on the basis of section 25136 would provide a more accurate reflection of California income.

Thank you very much for your consideration of our comments.

Very truly yours,

Amy L. Silverstein

Ameriprise Financial

Ameriprise Financial, Inc.
1163 Ameriprise Financial Center
Minneapolis, MN 55474

December 15, 2006

Ms. Colleen Berwick
California Franchise Tax Board
Legal Branch
P.O. Box 1720
Rancho Cordova, California 95741-1720

RE: Proposed California Code of Regulations, Title 18, Section 25137-14
Mutual Fund and Asset Management Service Providers

Dear Ms. Berwick:

On October 30, 2006, the California Franchise Tax Board (the "FTB") officially published its notice of intent to begin the rulemaking process with respect to the above-referenced proposed regulation. In response to that notice, we are hereby submitting comments that address the impact of the proposed regulation on Ameriprise Financial, Inc. ("Ameriprise Financial" or the "Company") and our suggested changes to the regulation that would provide more flexibility in its implementation.

Summary of Position

As you are aware, the proposed regulation would modify the sales factor calculation in the apportionment formula by assigning the receipts of a mutual fund service provider ("MFSP") from services provided to or on behalf of a mutual fund based on the number of shares owned by the fund's shareholders domiciled in California. Our concern is that the proposed regulation, as currently written, would result in double taxation and an inequitable apportionment of Ameriprise Financial's MFSP income (including its asset management service income) to California. As will be more fully discussed below, Minnesota law provides that fees collected by an MFSP should be apportioned to Minnesota based upon the location of the fund and not where the shareholders are domiciled. Thus, to the extent the receipts of a Minnesota MFSP are apportioned to California under the proposed regulation (based on shareholders and beneficiaries domiciled in that state) and also to Minnesota (based on the location of the fund), such receipts would be subject to double state taxation. To avoid this situation, we respectfully recommend (1) that the proposed regulation be made elective, (2) that the scope of the proposed regulation be narrowed to exclude an MFSP's income from asset management services, and (3) that the proposed regulation be amended to confirm that an MFSP may continue to seek relief under section 25137 if the proposed regulation would result in an inequitable apportionment of its income to California.

Ameriprise Financial

Ameriprise Financial, Inc.
1163 Ameriprise Financial Center
Minneapolis, MN 55474

The Business of Ameriprise Financial.

Ameriprise Financial is a leading financial planning and services company with financial advisors and registered representatives who provide solutions for clients' asset accumulation, income management and insurance protection needs. The advisors and representatives offer a full range of products required to implement their clients' personalized financial plans. In addition, Ameriprise Financial (itself and through its subsidiaries) acts as an MFSP and provides investment management services (including asset management services) to the RiverSource Investments family of funds and Ameriprise Financial certificates and to its institutional clients, alternative investments, insurance assets and managed account programs. Other products and services offered by the Company include auto and home insurance, banking, brokerage and managed Products, 401(k) retirement plans, financial education and retirement planning services, trusts and certificates, life insurance, and annuities.

Ameriprise Financial (including a significant portion of its operations) is headquartered in Minnesota. The Company has financial advisors, representatives and asset management services divisions throughout the United States. The services and products provided to retail customers, and to a lesser extent, institutional customers, are the primary source of the Company's revenues and net income. Ameriprise Financial and its affiliates file their state income tax returns on a unitary basis in several states including California.

The RiverSource Funds is a group of mutual funds sponsored by RiverSource Investments, LLC, a wholly owned direct subsidiary of Ameriprise Financial. There are approximately 100 funds that comprise the RiverSource Funds, most of which are organized as Minnesota corporations. Approximately six to ten of the funds constitute Massachusetts business trusts. The RiverSource Funds contract with RiverSource Investments and Ameriprise Financial directly or with affiliated companies of these entities for investment management, administration, transfer agency, custodian, underwriting and distribution services. The principal place of business for the RiverSource Funds is Minnesota. A common, independent board of directors/trustees oversees all of the RiverSource Funds and generally conducts its business in Minnesota.

Background and Impact of the Proposed Change.

Under current law, California's general rule apportions the Company's MFSP income by assigning such income to the jurisdiction where the income-producing activity related to the service is performed.

The proposed regulation would modify the sales factor calculation by assigning an MFSP's receipts from services provided to or on behalf of a mutual fund based on the

Ameriprise Financial

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number of shares owned by the fund's shareholders domiciled in California. The Staff of the FTB provided the following rationale for changing the calculation of the sales factor for MFSPs:[1]

> The normal apportionment provisions set forth in Revenue and Taxation section 25136 assign receipts to the location where the income producing activity occurs. For [MFSPs], this usually results in most, if not all, of their receipts for services being assigned to one location. This is at odds with the purpose of the sales factor, which is to reflect the market for a taxpayer's goods and services. <u>This problem has been remedied in most states by overriding the normal UDITPA rules and assigning receipts to the numerator of the sales factor based upon the location of the underlying shareholders of the mutual funds.</u> This location is usually deemed to be the mailing address on file with the fund. Such a methodology would appear to be appropriate for use in California as well. [Emphasis added.]

The Staff provided an additional reason for the regulation which is to avoid dealing with section 25137 petitions "on a piecemeal basis." Rather, the "Staff believes that it is appropriate to formally recognize the need for a variance from standard [UDITPA] provisions."[2]

<u>Minnesota Apportionment Law and the Lutheran Brotherhood Decision.</u>

The general rule regarding the apportionment of net income to Minnesota is set forth in Minn. Stat. §290.191, subd. 1, which provides that "the net income from a trade or business carried on partly within and partly without this state must be apportioned to this state as provided in this section." Subdivision 2 of that section further provides an apportionment formula of general application. Regarding the calculation of the sales factor, Minn. Stat. §290.191, subd. 5(j) provides a special rule for service income:

> <u>Receipts from the performance of services must be attributed to the state where the services are received</u>. For the purposes of this section, receipts from the performance of services provided to a corporation, partnership, or trust may only be attributed to a state where it has a fixed place of doing business. If the state where the services are received is not readily determinable or is a state where the corporation, partnership, or trust receiving the service does not have a fixed place of doing business, the services shall be deemed to be received at the location of the office of the customer from which the services were ordered in the regular course of the customer's trade or business. If the ordering office cannot be

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[1] Request for Permission to Proceed with Formal Regulation Process on Proposed Regulation 25137-14, Relating to Mutual Fund Service Providers (6/19/06).
[2] <u>Id.</u>

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determined, the services shall be deemed to be received at the office of the customer to which the services are billed. [Emphasis added.]

In Lutheran Brotherhood Research Corp. v. Commissioner, 656 NW2d 375 (Minn. Sup. Ct. 2003), the Minnesota Supreme Court held that the consumer of services provided by an MFSP to a mutual fund is the fund itself and *not* its shareholders for purposes of this statute. Accordingly, the Supreme Court determined that the fees collected by the MFSP should be apportioned to Minnesota based on where the fund was located and not where the shareholders were domiciled.[3]

Lutheran Brotherhood was a Minnesota fraternal benefit society that was the parent corporation of various entities and that operated a group of six mutual funds referred to as the Lutheran Brotherhood Family of Funds (LB Family). The funds contracted directly with Lutheran Brotherhood Research Corporation (LBR) and its subsidiary, Lutheran Brotherhood Securities (LBS), for management and investment advisory services. The contracts identified Minnesota as the principal place of business of LBR, LBS, and each of the funds. Thereafter, the LB Family was reorganized as a Delaware business trust and each of the funds became sub-trusts. The principal office of the trust was in Minnesota and most of the trustees of the LB Family were residents of that state as well, although the fund assets were held by a custodial bank in Massachusetts.

The Minnesota Supreme Court rejected the taxpayer's argument that the mutual fund was merely a conduit and that the services were consumed by the investors in the mutual fund. In so doing, it considered the fact that a mutual fund could not exist unless a separate entity held and managed the fund's assets and acted as an intermediary between the fund and its investors. The Court noted that the trustees of the LB Family determined the investment objectives of the funds and, through its contracts, continuously monitored the performance of the MFSPs. Thus, the Court concluded, the LB Family was the consumer of the benefits of the services of LBR/LBS, and the fees received by LBR/LBS for those services were appropriately attributed to Minnesota as the location of LB Family.

Because the funds managed by Ameriprise Financial's MFSP are located in Minnesota, 100 percent of the income earned by Ameriprise Financial's MFSP is apportioned to Minnesota and not to the location of the funds' shareholders. Similarly, a significant portion of the income received by Ameriprise Financial's MFSP from asset management services provided to its institutional clients (insurance companies, pension

[3] At the time Lutheran Brotherhood was decided, the Minnesota apportionment statute looked to where the benefits of the services were "consumed." Pursuant to a technical amendment, the statute has since been amended to tax income from services in the state where the services are "received." Such amendment should not alter the conclusions reached in Lutheran Brotherhood for future tax years.

funds, etc.), is apportioned to Minnesota because Minnesota law focuses on the entity receiving the benefit of the services rather than its underlying beneficiaries.

The proposed regulation, as currently written, would result in an inequitable apportionment of Ameriprise Financial's MFSP income (including its asset management service income) that is apportioned to California based on shareholders domiciled in California because such income would be subject to duplicative state taxation. Such a result is also "at odds with the purpose of the sales factor, which is to reflect the market for a taxpayer's goods and services."[4] To avoid this situation, we respectfully recommend, as discussed below, (1) that the proposed regulation be made elective, (2) that the scope of the regulation be narrowed to exclude an MFSP's income from asset management services, and (3) that the regulation be amended to confirm that an MFSP may continue to seek relief under section 25137 if the proposed regulation would result in an inequitable apportionment of its income to California.

Recommendation That the Proposed Regulation Be Made Elective.

On its face, the proposed regulation appears to be non-elective. Specifically, Prop. Reg. §25137-14(b) provides that:

> The property, payroll and sales factors of the apportionment formula for [MFSPs] shall be computed pursuant to Section 25128 through 25137 of the Revenue and Taxation Code and the regulations adopted pursuant thereto, except as provided in this regulation.

The proposed regulation then proceeds to describe the method for calculating the sales factor for MFSPs. Because the proposed regulation would result in double taxation for MFSPs providing services to mutual funds located in Minnesota, we request that the proposed regulation be made elective, as has been done in at least one other state,[5] but only for situations similar to that which currently exists in Minnesota where the state's apportionment law allocates an MFSP's receipts from services provided to a mutual fund on the basis of the location of the fund rather than the domicile of the fund's shareholders. If such an election were available, only companies subject to double taxation and similarly situated to Ameriprise Financial would avoid the inequitable apportionment of its MFSP income to California that results from the interaction of the two states' inconsistent apportionment laws. Accordingly, we propose that the following language be added as new subsection (c) to Section 25137-14 of the proposed regulation:

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[4] Request for Permission to Proceed with Formal Regulation Process on Proposed Regulation 25137-14, supra.
[5] The State of Maine permits an MFSP to elect to apportion its income using a sales factor formula that accounts for shareholders in Maine and elsewhere. See Me. Rev. Stat. Ann. §5212 (2). The election is irrevocable for successive 5-year periods.

"(c) *Election out of special apportionment formula for certain mutual fund service providers.* Notwithstanding any other provision in this regulation, a mutual fund service provider may elect, under the limited circumstance specified herein, not to apportion its total receipts for the taxable year pursuant to the method set forth in Section 25137-14(b)(1) of the Code of Regulations. The election is available to a mutual fund service provider that meets the following two conditions: (i) The mutual fund service provider is located in a state other than California, and (ii) that other state's apportionment law allocates the mutual fund service provider's income based on the location of the fund rather than on the location of the fund's shareholders. If the mutual fund service provider makes such an election, the property, payroll and sales factor of the apportionment formula for mutual fund service providers shall be computed pursuant to Sections 25128 through 25137 of the Revenue and Taxation Code and the regulations pursuant thereto as if Section 25137-14(b)(1) had not been promulgated."

The Scope of the Asset Management Services Apportionment Provision Should Be Narrowed.

In its present form, the proposed rule would also require that an MFSP, which performs services for a fund, assign the receipts from performing asset management services to a pension plan, retirement account or institutional investor (such as an insurance company or a private bank) to California if the *beneficiary* owning the assets is domiciled in California. Initially, it should be noted that although the proposed rule is clear what receipts from asset management services are to be apportioned, it is not clear as to who the beneficiary is for purposes of this rule. Under Minnesota law, income received by an MFSP from asset management services provided to institutional clients in Minnesota is currently apportioned to Minnesota because Minnesota law focuses on the location of the entity receiving the benefit of the services rather than its underlying beneficiaries. If the California proposed rule is finalized, companies like Ameriprise Financial would be double taxed on the income their MFSP receives from providing asset management services to institutional clients to the extent those clients have beneficiaries that are domiciled in California.

Not only is the double taxation a concern that directly impacts Ameriprise Financial and other companies that are similarly situated, we are also concerned about the need for and impact of the proposed rule. As noted above, the Staff of the FTB focused on the "need for an alternative apportionment methodology" for MFSPs that provide services to mutual funds due to the increased amount of Section 25137 special relief petitions from California's standard apportionment rules.[6] However, there was no

[6] See Request for Permission to Proceed with Formal Regulation Process on Proposed Regulation 25137-14, Relating to Mutual Fund Service Providers (June 19, 2006).

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mention that asset management service providers had been requesting similar relief. Similarly, in the Notice of Public Hearing dated June 19, 2006, that accompanies the proposed regulation, the rule is described generally without any explanation of its purpose:

> Subsection (b)(1)(B) provides rules for the assignment of receipts from asset management services. <u>The rule only applies to unitary businesses that are also mutual fund service providers. This was done to limit the scope of the regulation.</u> The rule adopts a domicile concept to represent the market. It also provides rules for pension plans and other entities and assigns these based on the domicile of the beneficiaries under subsection (b)(1)(B)(i) and, if this is not known, by a reasonable method to approximate this information statistically. Subsection (b)(1)(B)(ii). If no method is developed, these receipts are excluded. [Emphasis added.]

It should be noted, however, that the Explanation of the Discussion Draft 25137-14 dated June 19, 2006, simply notes that "interested parties requested [the] addition" of the provisions relating to the apportionment of the receipts from asset management services without providing any rationale for that provision. There is no other indication that the apportionment of these receipts presented a concern to the staff of the FTB. While this provision may provide a benefit to the particular interested party, having it apply to all taxpayers may result in unintended consequences to companies like Ameriprise Financial which has an MFSP for its mutual fund that also provides asset management services to institutional clients with which it is unitary.

Thus, for example, to the extent an insurance company paid an unrelated non-California entity that was not an MFSP a fee for asset management services, that fee would not have to be apportioned to California notwithstanding that the insurance company may have beneficiaries that are domiciled in California. The mere fact that the fees for such asset management services are instead paid by an insurance company to an MFSP (both being California nonresidents) should not render that income allocable to California based on the beneficiaries domiciled in that state. The proposed rule would thus produce inconsistent apportionment results in the case where an insurance company pays a fee to more than one asset management service provider if one such provider was also an MFSP. Accordingly, we respectfully request that the scope of that regulation be curtailed by deleting section 25137-14(a)(7) (defining the term "Asset Management Services") and section 25137-14(b)(1)(B) including subsections (1) and (2) thereof (assigning receipts that an MFSP receives from performing asset management services to institutional clients) and any other references to the apportionment of receipts from asset management services from the proposed regulation.

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In the alternative and in an effort to resolve the situation of double taxation impacting Minnesota MFSPs that are similarly situated to Ameriprise Financial, we propose the following amendment to section 25137-14(b)(1)(B)(1) such that an MFSP's receipts from asset management services provided to an insurance company be assigned to California based on the domicile of that company rather than that of its beneficiaries:

> In the case of asset management services directly or indirectly provided to a pension plan, retirement account or institutional investor, such as private banks, national and international private investors, or international traders, receipts shall be assigned to this State to the extent the domicile of the beneficiaries of the plan, beneficiaries of the account or beneficiaries of the similar pool of assets held by the institutional investor, is in this State. Receipts from asset management services provided directly or indirectly to an insurance company shall be assigned to this State only if the domicile of such insurance company is in this State.

Clarification of MFSP's Continuing Right to Seek Relief under Section 25137.

We are also concerned that the proposed regulation may preempt an MFSP from seeking relief under Section 25137 of the Revenue and Tax Code because of the FTB's desire to limit responding to such petitions on a "piecemeal" basis. Therefore, we believe that the proposed regulation should make it clear that taxpayers may continue to seek special relief under Section 25137 in the event neither the California apportionment rules applicable to MFSPs nor the general apportionment rules result in an equitable apportionment.

Thank you for providing Ameriprise Financial with the opportunity to submit comments on the proposed regulation. After you have had an opportunity to review this material, please contact Richard Bush (612-671-5219) or Brian Pietsch (612-671-6837) with any questions or comments that you may have.

Respectfully submitted,

Richard N. Bush

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Corporate Tax Department
Ameriprise Financial, Inc.

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December 15, 2006

Ms. Colleen Berwick
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Legal Branch
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Re: Proposed Regulation 25137-14, Mutual Fund Service Providers

Dear Ms. Berwick:

The Franchise Tax Board (FTB) is considering the adoption of Regulation 25137-14 on Mutual Fund Service Providers. Manatt represents a coalition of mutual fund companies that provide services to mutual funds. The members will be subject to the regulation if adopted. The companies are opposed to the regulation in its current form because it singles out mutual fund advisors for discriminatory treatment. It requires mutual fund advisors to apply the "Finnegan" application for its unitary group while all other financial service advisors would apply the "Joyce" application for its unitary group. As mutual fund advisors also provide the same or similar services as other financial service companies, the adoption of the regulation would violate the California constitutional requirement of equal protection of the laws (taxing the same type of income earned by different taxpayers differently). It would also be unfair if mutual fund advisors are singled out as the only taxpayers subject to the Finnegan theory of unitary apportionment. In a highly competitive market for customer assets, this nonuniform application of taxation will create an uneven playing field.

California apportions the amount of a taxpayer's income taxable in the state by comparing the amount of the taxpayer's property, payroll, and sales in California to the taxpayer's total property, payroll, and sales. Apportionment of the sales factor for sales other than tangible personal property is based on where the income-producing activity has occurred. Revenue and Taxation Code Section 25136. Mutual fund service providers provide services that are apportioned under the provisions of Section 25136.

At the request of some California-based mutual fund companies, the FTB staff held a symposium on October 20, 2005. The FTB has granted individual variances from the standard apportionment formulas to a number of taxpayers under the provisions of Revenue and Taxation Code Section 25137. The staff proposed sourcing sales based on the location of the shareholders of the mutual fund. Following the symposium, the staff recommended the adoption of a regulation that would apply generally to mutual fund service providers based on the underlying location of the mutual fund shareholders.

The coalition does not object to the use of the location of the shareholders to determine the sales factor. However, the proposed regulation would also change the determination of which sales taxpayers will have to be included in the apportionment formula. In subsection (b)(1)(C), the regulation would assign the receipts based on the activities of the whole unitary group if any member of the group has nexus in California, even if no group member with nexus in California is a mutual fund service provider. This makes no sense as a matter of tax policy or fundamental fairness. This change in the normal method of apportionment will unreasonably apportion sales to California. The coalition opposes this provision. It is unnecessary and it flies in the face of judicial and Board of Equalization decisions.

When considering a regulation, the administrative agency must meet the standards of authority, reference, consistency, clarity, nonduplication, and necessity. Government Code Section 11349.1. Consistency means being in harmony with, and not in conflict with or contradictory to, existing statutes, court decisions, or other provisions of law. Government Code Section 11349(d). Necessity means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, *court decision (emphasis added),* or other provision of law that the regulation implements, or makes specific, taking into account the totality of the record. For purposes of this standard, evidence includes, but is not limited to, facts, studies, and expert opinion. Government Code Section 11349(d). The proposed regulation fails to meet both of these standards.

The appellate courts and Board of Equalization (BOE) have established by decision that the sales of companies with no taxable nexus in the state should not be included in sales attributed to California. Citicorp North America v. FTB (10/02/02) 83 Cal. App. 4th 1403; Appeal of Joyce, Inc. (11/23/66) Cal. St. Bd. of Equal. (Joyce); In re Huffy (4/22/99) 99-SBE-005 (Huffy). Huffy specifically overruled decisions by the SBE in Finnegan I (8/25/88) 88-SBE-022 and Finnegan II (1/24/90) 92-SBE-024. After Huffy, no longer could an out-of-state company with no tax nexus with California be forced to include its sales in the California sales factor just because another member of the unitary group had tax nexus in the state. If a taxpayer does not have tax nexus with California, the sales of the taxpayer without nexus are excluded from the sales factor in California. Proposed regulation 25137-14 (b)(1)(C) is inconsistent with the decisions in Joyce and Huffy. As a result, the regulation violates the consistency standard of Government Code Section 11349(d). No reason has been advanced why the mutual fund service industry should be treated differently than other industries.

The BOE has recognized, as it must, that other states are following Joyce and that use of a Finnegan approach will lead to less rather than more uniformity.

If the proposed regulation is adopted using Joyce rather than Finnegan, many members of the coalition will still have a higher sales factor than under current law, and California mutual companies will still face lower overall taxation. However, even with this potential for a higher tax burden, the coalition does not object to the adoption of a sales factor based on shareholder location if the regulation treats the mutual fund service industry the same as other industries and uses a Joyce rule.

The coalition also objects to the use of the "throwback" provision in subsection (b)(1)(D). The FTB does not have the legal authority to adopt a throwback rule in this context. A throwback rule is intended to "throwback" sales of "tangible property" to California when the taxpayer is not taxable in the state of delivery. Revenue and Taxation Code Section 25135. Revenue and Taxation Section 25136, which determines the location of sales for intangible property, including services, does not provide for a throwback rule. Clearly, the legislature understood how to draft a throwback rule and if it had intended to adopt a throwback rule for intangible property it would have done so in Revenue and Taxation Code Section 25136.

Revenue and Taxation Code Section 25137 allows the FTB to require an alternative apportionment method only when the normal apportionment provisions of the law do not fairly represent the extent of the taxpayer's business activity in the state and the alternative is reasonable. The entity proposing the alternate formula, under the regulation the FTB, has the burden of proving by clear and convincing evidence that the alternative is necessary to represent fairly the business activity. Microsoft Corporation v. Franchise Tax Board (2006) 39 Cal.4th 750, 765. The FTB has not presented anything close to clear and convincing evidence why there needs to be a deviation from the Joyce decision on nexus or throwback.

In the Statement of Necessity in the regulation announcement, the FTB only states, "there has been relief granted under Revenue and Taxation Code Section 25137 on a case-by-case basis but that there is no comprehensive regulation for mutual fund service providers." The FTB, however, has made no showing as to why a comprehensive regulation is necessary, nor has it justified an approach that ignores the clear statutory language. Section 25137 allows the FTB to make decisions on a case-by-case basis. In light of the Microsoft decision establishing the FTB's burden to show that an alternative is needed by clear and convincing evidence, the FTB has failed to show with substantial evidence the necessity of subsection 25137-14 (b)(1)(C).

The FTB is acting at the request of a small group of mutual fund companies. These companies will continue to be able to request individualized relief under Revenue and Taxation Code Section 25137. Alternatively, the FTB can amend the regulation to remove subsections (b)(1)(C) and (D). As stated earlier, if the sections are deleted many coalition members will still face an increase in their apportionment factors, but in a more equitable manner, based on the rule in Joyce.

In addition to the comments describing the coalition's basis for opposition to the regulation, the following requests for clarifications and amendments are made:

Clarify the definition of "mutual fund service provider."

Clarify how "Joyce vs. Finnegan" will work in a unitary return that has both mutual fund service providers and nonmutual fund service providers, but files a unitary return in California.

A request that subsection (b)(1)(A)(2) be amended to read as follows:

> "The regulated investment company's taxable year for computing the shareholder ratio shall be the taxable year that ends during the taxable year of the principal member or the mutual fund service provider's combined reporting group. Notwithstanding the above, a mutual fund service provider may use the year-end of the RIC's fund advisor for this calculation, as long as the mutual fund service provider consistently uses this method from year to year. For purposes of this provision, a RIC's fund advisor is the person that is directly and primarily responsible for providing investment advice to the RIC under a contract entered into pursuant to 15 U.S.C. s. a-15(a)."

The additional language included in the above section is the same language that has been adopted by the state of Massachusetts. This additional language eases the administrative burden on providers of mutual fund services who may have hundreds of mutual funds with year-ends spread over the entire year.

The coalition would like to propose that the following language be added to help ease the administrative burden for those members of the industry that do not derive a significant portion of their revenues from RIC services.

> "A mutual fund service provider that derives less than 50% of its gross income from the direct or indirect provision of management, distribution, or administrative services to or on behalf of a regulated investment company is not subject to the provisions of this section."

The adoption of our proposed amendments will move California towards more uniformity with other states and make compliance with the regulation easier.

Thank you for your attention to this matter.

Sincerely,

Fred Main

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BARCLAYS GLOBAL INVESTORS

December 18, 2006

DELIVERED BY E-Mail
Ms Colleen Berwick
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Re: Comments Regarding Proposed Apportionment Regulations for Mutual Funds and Other Asset Managers

Dear Ms Berwick:

Thank you for the opportunity for Barclays Global Investors to provide comments on Regulation 25137-14. Our comments and questions are listed below.

<u>Specific Comments on Regulation 25137 -14</u>

Apportionment According to Shareholder Identification Rule (Subsection (b)(1)(A)1)

Subsection (b)(1)(A)1 contains rules regarding the assignment of fund shares based on a reasonable method derived from information received from the shareholder of record. If no information is received, then the shares are eliminated from the ratio of the given fund.

Receipts from closed-end mutual funds and exchange traded funds would be subject to this subsection with regard to apportionment. These types of funds are traded on public markets such as the New York Stock Exchange however asset managers for such funds do not have direct access to information about the location of investors in the funds. Consequently, these receipts would therefore be eliminated from the sales factor. If these receipts are thrown out of the sales factor it may distort the overall apportionment computation for the unitary group.

A reasonable estimate to apportion these funds could be derived based on information about investors using US national census data. This information is dependable and would be less subject to manipulation. We would like to propose that this methodology be taken into account as an option to source receipts when shareholder of record information is not available.

Further Clarification As to What Might Constitute a "Reasonable Method" under Subsection (b)(1)(B)

Subsection (b)(1)(B) outlines rules to apportion receipts from asset management services. These rules also adopt a market sourcing concept based on the domicile of the beneficiary and allow for a "reasonable method to approximate this information statistically" if the actual data is not known.

We propose that more clarification be given as to what might constitute a "reasonable method". Specifically, would using a US national census data be an acceptable statistical approach?

Confirmation of Regulation 25137-14 Applicability to Both Financial and General Corporations.

Please confirm that Regulation 25137-14 will apply to both financial and general corporations as the focus of this new regulation is on the type of receipt rather than the type of entity for California tax purposes.

* * *

We hope that our comments and questions are helpful to you and other tax payers that will be subject to the new rules. We would be pleased to try to provide any additional information that might be useful to further explain the comments outlined above.

Sincerely,

Neal Reilly

Capital Group℠
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December 18, 2006

Mr. Carl Joseph
Franchise Tax Board, Legal Department
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Rancho Cordova, CA 95741-1720

Re: Comments on FTB Proposed Regulation 25137-14 Regarding Apportionment for Mutual Fund Service Providers

Dear Mr. Joseph:

The Capital Group Companies, Inc. ("Capital") fully supports the proposed regulation of the Franchise Tax Board's Legal Department to adopt a shareholder residency method of apportioning a mutual fund service provider's California taxable income in order to fairly reflect the service provider's market activity in the state. We concur with the FTB Legal Department's view that the current cost of performance method for assigning receipts is distortive when applied to the highly integrated business model of mutual fund service providers and therefore should be replaced with the shareholder residency market-based apportionment method which ideally suits businesses of this nature.

As part of the rulemaking process to date, Capital has filed two separate comment letters in support of the FTB effort to establish an industry-specific tax apportionment rule for mutual fund service providers. We attach those letters herewith and request that they be accepted as part of the rulemaking record, and further draw particular attention to the specific comments provided in Capital's June 16, 2006 correspondence which recommend modest amendments to the proposed regulation to facilitate its administration on a practical basis.

Capital offers the following comments in support of Proposed Regulation 25137-14.

I. Capital is a highly interdependent, unitary group that provides mutual fund and asset management services.

Capital and its subsidiaries provide investment management and related services to both the American Funds Group of mutual funds and to institutional investors such as pension plans, public retirement plans, endowments and foundations.

Capital's mutual fund services are directed toward literally millions of investors located throughout the United States and abroad with a large majority of those investors residing outside of California. Capital is among the three largest mutual fund investment managers in the country and is the largest manager of actively managed mutual funds in the world. Capital has been headquartered in California since its inception more than 75 years ago and has offices in many other states and countries.

Capital and its affiliates constitute a unitary group for purposes of our annual tax filings with the Franchise Tax Board. Included in this group are the companies that provide services to the American Funds Group of mutual funds, as follows:

Investment Advisor
Capital Research and Management Company ("CRMC") is the investment advisor to the American Funds and provides investment management services pursuant to an agreement with each fund. Under most agreements, the fund pays a monthly fee for investment management based on the fund's average daily assets. The investment results achieved by the investment advisor impact the ability of the distributor to market the fund and could impact the number of accounts that the administrative service provider services.

Distributor and Underwriter
American Funds Distributors, Inc. ("AFD") is the distributor and underwriter of the mutual funds and is a subsidiary of CRMC. The distributor earns fees by distributing and marketing the fund pursuant to an agreement with each fund. Depending upon the type of share class that is sold, the distributor is either paid by the customer directly (A shares) or through a third-party financing arrangement (B shares). The distributor earns no revenue on sales of other share classes. Investment results, effective marketing and investor education helps create demand for the American Funds family of mutual funds.

Administration Services
American Funds Service Company ("AFS") is the mutual fund transfer agency and shareholder-servicing company that provides shareholder record keeping services and acts as a transfer agent for each mutual fund pursuant to an agreement with each fund. Under most agreements, the shareholder-servicing agent is paid a fee usually based on a variety of transaction metrics. AFS has developed an array of additional services that are attractive to the customer/investor including automatic investment plans, automatic payroll deductions, systematic withdrawal plans, electronic funds transfers, toll-free telephone numbers and electronic receipt of statements and reports. These innovations are aimed at retaining the existing shareholder base, create ongoing customer loyalty and are essential to being regarded as a premier servicing company in the broker/dealer community. AFS is also a subsidiary of CRMC.

The various companies that service the mutual funds are interdependent and complementary with respect to their contractual obligations to each of the 30 mutual funds which comprise the American Funds family and the more than 20 million shareholders invested in the funds.

II. Mutual fund service providers are highly integrated and the income they generate is uniquely dependent on their relationship with shareholders who are generally located outside the provider's state of domicile.

The mutual fund industry is unique in that it is highly integrated but due to a web of extensive regulatory requirements cannot combine all services in one corporation.

Mutual fund service providers that are typically affiliated include: (1) an investment adviser/management company that manages the fund's portfolio in accordance with the fund's objectives, (2) a distributor that sells the fund's shares to the public, and (3) a transfer agent that services shareholder accounts, including processing orders to buy and redeem fund shares. Custodial and audit services are typically provided by unaffiliated parties.

The mutual fund usually contracts with a management company affiliated with the service providers. The fund board of directors elected by fund shareholders oversees the management of the business of the fund. Shareholders also approve material changes in the fund's contract with the investment manager or the investment objectives of the fund.

The Securities and Exchange Commission regulates mutual funds according to the rules of the Investment Company Act of 1940. The rules govern not only mutual funds but investment advisers, underwriters, directors, officers and employees of service organizations. For example, the SEC requires disclosure of fees and expenses charged by fund service providers under the contract, including sales charges, redemption fees, management and distribution fees, and typically conditions any increase on majority shareholder approval. Several other laws regulate the conduct of mutual funds, including the Internal Revenue Code, the Securities Act of 1933 which regulates public offerings of mutual funds, the Securities Exchange Act of 1934 which regulates broker-dealers, and the Investment Advisers Act of 1940 which governs the marketing and advertising of mutual fund service companies.

The ability of a mutual fund service provider to generate revenue crucially depends on the relationship with the investor. The fee for investment management, distribution, and transfer agency services is based on the fund's ability to attract and retain investors. As more customers invest in the fund, the fund derives more revenue. The fund's sales activity is directed at customers all over the world; the fund's shareholders will generally be located outside the mutual fund service provider's state of domicile.

III. The standard tax apportionment formula based on cost of performance is distortive when applied to mutual fund service providers.

When the standard apportionment method is applied to the mutual fund industry in particular, it does not produce a tax result that accurately and fairly represents a mutual fund service provider's business activity in California. The FTB has recognized this inequity and in recent years has approved several petitions from mutual fund service providers for alternative apportionment under Section 25137.

The standard method is intended to tax a business based on its income-producing assets and activities in the state.[1] It takes into account the property, payroll, and sales activity of a business in the state.[2] For tangible property, with regard to manufacturing businesses for example, sales are apportioned based on the location of the destination of the sales. However, for intangible property, as with mutual fund transactions, the sales factor is typically based on the location of the mutual fund service provider.

The most critical problem with the standard method is the inequitable way it apportions the income of a mutual fund service provider and disproportionately taxes sales activity that occurs in other states. Specifically, the standard method calculates the sales factor based on cost of performance which has the effect of assigning receipts to the location where the income-producing activity occurs, not where the relationship with the customer is based and where the sale actually occurs. For mutual fund service companies in particular, this method distorts the nature and extent of the taxpayer's business activity in California and correspondingly produces a grossly inequitable tax result.

In apportioning sales for service providers based on the location of the business as opposed to the location of the customer, the sales factor often replicates the property and payroll factors. In so doing, it gives disproportionate weight to the location of the taxpayer in determining the tax liability. This undermines the purpose of the sales factor. According to respected tax commentators Jerome Hellerstein and Walter Hellerstein, the sales factor "is designed to give weight in the overall apportionment factor to the states in which the taxpayer markets its goods."[3]

But the opposite happens when the standard formula is applied to mutual fund service providers. The standard formula assigns most, if not all, of a mutual fund service provider's revenue to the state where the company is located because that is typically where the income-producing activity is deemed to occur. However, this flies in the face of the fact that the earnings of mutual fund service companies depend directly on the relationship between the investor and the mutual fund service provider. Rather, the tax system should reflect the market for the services.[4]

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[1] The apportionment formula should strive to "give appropriate weight to the various factors which are responsible for earning the income." George T. Altman and Frank M. Keesling, *Allocation of Income in State Taxation*, (Chicago: Commerce Clearing House, Inc. 2 Ed., 1950), p. 107.
[2] California Revenue and Taxation Code Section 25136. (All statutory references are to California Revenue and Taxation Code unless otherwise indicated.)
[3] Jerome Hellerstein and Walter Hellerstein, *State and Local Taxation*, 2d Ed. 1993, p. 8.
[4] *McDonnell Douglas Corporation v. Franchise Tax Board*, 26 Cal. App. 4th 1789, 1796 (1994). See also *Appeals of Bechtel Power Corporation et al.,* Cal. St. Bd. Equal., No. 97-SBE-002, March 19, 1997.)

IV. The shareholder residency method cures the distortion and levels the playing field.

Proposed regulation 25137-14 remedies the distortion that occurs when the standard apportionment method is applied to mutual fund service providers by assigning receipts based on the location of the mutual fund shareholders. This method provides a fair sense of how the income is generated by mutual fund service providers[5] by giving weight to the market for the services.

Under the standard apportionment method, lacking a meaningful market state factor, all revenues get attributed to the location of a company's offices and manufacturing facilities. But for mutual fund service providers a meaningful market state factor is readily obtained – the location of the customer – so shareholder residency should form the basis of the sales factor. In this way, the defect is avoided and the tax apportionment method reflects the market for the services.

The cost of performance rule unfairly discriminates against California-based mutual fund service providers. The cost of performance rule duplicates a mutual fund service provider's property and payroll factors and effectively punishes California-based fund companies for establishing their headquarters in the state.

Under cost of performance, non-California mutual fund service companies are able to take full advantage of the California marketplace without incurring any significant tax liabilities for their companies. Their advisory and business management companies with significant income have no sales in the California apportionment formula. They are effectively using the California marketplace without paying taxes.

But the reverse is not true for California-based mutual fund service providers. Other major mutual fund states, including New York, New Jersey, Massachusetts, and Connecticut, have rejected the cost of performance rule in favor of the shareholder residency method. Hence, California-based mutual fund service providers have the worst of all worlds – in California they are potentially subject to taxation on a majority of their income based on where their property and payroll are located but in the twelve states that have adopted the shareholder residency method, they are potentially subject to taxation again on the same income based on the shareholders that live in those states.

California's adoption of the shareholder residency method would redress this imbalance in the market place. It would lend uniformity to the national system of taxation. Adoption of shareholder residency in California is essential, otherwise a perverse incentive will continue to exist for companies to transfer their operations out of a California where the standard apportionment method puts them at a competitive disadvantage.

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[5] "[T]he factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." *Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159, 169 (1983).

V. If throwback is required, Capital supports the *Finnigan* approach contained in the proposal.

If the FTB determines that some form of throwback must be incorporated into this regulation, then Capital believes that it must be determined based on the principals outlined *In the Matter of the Appeal of Finnigan Corporation* (88-SBE-022-A, 01/24/1990). ("*Finnigan*")

With regard to the mutual fund services industry, the basic purpose of the sales factor should be to properly reflect the markets of the unitary group. The interdependence of the separate corporations outlined above demonstrates that the throwback rule should reflect substance over form such that the apportionment result should not depend solely upon whether the unitary business is conducted by several corporations or only by one.

The FTB should not consider the adoption of a throwback rule based on *the Appeal of Joyce, Inc.* (66-SBE-070, 11/23/1966). ("*Joyce*") This would result in most California based companies being subject to more apportionment to California than use of the standard cost-of-performance apportionment rule. This result would be inconsistent with the objectives of shareholder residence apportionment. The overall effect of shareholder residence apportionment and a throwback rule under *Joyce* would be to ignore the marketplace in which the unitary group operates.

In a highly regulated business such as is found among mutual fund service companies, companies operate in a manner that is inconsistent with the separate company apportionment method of *Joyce*, and in a manner that is far more consistent with the unitary apportionment methodology of *Finnigan*.

VI. Conclusion

In sum, Capital fully supports Proposed Regulation 25137-14 and, in particular, the adoption of the shareholder residency apportionment method which redresses the distortion associated with the current cost of performance rule and is ideally suited for the highly integrated business model of mutual fund service providers. If throwback is adopted, we agree with the FTB's adoption of the principles contained in *Finnigan*, as its unitary apportionment methodology is consistent with the highly interdependent nature of the mutual fund business model. It is also imperative to adopt this regulation as a policy matter to level the playing field with all of the other major mutual fund states in the country that have adopted shareholder residency rules lest California-based companies continue to labor under a competitive disadvantage in the marketplace.

Very truly yours,

James M. Brown

Allianz

Allianz of America Corporation

Richard A. Hayes

Senior Vice President & Tax Director

January 12, 2007

Mr. Carl Joseph
Tax Counsel
Franchise Tax Board
Legal Branch MS B-17
P.O. Box 1720
Rancho Cordova, CA 95741-1720

Re: Proposed Reg. 25137-14 Apportionment for Mutual Fund Service Providers

Dear Mr. Joseph:

The attached comments are submitted by Allianz of America, Inc. in support of proposed regulation 25137-14. These comments are in the nature of a response to comments made by opponents of the regulation, who argue that the FTB exceeded its authority under Rev. and Tax. Code Section 25137 in proposing the alternate apportionment formula contained therein.

Allianz of America is the parent company of Allianz Global Investors of America, which is engaged in providing mutual fund services and other asset management activities. The Allianz Global Investors group, which has in excess of $600 billion assets under management, is comprised of:

1) PIMCO – headquartered in Newport Beach, CA
2) Nicholas Applegate – headquartered in San Diego, CA
3) RCM Capital Management – headquartered in San Francisco, CA
4) Oppenheimer Capital – headquartered in New York, NY

Allianz Global Investors files as part of the Allianz of America California water's edge combined return, which also includes Allianz of America's other subsidiaries and the US operations of its affiliates, Dresdner Bank AG and Dresdner Kleinwort.

If you have any questions, please do not hesitate to contact me by email or at my phone number shown below.

Respectfully submitted,

Richard A. Hayes

Attachment

777 San Marin Drive
Novato, CA 94998
Phone 415 899 3176
Fax 415 899 3137

COMMENTS IN SUPPORT OF PROPOSED REGULATION 25137-14

These comments are submitted by Allianz of America, Inc in support of proposed Regulation 25137-14 ("the regulation"). We have reviewed and endorse virtually all of the comments submitted in conjunction with the December 18, 2006 FTB symposium by other interested parties supporting the regulation. Our additional comments are in the nature of a response to comments made by opponents of the regulation who argue that the FTB exceeded its authority under Revenue and Taxation Code Section 25137 ("Section 25137") in proposing the alternate apportionment formula contained therein. In that regard, our comments will be set forth as a response to the December 14, 2006 letter of Federated Investors, Inc. ("Federated"), which represents the most extensive statement of the opponents' position.

Overview

Federated argues that the FTB lacks the authority to promulgate the regulation and secure Office of Administrative Law ("OAL") approval because the regulation "is not consistent with the law". This begs the question. A special industry regulation promulgated by the FTB under Section 25137 will, by definition, be inconsistent with the law because this statute is only used by the FTB to require an apportionment or allocation rule at variance with the otherwise applicable California Uniform Division of Income for Tax Purposes Act ("UDITPA") provisions The OAL requirement of "consistency with the law" (Govt. Code Section 11349.1) has obvious reference to limitations upon the FTB's ability to promulgate regulations under sections of Revenue and Taxation Code that are directive and not merely enabling provisions

Federated itemizes four points in support of its contention that the regulation should be denied OAL approval. First, the regulation is inconsistent with the UDITPA sales factor assignment of receipts from other than tangible personal property. This is true. As noted above, that is what Section 25137 is all about.

Second, the regulation's adoption of the *Finnigan* sales factor throwback rule is not authorized and is contrary to the *Joyce* approach currently adopted by the FTB with respect to the throwback of receipts from sales of tangible personal property. Again, this is true, but has no significance. The *Huffy* SBE appeals decision did not invalidate the *Finnegan* approach but rather superseded it prospectively. The *Citicorp NA* Court of Appeal decision held that the *Finnigan* approach was constitutional, and there is no other California law that limits the discretion of the FTB to elect that approach in the course of promulgating a Section 25137 special industry regulation

Third, the FTB has not met its burden of establishing the basis for a regulatory adjustment by clear and convincing evidence, a standard of proof established by the Supreme Court in *Microsoft*. The *Microsoft* case does not address the FTB rule making authority under Section 25137, but deals instead with an individual taxpayer petition thereunder. No case has held the FTB to a clear and convincing evidence burden of proof in the exercise of its Section 25137 regulatory powers. Commentators recognize that broad latitude should be accorded the taxing authorities in their rule-making powers under the Section 17 UDITPA counterpart to Section 25137. Further, even if the FTB were subject to this burden of proof, it has clearly been met in this case.

Finally, the approach of the regulation as respects the destination approach under MFSP shareholder sourcing and the *Finnigan* throwback rule are said to be inconsistent with the concept of uniformity. The destination sourcing approach of the regulation is consistent with the sourcing rules in 14 states including major money center states critical to the MFSP industry. These states are on the forefront of a recent movement to adopt destination sourcing rules with respect to MFSP income in order to prevent tax overlaps and gaps. Other states are expected to follow this trend. The *Finnigan* throwback rule is logical as applied to MFSPs in light of their extensively regulated, highly integrated, multicorporate character. Again, the adoption of the *Joyce* approach by the SBE in *Huffy* in no way limits the authority of the FTB to adopt a *Finnigan* approach in conjunction with a special industry Section 25137 regulation.

The Regulation Sourcing Rule as Contrary to Law

Federated argues that the FTB is attempting to adopt a tangible personal property destination sourcing rule of Revenue and Taxation Code Section 25135 to the sales factor with respect to other receipts subject to Revenue and Taxation Code Section 25136. This is not so. The FTB has expressly recognized that Section 25136 controls. That is why the regulation is promulgated under the auspices of Section 25137.

Nevertheless, it is instructive to recall that the UDITPA sales factor was primarily designed to recognize the contribution of the market states to a multistate taxpayer's profitability through the application of destination sourcing rules. *See* Hellerstein & Hellerstein, *State Taxation* (3d Ed. 1998) Para. 8.06[2]. In this manner, the sales factor serves to counterbalance the property and payroll factors that are origin sourced to the headquarters states. *Id.* The lack of a destination sourcing rule with respect to receipts from other than tangible personal property frustrates this purpose. In that regard, Professor Hellerstein noted "[i]n recent years, increasing attention has focused on the receipts factor as applied to sales other than sales of tangible personal property and on the possibility of modifying it to effectuate the purpose of the sales factor to attribute a share of a multistate taxpayer's income to the market state". *Id.* at p. 8-56. Thus, the representation of Federated that Sections 25135 and 25136 are different statutes addressing different treatments, even if relevant to the promulgation of a regulation under Section 25137, is an oversimplification.

The Throwback Provision as Contrary to Law

Federated suggests that some kind of mutual exclusivity exists between the *Joyce* and *Finnigan* throwback rules such that the FTB is powerless to revert to the latter after the SBE reinstated the former in the *Huffy* appeals decision even when, as here, the FTB is acting under Section 25137 to propose a special industry regulation. Nothing in the law supports such a conclusion.

First of all, *Finnigan* was recognized to be a valid FTB approach in *Huffy* (99-SBE-005, Apr. 22, 1999; modified 99-SBE-005-A, Sept 1, 1999) It was discarded prospectively only because it lacked uniformity with the vast majority of other states that adopted the *Joyce* approach. Additionally, the California Court of Appeal in *Citicorp North America, Inc v Franchise Tax Board* (83 Cal. App 4th 1403 (2000)) held that the *Finnigan* throwback rule was constitutional.

Given that the *Finnigan* approach was neither an improper FTB position nor invalid in a constitutional sense, what principle can be evoked to limit the FTB's discretion to promulgate a special industry regulation with this sales factor throwback rule? There is no quarrel with the FTB variance from the otherwise applicable UDITPA rules, because that is what Section 25137 is all about. All the FTB need establish is that this feature better ensures that the taxpayer's California values will be fairly reflected as a consequence thereof.

This case can easily be made. The MFSP industry is unusual insofar as its members are highly regulated and literally forced to conduct their business operations through multiple corporate entities performing differing but integrated service activities. An excellent discussion of this unique aspect of the MFSP industry is contained in the November 14, 2006 submission of Franklin Resources, Inc. In light of this, the regulatory adoption of a *Finnigan* throwback rule to complement a MFSP shareholder sourcing approach makes great sense. Under *Finnigan*, a throwback of receipts under the sales factor to the MFSP commercial domicile will be averted if any member of the taxpayer's unitary combined reporting group is taxable in the shareholder state. This overcomes the complications in dealing with multiple MFSP entities that are in reality engaged in a single highly integrated business.

The Clear and Convincing Evidence Standard as Applicable to the Section 25137 Regulatory Process

Federated relies heavily upon the recent California Supreme Court decision in *Microsoft Corporation v Franchise Tax Board* (39 Cal 4th 750 (2006)) in support of the proposition that, in order to promulgate a special industry regulation pursuant to Section 25137, the FTB must establish by clear and convincing evidence that a deviation from the standard UDITPA formula is warranted. *Microsoft* dealt with an individual taxpayer Section 25137 petition, not a FTB regulation Nothing in the opinion suggests that the court intended this test to be applied to the Section 25137 regulatory process, nor would such an application make sense either from a tax policy perspective or from a pragmatic standpoint.

The Federated comment states at page 8 that the court treats a Section 25137 deviation from the standard apportionment formula under the same burden of proof regardless of whether it is an ad hoc application or a regulatory action No authority is given in support of this statement other than a citation to footnote 18 of the *Microsoft* decision Footnote 18 is unrelated to any such proposition In this footnote, the court addresses the point made by amicus Multistate Tax Commission that, in dealing with the inclusion of receipts from the disposition of short term securities, some states exclude return of principal from the definition of "sales" while others evoke a Section 25137 UDITPA approach. The court notes that it will take the latter approach. That is, the court was not going to construe "sales" in Revenue and Taxation Code Section 25134 as exclusive of return of principal on short term securities, but rather would look to whether actionable distortion existed under Section 25137 on the individual facts before it. Nothing in this footnote speaks to what standard the court would apply in review of a special industry regulation promulgated by the FTB thereunder The other cases cited by Federated similarly do not address the regulatory burden of proof.

To limit the FTB authority to promulgate special industry regulations under Section 25137 would be contrary to sound tax policy and impractical as well In a discussion of the use of Section 18 of UDITPA, Section 25137's counterpart, to promulgate special industry regulations, Professor Hellerstein notes that there are no reported cases successfully attacking such regulations on the ground that they exceed the scope of the authority UDITPA grants to the administrators. Hellerstein & Hellerstein, *State Taxation* (3d Ed. 1998), Para. 9 20[1]. In describing the power delegated to the taxing authority to promulgate regulations when the allocation and apportionment provisions "do not fairly represent the extent of the taxpayer's business activities in the state", Hellerstein has characterized it as "very broad" and "appropriate to the problem at hand". In footnote 21 of the *Microsoft* opinion (*supra* at page 770) Professor William Pierce was described as seeing Section 18 of UDITPA "as necessary to deal with unconstitutional results, but also as a provision the gave both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation land apportionment could be achieved " *Id.*

From a practical perspective, the imposition of a clear and convincing burden of proof upon the FTB regulatory effort under Section 25137 could open the way to a challenge to existing regulations and subject the FTB staff to an impossible data gathering exercise. The exchange between Brain Toman representing Federated and Carl Joseph representing the FTB at the December 18, 2006 symposium is instructive in this regard Mr. Toman had described the heavy burden that the clear and convincing evidence requirement placed on the FTB promulgating a regulation under Section 25137. (Reporter's Transcript, p. 21) Mr. Joseph asked whether Mr. Toman was suggesting that existing regulations might be invalid for failure to meet this burden. Mr. Toman replied that maybe that was not a problem because at the time these regulations were adopted "the California Supreme had not clarified the level of burden of proof" as applicable to regulations promulgated under Section 25137, but that the new standard now applied to the regulations at issue "regardless of what's happened in the past". Of course, this cannot be the law because no one is suggesting that the *Microsoft* court fashioned a new evidentiary test, so the test Federated espouses must be the standard to test the validity of all prior regulations. Such a consequence would be absurd

As respects data gathering, Mr Toman argued that the FTB staff would have to contact "the universe of all entities affected by this regulation and attempt to secure information" to establish distortion that would support their regulatory effort (Reporter's Transcript, p. 22) Mr. Joseph asked if Mr Toman thought the FTB staff had the authority to gather such data. Mr. Toman replied that he thought that the staff had the authority "to ask whatever they want to ask whether or not the taxpayer is going to comply with it" That is not a satisfactory situation for the FTB staff. As regards the instant regulation, the out-of-state MFSPs will clearly not be forthcoming if asked to provide data in support of a regulatory proposal that will raise their tax bill if promulgated. This approach effectively emasculates the ability of the FTB to promulgate regulations under Section 25137 to the detriment of the state and taxpayer alike. The very folly of this approach is proof that the factual development demanded of taxpayers in individual Section 25137 cases such as *Microsoft* cannot be rationally be extrapolated to apply to FTB staff investigatory efforts in conjunction with the promulgation of a Section 25137 regulation.

The Federated comment paper discusses the clear and convincing evidence standard and refers to cases applying distortion standards in a constitutional context. See pp. 7-11 In footnote 11, continued on page 8, it is observed that "[o]ne might quibble" that a lesser burden of proof should apply. Footnote 16 of the *Microsoft* opinion expressly states that such a lesser standard applies. The bulk of the analysis contained in these pages is therefore inapposite

The Case for Section 25137 Regulatory Relief

It has been established above that the FTB has broad discretionary powers in promulgating Section 25137 regulations and need only show that the application of existing law does not fairly reflect the taxpayer's California business activities and that the alternative formula the FTB proposes is a reasonable way to address this problem. Nevertheless, even if it be assumed for the sake of argument that the FTB needed to establish distortion under a clear and convincing evidence standard, that standard is met in this case.

It should be stated again that the FTB cannot reasonably be required to collect extensive data from the universe of potentially affected taxpayers as a condition of establishing sufficient distortion to support the promulgation of a special industry regulation. First of all, the FTB is unaware of the existence of many such potential taxpayers, particularly those located out of state. Moreover, it lacks the authority to force responses to information requests from such entities. Such data gathering is appropriate in instances of individual taxpayer relief under Section 25137 because there is only one taxpayer and the FTB has administrative discovery powers over that taxpayer as a condition of granting relief. In the case of the promulgation of a special industry regulation, the appropriate procedure is to conduct a symposium and seek input. That has been done in this case, and economists retained by local and out-of-state industry members have submitted estimates of the fiscal impact of the regulation in question using proxies This should be sufficient to demonstrate a material distortion.

Federated has enumerated five elements of proof it asserts the *Microsoft* opinion has set forth that must be satisfied if the FTB is to justify the promulgation of a special industry regulation under Section 25137. See pp. 11-12. These elements are not itemized as such in the opinion and two of them are non-existent or inapplicable on their face. Nevertheless, they will be addressed below to illustrate that even the Federated version of the clear and convincing evidence test, where applicable, is met in this case.

The first test requires that the taxpayer's California activities be examined in relation to its activities everywhere. Clearly that has been done. The California service production activities are taken into account and it is noted that the existing EDITPA sales factor attribution rules totally ignore the contribution of the non-California shareholder states to profitability.

The second test is that there must be a reasonable determination that there is a material distortion in at least one of the factors. Clearly, that has been done here. If the sales factor is destination sourced in recognition of the unique character of the relationship of the MFSPs to their customer and continued profitability, a material change in their tax liability results. Dr. Hamm, the economist retained by Federated, estimates that the California-based MFSP-related revenues will decrease in an amount approximating $370 million under the regulation. Dr. Romero, retained by California MFSPs, also estimates that California-based MFSPs will experience material, but greatly reduced, tax decreases as well, but the out-of-state MFSP tax increases will counterbalance this. What more is needed to establish materiality?

The third test is said to require that the distortion must be traced to a function that is "qualitatively different from the principal business of the taxpayer". The source of this test is the observation in the *Microsoft* opinion at page 766 that the *Merrill Lynch* SBE appeals decision rejected the application of Section 25137 to securities sold on the taxpayer's own account. The *Microsoft* court noted that these sales were not qualitatively different from the taxpayer's main business. This test can only makes sense when applied in the context of the quantification of a factor as opposed to the determination of whether a factor should be geographically sourced in one manner or other, as here, or whether a particular value should or should not be reflected in a given factor at all. Regulation 25137-4.2, for example, applies to financial corporations and directs the inclusion of loans as intangibles in the property factor. Loans are clearly part of the taxpayer's main line of business, yet no one has suggested that these regulations are invalid. The notion that this standard is relevant outside of a valuation application is irrational.

The fourth test requires the determination that the other factors do not counterbalance the distortion of concern to the FTB. The origin sourcing character of the property and payroll factors in the instant matter ensures that this is not possible. Again, these two factors are weighted to emphasize the contribution to the commercial domicile or headquarters state of the taxpayer to profitability. The proposed regulation is intended to correct the distortive effect of ignoring the market state or MFSP shareholder location under the sales factor income producing activities sourcing rule. By definition, the property and payroll factors cannot offset this deficiency. If there is some basis for Federated to maintain otherwise, they should articulate it. In the *Microsoft* opinion, in footnote 22 on page 771, the court rejects an argument by the taxpayer that any distortion resulting from the inclusion of gross receipts from redemptions in the sales factor is counterbalanced by the failure of the standard formula to provide for the inclusion of intangibles in the property factor. After noting that the taxpayer did not raise this challenge in the courts below, the court went on to note"[t]he Board had to establish distortion: having done so, it did not have to disprove the existence of every other conceivable source of distortion" It would follow that the FTB should not be forced to divine possible counterbalancing influences that Federated speculates might exist.

The fifth test Federated articulates is "whether any knowledgeable observer would concede that the result produced by the statutory formula cannot be defended as within the range of a reasonable result", citing the *Microsoft* opinion at page 770. This quote does not appear to be directly from the opinion. Moreover, it appears to add little to the tests earlier discussed. In any event, a knowledgeable observer can appreciate that the unique and ongoing relationship between an MFSP and its shareholders so transcends the ordinary role of a consumer of services as to warrant a concession that the disregard of the contribution of the latter to profitability under the standard UDITPA sales factor income producing activity sourcing rule is unfair and distortive

Uniformity

The FTB noted in its announcement of the December symposium that the modification of the sales factor attribution rules to shareholder location as respects MFSPs promotes uniformity. Indeed, some 14 states have adopted such sourcing rules. These states are identified in the November 14, 2006 Franklin Resources, Inc. comment in footnote 6 at page 5. Most of the major money center states where MFSPs have a disproportionate percentage of their shareholders are included in this group. Moreover, this approach is reflective of a recent trend in recognizing the fairness of apportionment of MFSP receipts based upon a destination sourcing or shareholder location. Federated attempts to challenge the uniformity argument, asserting that only a "super majority position" can justify a regulation based on the concept of uniformity. It cites no authority for this position because none exists. It also argues that the courts do not rely on trends to support regulatory change in the name of uniformity, citing *Hoechst Celanese Corporation v. Franchise Tax Board* (25 Cal. 4th 518 (2001). No such statement appears to have been made by the court in this case. On the contrary, the court, in discussing whether California's business income statute encompasses a functional test as well as a transactional test, notes that four of five states whose courts construed their statutes to encompass only the transactional test passed legislation overriding this determination and adopting both tests. One could say that the court was very respectful of trends.

Clearly, the fact that 14 states have adopted shareholder sourcing rules as respects MFSPs is significant. It is also significant that these estates include critical money center states. These states are the vanguard of a movement toward uniform recognition of destination sourcing of MFSP receipts as fair and appropriate. Federated's argument to the contrary is simply without merit. Moreover, there are compelling reasons for the regulatory relief proposed by the FTB independent of the need for uniformity of taxation as discussed at length above.

Conclusion

The opposition to the regulation is without analytical substance and is inimical to sound tax policy. The regulation as proposed will clearly secure OAL approval if adopted

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Federated
WORLD-CLASS INVESTMENT MANAGER®

January 15, 2007

VIA FAX (916-845-3648) AND U.S. MAIL

Mr. Carl Joseph
Franchise Tax Board
Legal Branch
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Rancho Cordova, CA 95741-1720

Re: **Proposed Adoption of California Code of Regulations, Title 18, Section 25137-14**
Mutual Fund Service Providers and Asset Management Service Providers
Post-Hearing Written Comments of Federated Investors, Inc.

Dear Mr. Joseph:

Pursuant to the permission given by you at the haring held before you on December 18, 2006, concerning the captioned proposed regulation, enclosed are the post-hearing written comments of Federated Investors, Inc. ("Federated"). Also enclosed is a revised analysis of the impact of the captioned proposed regulation on the State's General Fund.

Thank you for allowing Federated the opportunity to submit the enclosed written materials.

Very truly yours,

G. Andrew Bonnewell
Vice President
Senior Corporate Counsel

Enclosures

Cc: **Via Fax (916-845-3648) and U. S. Mail**
Ms. Colleen Berwick
Franchise Tax Board
Legal Branch
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Rancho Cordova, CA 95741-1720

POST-HEARING COMMENTS

COMMENTS OF FEDERATED INVESTORS, INC. TO SUBMITTALS MADE, TESTIMONY GIVEN AND ISSUES DISCUSSED AT THE DECEMBER 18, 2006 HEARING BEFORE FRANCHISE TAX BOARD STAFF CONCERNING THE PROPOSED ADOPTION OF CALIFORNIA CODE OF REGULATIONS, TITLE 18, SECTION 25137-14 – MUTUAL FUND SERVICE PROVIDERS AND ASSET MANAGEMENT SERVICE PROVIDERS.

INTRODUCTION

At the hearing held on December 18, 2006 before Franchise Tax Board ("FTB") staff concerning the proposed adoption of California Code of Regulations, Title 18, Section 25137-14 – Mutual Fund Service Providers and Asset Management Service Providers ("Proposed Regulation") – the FTB hearing officer authorized post-hearing comments to be submitted by interested parties by January 15, 2007. Below are the comments of Federated Investors, Inc. ("Federated") to submittals made, testimony given and issues discussed at the December 18, 2006 hearing before FTB staff.

LEGAL ISSUES

I. FTB staff has completely failed to satisfy its high burden of proof to proceed with the Proposed Regulation.

a. The legal standard required for FTB staff to satisfy its burden of proof.

In order to proceed with the Proposed Regulation, FTB staff has to satisfy its high burden to prove by clear and convincing evidence that the variation it seeks under the Proposed Regulation from the standard apportionment formula rules, regulations and case law regarding sales of other than tangible personal property is appropriate.

The California Supreme Court has recently made it abundantly clear that the party seeking to deviate from the standard apportionment formula has the burden to prove by clear and convincing evidence that such a deviation is warranted. See Microsoft Corporation v. Franchise Tax Board (2006) 39 Cal.4th 750 at 765, [47 Cal. Rptr. 3d 216] ("Microsoft").

The clear and convincing evidence standard is a higher burden than the normal preponderance of the evidence standard applicable to most tax cases. Clear and convincing evidence is an intermediate standard of proof that is more than the "preponderance of the evidence" standard used in most civil cases and less than the "beyond a reasonable doubt" standard used in criminal cases. See 32A C.J.S. Evidence § 1306. Clear and convincing evidence is required where the wisdom of experience has demonstrated the need for greater certainty. Id. Evidence is clear and convincing if it places in the fact finder an abiding conviction that the truth of the factual contentions is highly probable. Id. Clear and convincing evidence is that which leaves no reasonable doubt in the mind of the trier of fact as to the proposition in question. Id.

In Microsoft, the California Supreme Court in examining FTB's burden to prove the propriety of a deviation it sought from the standard apportionment formula sales factor stated:

> As the party invoking section 25137, the Board [FTB] has the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation, and (2) its proposed alternative is reasonable (Citations).

Microsoft, supra at 765.[1] (Emphasis added.)

As alluded to above, clear and convincing evidence is defined as:

> [C]lear, explicit and unequivocal, so clear as to leave no substantial doubt, and sufficiently strong to command the unhesitating assent of every reasonable mind.

See Witkin, California Evidence, 4th Ed., Burden of Proof and Presumptions, § 38.

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[1] Prior to the Microsoft decision, the California Supreme Court had previously held that the evidentiary standard to satisfy the burden of proof to allow deviation from the standard apportionment formula was the clear and convincing evidence standard. McDonnell Douglas v. Franchise Tax Board (1968) 69 Cal.2d 506 at 512. The clear and convincing evidentiary standard has been applied in numerous California appellate cases, both to pre-UDITPA years (e.g., RKO Teleradio Pictures, Inc. v. Franchise Tax Board (1966) 246 Cal. App.2d 812 at 819; Montgomery Ward & Company v. Franchise Tax Board (1970) 6 Cal.App.3d 149 at 155; and Chase Brass v. Franchise Tax Board (1977) 70 Cal.App. 3d 457 at 471) and UDITPA years (e.g., Anaconda Company v. Franchise Tax Board (1982) 130 Cal.App. 3d 15 at 30; Colgate-Palmolive Company, Inc. v. Franchise Tax Board (1992) 10 Cal. App. 4th 1768 at 1786-87). One might quibble that the cases cited in this footnote dealt with "distortion" in the constitutional context and that a lesser burden of proof (i.e., preponderance of the evidence) would apply in the statutory context of section 25137. However, the California Supreme Court has now made it mandatory that the clear and convincing evidentiary standard also applies in the statutory context of section 25137.

As should be obvious, as a legal matter, FTB staff's burden of proof is not easily satisfied.

Also, as explained at the hearing, and set forth in Federated's written comments, the California Supreme Court has not limited this burden of proof to ad hoc applications of section 25137. As the Court noted, some states may attempt to cure "distortions" by regulatory revision, other states may attempt to cure "distortions" on an ad hoc basis. See Microsoft, supra at 767, fn. 18. In either event, whether "distortion" is addressed by regulatory action or on an ad hoc basis, the party seeking to deviate from the standard apportionment formula has the burden to prove by clear and convincing evidence that such a deviation is warranted.

b. The factual standard required for FTB staff to satisfy its burden of proof.

As a factual matter, whether evidence is clear and convincing requires comparing, testing, weighing, and judging its worth as such evidence is considered in connection with the facts and circumstances in the record. See 32A C.J.S. Evidence § 1306. Suspicion and speculation do not rise to the level of clear and convincing evidence. Id.

c. The evidence offered to date by FTB staff to satisfy its burden of proof.

1. Use of a market state approach regarding sales of mutual fund shares and services.

So far FTB staff has offered no objective evidence to meet its burden of proof. All FTB staff has offered so far are self-serving allegations. Just because FTB staff alleges there is distortion in the present situation does not make it so, at least as far as the California Supreme Court is concerned.

As stated above, whether evidence is clear and convincing requires comparing, testing, weighing, and judging its worth as such evidence is considered in connection with the facts and circumstances in the record. However, there are no facts and circumstances in the record, just theoretical assertions. Mere theoretical assertions do not prove that the standard apportionment formula sales factor does not work (i.e., or in FTB staff's words, has "broken down"), or is otherwise inappropriate.

For example, FTB staff has not compared the results of the application of the standard apportionment formula sales factor to the results of the application of the sales factor it seeks to utilize in the Proposed Regulation to determine the extent to which there is a percentage difference adequate enough to warrant deviating from the standard apportionment formula sales factor. Such a comparison has not been made with respect to the California based Mutual Fund Service Providers ("MFSP's"), out-of-state based MFSPs, or a combination of the two.

Furthermore, FTB staff has not compared the results of the application of the overall standard apportionment formula to the results of the application of the apportionment formula it seeks to utilize in the Proposed Regulation to determine the extent to which there is a percentage difference in the overall formula adequate enough to warrant deviating from the standard apportionment formula. Such a comparison has not been made with respect to the California based MFSP's, out-of-state based MFSPs, or a combination of the two.

In the Appeal of Merrill, Lynch, Pierce, Fenner & Smith (6/2/89) 89-SBE-017 ("Merrill Lynch") such a comparison was made. The State Board of Equalization found that a change in the apportionment percentage of 23 to 36% from the treatment required by the standard apportionment formula sales factor to that asserted as proper by the FTB was a "far cry" from the 250% change in the apportionment percentage in Hans Rees and held against the FTB on its distortion argument. The Merrill Lynch standard set forth above is directly applicable to the Proposed Regulation as the business activities of the taxpayer in that case (i.e., trading in securities as a principal and purchasing securities for its own account) were a "fundamental segment" of its unitary business, just as sales of mutual fund shares and services is a "fundamental segment" of the business of a MFSP.

As another example, FTB staff has not tested the impact of the fact that, on a geographic basis, some MFSPs are more profitable than others. Applying a sales factor that deviates from the standard apportionment formula sales factor may only not cure a perceived distortion, it may exacerbate distortion. For example, the sales factor methodology in the Proposed Regulation may export income out of a state, or import income into a state, out of all appropriate proportion to a taxpayer's business activities in each state.[2] This type of analysis has not been performed by FTB staff.

In Microsoft, the California Supreme Court used profitability analyses to compare the impact of high-profit operations to low-profit operation within a single worldwide unitary group to ascertain if distortion existed by application of the standard apportionment formula sales factor. By analogy, such a comparison within an industry group would be appropriate here to judge the impact of a special formula on the distribution of income. This type of comparison has not been made by FTB staff.

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2 FTB staff may argue that such a result does not violate the "rough approximation" concept behind formula apportionment. If that argument is made, it would fail as staff has yet to prove that the present standard apportionment formula sales factor, and the standard apportionment formula as a whole, does not already meet the "rough approximation" standard.

As stated above, all FTB staff has offered so far to satisfy its burden of proof are self-serving allegations. The most apparent ones are:

1. Section 25136 with respect to MFSPs has "broken down."

As pointed out at the hearing, "broken down" is not a test to prove distortion; nor is "broken down" an objective evidentiary fact which can be analyzed to ascertain if FTB staff has met its high burden of proof to go forward with the Proposed Regulation.

2. Section 25136 with respect to MFSPs does not reflect the "market state."

Also as pointed out at the hearing, section 25136 with respect to any taxpayer is not designed to reflect the market state. Again, this allegation is not an objective evidentiary fact which can be analyzed to ascertain if FTB staff has met its high burden of proof to go forward with the Proposed Regulation.

3. Under that standard formula, over taxation "can" result.

As pointed out at the hearing, FTB staff does not allege that over taxation "will" result – just that over taxation "can" result. Furthermore, staff has submitted no objective proof of actual over taxation, nor has it submitted authority that over taxation is constitutionally impermissible.

Quite to the contrary, as pointed out by the California Appellate Court in Citicorp North America, Inc., et al. v. Franchise Tax Board (2000) 83 Cal. App. 4th 1403 [100 Cal.Rptr.2d 509] ("Citicorp"):

> Exposure to duplicative taxation resulting from a lack of uniformity among the states does not present a constitutional issue. The Supreme Court has acknowledged the fact that companies doing business in more than one state may be exposed to different taxing rules. The court recognized the differences that exist between the various states in how taxes are calculated. "[W]hile some States such as Iowa assign sales by destination, 'sales can be assigned to the state . . . of origin, the state in which the sales office is located, the state where an employee of the business making the sale carries on his activities or where the order is first accepted, or the state in which an interstate shipment is made.'"
>
> * * *
>
> Plainly, the Constitution does not mandate that every state treat every item of income alike and assign the apportionment of sales in a uniform manner.

Citicorp, supra at 1425.

Thus, the allegation that over taxation can result if the Proposed Regulation is not put in place is just one more allegation, not an objective evidentiary fact, which can be analyzed to ascertain if FTB staff has met its high burden of proof to go forward with the Proposed Regulation.

2. Use of the Finnigan approach as a sales throw back rule.

As pointed out at the hearing, since 2000, the Joyce sales throw back rule has been the law in California. If FTB staff seeks to deviate from the Joyce sales throw back rule, it has to satisfy its high burden to prove by clear and convincing evidence that such a deviation under the Proposed Regulation from the Joyce sales throw back rule is appropriate.[3]

In an attempt to meet its high burden of proof, in its INFORMATIVE DIGEST/PLAIN ENGLISH OVERVIEW, FTB staff alleges that the Proposed Regulation will "make sure that there will be market assignment of receipts based on the activities of the entire unitary group rather than an entity-by-entity basis."

As previously noted, as a factual matter, whether evidence is clear and convincing requires comparing, testing, weighing, and judging its worth as such evidence is considered in connection with the facts and circumstances in the record. See 32A C.J.S. Evidence § 1306. Suspicion and speculation do not rise to the level of clear and convincing evidence. Id. The record to date only contains FTB staff allegations, not objective facts based on any type of credible evidentiary analysis regarding use of the Joyce approach.

First, as explained above, FTB staff has not submitted any objective evidence that the application of the standard apportionment formula sales factor is inappropriate. Thus, this foundational requirement to utilize section 25137 to deviate from the standard apportionment formula sales factor has not been satisfied.

Second, FTB staff has not submitted any objective evidence that the Joyce approach to sales throw back is inappropriate; especially considering the Joyce approach is California law.

For example, FTB staff has not produced any type of numerical analysis on the difference between the Joyce and Finnigan sales throw back approaches under the sales

[3] In the Proposed Regulation, FTB staff seeks to use the Finnigan sales throw back rule; a rule that is not the law in California under the standard apportionment formula sales factor, and a rule rejected by a super majority of the states.

factor it seeks to utilize in the Proposed Regulation to determine the extent to which there is a percentage difference adequate enough to warrant deviating from the Joyce sales throw back rule. Such a comparison has not been made with respect to the California based MFSP's, out-of-state based MFSPs, or a combination of the two.

Furthermore, FTB staff has not produced any type of numerical analysis on the difference between the Joyce and Finnigan sales throw back approaches on the overall apportionment percentage under the Proposed Regulation to determine the extent to which there is a percentage difference adequate enough to warrant deviating from the Joyce sales throw back rule. Such a comparison has not been made with respect to the California based MFSP's, out-of-state based MFSPs, or a combination of the two.

Thus, FTB staff has failed to satisfy its high burden to prove there is "distortion" in the application of the standard apportionment formula sales factor in the first place, and even if it did, that the application of the Joyce sales throw back rule also causes "distortion." Furthermore, even if FTB staff did meet its burdens described above, it has not met its burden to prove that the Finnigan sales throw back rule cures the "distortion."[4]

II. There is no basis for the application of the Finnigan sales throw back rule provided for in the Proposed Regulation.

During testimony at the hearing, several statements were made that warrant comment. Those statements were:

a. There is nothing in the law that would require the adoption of a Joyce sales throw back rule.

Quite to the contrary, for the reasons just explained, this statement is wrong. First, Joyce is the law in California, as it is in almost every state that uses an apportionment of income scheme; Finnigan is not the law in California. Thus, as a legal matter, the Joyce approach is required to be used unless FTB staff can prove another approach is applicable.

Second, in order to deviate from the Joyce approach under section 25137, FTB staff must prove, to begin with, that a deviation from standard apportionment formula

[4] Also, as testified to at the hearing, FTB staff's position on the Finnigan sales throw back rule is illogical and contradictory. It is incomprehensible that the Joyce sales throw back rule would work under the "market state approach" of section 25135, but some how not work under the proposed "market state approach" proposed by FTB staff under section 25137 with respect to MFSPs. FTB staff's illogical and contradictory position on the use of the Finnigan approach is inexplicable.

sales factor is appropriate. FTB staff has not satisfied its high burden of proof in that regard. The record is devoid of any objective evidence on this point.

Third, even if FTB staff was to meet its high burden of proof to deviate from the standard apportionment formula sales factor, it must then prove that the Joyce approach fails to fairly represent the business activities of MFSPs in a state. Again, FTB staff has not satisfied its high burden of proof in that regard. The record is also devoid of any objective evidence on this point.

Fourth, even if FTB staff was to meet its high burden of proof to deviate from the standard apportionment formula sales factor, and it proves that the Joyce approach fails to fairly represent the business activities of MFSRs in a state, FTB staff must prove the Finnigan approach "cures" the "distortion" caused by the Joyce approach. Again, FTB staff has not satisfied its high burden of proof in that regard. And again, the record is devoid of any objective evidence on this point.

b. MFSPs are highly integrated businesses that fit within the context of section 25137.

In Microsoft, supra, it was proven at trial that Microsoft Corporation was a highly integrated business. Despite this proven fact, in the context of a section 25137 analysis, no court at any level (i.e., trial, appellate and Supreme) gave this fact any relevance in their analyses of the application of section 25137. Federated submits the degree of MFSRs corporate integration is irrelevant to any purported need for the Proposed Regulation.

c. If California fails to move to a shareholder-residency approach for apportionment of receipts, there will be a threat of multiple taxation.

As explained above, the Constitution does not mandate that every state treat every item of income alike and assign the apportionment of sales in a uniform manner. See Citicorp, supra at 1425. Regardless of the approach taken, because of the differences in apportionment schemes, there will always be a threat of multiple taxation and under taxation. This threat is not a substantive reason to deviate from a standard apportionment formula sales factor and standard apportionment formula scheme.

Addendum to the Testimony of William G. Hamm, Ph.D.

Proposed Regulation 25137-14

Hearing Date December 18, 2006 – Sacramento, CA

On December 18, 2006, staff of the Franchise Tax Board ("FTB") held a hearing on Proposed Regulation 25137-14. This regulation would change the method that mutual fund service providers ("MFSPs") must use to calculate the sales factor in their income apportionment formula. During the hearing, I explained why the proposed change would reduce General Fund revenues relative to the revenues that would be yielded by the standard method set forth in the Uniform Division of Income for Tax Purposes Act ("UDITPA"). I also presented, for illustrative purposes, an estimate of the potential revenue loss to California's General Fund if the proposed regulation is adopted.

This addendum to my testimony responds to testimony given at the hearing by Mr. Phil Spilberg – Director of the FTB's Economic and Statistical Research Bureau. It also provides revised parameters for estimating the fiscal impact of the proposed regulation.[1]

Mr. Spilberg's Testimony

Mr. Spilberg testified that two of my assumptions account for most of the difference between the $370 million potential revenue loss estimate I presented and the FTB staff's estimate of a $10 million gain: (1) my use of an assumed 0.7% average return on managed assets in estimating the MFSPs' worldwide income, and (2) my use of an implicit 4.42% tax rate on worldwide income apportioned to California using the sales method.

Mr. Spilberg did not address my logic in concluding that the proposed regulation would reduce General Fund revenues relative to the amount that would be yielded by the standard apportionment method.

Average Return on Managed Assets

I derived the 0.7% estimate of MFSPs' weighted average return on managed assets using data primarily from two sources: (1) the highly respected Investment Company

[1] This document serves as an addendum to my written testimony submitted for the December 18, 2006 hearing, and should be considered in conjunction with it.

Institute ("ICI"), which publishes information on assets managed by the 348 mutual fund companies that comprise the industry in the U.S., and (2) Fox-Pitt Kelton – a Global Investment Bank. Based on Mr. Spilberg's comments, I reevaluated both data sources.

Mr. Spilberg suggested that the measure of income I used does not reflect certain MFSP costs, such as interest expense and indirect business expenses. To ensure that this is not the case, I have recalculated the weighted average return using pre-tax income, as reported to the Securities and Exchange Commission ("SEC") by the 16 largest publicly held MFSPs. Pre-tax income reflects all expenses involved in providing services to mutual funds.

More importantly, Mr. Spillberg's comments caused me to discover a large discrepancy between the ICI data and the SEC data that may have inflated my estimate of the MFSPs' weighted average return on managed assets. When I compared the assets under management ("AUM") reported by ICI for publicly held MFSPs with the AUMs reported by these same companies in their Form 10-Ks, I found that ICI appears to use a much narrower definition of "assets" than the MFSPs themselves.[2] When I recalculated the ratio of pre-tax profits to managed assets for the 16 largest publicly held MFSPs, using information on AUMs contained in their 10-Ks, the ratio dropped significantly. For these 16 MFSPs, which account for 14% of total mutual fund assets under management, the weighted average return on managed assets (broad definition) is 0.2%. Exhibit A-1 shows the ratios for individual companies, as well as the simple and weighted averages for all 16 companies.

Marginal Tax Rate on Income Apportioned Using the Sales Factor

Mr. Spilberg testified that the 4.42% tax rate on income apportioned to California using the sales factor "could be substantially too large."

The effective tax rate for California MFSPs could be less than 4.42% if these taxpayers are able to take advantage of tax credits and other factors that reduce the amount of income subject to California's Corporation Tax. Whether the difference between the statutory and effective tax rate is significant depends on the magnitude of any such factors.

[2] For example, 16 large publicly traded MFSP companies report AUMs totaling $3.8 trillion, while ICI reports AUMs of $1.4 trillion for these companies.

I am not aware of any publicly available data indicating that these credits are significant in the case of MFSPs headquartered in California. Should such data become available, I will reconsider the tax rate I used in estimating the potential General Fund revenue impact of the proposed regulation.

Revised Estimates of California Income Apportionment

I have re-estimated the worldwide taxable income of all MFSPs, public and private, using the 0.2% return-on-managed-assets figure and the ICI's reported AUM ($9.7 trillion). The result is estimated worldwide taxable income for all MFSPs totaling $19 billion (please see Exhibit A-2).

Assuming (1) worldwide income from mutual fund servicing totals $19 billion, (2) a 4.42% tax on income apportioned to California using the sales factor, and (3) no out-of-state MFSP would be able to escape California's corporation tax due to the absence of income tax nexus, the proposed regulation would result in an estimated annual revenue loss relative to the standard apportionment method of $106 million (please see Exhibit A-2).

Potential Limitation of Analysis

There are two important caveats to this analysis. First, the profitability of the firms used to calculate the revised weighted average return on managed assets may not be representative of overall industry profitability. The 0.2% return is derived from a set of 16 large, publicly-traded MFSPs, and does not reflect the returns achieved by either privately held MFSPs (*e.g.*, Fidelity Investments), or large conglomerates that conduct a variety of businesses including the provision of services to mutual funds (*e.g.*, J.P. Morgan Chase & Company).

Second, the $106 million General Fund revenue loss is estimated using the narrow definition of AUM employed by ICI, while the 0.2% return reflects the broader definition used by the companies themselves. Clearly, the ICI data understates total mutual fund assets under management. Other things equal, the estimated revenue loss would be significantly greater than $106 million if the 0.2% return was applied to total assets under management calculated using the broader definition. Unfortunately, there is no data on AUM using the broader definition for the industry as a whole.

As I emphasized during my testimony on December 18th, I present the estimated revenue loss for illustrative purposes only. While the proposed regulation clearly will reduce General Fund revenues relative to the standard apportionment method, the size of the reduction will depend on both the MFSPs' combined worldwide income, and the relative profitability of California-based and non-California-based MFSPs.

FTB Staff Estimate Reflects Asymmetrical Assumptions

A third factor accounts for the difference between my estimate of a revenue loss from the proposed regulation and the FTB staff's estimate of a revenue gain: tax relief granted under Revenue and Tax Code Section 25137. Apparently, the FTB staff estimate reflects the tax relief granted to California-based MFSPs in the past, but it implicitly assumes that no tax relief will be granted to out-of-state MFSPs in the future if the proposed regulation is adopted. In my opinion, this is unrealistic, and causes the staff to overestimate potential General Fund revenue from taxing out-of-state MFSPs.

It is my understanding that the FTB staff has permitted certain California MFSPs to calculate their sales factors using the market-based approach because it believes the UDITPA method (costs of performance) causes an overstatement of the sales factor for these taxpayers. If California adopts the proposed regulation, it will then overstate the sales factor for certain out-of-state taxpayers. For example, a MFSP in Minnesota will have 100% of its sales reflected in its home-state's sales factor, and an additional 12% reflected in its California sales factor. I would expect MFSPs headquartered in the 32 states (other than California) that still use the UDITPA method to seek relief from overstatement of the sales factor in California by petitioning the FTB under the Revenue and Tax Code Section 25137. If the FTB applies the same equity criteria to these petitions that its staff has applied to similar petitions from California-based MFSPs, it will approve many of these petitions, thereby reducing the tax liabilities for these firms.

In short, the FTB staff estimate makes no allowance for the tax relief that out-of-state MFSPs will seek, based on clear-cut overstatement of their sales factors. Were allowance for this tax relief incorporated in the staff's estimate, its estimate of the proposed regulation's net impact on General Fund revenues would be closer to my estimate.

I am happy to elaborate on my methodology and conclusions if it would be helpful to the FTB and its staff. Thank you for allowing me to submit this addcndum to my testimony.

Exhibit A-1

Return on Managed Assets - Selected Publicly Held Mutual Fund Service Providers

(Dollars in Millions)

	Ticker	Firm [1]	Managed Assets (per ICI) [2]	Managed Assets (per 10-K) [3]	Pre-Tax Profit (EBT) [4]	Return on Managed Assets (per ICI) [5]	Return on Managed Assets (per 10-K) [6]
1	BEN	Franklin Templeton Investments (California-based)	309,825	464,800	1,524	0.49%	0.33%
2	FII	Federated Investors	195,513	213,423	280	0.14%	0.13%
3	TROW	T. Rowe Price	193,259	269,500	679	0.35%	0.25%
4	LM	Legg Mason	189,202	850,800	649	0.34%	0.08%
5	JNS	Janus	88,903	148,500	169	0.19%	0.11%
6	SEIC	SEI	83,046	148,538	295	0.36%	0.20%
7	AB	Alliance Capital Management L.P.	77,207	578,552	933	1.21%	0.16%
8	NTRS	Northern Trust Mutual Funds	59,774	617,900	888	1.49%	0.14%
9	EV	Eaton Vance	43,355	113,300	263	0.61%	0.23%
10	AMG	Affiliated Managers Group	41,443	184,300	334	0.81%	0.18%
11	WDR	Waddell & Reed Funds	38,050	41,863	96	0.25%	0.23%
12	JNC	Nuveen	17,393	136,117	279	1.60%	0.20%
13	GBL	Gabelli Funds	8,635	24,761	102	1.20%	0.41%
14	GROW	U.S. Global Investors	4,284	4,638	5	0.11%	0.10%
15	VALU	Value Line	3,528	3,604	38	1.08%	1.05%
16	DHIL	Diamond Hill Funds	1,986	1,531	2	0.10%	0.13%
		Sample Total	1,355,310	3,802,127	6,535		
		Weighted Average Return on Managed Assets [7]				**0.7%**	**0.2%**
		Simple Average Return on Managed Assets				**0.6%**	**0.2%**
		Total Industry Assets (348 Firms)	**9,722,162**				
		Sample % (16 Firms)	**13.9%**				

Sources and Notes:

[1] Firms in the sample are publicly-traded MFSPs. Firms in sample selected based on MFSP-related focus; large diversified conglomerates excluded.
[2] Total Assets as of 9/30/2006, as reported by the Investment Company Institute.
[3] Total Managed Assets from 10-Ks or 10-Qs as of 12/31/2005 (except EV and VALU as of 1/31/2006 and GROW as of 6/30/2006).
[4] Annual pre-tax profit as of 12/31/2005 (except EV and VALU as of 1/31/2006).
[5] = [4] / [2]
[6] = [4] / [3]
[7] Annual revenue figures as of 12/31/2005 used for weighting.

Exhibit A-2

Calculation of California Income Apportionment

Difference Between Current and Proposed Systems

(Dollars in Millions)

	California Income Apportionment	
	Current System	**Proposed System**
Total Managed Assets [1]	$9,722,162	
Estimated Return on Managed Assets [2]	0.2%	
Estimated World Wide Taxable Income [3]	$19,444	
California Tax Portion [4]	4.42%	4.42%
California Percentage Apportionment [5]	24.0%	11.7%
Total California Income [6]	**$206**	**$101**
Difference [7]	**$106**	

Notes:

[1] Total assets under management as of 9/30/06, as reported by the Investment Company Institute, ww.ici.org.

[2] Estimated ratio of pre-tax profits to managed assets, based on publicly traded MFSPs.

[3] = [1] * [2]

[4] Implicit tax on sales.

[5] California apportionment. In the current system based on the percentage of California-based assets under management. In the proposed system, based on the percentage of California-based income for NAICS 523 (as reported by BEA).

[6] = [3] * [4] * [5].

[6] = [3] * [4] * [5].

[7] = Difference in California Income between current system and proposed system.

Estimated income apportionment figures do not incorporate any tax relief that may have been granted to California MFSPs.

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Re: Proposed Regulation 25137-14—Mutual Fund Service Providers and Asset Management Service Providers

Dear Ms. Berwick:

Please accept the following submission as our second set of comments regarding proposed regulation 25137-14. In the following pages, we address two points, first the authority of the Franchise Tax Board ("FTB") to promulgate the proposed regulation, and second, the superiority of crafting the regulation to apply to any and all receipts earned from providing the enumerated services rather than only to taxpayers (or unitary groups) having earned more than 50% of their revenues from the enumerated services.

First, we wish to add our voice to the chorus of those attesting to the FTB's authority to promulgate the proposed special apportionment regulation for taxpayers providing mutual fund and asset management services. In particular, we concur that the FTB has made findings adequate to establish the need for the regulation, *i.e.*, that the cost of performance method for assigning receipts earned in providing the aforementioned services is distortive and that apportioning such receipts based on shareholder residency appropriately remedies this distortion.

The FTB's own findings, based in large part on its experience of auditing such taxpayers and considering their section 25137 petitions, and based on the experience of other states, amply support the need for the regulation. Additionally, the following interested party submissions corroborate and supplement the FTB's own findings: letters from Pillsbury Winthrop Shaw Pittman LLP on behalf of Franklin Resources, Inc (dated November 14, 2006), and The Capital Group Companies, Inc. (dated December 8, 2006). The Pillsbury and Capital Group submissions thoroughly elaborate on the unique

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characteristics of the industry, the problems arising out of application of the standard apportionment formula, the basis for concluding that applying the standard regulation to mutual fund service providers is distortive, and the justification for remedying the distortion via a market-based sourcing methodology.

In questioning whether the law affords the FTB authority to promulgate this regulation, certain interested parties claim the recent *Microsoft* decision either raised the standard the FTB must satisfy to promulgate a section 25137 regulation or, alternatively, articulated a considerably higher standard than the FTB has previously assumed to apply. However, we question whether *Microsoft* is authoritative as to this point. After all, *Microsoft* did not involve authority to promulgate a section 25137 regulation but instead involved an attempt by FTB to modify the standard apportionment formula for a specific taxpayer in the absence of a 25137 regulation directly on point. In any event, we do not believe *Microsoft* may be read to increase the FTB's burden to promulgate section 25137 regulations.

Certain interested parties have also expressed the view that a taxpayer's ability to petition for relief under section 25137 obviates the need for the proposed regulation. To the contrary, we believe failure to address this industry-wide problem with an industry-wide solution will perpetuate the lack of uniformity that now exists. The proposed regulation will promote the uniformity that UDITPA seeks.

Finally, to the extent some commentators have suggested the FTB has not identified a sufficient need to extend the regulation beyond regulated investment companies to taxpayers providing asset management services, please note that such services are, in all material respects, the same as services provided to mutual funds. Since there can be no meaningful distinction drawn between the two categories of services, it is incumbent upon the FTB to extend the regulation to both such categories.

<u>Second</u>, we wish to reiterate our objection to the notion that the proposed regulation would be confined to taxpayers or unitary groups earning more than 50% of their revenues from providing enumerated services (the "50% Approach") because the concept resurfaced at the December 18, 2006 hearing. As we have stated before, we strongly believe the regulation should apply to all revenues earned from specified services (*i.e.*, management, distribution and administration) provided to mutual funds (hereinafter the "Revenue Approach").

(1) <u>*The Revenue Approach will promote uniformity to a greater degree than any other approach*</u>. Twelve states (of which we are aware) have adopted special sourcing

rules for mutual fund service providers. Of those twelve states, ***eight*** apply the Revenue Approach. Of the eight states that have adopted the Revenue Approach, three are among the most populous states in the Country—New York, New Jersey, and Texas. Plainly, the Revenue Approach will promote uniformity to a greater degree than any other approach.

(2) *The Revenue Approach also will achieve the most accurate computation of California-source income.* Just as a central goal of any apportionment methodology is achieving the most accurate computation of income, so, too, is a principal goal of the regulation to source a mutual fund service provider's income more accurately. Thus, motivating this regulation project are both the observation that currently a mutual fund service provider's sales factor replicates its property and payroll factors rather than reflecting the market for the taxpayer's services, and the recognition that correcting that problem will result in a more accurate reflection of income.

In providing the most narrowly tailored solution to this problem, *i.e.*, sourcing the targeted receipts, and only those receipts, on a market basis, the Revenue Approach necessarily achieves a more accurate representation of income. By contrast, the 50% Approach produces a less accurate reflection of income in that, for taxpayers under the 50% threshold, none of their income from providing the specified services to mutual funds will be sourced on the basis of the regulation and instead all such income will be sourced on the basis of the income producing activity test. As a result, if the 50% Approach applied, two taxpayers could have nearly identical activity in all respects; however, if the revenues of one slightly exceeded the 50% threshold while the revenues of the other fell just under the 50% threshold, their income would be apportioned very differently. The dramatically different outcomes for nearly identically situated taxpayers evidences the 50% Approach's troubling propensity to produce inaccurate apportionment results.

At least in part for these reasons, two-thirds of the states with special apportionment rules for mutual fund service providers have concluded that the Revenue Approach is the superior method for achieving the objectives they sought.

(3) *The Revenue Approach will minimize the possibility of taxpayer manipulation.* The 50% Approach is potentially subject to manipulation by taxpayers in that it may be possible for a taxpayer to plan for an entity to fall short of or exceed the 50% revenue threshold in order to achieve a desired result. While admittedly, it would be more

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difficult for a taxpayer to achieve a desired result if the rule were applied on a unitary group basis,[1] the Revenue Approach allows for no manipulation of this type at all.

(4) *The Revenue Approach will minimize administrative costs*. Since eight of twelve states that have modified the standard formula for mutual fund service providers have adopted the Revenue Approach, applicable taxpayers should have processes in place to gather the data necessary to apply the modified formula. Therefore, contrary to the comments by at least one interested party, in all likelihood California's adoption of the Revenue Approach would not increase the administrative burden of such taxpayers.

Furthermore, the 50% Approach would require annual classification of taxpayers based on the majority of their revenues, leading to administrative burdens and, potentially, disputes between taxpayers and the FTB regarding classification. Applying the modified rule to all revenues from providing mutual fund services will minimize administrative burdens and disputes between taxpayers and the FTB.

* * *

Please note that this letter is intended to supplement our earlier comments rather than to supersede them. Accordingly, we look forward to the FTB's responses to the comments in each of our two submissions. Thank you very much for your consideration.

Very truly yours,

Amy L. Silverstein

[1] A significant problem with the unitary group approach is that it will severely limit the universe of taxpayers able to benefit from the regulation. For example, diversified financial institution unitary groups almost certainly would be precluded from applying the regulation, even though a substantial portion of their activity may involve providing services to mutual funds.

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January 16, 2007

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Re: FTB Proposed Regulation 25137-14
Apportionment for Mutual Fund Service Providers
Comments Regarding Information Provided by Federated Investors

Dear Mr. Joseph:

As you are aware, Federated Investors, Inc. provided oral and written testimony during the FTB hearing on this matter in Sacramento on December 18th. This testimony included an analysis of various legal issues and an economist's report regarding the impact of the regulation on the State's General Fund revenues.

We have reviewed the materials provided by Federated and do not consider them to be thoroughly researched, rigorous or accurate in many respects. Jeff Vesely of Pillsbury Winthrop will provide comments in a separate letter on the various legal issues that were raised by Mr. Toman's oral and written testimony. This letter intends to address the issues raised by Mr. Hamm's oral and written testimony and his comments regarding an economic analysis of the proposed regulations.

The overall conclusion of the economic analysis prepared by Mr. Hamm is that the State's General Fund revenues will decrease by an estimated $370 million. The FTB previously estimated a net revenue gain of about $10 million. Our analysis indicates that the Mr. Hamm's estimated net revenue loss is the direct result of numerous errors in the use of facts, assumptions and the analysis that are applied to these facts and assumptions. Our analysis has concluded that the FTB's estimate of a $10 million static revenue gain is much more representative of the impact that this regulation will have on the State of California's General Fund revenues. Our analysis is consistent with an independent fiscal analysis conducted by Dr. Phillip Romero of Forward Observer, a Sacramento-based economic and policy consulting firm.

We disagree with Mr. Hamm's conclusions for all of the reasons that are discussed in the materials immediately below. For clarity, we have addressed our objections and comments in the order presented in Mr. Hamm's written report. Mr. Hamm's paragraph headings are copied and highlighted in blue.

C. Key Variables Determine the Net Impact on General Fund Revenue.

1. The market share of California-based MFSPs

While Mr. Hamm's discussion of the impact of the proposed regulation on California-based MFSPs contains loose language concerning the application of the sales factor in the combined apportionment factor calculation, we do not disagree with the gist of his comments. He does, however, ignore the impact of throwback on California-based MFSPs, and in so doing, exaggerates the impact of these changes on California-based companies.

2. The percentage of mutual fund shares held by California residents

Mr. Hamm's simplistic comments are misleading. For California-based MFSPs and MFSPs that are based out-of-state, as the percent of the funds' shareholders residing in California goes down, their California tax liabilities will go down; the reverse is also true for both California-based and out-of-state MFSPs.

3. The relative profitability of California-based and out-of-state MFSPs

We cannot agree with Mr. Hamm's generalization that if California-based MFSPs are more profitable than their out-of-state competitors, the proposed change in the apportionment method would bring about a relatively larger reduction in General Fund revenues. As will be discussed in detail below, there is no evidence showing that California-based MFSPs are any more profitable than their out-of-state competitors. The data that Mr. Hamm uses to support this conclusion are clearly erroneous.

Second, even if California-based MFSPs were shown to be marginally more profitable than their out-of-state competitors, apportionment and the calculation of a unitary group's California income tax liability on the combined franchise tax return is a dynamic process that involves many variables. All of these variables can have an impact on the final tax liability, and to suggest that one variable will cause the resultant tax liability to increase or decrease ignores the particular facts and circumstances of each taxpayer, the complexity of the resulting apportionment calculation and the importance of other interactive variables. This calculation can only be done with actual income tax data for all industry participants, data that Mr. Hamm and the undersigned do not have access to.

4. The percentage of total mutual fund shareholders residing in California that are serviced by members of taxpaying groups lacking income tax nexus

Again, Mr. Hamm's conclusions are not realistic. We would argue that the majority of the non-California-based MFSPs listed in his Exhibit 3 are subject to California franchise tax because they have one or more members of their unitary group doing business in California. In writing his report, Mr. Hamm essentially suggests that out-of-state MFSPs access the California marketplace without any physical presence in the state. We believe that the percentage of these companies that do not have a member of their unitary group doing business in California, and therefore would not be impacted by the provisions of this regulation, is relatively small. The non-California-based MFSPs that do have a member of their unitary group doing business in California, and would be subject to tax under this regulation would generate enough additional tax revenues, together with the impact of the throwback provisions on California-based MFSPs, to make the impact of this regulation effectively revenue-neutral. This is the conclusion reached by the Franchise Tax Board in their analysis of the economic impact of the changes made by Regulation Section 25137-14.

D. Data Sources.

1. Market share of California MFSPs

The fact that the companies listed in Exhibit 3 are headquartered in California does not automatically lead to the conclusion that under cost of performance apportionment for sales (COP) that 24% of the revenues of the mutual fund industry are taxable in California. Many of the companies listed in this exhibit have operations within and outside of California. Under COP, assets managed by companies that have a preponderance of their operations outside of California will not have factors assigned to California in the sales factor apportionment computation. In making his direct correlation, Mr. Hamm strongly suggests otherwise.

Additionally, the profitability of mutual fund asset management is multi-dimensional. MFSP management of emerging markets and international equity assets has a higher profit margin than the management of fixed income securities, and in particular, municipal fixed income securities. MFSPs using active management strategies generate a much higher profit margin that MFSPs that use passive management strategies, such as exchange traded funds and index funds. Finally, other dynamics may have just as much an impact on MFSP profitability, including the relative size of expense ratios, the number and size of assets under management, and the existence of tiered-management fee structures. All of these factors will have an impact on profitability, and to suggest that a simple direct correlation can be made is simplistic in the extreme.

2. Mutual fund shares held by California residents

We have no comments about this paragraph.

3. Relative profitability of California and foreign MFSPs

It is the conclusion reached in reliance on the discussion in this paragraph and the data contained in Exhibit 4 that we must make our strongest objection. Based on the data in Exhibit 4, Mr. Hamm concludes that Franklin Templeton Investments achieved an operating margin of 50.5 percent in 2005, which contrasted with the operating margins achieved by non-California MFSPs, which ranged from 19.4 percent to 42.8 percent, with a weighted average of 32.9 percent. Based on this Franklin Templeton Investments operating margin, he calculates a Return on Managed Assets percentage for Franklin of .70 percent, and then concludes that this return on managed assets is representative of all California-based MFSPs. Mr. Hamm states that this data was extracted from information on margins published by Thompson Financial, as well as with information from an analysis of Form 10-Ks filed by several out-of-state MFSPs or their parent companies.

This is a brazen example of the selective use of data to support a predetermined conclusion. Mr. Hamm knows that his overall conclusion is extremely sensitive to this particular data, yet his analysis ignores the most trusted source of information available about the company, Franklin Templeton Investments, that he chooses as the model for all California-based MFSPs. Franklin Templeton Investments is a dba for the group of companies that perform investment management and related operations under Franklin Resources, Inc. Franklin Resources, Inc. is the parent company that files a combined California franchise tax return for this unitary group. Franklin Resources' stock is publicly traded on the New York Stock Exchange, and its financial statements are publicly audited by Pricewaterhouse Coopers and regularly filed with the Securities & Exchange Commission, the Federal Reserve Bank and other governmental agencies. As public documents, this financial information is available to anyone who has an interest in the financial condition of our company, including investors, government regulators and financial analysts.[1]

The important point to be made is that Franklin Resources' combined operating income for 2005 is listed in its audited Annual Report as $1,288,376,000, not $2,176,600,000 as listed in Exhibit 4 of Mr. Hamm's report. Franklin Resources' assets under management is listed as $453.1 billion (based on year-ending balances) and $410.8 billion (based on a simple monthly average).

Based on this corrected information, Franklin Templeton Investment's operating margin for its Fiscal Year Ended September 30, 2005 was 29.893 percent (rounded to 30%). Franklin Templeton's return on managed assets, using this corrected operating margin, was .314 percent (based on monthly average AUM) and .284 percent (based on year-ending AUM). These figures are nowhere near the figures used in Mr. Hamm's analysis in Exhibit 4: an operating margin of 50.5 percent and a return on managed assets of .7%. Mr. Hamm then compounded this error by extrapolating it to all of the rest of the California MFSPs. A much more correct extrapolation would suggest that California MFSPs have the same operating margins and the same average return on managed assets as out-of-state MFSPs.

Mr. Hamm's additional comments about the Vanguard Group and its passive asset management style and its low profitability also miss the point. Many other companies, including several California-based mutual fund

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[1] Franklin Resources, Inc. financial statements are available for public viewing on the SEC's website, and on Franklin Templeton Investments corporate website. The link to the latter is: (https://www.franklintempleton.com/retail/jsp_cm/global_nav/company/annual_reports.jsp. Click on the 2006 Annual Report in the middle of the page. Note that the 2006 Annual Report repeats the information contained in the 2005 Annual Report and compares it to the financial information from 2006 and 2004. The data showing FRI's operating income are contained on page 79 of the Annual Report (or on page 111 of 179 of the Adobe Acrobat file on the website). The data showing FRI's average annual and year-end assets under management are contained on page 43 of the Annual Report (or on page 75 of 179 of the Adobe file on the website.)

companies, operate using a passive asset management style or seek to keep their operating margins lower than the industry average. To single out the Vanguard Group for this treatment while ignoring the rest of the industry is another example of the selective use of data to support a predetermined conclusion.

4. Worldwide taxable income

This calculation is fatally flawed by the use of a .7 percent weighted average return on managed assets for the 11 publicly traded firms in his analysis. Not only has the .7 percent been shown to be invalid, but the analysis extrapolates this percentage to the entire mutual fund industry. In paragraph 3, the report had earlier come to the conclusion that non-California based MFSPs, which were stated in the report to amount to roughly 76 percent of all of the assets managed by the industry, have an weighted average return on managed assets of 32.9 percent. The use of erroneous data and the inconsistencies in its application can only lead one to disbelieve all of the conclusions reached in this report.

An additional point needs to be made when addressing worldwide taxable income. Most California-based MFSPs report income on their combined California franchise tax returns using a California waters'-edge election, thereby avoiding the requirement for reporting foreign-based operations in their tax returns (with appropriate exceptions for certain items such as partially include entities). Most California-based MFSPs report income in their financial statements on a worldwide basis. To bridge from the former to the latter requires significant taxpayer-based book-to-tax adjustments that cannot be taken into account in this type of macro-analysis. The only agency with the capability to accurately estimate these adjustments is the Franchise Tax Board.

E. Impact of the Proposed Regulation on General Fund Revenues

1. The discussion by Mr. Hamm and his use of Chart 1 is consistent with his misuse of data and assumptions earlier in his analysis.

2. This can best be illustrated with a detailed review of Exhibit 5, the overall comparison of the current system and proposed regulation. This Exhibit again uses an estimated return on managed assets of .7 percent, even though it has previously stated that the average return on managed assets for non-California-based companies is only in the range of .3 percent. In so doing, it grossly overstates the estimated worldwide taxable income in line [3]. It then uses an implicit tax on sales of 4.42 percent (50%

of the franchise tax rate for corporations), assuming that 100 percent of all worldwide taxable income as calculated in [3] would be subject to tax in California. It then applies an apportionment percentage to this figure to give the result that Mr. Hamm and his supporters were looking for.

This Exhibit and its estimated tax calculation grossly overstate the revenue being generated by California-based companies in the current cost of performance system. It does not consider the amount of income that is not subject to tax or is subject to tax at reduced rates of taxation (as a result of the apportionment calculation) under COP. It does not consider any of the necessary adjustments to taxable income in arriving at income subject to apportionment in the California combined return. It overstates the rate of tax on income currently subject to tax in California, as a result of reductions from operating losses, credits and the application of petitions for Sec. 25137 relief.

In summary, we would conclude that Mr. Hamm made fundamental errors in his analysis that led to the grossly inaccurate results that he reported. We strongly feel that the Franchise Tax Board's economic analysis must be used by the Board in its review of the fiscal impacts of this regulation. After all, the Franchise Tax Board is the only agency with the actual tax return data necessary to accurately compute the fiscal impact of this proposed regulation. Furthermore, the Franchise Tax Board's analysis is further corroborated by an independent fiscal analysis conducted by the consulting firm Forward Observer.

If you feel that it would be helpful, we are available to discuss with you the conclusions that are rendered in this letter, and to answer any questions that you may have about these items or the regulation project in general.

Very truly yours,

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Senior Tax Counsel

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January 16, 2007

Mr. Carl Joseph
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Re: Comments on Federated Investors Submission related to FTB Proposed Regulation 25137-14 Regarding Apportionment for Mutual Fund Service Providers

Dear Mr. Joseph:

I attended the FTB hearing in Sacramento on December 18, 2006. During that hearing, William G. Hamm, an economist representing Federated Investors, Inc. ("Federated"), testified as to his analysis of the impact of the Proposed Regulation on the State's General Fund. His report was also included in Federated's written submission.

Mr. Hamm concluded that the proposed regulation would reduce General Fund revenue by $370 million while the FTB staff had calculated that the regulation would increase General Fund revenue by $10 million. We have reviewed Mr. Hamm's testimony and report and do not agree with many of his assumptions and facts that he relied on in his analysis. We will discuss each area where we disagree by identifying the corresponding section of Mr. Hamm's report below.

C. Key Variables Determining the Net Impact on General Fund Revenue

1. The market share of California-based MFSPs

   Mr. Hamm is partially correct in his comments that the proposed regulation would tax "only income earned from servicing shareholders who are California residents" thereby reducing tax liabilities for California MFSPs. Mr. Hamm neglects to mention that the proposed regulation also includes a throwback provision which would have California MFSPs pay tax on income related to shareholders living in those states which must be thrown back.

2. The percentage of mutual fund shares held by California residents

   Mr. Hamm is correct, however, his position could be more clearly stated. <u>For both California and out-of-state MFSPs</u>, as shareholders residing in California increases, the California tax liability will increase and as shareholders residing in

California decreases, California tax liability will go down.

3. The relative profitability of California-based and out-of-states MFSPs

   Mr. Hamm postulates two assumptions in this statement. The first is "Other things equal". This is a dangerous assumption to make under the tax regime in California. The calculation of the California tax liability on a unitary return (possibly water's edge) with 3 factor apportionment is a very complex calculation that relies on many variables. The change in one variable may cause resultant changes in other variables, thereby making it difficult to support this assumption.

   Mr. Hamm's other assumption that California MFSPs are more profitable than the out-of-state MFSPs is based on erroneous and limited data. The Franchise Tax Board is in the best and only position to make calculations based on this data using actual tax returns filed by MFSPs.

4. The percentage of total mutual fund shareholders residing in California that are serviced by members of taxpaying groups lacking income tax nexus.

   Again, we would not agree with this assumption, and Mr. Hamm provides no foundation to support using this assumption. Most MFSPs would have at least one member of their unitary group doing business in California and would therefore already be filing a unitary return in California. We believe that the majority of the MFSPs listed in his Exhibit 3 would be subject to California taxes.

D. Data Sources

1. Market share of California MFSPs

   We agree that California based MFSPs may account for managing approximately 24% of the Assets Under Management (AUM). However, this does not translate into 24% of the revenues being 100% taxable in California as Mr. Hamm's calculations suggest. Many of the California based MFSPs have operations both within and without the State of California. Under cost of performance, revenues will be sourced to where the preponderance of the operations are located. Mr. Hamm also assumes that the out-of-state MFSPs would have had 0% of their revenues reported/taxable in California. Clearly, the out-of-state MFSPs have some presence in California and would have some revenues currently sourced to California.

3. Relative profitability of California and foreign MFSPs

   This area and Exhibit 4 are the starting point for all of Mr. Hamm's calculations and his resulting conclusion. The data used in this area is misleading at best and its use to extrapolate results for all California MFSPs is dangerously inaccurate. Mr. Hamm uses data from Franklin Templeton (Franklin) to come to his conclusions for all California based MFSPs. I was not convinced that Franklin had a 50% profit margin, so I pulled a copy of their 2005 10-K which is publicly available. The operating revenues reported in Exhibit 4 were correct at $4,310.1 (millions), however, all other information was incorrect. According to the 10-K, operating profits were $1,288.4 million not the $2,176.6 that Mr. Hamm reported. Therefore, the revised operating margin should be 29.89%. Also, the 10-K reports Franklin as having $453.1 billion of ending assets under management or $410.8 billion of average assets under management not the $309.825 reported by Mr. Hamm. Based on the average assets under management, this would provide a .314% return on managed assets instead of the .7% assumed by Mr. Hamm. These revised calculations are much more in line with the majority of all of the other MFSPs listed in Exhibit 4. Therefore, a better assumption would be that both in state and out-of-state MFSPs have approximately a .3% return on managed assets.

Mr. Hamm's other comments regarding Vanguard Group illustrates his lack of familiarity with the mutual fund industry. There are many other companies, including several California based mutual fund companies, that manage mostly fixed income products or index products which have the result of returning reduced operating margins. It is unreasonable to state in the absolute that the out-of-state group of MFSPs would have a lower overall profitability without making sure that the comparison is between equity manager to equity managers or fixed income managers to fixed income managers.

Again, the Franchise Tax Board is the only agency that could possible calculate the effect of this regulation reliably using actual tax return data.

In conclusion, we believe that Mr. Hamm's analysis has multiple errors in both the assumptions and data he uses to support his conclusion. The only agency with access to actual tax returns and the data necessary to compute a realistic fiscal analysis is the Franchise Tax Board. We strongly urge the Board to rely upon the conclusion of a $10 million increase to the General Fund revenue reached by the Franchise Tax Board in its analysis of the fiscal impact of this proposed regulation.

If you have any questions, please don't hesitate to call me.

Yours truly,

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January 16, 2007

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BY ELECTRONIC AND U.S. MAIL

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Re: FTB Proposed Regulation 25137-14 Regarding Apportionment for Mutual Fund Service Providers

Dear Mr. Joseph:

This letter is submitted on behalf of Franklin Resources, Inc. in response to comments received by the Franchise Tax Board ("FTB") in opposition to Proposed Regulation 25137-14 (the "Proposed Regulation"), and supplements our previous letter to you dated November 14, 2006.

1. The Proposed Regulation is consistent with UDITPA and Sections 25136 and 25137.

It has been argued that the Proposed Regulation is inconsistent with the provisions of California's standard apportionment formula concerning the treatment of sales of other than tangible personal property (i.e., intangibles and services) for sales factor purposes. In particular, opponents contend that the Proposed Regulation is inconsistent with Section 25136 of the Revenue and Taxation Code[1] and the provisions of the Uniform Division of Income for Tax Purposes Act ("UDITPA"), as adopted by California.[2]

This argument plainly is erroneous, since the FTB has proposed a regulation under Section 25137, not Section 25136. Section 25136 sets forth the general rule for the inclusion of the sales of intangibles and services in the sales factor of the standard

[1] Unless otherwise indicated, all statutory references are to the California Revenue and Taxation Code and all regulatory references are to Title 18 of the California Code of Regulations.

[2] California's version of UDITPA was enacted as Sections 25120 through 25139.

apportionment formula. Under Section 25136, such sales are attributed to California if the income producing activity with respect to the sale, based on cost of performance, occurs in this state. The Proposed Regulation, however, does not interpret Section 25136. Rather, the Proposed Regulation is being issued under Section 25137.

Section 25137 provides for an equitable adjustment of the standard apportionment formula, if the standard formula fails to fairly reflect the extent of the taxpayer's business activity in this state. The express purpose of Section 25137 is to allow a departure from the standard apportionment formula to remedy the distortion that may arise from the application of the standard formula. In particular, Section 25137 provides for the employment of "any other method," if reasonable, to effectuate an equitable apportionment of the taxpayer's income.

Because the Proposed Regulation is being issued under Section 25137 to cure a distortion that arises under the standard apportionment formula, FTB staff may depart from the standard formula (i.e., Section 25136) and may adopt a proposed regulation relating to sales of mutual fund services that is based on shareholder residence rather than income producing activity or cost of performance. A sales factor apportionment rule based on shareholder residence is a reasonable "other method" that appropriately addresses the unique features of the mutual fund service industry.

Opponents also contend that the Proposed Regulation impermissibly adopts a sales factor rule based on shareholder residence, which is a "market state approach" that only applies to sales of tangible personal property. As discussed above, such an argument is fundamentally flawed, since it wholly ignores the plain language of Section 25137 which expressly permits the use of "any other method" to remedy distortions that arise under the standard apportionment formula.

Moreover, it is simply inaccurate that a market state approach is limited to sales of tangible personal property. The theoretical basis for the inclusion of a sales factor in the apportionment formula is to balance the property and payroll factors, which heavily emphasize those states in which the taxpayer is physically located. William Pierce, the principal draftsman of UDITPA, noted that sales generally should be attributed to the consumer state to avoid "merely duplicat[ing] the property and payroll factors."[3] Pierce further noted:

> Moreover, it is believed that the contribution of the consumer states toward the production of the income should be recognized by attributing the sales to those states.[4]

While perhaps more readily apparent in a manufacturing context, Pierce's observation nonetheless applies equally to sales of tangible personal property as well as intangibles and services.[5] In the specific context of the mutual fund services industry, the standard sales factor apportionment rule under Section 25136 (i.e., income producing activity and cost of performance) essentially duplicates the property and payroll factors. This is at odds with the underlying rationale of UDITPA's adoption of a balanced three-factor apportionment formula. Instead, the Proposed Regulation, by using shareholder residence and adopting a market-based approach to the sales factor, furthers the fundamental purpose of the sales factor in recognizing the consumer states and thus balancing the effects of the property and payroll factors.[6]

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[3] William J. Pierce, "The Uniform Division of Income for State Tax Purposes," 35 *Taxes* 747, 780 (1957); see also George T. Altman and Frank M. Keesling, *Allocation of Income in State Taxation* (New York: CCH, 1946), 124-25 ("The answer, which is, it is believed, adequate and even compelling, is that in many instances some factor such as sales is needed to balance the property and payroll factors. . . . If the reason for the use of the factor is to balance the other two factors, then obviously the sales should be apportioned in such a manner as to offset rather than aggravate the effects of the property and the payroll factors.").

[4] Pierce, 35 *Taxes* at 780.

[5] See Frank M. Keesling and John S. Warren, "California's Uniform Division of Income for Tax Purposes Act, Part II," 15 *UCLA L. Rev.* 655, 674-76 (analyzing sales of services by transportation, telephone and similar companies in a manner "consistent with the theory controlling the apportionment of sales of tangible property").

[6] Again, the underlying rationale of the sales factor is to reflect the contribution of the consumer state. Altman and Keesling stated:

> It is believed that the only proper method for making the apportionment is to employ a formula which give weight to the various factors responsible for the earning of income, such as property, which reflects either the capital investment or the general size and importance of the business, payroll, which indicates the value to the taxpayer of the services of its employees, *and sales, which give weight to the activity of the taxpayer in obtaining customers without which, of course, the business would not function.*

(... continued)

Finally, opponents cite Pierce and other well-known UDITPA commentators regarding the standard apportionment rules for sales of intangibles and services under UDITPA section 17, the California counterpart to which is Section 25136. Opponents, however, fail to point out that Pierce and other commentators identified UDITPA section 17 as seriously deficient and that it was expected that state tax authorities would use their authority under UDITPA section 18 (e.g., Section 25137) to adopt a special formula to address certain types of sales income.

Frank Keesling and John Warren, far from endorsing a rule based on income producing activity and cost of performance, noted:

> The Act [California's UDITPA] provides that sales, other than sales of tangible personal property, shall be apportioned to the state or country in which the income-producing activity is performed and if the income-producing activity is performed in two or more states, the sales shall be apportioned to the state in which the greatest proportion of such activity is performed, the proportion to be determined on the basis of cost of performance. *These provisions are seriously deficient.*
>
> First of all, the expression *"income-producing activity" is inappropriate for use in the apportionment of sales. . . .*
>
> The provisions of the Act relating to the apportionment of sales where the income-producing activities take place in two or more states or countries are *arbitrary and capricious to the point of possibly being unconstitutional.*[7]

Similarly, Pierce stated:

> Another problem arises in conjunction with sales other than sales of tangible personal property. Section 17 of the uniform act attributes these sales to the state in which the income-producing activity is performed. . . . However, there are many unusual fact situations connected with this type

(... continued)

Allocation of Income in State Taxation at 97 (emphasis added). Thus, a rule that adopts a market state approach, such as the Proposed Regulation, furthers the basic purpose of the sales factor.

[7] Keesling and Warren, 15 *UCLA L. Rev.* at 672-73 (emphasis added).

> of income and probably *the general provisions of Section 18 should be utilized for these cases*. . . . The national conference considered this problem at length and concluded that for certain types of sales income, exceptions would have to be established by the tax collection agencies, since no formula seemed to be satisfactory for every conceivable situation.[8]

The Proposed Regulation is such an exception to the standard apportionment formula and is being established under California's counterpart to UDITPA section 18 (i.e., Section 25137). Thus, the Proposed Regulation not only is consistent with Sections 25136 and 25137, but also appropriately addresses the deficiencies arising under the standard apportionment provisions regarding sales of intangibles and services in the mutual fund industry, as anticipated by UDITPA drafters and commentators.

2. The Proposed Regulation is not inconsistent with California law concerning sales throwback.

Opponents also contend that a sales throwback rule in the Proposed Regulation that is based on *Finnigan*,[9] rather than *Joyce*,[10] is inconsistent with California law. In particular, opponents cite to *Citicorp North America, Inc. v. Franchise Tax Board*, 83 Cal. App. 4th 1403 (2000) and *Appeal of Huffy Corporation*, 99-SBE-005 (Apr. 22, 1999), which are misdescribed as having "overruled" *Finnigan*. Opponents' argument is flawed for a number of reasons and relies on an erroneous description of the *Citicorp* and *Huffy* decisions.

First, the issue whether sales should be thrown back under a *Finnigan* or *Joyce* rule has arisen specifically in the context of sales of tangible personal property under Section 25135. *Citicorp* and *Huffy* both involved an interpretation of Section 25135 and sales throwback of tangible personal property in particular. However, neither sales of tangible personal property nor Section 25135 is at issue in the Proposed Regulation. The Proposed Regulation relates to sales "other than sales of tangible personal property" and is being issued under Section 25137, which *Citicorp* and *Huffy* did not address.

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[8] Pierce, 35 *Taxes* at 780-81 (emphasis added).

[9] *Appeal of Finnigan Corporation*, 88-SBE-022 (Aug. 25, 1988), *opinion on petition for rehearing*, 88-SBE-022A (Jan. 24, 1990).

[10] *Appeal of Joyce, Inc.*, 66-SBE-070 (Nov. 23, 1966).

Second, *Huffy* did not overrule *Finnigan*. Rather, the State Board of Equalization ("SBE") in *Huffy* merely readopted the *Joyce* rule on a prospective basis. The SBE did not overrule *Finnigan*, and, in fact, applied *Finnigan* to the taxpayer at issue in *Huffy*. In addition, the SBE in *Huffy* maintained that there were "theoretically good reasons" for the implementation of *Finnigan* in California. Similarly, the Court of Appeal in *Citicorp* recognized the sound theoretical basis of *Finnigan*, and thus upheld the application of the *Finnigan* rule to the taxpayer at issue in *Citicorp*.

Third, the Proposed Regulation is being issued under Section 25137, which permits the use of "any other method," if reasonable, to achieve equitable results. Plainly, such "other method" includes an approach outside the standard apportionment provisions. Thus, neither *Citicorp* nor *Huffy*—which interpret the standard sales factor apportionment rules under Section 25135—limits the range of alternative apportionment methods that may be adopted under Section 25137.

Finally, opponents contend there is no substantive reason why a *Joyce* sales throwback rule should not also work for Section 25137 purposes. The Proposed Regulation appropriately adopts *Finnigan*, because a *Finnigan* rule—unlike *Joyce*—specifically addresses both the special features of the mutual fund industry and the nature of the distortion that arises under the standard apportionment formula as applied to such industry.

A *Finnigan* rule is appropriate here, because such a rule, unlike *Joyce*, looks to the entire unitary business of mutual fund service providers, and not a specific entity within such business, for purposes of determining whether sales throwback applies. By adopting a *Finnigan* approach, the Proposed Regulation takes into account the unique features of the mutual fund business, which, due to heavy government regulation, is often conducted through separate legal entities that operate in various locations. Thus, a *Finnigan* rule is reasonable in the context of the mutual fund industry.

In contrast, blind adherence to a *Joyce* rule for purposes of a special formula for the mutual fund industry would be completely inappropriate, since it would not take into account the unique nature of that industry. That the court and the SBE in *Citicorp* and *Huffy*, respectively, may have adopted a *Joyce* rule prospectively for purposes of Section 25135 does not necessarily mean that *Joyce* is a reasonable rule for purposes of employing an alternative apportionment method under Section 25137. No evidence has been presented by the opponents that a *Joyce* rule would better address the unique features of the mutual fund industry and the distortion that arises under the standard apportionment formula when applied to that industry.

Thus, the Proposed Regulation, which permissibly and reasonably includes a *Finnigan* rule for sales throwback, is entirely consistent with California law.

3. FTB staff has satisfied the requisite evidentiary standards under Section 25137.

Opponents further argue that FTB staff has not met its burden of proving by "clear and convincing evidence" that a departure from the standard apportionment provisions is warranted in this case. Opponents cite as authority, *Microsoft v. Franchise Tax Board*, 39 Cal. 4th 750, 765 (2006), and also point to the SBE's quantitative analyses of distortion in *Appeal of Merrill, Lynch, Pierce, Fenner & Smith*, 89-SBE-017 (June 2, 1989) and *Appeals of Pacific Telephone & Telegraph Co.*, 78-SBE-028 (May 4, 1978).

Opponents' reliance on *Microsoft*, as well as *Merrill, Lynch* and *Pacific Telephone*, is misplaced. First, the *Microsoft* Court did not establish a new burden of proof for deviations from the standard apportionment provisions. Prior to *Microsoft*, California courts and the SBE held that distortion must be shown by "clear and convincing evidence" in order to depart from the standard apportionment formula. See, e.g., *McDonnell Douglas Corp. v. Franchise Tax Board*, 69 Cal.2d 506, 512 (1968); *Appeal of Fluor Corporation*, 95-SBE-016 (Dec. 12, 1995).

Second, *Microsoft*, *Merrill, Lynch* and *Pacific Telephone* did not specifically address the requisite evidentiary standard that the FTB needs to satisfy to issue a special industry regulation under Section 25137. Instead, these cases involved a determination whether California's standard apportionment provisions should be applied to a particular taxpayer's specific facts and circumstances. Such determinations, which may involve numerical comparisons, distortion percentage computations or qualitative analyses, necessarily are made on a case-by-case basis.[11]

By comparison, a special industry formula issued as a regulation under Section 25137 is intended to apply on an industry-wide basis. It is neither practical nor required that the FTB employ quantitative comparisons and distortion percentages to show that distortion results from applying the standard apportionment provisions to all members of the mutual fund industry. Rather, as the SBE noted in *Appeal of Crisa*, 2002-SBE-004 (June 20, 2002), a decision which was endorsed by the Court in *Microsoft*:

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[11] See, e.g., *Microsoft*, 39 Cal. 4th at 771-72.

> The central question under section 25137 is not whether some quantitative comparison has produced a large-enough "distortive" figure. Rather, the question is whether there is an unusual fact situation that leads to an unfair reflection of business activity under the standard apportionment formula.

Regulation 25137(a)[12] specifically provides that in the case of certain industries where the standard apportionment provisions do not set forth appropriate procedures for determining the apportionment factors, the FTB is not precluded from establishing appropriate procedures for each such industry, provided the procedures are applied uniformly. In the exercise of its authority, the FTB (and the Multistate Tax Commission) previously has adopted numerous industry-wide special regulations under Section 25137 (and UDITPA section 18)—many in effect since at least the 1970s—for contractors, franchisors, banks and financial corporations, commercial fishing, airlines, motion pictures and television, railroads, combination of general and financial corporations, trucking companies and print media.[13] These Section 25137 regulations were adopted based on a qualitative review of the distortive effects of the standard apportionment provisions as applied to a particular industry—no specific quantum of distortion was required or shown.[14]

Here, the FTB has performed a similar qualitative review. The FTB has demonstrated that an unusual fact situation exists when the standard apportionment provisions are applied to the mutual fund industry. The FTB has looked to a dozen or so states which identified a need to modify their apportionment provisions with respect to mutual fund service providers to take into account shareholder residence.[15] In addition, FTB staff has considered numerous Section 25137 petitions, analyzing the distortive effect of applying the income producing activity rules under the standard formula to the mutual fund

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[12] Regulation 25137(a) is substantially similar to Regulation IV.18.(a) of the Multistate Tax Commission Regulations which was issued under UDITPA section 18.

[13] See Regulations 25137-2, 25137-3, 25137-4.1, 25137-4.2, 25137-5, 25137-7, 25137-8, 25137-9, 25137-10, 25137-11 and 25137-12. Contrary to assertions by opponents, adoption of a special industry formula for the mutual fund industry does not require legislative action or a statutory change. Such a formula may be adopted by regulation under Section 25137, which is consistent with California's longstanding approach to industry-wide variances from the standard apportionment provisions.

[14] See, for example, Comments, Responses and Recommendations, Regulation 25137-10 (issued by FTB staff in connection with the public hearing held on November 17, 1989 to consider the adoption of Regulation 25137-10), pp. 4-6.

[15] See FTB Notice 2005-3 and discussion paper referenced therein.

industry. In each instance, the FTB has granted relief under Section 25137.[16] Rather than continuing to consider such petitions on an *ad hoc* basis, FTB staff is seeking to establish, by way of the Proposed Regulation, a uniform procedure that applies on an industry-wide basis. This approach is consistent with the mandate under Regulation 25137(a) that special industry formulas "be applied uniformly." In all, the FTB has satisfied the requisite evidentiary standard under Section 25137 and has demonstrated the need for the Proposed Regulation.

4. The Proposed Regulation furthers uniformity among states.

Opponents also contend that a "super majority," rather than a clear trend, of states adopting a shareholder residence rule for the mutual fund industry is required for the Proposed Regulation to be adopted. The opponents' argument is baseless and impractical.

In *Citicorp*, for example, the Court upheld the application of *Finnigan* to the taxpayer at issue. In so doing, the Court expressly rejected the taxpayer's argument that *Finnigan* was an invalid rule because it was not adopted by a majority, much less a super majority, of states.[17] Furthermore, a super majority requirement is neither practical nor sound policy, since it essentially would preclude the adoption of a rule, regulation or interpretation which a board or a court, as the case may be, determines to be a novel, but fairer or better approach.[18]

Opponents also have argued that the Proposed Regulation potentially would lead to "double taxation" since certain other states have not yet adopted a shareholder residence rule. Opponent's argument erroneously assumes that the Proposed Regulation, and not the laws of those states that have not yet adopted a special rule for the mutual fund industry, would be the cause of any double taxation. In upholding the application of the FTB's special apportionment regulations under Section 25137 where other states may

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[16] See Transcript of FTB Public Hearing on December 18, 2006, pp. 31-32.

[17] *Citicorp*, 83 Cal. App 4th at 1418. The Court in *Citicorp* held that "[m]erely pointing to the fact that the Board's decision in *Finnigan* ultimately proved to be a minority position does not support Citicorp's challenge to the legality or constitutionality of the *Finnigan* interpretation of the relevant statute." *Id.*

[18] See *Citicorp*, 83 Cal. App 4th at 1418 ("Adherence to an outmoded rule for the sake of consistency in the face of compelling reasons to change is not a virtue.")

have failed to enact a similar rule, the SBE previously has rejected the potential for double taxation as a basis for invalidating such regulation.[19]

Furthermore, even if the adoption of a shareholder residence rule by a majority of states was necessary for the adoption of the Proposed Regulation, the fourteen states that have a shareholder residence rule are the headquarters states of mutual fund service providers which represent well over half of the industry's total assets under management.[20] If California is included, nearly 80 percent of the mutual fund industry's total assets under management would be covered under a shareholder residence rule.

In short, the trend in recent years is that an increasing number of states have adopted a shareholder residence rule for the mutual fund industry. Currently at least fourteen states, representing most of the mutual fund industry's total assets under management, have adopted such a rule. Plainly, the Proposed Regulation would further, rather than thwart, uniformity.

Conclusion

In sum, FTB staff has demonstrated the need for an industry-wide variance from the standard apportionment formula for the mutual fund industry and has proposed a reasonable alternative method to effectuate an equitable apportionment of income of mutual fund service providers. The Proposed Regulation is consistent with California law and would promote, rather than thwart, uniformity since it would bring California in

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[19] See *Appeal of the O.K. Earl Corporation*, 77-SBE-051 (April 6, 1977). The SBE noted:

> During oral argument appellant's counsel stated that respondent's special formula [relating to construction contractors] clearly reaches an unreasonable result in this case because in each year it taxes well over 90 percent of the unitary income from the Ohio project, while the State of Ohio has taxed 100 percent of the same income. . . . While we sympathize with appellant's plight, however, we believe that its criticism of respondent is misplaced. Respondent's formula has made a reasonable effort to measure the contribution of the Ohio activities to the earning of the total unitary income. The law of the State of Ohio, on the other hand, apparently does not recognize that appellant's California operations . . . made any contribution at all to the income realized from the Ohio project. It seems to us, therefore, that respondent's formula is not the source of any unfairness that may exist in this case.

[20] See Testimony of William G. Hamm, Ph.D., Proposed Regulation 25137-14, December 18, 2006—Sacramento, California, Exhibit 3.

line with an ever increasing number of states that have established a shareholder residence rule for mutual fund service providers.

Very truly yours,

Jeffrey M. Vesely

cc: John I. McBeth

Kerne H. O. Matsubara
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15263.0007

January 16, 2007

Via Hand Delivery

Colleen Berwick
Franchise Tax Board - Legal Branch
9646 Butterfield Way
Sacramento, CA 95827

Dear Colleen:

Enclosed is my letter of comment submitted on behalf of Barclays Global Investors on Proposed Regulation 25137-14. Please add the letter to the record.

I am not sure if Roburt Waldow and I are on your circulation list. Please add us. Roburt is the same address, email: Roburt.Waldow@HellerEhrman.com, telephone: 415-772-6765. My information appears on the letterhead.

I am also sending a copy of this letter by email and request confirmation of receipt.

Thank you.

Very truly yours,

Joanne M. Garvey

cc: Carl Joseph (Franchise Tax Board)

HellerEhrman LLP

January 16, 2007

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Colleen Berwick
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Re: Proposed Regulation 25137-14

Dear Ms. Berwick:

This letter further supplements the earlier submissions by Barclays Global Investors with respect to proposed regulations governing computation of the sales factor for mutual fund service providers.[1]

Interested party submissions with respect to the proposed regulations and testimony at the hearing on December 18, 2006 raise three major issues: compliance by the Franchise Tax Board with standards for adoption of a regulation under Section 25137 of the California Revenue and Taxation Code,[2] the propriety of adopting a "throwback" provision for sales of services in the context of the shift of the sales factor to a market approach; and the scope of a throwback provision, if adopted. Part I of this letter discusses these issues in general terms and also comments on (i) the "impact study," submitted by Mr. Hamm on behalf of Federated Investors, Inc. ("Federated"),[3] on the effect of the proposed regulation on California's General Fund and (ii) the inclusion of asset management services in the proposed regulation. Part II of this letter makes specific comments on the regulation provisions.

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[1] Letters dated October 27, 2005 and November 3, 2005 in conjunction with the Franchise Tax Board symposium, and the letter dated December 18, 2006, and testimony by Neal Reilly, Assistant Director of Tax, at the hearing on December 18, 2006.

[2] All references to "Section" are to the California Revenue and Taxation Code. References to "Reg." or regulation are to Title 18 of the California Code of Regulations.

[3] We refer to specific entities or representatives in this discussion in order to associate the arguments made with presentations already supplied either before or as part of the hearing on December 18, 2006.

I. Major Issues Raised.

A. Compliance with Standards for Adoption of Regulation

The submission by Mr. Toman on behalf of Federated, attached to the letter dated December 14, 2006 from G. Andrew Bonnewell, contends, among other matters, that the Franchise Tax Board staff position is not consistent with the present Section 25136 (sales of other than tangible property), that the Franchise Tax Board staff has not met the burden of proof to deviate from the standard factor rules under the authority of Section 25137 and that the market state approach is not consistent with the concept of uniformity as interpreted by the California courts.[4]

1. The Purpose of Section 25137 Is Variation From the Standard Apportionment Formula

Federated argues that the Proposed Regulation is inconsistent with the statute (Section 25136), regulations and case law governing the treatment of receipts from the provision of services for sales factor purposes.[5] However, as Federated acknowledges in Part III of its submission, Section 25137 provides for variation from all of the standard apportionment rules, including Section 25136.

Section 25137 is the "safety valve" to the Uniform Division of Income for Tax Purposes Action ("UDITPA"), adopted by California as Sections 25120 through 25137. Professor Pierce, the principal drafter of UDITPA, characterized sales of other than tangible property as a "problem" area. While Professor Pierce felt that in many types of service functions the cost of performance approach of UDITPA Section 17 (Section 25136) appeared adequate, he recognized there were many unusual fact situations connected with services income. He concluded: "...probably the general provision of Section 18 (Section 25137) should be utilized for those cases."[6] Thus, sales from services are identified from the

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[4] The submission also deals with the throwback rules which we will address separately.

[5] Proposed Regulation 25137-14 shifts the standard sales factor rule that assigns receipts to the location where the service provider incurs the preponderance of the costs of providing the service to a market-based approach that assigns receipts to California based on the ratio of California customers to customers everywhere.

[6] William S. Pierce, *The Uniform Division of Income for State Tax Purposes Act,* 35 Tax Magazine, 747, 780 (1957).

inception of UDITPA as a prime area in which to consider deviation from the standard sales factor.

2. Compliance with Section 25137

Federated contends that the Franchise Tax Board has not met the requirements of Section 25137 for variation from the standard provision. *Microsoft Corporation v. Franchise Tax Board,* 39 Cal.4th 750 [47 Cal.Rptr.3d 16] (2006), involved a dispute between the taxpayer, Microsoft, and the Franchise Tax Board on the proper treatment of gross receipts from Microsoft's treasury activities for purposes of the sales factor. The California Supreme Court stated that the party invoking deviation from the standard sales factor (in this case the Franchise Tax Board) has the burden of proving by clear and convincing evidence that the approximation provided by the standard formula is not a fair representation of the taxpayer's California business activities, and that the proposed alternative is reasonable. From this, Mr. Toman, representing Federated, argues that, under the *Microsoft* decision adoption of a regulation under the authority of Section 25137 now requires a new procedure, some form of evidentiary hearing, in order to meet what he characterizes as a new standard of proof, "clear and convincing." Such a procedure is neither provided nor called for by the provisions of the Government Code[7] on the adoption of regulations or by Section 19503, authority of the Franchise Tax Board to adopt regulations.

Federated is incorrect in contending that *Microsoft* requires a change in the regulatory process to meet the standards under Section 25137. Such a position would throw into question the validity of other regulations already adopted under Section 25137, particularly industry wide-regulations adopted pursuant to Reg. 25137(a). To date, the Franchise Tax Board has adopted ten (10) special industry regulations under the authority of Section 25137.[8] The Supreme Court makes no mention of the regulatory process in its *Microsoft* opinion, nor does the court indicate anything at all about the regulatory process.[9] Federated argues that the California Supreme Court's failure to "carve out" the regulatory process in its opinion (which concerns only the dispute between a taxpayer and the Franchise Tax Board) from application

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[7] Government Code Sections 11346 *et seq.*

[8] Regs. 25137-2 (contractors), -3 (franchisors), -4 (banks and financial corporations), -5 (commercial fishing), -7 (air transportation companies), -8 (motion picture and television producers and networks), -9 (railroads) , -10 (general and financial corporations), -11 (trucking companies) and -12 (print media).

[9] Mr. Toman's citation to Footnote 18 of *Microsoft* to support his claim that the California Supreme Court applies the standard to regulations asks more from that footnote than it says.

of the "clear and convincing" standard means that this "new" standard applies. However, no court favors *sub silentio* change. Moreover, the standard is not "new". *See, e.g., Appeal of Fluor Corporation,* 95-SBE-016 (December 12, 1995). Whether it would apply in these circumstances is subject to debate.

However, any such debate is unnecessary here. There is ample evidence in the record to support the need for and appropriateness of the Proposed Regulation to meet any standard. The Franchise Tax Board has set forth sufficient explanation with reference to its experience and the problems and information submitted to it in support of petitions by mutual fund service providers under Section 25137 for alternate treatment. Fourteen other states have seen the problem and adopted provisions that are similar to the Proposed Regulation. Interested parties have made extensive presentations, both written and oral. These presentations are not mere "allegations" as claimed by Mr. Toman but testimony by knowledgeable persons with experience and expertise in the industry.

Even a Federated witness, Mr. Hamm, has provided strong evidence of distortion at pages 5 and 6 of his impact study, namely that standard sales factor provision assigns to California 100% of the revenues from servicing 24% of all mutual fund shares, even though Californians hold only 11.7% of all mutual fund shares. This demonstrates a gross disconnect between the actual market for services and assignment of receipts for such services under the standard cost of performance sales factor.

Other evidence in the record clearly demonstrates that such assignment of receipts duplicates the property and payroll factors, thus undercutting the purpose of the use of a sales factor (to represent the market).

Federated's attack on the process under the guise of burden of proof is ill-advised. The Franchise Tax Board staff should be complimented on the thoroughness and industry with which it has pursued these necessary changes in accordance with the proper regulatory standards.

3. The Proposed Regulation Aids Uniformity

Federated also contends that the proposed regulation would deviate from the goal of uniformity under UDITPA. Fourteen states have adopted a shareholder based sales factor. These states are home to 29 of the 39 non-California based mutual fund companies set forth in Mr. Hamm's listing of the 50 largest mutual fund companies. See Exhibit 3 of the Hamm report. The 29 mutual fund companies in the states that have adopted the shareholder-based sales factor collectively represent well over a majority of total assets under management in the industry. This is not just a "trend."

Rather, this is a classic example of an unusual factual situation, affecting a particular industry, that warrants deviation from the standard apportionment rules as contemplated by UDITPA. A uniform solution has already been adopted by a majority of the states that are home to the industry. Mutual funds service providers that are based in California are now disadvantaged by a lack of uniformity: they are subject to a sales factor rule that assigns 100% of their revenues to California while non-California based competitors are required to assign little or nothing of their revenues to California. At the same time, a full two-thirds of the largest non-California based mutual fund companies enjoy the use of a shareholder proportion sales factor, as opposed to an "all or nothing" cost of performance rule, to determine their home state income.[10]

4. Legislation is Not a Solution

Finally, Federated proposes that proponents of the proposed regulation should seek legislation rather than change the sales factor by regulation. This, of course, ignores and undercuts the purpose of Section 25137, flexibility to permit deviation from the standard UDITPA regulations where they do not fairly reflect a taxpayer's business activities in California. In particular Regulation 25137(a) supports the use of <u>regulations</u> to seek <u>industry</u> solutions.[11] California has generally not used legislation for an industry-wide change to the UDITPA provisions.[12]

B. Adoption of a Throwback Provision for Sales (Receipts) from Services

The proposed regulation presently provides for certain throwback provisions. All commentators oppose the use of any throwback provisions since such provisions essentially return a taxpayer to the cost of performance approach of the present sales factor and thus undercut the purpose of the change.

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[10] In light of this, it is perhaps not surprising that Manatt, Phelps and Phillips, representing an unidentified coalition of opponents to the proposed regulation, does not object to the use of the shareholder sales factor. Rather its objection is to the combination of the factor with the *Finnigan*-type provisions. (See Part C hereafter)

[11] Reg. 25137(a) is an original UDIPTA regulation which means that it also is a <u>uniform</u> provision.

[12] One exception is Section 25141, which deals with professional sports teams. The double weighted sales factor provision, Section 25128, applies to all businesses in including or excluding four factors treatment.

Barclays Global Investors agrees with other commentators that the better approach is elimination of any throwback provisions. A purpose of a throwback provision is to prevent the creation of "nowhere income." Concerns about "nowhere income" arise primarily from the opportunity for manipulation, but the use of the shareholder rule avoids this. Unlike the situation in Section 25135 where the determination of the place of a sale generally lies in the hands of the seller, the location of the receipt under the proposed regulation is the location of an independent third party, the shareholder.

Further, since receipts from provision of services are not protected by Public Law 86-272, a corporation may not be taxable on such receipts by a state because that state has determined not to tax as opposed to the more abstract question of whether the state could tax. That a state has jurisdiction to tax but chooses not to exercise it should not mean that California gets the loose change from another's pocket.

Accordingly, there is not the same basis here for use of a throwback provision as there would be in the sale of tangible personal property.

C. If a Throwback Rule is Adopted, It Should be *Finnigan* Rather than *Joyce*[13]

If the Franchise Tax Board should determine that a throwback provision is required, Barclays Global Investors supports throwback under the "*Finnigan* approach," as the Proposed Regulation now provides, rather than *Joyce*.

Under the provisions of Reg. 25137-14(b)(1)(C) receipts from administrative, distribution and management services provided by a non-California taxpayer to a regulated investment company with shareholders in California are assigned to the numerator of the sales factor to determine the group's business income apportioned to California on a unitary basis.[14] This differs from the "*Joyce*" approach, where such receipts would be excluded from the numerator of the sales factor.

The "throwback" provision in Reg. 25137-14(b)(1)(D), assigning receipts from applicable services to the state where the preponderance of the costs of providing the service are incurred if the receipts would otherwise be assigned under the provisions of the Proposed Regulation to a state in which no member of the mutual fund service providers' unitary group

[13] *Appeal of Finnigan Corporation,* 88-SBE-022A (January 24, 1990); *Appeal of Joyce, Inc.*, 66-SBE-070 (November 23, 1966).

[14] As set forth in Part II, we suggest that the language of this provision be clarified to include the receipts from the provision of all services covered by the regulation.

is taxable, simply reverts to Section 25136 as if the Proposed Regulation does not exist in this situation. See Part II.N. Like *Finnigan*, the focus is on the unitary group rather than on a single entity as in *Joyce*.

The contention that the courts have overruled *Finnigan*, thus foreclosing its use in regulations adopted under Section 25137, is incorrect. Mr. Vesely's comments in his letter of November 14, 2006 on behalf of Franklin Resources, Inc. accurately describe the *Finnigan* and *Joyce* rules and, in particular, the effect of *Citicorp* (*Citigroup North America, Inc. v. Franchise Tax Board*, 83 Cal. App. 4th 1403 (2000)). At issue at *Citicorp* was the application of the so-called *Finnigan* rule to receipts of the taxpayer's South Dakota credit card affiliate. Under the *Joyce* rule such sales would not be includable in the California numerator of the taxpayer's unitary group since the affiliate was not taxable in California. Under the *Finnigan* rule such sales were includable. The State Board of Equalization had decided to return to the *Joyce* rule with respect to sales, but the Board refused to apply the return to *Joyce* retroactively. The Court of Appeal affirmed the Board's prospective-only approach to the application of *Joyce* and the validity of the *Finnigan* rule while it was extant.

The Court of Appeal determined that it is within the jurisdiction of the State Board of Equalization to apply *Finnigan* prior to the time the Board had decided to return to *Joyce*. This clearly is not an "overruling" of *Finnigan* but rather an affirmation of its validity until withdrawal. This is particularly true because the withdrawal rested on the failure of the *Finnigan* rule to achieve the expected acceptance by other states to become a uniform rule.

In contrast to the *Finnigan/Joyce* debate which cuts across <u>all</u> sales, the proposed regulation is limited to a single industry. That industry, for regulatory and other reasons, has usually operated in three (or more) separate entities to provide the necessary administrative, distribution and management services for a regulated investment company and similar services in the management of assets for other entities.[15] Use of *Joyce* in those circumstances would elevate form over the substance of such a tightly integrated industry. Since the only receipts affected by the Proposed Regulation are the receipts from the specified services, it makes sense to include the receipts of those entities that are providing such services in the numerator of the special sales factor where the recipients of such services are in the state. This provides uniformity of treatment across the industry no matter the form in which the activities are conducted.

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[15] To be included in the proposed regulation, administrative services <u>must</u> be provided by a member of the same unitary group that provides distribution and management services to one or more regulated investment companies. Distribution and management services must be provided, respectively, by contracts under 15 USC, Sections 80a-15(b) and 80a-15(a), as amended. Proposed Reg. 25137-14(a)(1), (2) and (3).

Mr. Main contends that Sections 25137-14(b)(1)(C) and (b)(1)(D) of the Proposed Regulation fail the consistency and necessity requirements in adopting a regulation.

Consistency means being in harmony with and not in conflict with or contradictory to existing statutes, court decisions or the provisions of law. Mr. Main contends that the Proposed Regulation contradicts *Joyce,* and *Appeal of Huffy,* 99-SBE-005 (April 22, 1999). Mr. Main argues that "no reason has been advanced why the mutual service industry should be treated differently from other industries."

On the contrary, the Proposed Regulation is consistent with the linchpin of California taxation, the unitary theory. Both the Franchise Tax Board staff and other commentators have pointed out the highly integrated nature of the industry combined with its ordinary conduct, for regulatory and other reasons, of provision of the different types of services in separate corporations. That the industry is unique is amply set forth in the record. Section 25137 is made for these circumstances. As discussed above, *Citicorp* did not overrule *Finnigan* and the State Board withdrew *Finnigan* because it was not accepted by other states. Section 25137 permits the Franchise Tax Board to adopt reasonable variations from the standard apportionment provisions to fairly reflect a taxpayer's California activities. This limited use of a *Finnegan*-like approach is entirely consistent with Section 25137's requirements.

Similarly as set forth in Subpart A the Franchise Tax Board has more than satisfied the showing for a required need for a comprehensive industry-specific regulation.

D. The Effect of Proposed Regulation on California's General Fund

Mr. Hamm supplied on behalf of Federated an analysis of the effect of the proposed regulation on California's general fund. He concludes that the proposed regulation would cost the state $370 million in taxes foregone. The Franchise Tax Board staff estimated a tax gain of $10 million.

Mr. Hamm's analysis is helpful in that it quantifies the distortion that the present regulation creates among mutual fund service providers. See Subpart A, *supra.* His analysis also underscores the fact that California based mutual fund service providers bear virtually all the burden of the distortion in the present regulation.

However, his assumptions are seriously flawed. For example, it is our understanding that the Franklin profit margin, on which Mr. Hamm based his conclusion that California based mutual bund providers are more profitable than the non California based providers, is incorrect. He also relies on financial data that may not take into account such tax differences as a water's-edge election and the application of separate rules applicable to financial and general corporations. Finally, Mr. Hamm wholly ignores the effect of the throwback provisions.

Others will probably more carefully critique Mr. Hamm's analysis, but the wild difference in effect on revenues ($380 million) between the Franchise Tax Board's analysis ($10 million gain) done in accordance with its standard procedures and Mr. Hamm's ($370 million loss) of necessity raises questions of credibility.

E. Inclusion of Asset Management Services

Two commentators have proposed the elimination in whole or in part of receipts from asset management services included in this proposed regulation (Ameriprise Financial letter, dated December 15, 2006 and Manatt, Phelps and Phillips, letter dated December 15, 2006). Asset management service providers have significant California receipts that are affected by the cost of performance provisions. Qualifying asset management providers are already part of the industry: asset management providers must also provide services to regulated investment companies before qualifying for inclusion of their receipts in the Proposed Regulation. Further, for their receipts to be covered by the Proposed Regulation, the services must be of the same type provided to regulated investment companies. The amounts at issue for California asset managers are substantial, even at the 50% level (See testimony of Neal Reilly at December 18, 2006 hearing). The same issues of distortion apply here as apply in the provision of administrative, management and distribution services for regulated investment companies.

An exclusion of asset managers whose receipts from provision of services to regulated investment companies is less than a specified percentage of their total receipts is also uncalled for. It would require review every year to determine if an asset manager was in or out, an administrative nightmare. Further, of the fourteen states with the shareholder ratio receipts factor, only four limit receipts to those from the provision of services to regulated investment companies. Thus the inclusion of receipts from asset management services provided by mutual fund service providers to entities other than regulated investment companies is reasonable and in keeping with the scope of provisions adopted by other states.

II. Comments on Specific Provisions.

Following are comments on specific provisions of the proposed regulations.

A. Reg. 25137-14(a)(4)

The regulation uses the concept of "domicile" both to assign receipts from the provision of administration, distribution and management services and to assign receipts from the provision of asset management services. The definition of "domicile" in this regulation relates only to the location of shareholders of a regulated investment company. Under this definition, a shareholder's domicile is presumed to be the shareholder's mailing address as it appears on the records of the regulated investment company or the mutual fund service provider, but such a presumption can be overcome by actual knowledge. The definition of "domicile" should be amended to provide the same rules for determining the domicile of a beneficial owner of assets in respect of which asset management services are provided.

F. Reg. 25137-14(a)(7)

The defined terms "administrative services," "distribution services," and "management services" set forth in paragraphs (1), (2), and (3) of subdivision (a) apply only to services provided to regulated investment companies. Thus, the definition of "asset management services" at Reg. 25137-14(a)(7) should be amended to make clear that the services are those that would be administrative, distribution or management services within the meaning of Reg. 25137-14(a)(1)-(3) if provided to a regulated investment company.

G. Reg. 25137-14(b)(1)(A)1

Subparagraph (b)(1)(A)1 of the regulation contains a special rule for determining the location of shares held by a shareholder of record other than an individual as depositor for a separate account. One would expect this special rule to be set forth in the definition of "domicile" at Reg. 25137-14(a)(4). Regardless of its location within the regulation, however, the special rule should be amended to permit mutual fund service providers to use any reasonable method for determining the domicile of the underlying beneficial owners of shares.

A mutual fund service provider's liability for taxes in California should not turn on the record keeping practices of shareholders of record. In the event a shareholder of record does not provide a mutual fund service provider with some or all of the information needed to determine the domicile of the beneficial owners of the shares held by the shareholder of record, a mutual fund service provider should be allowed to use any reasonable method to identify the domiciles of the beneficial owners of the shares. Only where a mutual fund service provider is unable to devise a reasonable method to identify the domicile of such beneficial owners should the related receipts be disregarded for purposes of computing the sales factor.

H. Reg. 25137-14(b)(1)(A)2

We agree with comments of other interested parties that, for purposes of computing the shareholder ratio, it would be administratively burdensome to use the taxable year of each regulated investment company to determine the applicable shareholder ratio. A far less cumbersome approach, and one no less reliable, would be to use the mutual funds service provider's taxable year to determine the applicable shareholder ratio for any given regulated investment company. The inquiry is the same, namely what is the average annual geographical composition of shareholders for a given regulated investment company. The only difference is the beginning and ending dates for purposes of computing the average.

I. Reg. 25137-14(b)(1)(B)

The phrase " in addition to performing services for regulated investment companies," is unnecessary, as the term "mutual fund service provider" makes it clear that the unitary business governed by the provision performs such services.

We would propose substituting "beneficial owner of" for "individual owning" and deleting the word "location" as unnecessary.

J. Reg. 25137-14(b)(1)(B)1&2.

These provisions should be combined and amended slightly to give mutual fund service providers maximum flexibility in devising reasonable methods for determining the domiciles of beneficial owners of assets held by entities for whom asset management services are rendered.

We do not agree with Ms. Silverstein's suggestion at pages 2-3 of her letter to Colleen Berwick, dated December 15, 2006, that the throwout rule be replaced with a cost of performance throwback rule. We believe a throwout rule is less distortive than a throwback approach, and thus, is more consistent with the avowed intent of these regulations.

K. Reg. 25137-14(b)(1)(B)2 (NEW)

Asset management services include services provided to certain institutional investors, such as charitable institutions exempt from federal income tax under Section 501(c)(1) of the Internal Revenue Code, that do not hold assets for a defined group of beneficial owners. Rather, such institutions generally hold investment assets for the purpose of using the returns thereon to support their broad-based charitable purposes. The regulation, which focuses on looking through the entities to identify the domiciles of the beneficial owners of the assets, does not identify how to assign receipts from asset management services provided to such institutions. We believe that it would be appropriate and consistent with the intent of the regulation to allow mutual fund service providers to use any reasonable basis to identify the domicile of the beneficiaries of such entities. Only where a mutual fund service provider is unable to devise a reasonable method to identify the domicile of the beneficiaries should the related receipts be disregarded for purposes of computing the sales factor.

L. Reg. 25137-14(b)(1)(C)

The avowed intent of the proposed regulation is to assign the receipts of the mutual fund service provider from both administration, management and distribution services and asset management services, based on the location of the shareholders and beneficial owners of assets. As currently drafted, Subparagraph (C) makes clear that receipts of non-taxpayer members from the provision of management, distribution and administration services to or on behalf of a regulated investment company with California shareholders are to be assigned to the numerator of the sales factor for purposes of determining the unitary group's business income apportionable to California, even though the specific entity that performed the services is not a California taxpayer. The regulation as currently drafted does not provide similar treatment for receipts of non-taxpayer members from the provision of asset management services directly or indirectly for beneficiaries domiciled in California. The rule for receipts from asset management services should follow the rule for receipts from management, distribution and administration services provided to or on behalf of regulated investment companies.

M. Reg. 25137-14(b)(1)(C)1.d

This provision should be amended to make clear that a taxpayer's California sales factor is determined under Rev. and Tax. Code sections 25135 – 25137, and the regulations promulgated thereunder, including without limitation Reg. 25137-14. If a taxpayer member of a mutual fund service provider has receipts from the sale of tangible personal property, the California numerator of that taxpayer will be determined in part by Rev. and Tax. Code section 25135. Similarly, if the taxpayer member has receipts from services that are not asset management services or management, distribution or administration services, the taxpayer's California numerator will be determined in part by Rev. and Tax. Code section 25136. Finally, if a mutual fund service provider has as a member of its unitary group one or more financial corporations, the California numerator of the sales factor may be determined in part by Reg. 25137-4.2 or Reg. 25137-10.

N. Reg. 25137-14(b)(1)(D)

The inclusion of a throwback rule runs counter to the purpose of adopting a market-based approach to assigning receipts. The standard cost of performance rule for assigning receipts is distortive as applied to mutual fund service providers. The regulation is intended to provide industry-wide relief from this distortion by calculating the sales factor with reference to the location of the real customers served by the mutual fund service providers. This curative approach is undermined by a throwback rule that operates to restore some or all of the distortion caused by the standard cost of performance rule. For this reason, the provision should be deleted. See also comments at Part I, subparts B and C.

If the provision is retained, it simply does not work as written. It assumes the shareholder ratio assigns receipts to specific states other than California but the ratio does not. As a result, changes are necessary to effectuate the intent of the provision. Also, the provision currently relates only to receipts from administrative, distribution and managements services, not administrative management services.

III. Conclusion.

The time is ripe for an industry-wide solution to the inequities of the present sales factor when applied to mutual fund service providers. The unfairness is real. The proposals are fair, reasonable and in keeping with what other money center states have done as a solution. The opposition has had every opportunity to participate, but it has not. Instead, it has launched a last minute attack on process, not substance. The Franchise Tax Board should proceed with the adoption of the Proposed Regulation.

Very truly yours,

Joanne M. Garvey

Joanne M. Garvey

cc: Carl Joseph
Franchise Tax Board – Legal Branch

Taxing Mutual Funds: The Revenue Impact of Proposed FTB Regulation 25137-14

Philip J. Romero[1]
University of Oregon and Forward Observer
January 16, 2007

Introduction

The California Franchise Tax Board is currently considering the promulgation of Regulation 25137-14, which will provide for special sourcing rules for mutual fund service providers (MFSPs). The author was retained by Allianz of America, Barclays Global Investors, Capital Group, and Franklin Templeton (four California-based MFSPs) to estimate the fiscal impact of this regulation.

This report contains an analysis of the fiscal implications of the regulation. An outline of the method used in arriving at this estimate is contained in Appendix A.

The author is aware that two other estimates have already been submitted to the FTB. The FTB staff estimates an annual revenue gain of $10 million under the proposed regulation. The Law and Economic Consulting Group (LECG), retained by an out-of-state MFSP, projects a loss of $370 million.

The best analytic approach uses actual tax return data, as FTB did. However, because FTB has not published its methodology, an independent calibrating estimate was deemed useful. This method uses data from the four sponsoring MFSPs, supplemented by sample data from LECG's report, to be as accurate as possible. Its conclusions are very consistent, and in fact slightly more favorable to the proposed regulation, than FTB staff's.

Executive Summary

The proposed regulation will result in a net annual revenue gain of $12.6 million to the General Fund: an increase of $85.5 million in revenue from non-California MFSPs minus $72.9 million in reduced revenue from California MFSPs.

Our methodology is outlined in Appendix A.

[1] Dr. Philip J. Romero is Professor of Business Administration and former dean of the University of Oregon's business school, and a principal in the policy consulting firm Forward Observer. From 1991-98 he served as Chief Economist to the Governor of California, during which time he participated in legislative reforms of the unitary tax system. A full biography is contained in Appendix C.

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Background, Outline of Regulation, and Its Rationale

Background: Existing Law

Taxpayers having business activities within and without the state determine their California corporate income tax under the formula apportionment approach set forth in the Uniform Division of Income Tax for Tax Purposes Act (UDITPA). The formula apportionment approach assigns a portion of the business income of a multi-state taxpayer to California based on the ratio of its California property, payroll and sales to its total property, payroll and sales.

The three factor formula is designed to be a reasonable proxy for recognizing the contribution of the taxpayer's activities to its overall profitability on a geographic basis. The property and payroll factors essentially reflect the taxpayer's production activities and assign values to its commercial domicile. The sales factor is intended to reflect the contribution of the market states in providing a customer base to buy the taxpaying firm's goods and services.

The sales factor is thus "destination sourced" insofar as it assigns receipts from the sale of tangible personal property to the location of the customer. On the other hand, receipts from sales other than of tangible personal property are assigned to the state where the income-producing activity related to the sale is performed. For most service providers, this means the location of employee performing the service. This is typically a fair sourcing rule because the primary activity that generates the receipts in question is the labor of the service provider.

For MFSPs, however, the mutual fund shareholders themselves are particularly pivotal to the generation of income by the MFSP. Nevertheless, receipts currently are assigned under the UDITPA income-producing activity sourcing rule to where the service is performed based on cost of performance. The cost of performance standard is predicated upon the traditional "face-to-face" manner in which financial services, such as investment management, were provided. As with other types of today's financial services (e.g., credit card providers), it fails to reflect the truly national nature and importance of the relationships which MFSPs have with clients. Many of their services can be "delivered" to the client electronically from locations in other states.

Proposed Regulation 25137-14

This regulatory proposal of the FTB staff is designed to address this inequity by assigning receipts for sales factor purposes to the mutual fund shareholder or beneficial owner location rather than the MFSP employee location. Special industry regulations are authorized by the California Revenue and Taxation Code in instances where the otherwise applicable UDITPA apportionment provisions do not fairly represent the taxpayer's activity in this state. In the analysis describing this proposed regulation, FTB staff has represented that the application of the income producing activity sourcing rule produces such an unfair result. In this regard, the FTB has granted individual taxpayer relief under this statute with respect to two California-based MFSPs.

By assigning MFSP receipts to the location of the mutual fund shareholders or beneficial owners of assets, MFSPs commercially domiciled in California will experience a reduction in their sales factor. This is because receipts assigned entirely to California under the income producing activity sourcing rule will no longer be assigned to this state unless related to California mutual fund shareholders (which are a minority of most national firms' shareholders) or beneficial owners. Conversely, MFSPs commercially domiciled outside of California will experience an increase in the sales factor numerator that corresponds to their California mutual fund shareholders or beneficial owners (which currently are omitted entirely).

The regulation also contains a throwback rule that provides that receipts assigned to a mutual fund shareholder or beneficial owner state under its terms will be "thrown back", or assigned to the state where the income producing activity takes place, if the MFSP is not taxable in the mutual fund shareholder or beneficial owner state. The regulation further provides that a MFSP will regarded as taxable in this regard if any member of the MFSP's unitary business group is taxable in that state even though the MFSP receiving the income in question is not.

Fiscal Impact

There are two other analyses of the fiscal impact of the regulation, as mentioned earlier, that have been submitted in conjunction with this regulatory proceeding. Dr. William Hamm of LEGC estimated the regulation would *reduce* state general fund revenues by $370 million per year. The FTB staff has estimated that revenues would *increase* by $10 million per year. Such a wide disparity led to the request for this analysis, the methodology of which is outlined in greater detail in Appendix A.

As noted above, the regulations have the effect of generating general fund revenue losses with respect to California-based MFSPs, while producing revenue gains from MFSPs commercially domiciled elsewhere. The approach taken in this analysis is to estimate both revenue impacts and compute a net effect. The LECG analysis has estimated losses from reduction in the sales factor of California-based MFSPs, but has not explicitly estimated the offsetting gains associated with the increase in the sales factor of non-California based firms. This accounts for some of the disparity in the projections.

Table 1
Summary of Net Fiscal Impact

Revenue Gains from Non-California-based MFSPs:	+ $85.5 million
Revenue Losses to California-based MFSPs:	- $72.9 million
Net Revenue effect:	**+ $12.6 million**

Baseline (crude) estimate of MFSP tax revenues[2]: $474.3 million
Therefore: Effect as a percentage of baseline: + 2.7%

Conclusion

We estimate that the proposed regulation will increase General Fund revenues by $12.6 million. This estimate is quite close to (and modestly larger than) FTB staff's estimate.

[2] Because FTB does not publish industry-level (as opposed to sector-level) tax revenue, we made our own crude estimate, as LECG did: Mutual funds' share of financial sector assets under management (26.35%) x financial sector taxes collected ($1.8 billion) = $474. 3 million. We believe this is a considerable overestimate, but it provides a point of calibration. Our revenue impacts are very small percentages of the estimated baseline.

Appendix A
Notes on Fiscal Impact Estimate Methodology

The methodology of estimating the fiscal impact of Regulation 25137-14 is set forth below. The proposed regulation affects two groups of MFSPs in differing ways, requiring a separate analysis of each group. Under existing law, MFSPs commercially domiciled in California include all receipts from their provision of mutual funds and asset management services in the numerator of their sales factors for apportionment purposes regardless of where the mutual fund shareholders or beneficial owners are located.

Conversely, MFSPs commercially domiciled elsewhere exclude all receipts from the provision of mutual fund or asset management services from the numerator of their sales factors, regardless of whether these services are provided for the benefit of any California-domiciled mutual fund shareholders or beneficial owners.

The proposed regulations assign receipts from mutual fund or asset management services to California based on the proportion of California-domiciled mutual fund shareholders or beneficial owners who benefit from such services. On the one hand, General Fund revenue will decrease because the sales factor numerators of California-based MFSPs will be reduced in an amount equal to the proportion of their receipts attributable to mutual fund or asset management services provided to out-of-state mutual fund shareholders or beneficial owners. On the other hand, General Fund revenue will increase because the sales factor numerators of out-of-state MFSPs will be increased because receipts from mutual fund or asset management services provided to California-domiciled mutual fund shareholders and beneficial owners are added to the numerators of their sales factors. Therefore, we separately estimated General Fund revenue impacts for both groups of MFSPs and then arrived at the *net* fiscal impact.

Fiscal Analysis

As noted in the report, FTB staff estimates that the regulation will increase revenues by $10 million per year, whereas LECG projects a loss of $370 million per year. FTB relied on actual tax returns for a sample of MFSPs, which in principle should make its analysis authoritative. However, since FTB does not publish this analysis, an independent estimate was deemed necessary to calibrate FTB's. FTB offers only partial information to outside analysts, so any independent analysis, including this one, must rely on proxy data to provide at best rough estimates. LECG relied on such proxy data from financial publishers. This report relied on sample data from several California-based MFSPs, and relied on proxy data similar to LECG's for non-California-based MFSPs

The key inputs to this analysis are the total revenues and California market shares of California-headquartered vs. out of state-headquartered MFSPs, their profitability, and their effective California corporate tax rate. We estimated each as follows.

California market share, revenue, and profitability. The Financial Research Corporation produces an annual report of summary statistics on the top mutual fund groups. We used their "25 Largest Fund Groups: Assets and Estimated Net Flows", segregating the California vs. non-California firms. This top 25 captures 69.3% of the universe of mutual funds[3]. Of the total of $7.12 trillion in assets under management as of October 2006, California firms manage $1.75 trillion, or 23.6%.[4] This is virtually identical to the estimates of LECG and FTB staff (24%).[5] Since funds' expense ratios are based on assets under management (AUM), we assume that revenues (and therefore profits) will scale to assets, as LECG does. LECG computed a ratio of operating profits to AUM of 0.7%. In fact, an asset-weighted median of the firms in LECG's sample yields 0.33%. This is consistent with industry experience and data from sponsoring firms, which suggest that returns on assets under management are closer to 0.3% for both California and non-California-based MFSPs. This analysis uses a 0.3% return for both groups.

Share of customers located in California. Ideally, we would use state-by-state wealth data. However, the Federal reserve system—the main source of net worth and wealth data in the U.S.—does not report wealth at the state level. FTB staff used Census Bureau data, using California's share of the national population (12.19%) as a proxy for its share of mutual fund customers. We did the same.

Effective Tax Rate. FTB staff, in a phone interview on Jan. 4, 2007, indicated that the effective tax rate on MFSPs is approximately 6% (not 8.84% as assumed by LECG). The difference is due to prior year Net Operating Losses and other credits. Since FTB is unable to release data on MFSP incomes and taxes, we must make estimates based on proxies.

Throwback. As presently drafted the regulations will not allow a California-based MFSP to source revenue to a location outside of California if the service provider isn't taxable there. Instead the revenue will be "thrown back" to California. This has a significant effect on the changes in California's tax revenues that will result from adopting the regulation. Large California MFSPs are likely to be taxable in some major financial center states outside California (New York, Illinois, Texas, etc). They are unlikely to be taxable in all 50 states. They are thus unlikely to achieve the full potential benefit of market state sourcing. Large out-of-state MFSPs, on the other hand, will be taxable in California with few exceptions.

Appendix Table A-1 assumes that California MFSPs are taxable in 10 important states other than California and that fund assets are held in proportion the populations of

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[3] Percentage computed by comparing the $7.19 trillion in FRC's top 25 families to ICI's universe of $10.28 trillion. See ICI citation below.

[4] The California-headquartered firms among FRC's top 25 are: American Funds (Capital Group); Franklin Templeton; Barclays; PIMCO; Dodge & Cox; and Allianz America.

[5] LECG's analysis is documented in testimony by Dr. William Hamm on Dec. 18, 2006. FTB's analysis has not been documented in publicly available form. Our characterizations are based on a telephone interview with FTB coauthor Jay Bernstein on Feb. 4, 2007.

those states Connecticut, Florida, Georgia, Illinois, Massachusetts, New Jersey, New York, Ohio, Texas, and the District of Columbia.

Putting it together. The net fiscal impact of the proposed regulation is the difference between revenue losses from California-based MFSPs and revenue gains from non-California MFSPs . Table A-1 summarizes our calculations. The last section of Appendix Table A-1 compares our fiscal impact estimate to our approximation of baseline revenues collected from MFSPs. We believe that the proposed regulation will increase General Fund revenue by approximately 2.7% .

Appendix Table A-1

Proposed Regulation 25137-14

Computations of Estimated Tax **Dollars in Thousands**

Estimated Fiscal Impact

	MFSPs Outside California	MFSPs In California	Source
AUM in / outside California			
Total mutual fund industry AUM	$10,280,000,000	$10,280,000,000	ICI Nov. 2006
Percentage in / outside California	76.4%	23.6%	FRC top 25 MFSPs
Estimated AUM in / outside California	$7,853,920,000	$2,426,080,000	
Operating income as percentage of AUM			
Calif operating income		0.300%	Company Ests.; LECG report
Non-Calif	0.300%		
Operating income	$23,561,760	$7,278,240	
California taxable income before apportionment	$23,561,760	$7,278,240	
Change in apportionment factor as result of regulation 25137-14			
Shareholder residency factor 12.1 / 2	6.1%	6.1%	LECG Report
Cost-of-performance factor	0%	50%	
Difference in factors	6.1%	-44%	
Increase (decrease) in California taxable income	$1,425,486	-$3,198,786	

Appendix Table A-1, continued

Tax rate	6.00%	6.00%	FTB Staff 1/4/07
Increase (decrease) in California tax	$85,529	-$191,927	
CA Throwback Benefit Realization %	N/A	38%	Assumes Nexus Only in Money Ctr States
Increase (decrease) in California tax	$85,529	-$72,932	
Net Change in California tax	*$12,597*	Including throwback	
Calibration--baseline taxes collected	Universe		
Total financial sector AUM 2003	28,132,000,000	Fed Reserve	
Mutual funds AUM 2003	7,413,000,000	ICI	
Mutual funds' share of financial sector	26.35%		
Financial sector taxable income 2003	17,500,000	FTB 2004 annual report	
California taxes paid from fin sector 2003	1,800,000	FTB 2004 annual report	
CA taxes from mutual fund industry	474,300		
THEREFORE: % change in mutual fund taxes	2.7%		

Differences with other published analyses

Recall that LECG's estimated that the state would lose $370 M, while FTB's was of a gain of $10 M. Our estimate is close to, but modestly higher, than FTB's. Our attempt to put LECG's analysis in a format consistent with this report is in Appendix B. We note there our main differences with LECG's approach.

Since FTB does not publish its methodology and policy restricts staff's response to information requests, we cannot comment on the (small) differences between our analysis and FTB's. Our main difference with LECG's analysis is they do not explicitly calculate changes in revenues from California-based MFSPs and non-California-based MFSPs separately. We did, and attempted to be conservative in each case. Also, we were able to use data from several MFSPs—corroborated by a median of LECG's data--to make the analysis as accurate as possible. This is the next best alternative to using actual tax return data, as FTB did.

Appendix B
Common-Format Summary of LECG Revenue Impact Analysis

Because the two independent analyses available to FTB—LECG's and this report—produce such disparate results, FTB will probably wish to compare them in a common format. In Appendix Table B-1 we attempt to reconstruct LECG's analysis, as best we understand it, in the same format as our own. Separate communications from one or more of the sponsors of this report make extensive comments about LECG's approach.

The three most important differences between our approach and LECG's are: (1) We believe that LECG overestimated the industry's return on assets under management. We believe that 0.3% is more accurate than LECG's 0.7%. (2) We used an effective tax rate of 6% suggested by FTB staff (which reflects deductions and credits), not the statutory 8.84% used by LECG; and (3) we include the effects of "throwback", as described in Appendix A. As far as we can determine, LECG did not.

Proposed Regulation 25137-14
Computations of Estimated Tax — **Appendix Table B-1**
Estimated Fiscal Impact — **Reconstruction of LECG (Hamm) report**
Dollars in Thousands

	MFSPs Outside California	MFSPs In California	Source
AUM in / outside California			
Total mutual fund industry AUM	9,722,162,000	9,722,162,000	Hamm Report
Percentage in / outside California	76.0%	24.0%	Hamm Report
Estimated AUM in / outside California	7,388,843,120	2,333,318,880	
Operating income as percentage of AUM			
Calif operating income		0.700%	Hamm Report
Non-Calif	0.700%		Hamm Report
Operating income	51,721,902	16,333,232	
California taxable income before apportionment	51,721,902	16,333,232	

Change in apportionment factor as result of regulation 25137-14

Shareholder residency factor	**5.9%**	**5.9%**	**Hamm Report**
Cost-of-performance factor	**0%**	**50%**	
Difference in factors	**5.9%**	**-44%**	
Increase (decrease) in California taxable income)	**3,025,731**	**(7,211,122)**	
Tax rate	**8.84%**	**8.84%**	
Increase (decrease) in California tax)	**267,475**	**(637,463)**	
CA Throwback Benefit Reduction	**N/A**	**N/A**	**Estimate**
MFSPs without CA Nexus	**N/A**	**N/A**	**Estimate**
Throwback change in California tax	**0**	**0**	
Net Increase (decrease) in California tax	**(369,989)**		

Appendix C
Author's biography

Philip J. Romero, Professor and former Dean
University of Oregon Lundquist College of Business

Philip J. Romero has been a Professor of Business Administration at the University of Oregon's Lundquist College of Business since the summer of 1999, where he holds the Miller chair. He teaches courses combining economics and corporate strategy. From 1999-2004 he served as dean. The college is one of the two highest ranked business schools in the U.S. Northwest, with component programs (e.g. entrepreneurship, sports business) ranked as high as first in the world. During his tenure as dean the college broke records for student and faculty quality, research and teaching productivity, media visibility, and funds raised ($50+ million in four years). He developed and oversaw construction of the largest privately-funded academic building in state history.

Romero's background combines think-tank economics, corporate strategy, and high-level public policy. After working for most of the 1980s as a research economist and defense policy specialist at California's RAND Corporation, in 1990 he was named director of strategic planning for United Technologies Corp. (UTC). While serving in that job, Romero advised the UTC chairman, George David, on new market opportunities, acquisitions, and divestitures. He played a small role in UTC's turnaround in the early 1990's, helping convert its worst performing division into its second most profitable.

In 1991 Romero was tapped by newly-elected Gov. Pete Wilson to become California's chief economist. He served as troubleshooter on business and economic operations for Gov. Wilson until 1999, when term limits caused him to leave office. Romero was the author and lead implementer of key improvements in California's business climate. These reforms transformed California's recession-plagued economy in the mid-1990s: the state went from last in the nation in job growth to nearly twice the national average—from losing 1,000 jobs per day to gaining 1,000.

During his tenure in California's Governor's office, Romero served as acting director of the state Office of Planning and Research (OPR), the Governor's think tank. He transformed OPR from a moribund backwater into a powerful source of policy ideas and analysis. He also served as Wilson's national security adviser. As Chief Deputy Cabinet Secretary, he oversaw all state agencies that regulated or promoted business ($5B budget and 40,000+ employees). He was Executive Director of the California Managed Health Care Improvement Task Force, which designed an overhaul of state regulation of the HMO industry. Gov. Wilson summarized his role: "If it's big and complicated, we give it to Romero and he fixes it."

Romero has emphasized business and government collaboration by integrating business strategies into public policy. For example, he led the design of California's efforts to open telecommunications and utility monopolies to competition. Likewise, he improved public sector performance by opening government monopolies to competition, saving taxpayers more than $10 million per year. He remains active in public policy through fellowships with the Hoover Institution and the Pacific Research Institute, through consulting to California businesses and governor's office, and by publishing frequent opinion articles in major periodicals. From 2002 - 2005 he served as a director (and chair of the corporate governance committee) of Lithia Motors (*NYSE: LAD*), a Fortune 500 auto retailer, where he promulgated the firm's first corporate governance standards. Romero also serves on several private sector advisory boards, including the GLG hedge fund group.

Dr. Romero earned a Ph.D. (1988) and M.A. (1985) in Policy Analysis (mixture of economics and applied mathematics) with Distinction from the RAND Graduate School, and a B.A. in Economics and Political Science from Cornell University (1983). He has published numerous research papers on a range of strategy and policy topics, including nuclear arms control, conventional forces, command and control, selecting Presidential advisers, business regulation, tax policy, international trade, international economic growth, health reform, the Federal budget, and crisis management. He is co-author of five books: The De-Escalation of Nuclear Crises, California: Problemos Economicos, Sociales, y Politicos; The Northridge Earthquake, 1994; California Policy Options 2000, and California in the 21st Century.. He has taught graduate or undergraduate courses at UCLA, USC, Pepperdine, the U. of Oregon, and in the California State University system.

Philip Romero's public policy interests include international security, economic policy and government budgets, how governments compete for business investment and retention, on government's role in creating conditions that nurture durable market advantage for resident businesses, and on introducing competitive forces into the delivery of public services. He has consulted on strategy issues to scores of major companies, as well as the California and Oregon governor's offices.

Dr. Romero is a member of the Council on Foreign Relations and a recipient of its Ford Foundation Economics International Affairs Fellowship. He has also been a member of two states' Governor's Councils of Economic Advisers (appointed by governors of both parties), and a founding member of the Pacific Council on International Policy. In addition, he is a Distinguished Visiting Fellow at Stanford's Hoover Institution, a Senior Fellow in Business and Economic Studies at the Pacific Research Institute, and on the governing board of the California Legislature's Bipartisan center for Research on Policy.

A prolific author of newspaper opinion articles, his work has appeared in the *Wall Street Journal, Los Angeles Times, Sacramento Bee, Portland Oregonian*, and many other dailies. He has been interviewed by virtually every major news outlet, including the *Investor's Business Daily, the New York Times, the Economist, Business Week, Wall Street Journal,* Associated Press and United Press International, as well as major television and radio networks including the BBC, PBS, CNBC, NPR, and Bloomberg. He also serves as a columnist and member of Brainstorm magazine's editorial board (the Northwest's premier public affairs/business magazine). An experienced public speaker, he made 100 speeches per year from 1992-2004 (mostly on public policy for the economy and businesses.)

Married to Lita Flores since 1984, he is listed in Who's Who in America, Who's Who in the World, Who's Who in Finance and Business, Who's Who in the West, Who's Who Among America's Teachers, and is the recipient of several Latino leadership awards. He enjoys designing and playing historical simulation games.
3/06

John H. Munz
Managing Director
Global Director of Tax

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BARCLAYS GLOBAL INVESTORS

March 7, 2007

DELIVERED ELECTONICALLY
colleen.berwick@ftb.ca.gov

Ms Colleen Berwick
Legal Branch
Franchise Tax Board
PO Box 1720
Rancho Cordova CA 95741-1720

Re: AMENDMENTS TO PROPOSED REGULATION SECTION 25137-14 RELATING TO MUTUAL FUND SERVICE PROVIDERS

Dear Ms Berwick:

I am writing in response to the February 21, 2007, 15 Day Notice regarding Proposed Regulation 25137-14.

Barclays Global Investors is headquartered in San Francisco. We are a low-cost service provider in a very competitive industry. We believe that the proposed regulation will fairly tax both in-state and out-of-state mutual fund service providers and should be adopted.

We appreciate the attention that was given to the problems our industry faces as these regulations were being drafted.

Sincerely,

John H. Munz

cc: Joanne Medero
Marlene Nicholson
Neal Reilly

FRANKLIN TEMPLETON
INVESTMENTS

One Franklin Parkway
San Mateo, CA 94403-1906
tel 650/312.2000
franklintempleton.com

By Electronic and Mail Delivery

March 12, 2007

Mr. Carl A. Joseph
Franchise Tax Board – Legal Department
P.O. Box 1720
Rancho Cordova, California 95741-1720

Re: FTB Proposed Regulation 25137-14
Apportionment for Mutual Fund Service Providers
Comments Regarding Amendments to Proposed Regulations

Dear Carl,

I have been asked by our Senior Management to comment on your recent amendments to Proposed Regulation Section 25137-14.

We have reviewed the recent amendments to the proposed regulations regarding apportionment for mutual fund service providers. We support these changes as they generally increase the flexibility of mutual fund service providers in using shareholder-residency apportionment in California. We urge you to continue to move these regulations forward to their adoption.

It remains our position that cost of performance inequitably inflates the taxable income of California-based mutual fund companies in their calculation of California apportionment. It does this because cost of performance for apportioning sales replicates the property and payroll factors. In so doing, it violates the essential principle of an equitable apportionment system that the apportionment of sales should reflect the market for goods and services. Use of shareholder-residency apportionment for sales will reflect the market for goods and services, will significantly reduce the risk of double taxation for California-based mutual fund companies, and will level the playing field for mutual fund service providers by requiring that all companies pay their fair share of taxes for their use of the California market place. We strongly support the efforts of the Franchise Tax Board Legal Staff to adopt a regulation that will allow all mutual fund service providers doing business in California to use shareholder-residency factors for their sales apportionment.

We also continue to support the provisions of the regulation that adopt *Finnigan* throwback. As we have stated in our prior submissions on this regulation, *Finnigan* throwback is ideally suited to the mutual fund industry, an industry that is highly regulated and integrated in its essential functions. The use of *Finnigan* throwback matches this integration and the unitary model that it is highly correlated to. As we have stated and you clearly understand, a regulation to be adopted under Section 25137 does not require the adoption of any particular method of apportionment; it only requires a method that best fits the circumstances of a particular taxpayer or industry so that the resultant apportionment is both fair and reasonable in its application. *Finnigan* fits this requirement like a hand in a glove; *Joyce* does not. In fact, the adoption of shareholder-residency apportionment together with *Joyce* throwback will exacerbate rather than remedy the distortion that has been proven in at least three approved Section 25137 petitions on this subject. The litany of cases that we have cited in our prior submissions supports the concept that the Franchise Tax Board is free to adopt any throwback method so long as it is fair and reasonable under the circumstances in which it will be applied. We strongly support the current proposed regulation in its adoption of *Finnigan* throwback as it is the only throwback method that meets this requirement.

Thank you for assistance and the opportunity to provide comments. If you have any questions, please do not hesitate to contact me at (650) 312-5635 or John McBeth at (650) 312-2594.

Yours truly,

Mark G. Dunbar
Vice President – Franklin Templeton Companies, LLC

cc: Colleen Berwick

INVESTMENT COMPANY INSTITUTE

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

By Electronic Delivery

March 12, 2007

Ms. Colleen Berwick
Legal Department
Franchise Tax Board
P.O. Box 1720
Rancho Cordova, CA 95741-1720

Re: Mutual Fund Service Provider Regulation Should Not Include Throwback Rules

Dear Ms. Berwick:

The Investment Company Institute[1] appreciates the California Franchise Tax Board's ("FTB") efforts to address our concerns[2] in its revised draft of Regulation 25137-14 – "Mutual Fund Service Providers and Asset Management Service Providers (collectively, "MFSPs")." The FTB's revisions make the regulation more administrable by providing much-needed flexibility to MFSPs and accommodating the unique aspects of the mutual fund industry.

We remain extremely concerned, however, that the regulation's incorporation of throwback rules is inconsistent with the goals of market-based apportionment. While we understand that the FTB has incorporated throwback rules to eliminate "nowhere income," such rules are inherently distortive and negate the impact of the sales factor, which balances the payroll and property factors and gives weight to a MFSP's market activity in a particular jurisdiction. Throwback rules create distortions similar to those under the "cost of performance" apportionment system, which the new MFSP regulation was intended to correct.

We urge the FTB to eliminate throwback rules from the MFSP regulation. Alternatively, we reiterate our request that the FTB clarify that the throwback rules do not apply in situations where a

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[1] ICI members include 8,839 open-end investment companies (mutual funds), 658 closed-end investment companies, 363 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately $10.445 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households.

[2] *See* Institute letter to Carl Joseph, dated August 24, 2006 for a complete discussion of the Institute's comments regarding Regulation 25137-14.

taxpayer is subject to a state's taxing jurisdiction, regardless of whether a state chooses to impose a tax.[3] Such a rule also should clarify that "taxable" includes being subject to taxes other than income taxes, such as taxes on capital. For example, Texas does not impose an income tax, but it does impose a franchise tax on capital that is apportioned based on receipts. Taxpayers subject to such taxes should be considered "taxable" in a state. These recommended clarifications would not eliminate the distortive effect of the throwback rules, but they would make the MFSP regulation more accurately reflect a MFSP's market in a particular state, consistent with the goal of shareholder-based apportionment.

Please contact the undersigned at 202-326-5835 or lrobinson@ici.org if we can provide you with any additional information.

Sincerely,

Lisa Robinson
Associate Counsel – Tax Law

[3] *See* Institute letter to Carl Joseph, dated August 24, 2006.

Capital Group Companies

Julie M. Coleman Manth
Vice President, Treasury Operations
Central Services Division

The Capital Group Companies, Inc.
11100 Santa Monica Boulevard
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Phone (310) 996 6193
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By Electronic Delivery to colleen.berwick@ftb.ca.gov

March 12, 2007

Mr. Carl Joseph
Franchise Tax Board, Legal Department
P.O. Box 1720
Rancho Cordova, CA 95741-1720

RE: Amendments to Proposed Regulation Section 25137-14

Dear Mr. Joseph:

Thank you for the opportunity to comment on the amendments to Proposed Regulation 25137-14. As previously noted in our prior submissions, The Capital Group Companies, Inc. ("Capital") fully supports the Franchise Tax Board Legal Department's efforts to provide an apportionment method that is suitable for the business of mutual fund service providers.

We have reviewed the 15 Day Notice and the 15 Day Proposed Text. Capital supports the amendments to the proposed regulation and agrees with the FTB that these changes clarify the language within the regulation. Within the amendments, we had specifically requested some changes to the language. As such, we specifically approve of the following amendments as contemplated by the FTB:

- The change in section (b)(1)(A)(2) relating to the election by the taxpayer of the definition of taxable year.
- The changes made in the definition of domicile in section (a)(4) and
- The changes made in (b)(1)(A) and (b)(1)(B) allowing for more flexibility on determining the location of the shareholder.

This regulation initiative has been a long process and Capital would like to commend the FTB on its willingness to involve the industry in the process. We appreciate the efforts of the FTB legal staff during this process.

Please contact me at 310-996-6193 or jmc@capgroup.com if we can provide you with any additional information.

Very truly yours,

Julie M. Coleman Manth

STATE OF CALIFORNIA

FRANCHISE TAX BOARD

PUBLIC HEARING

MONDAY, DECEMBER 18, 2006

FRANCHISE TAX BOARD

9646 BUTTERFIELD WAY

TOWN CENTER GOLDEN STATE ROOM

SACRAMENTO, CALIFORNIA

10:00 A.M.

REPORTED BY: SANDRA VON HAENEL
CSR No. 11407

APPEARANCES

FRANCHISE TAX BOARD STAFF:

Colleen Berwick
Carl A. Joseph
Phil Spilberg

OTHER PARTICIPANTS:

James M. Brown	- Capitol Group Companies
Julie M. Coleman	- Capital Group
David R. Doerr	- Cal-Tax
Ernie Dronenburg	- Deloitte Tax
William G. Hamm	- LECG
Richard Harris	- Individual
Michael Herbert	- Price Waterhouse Coopers, LLP
Fred L. Main	- Manatt, Phelps & Phillips, LLP
John I. McBeth	- Franklin Templeton Investments
Neal M. Reilly	- Barclays Global Investors
Patrick Shannon	- Gregory
Amy Silverstein	- Silverstein & Pomerantz
Brian W. Toman	- Reed Smith LLP
Jeffrey M. Vesely	- Pillsbury Winthrop

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SACRAMENTO, CALIFORNIA

MONDAY, DECEMBER 18, 2006, 10:00 A.M.

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MR. JOSEPH: I think we are just about there. It is, by my watch, 10 o'clock.

Good morning. My name is Carl Joseph. I'm a tax counsel for the Franchise Tax Board. I will act as hearing officer for Proposed California Code of Regulation Title 18 Section 25137-14, the Special Industry Formula for Mutual Fund Service Providers.

Anyone who wishes to make an oral presentation at this hearing may do so in a few moments.

In addition, anyone who wishes to submit written comments regarding the Proposed Regulation may submit such comments to the Franchise Tax Board Legal Department, to the attention of Colleen Berwick, at P.O. Box 1720, Rancho Cordova, California 95741-1720, or fax their comments to (916) 845-3648 by 5 o'clock today.

I've already had a comment that a person is going to be requesting additional time.

MR. HARRIS: Can we get that clarified now, that you will extend the time?

MR. JOSEPH: What sort of time frame do you need?

MR. HARRIS: Well, until just two minutes ago --

MR. JOSEPH: Yes.

MR. HARRIS: -- my understanding was that this proposal was supposed to have in it a particular provision that would have dramatically reduced the scope.

MR. JOSEPH: That's correct. The item that was referenced or put on the Internet, I believe, October 27th is the correct version of the regulation.

MR. HARRIS: But it does not have in --

MR. JOSEPH: That's correct. That was taken out as part of the process at the symposium level when we had discussions with different entities.

So what was noticed on October 27th is correct.

MR. HARRIS: But the conversation that you and I had just a few minutes ago was such that it came as even --

MR. JOSEPH: I had forgotten that conversation.

MR. HARRIS: You had forgotten that.

MR. JOSEPH: Yes. But what was noticed was correct.

MR. HARRIS: No, I'm not suggesting it wasn't correct, but I am suggesting that until this -- until after the conversation with you this morning, it was my understanding that the 50 percent provision and the narrower scope was in there. Accordingly, I have now just made a Public Records Act request for everything that is in the file --

MR. JOSEPH: Yes.

MR. HARRIS: -- so I can have an opportunity to review it.

MR. JOSEPH: Okay.

MR. HARRIS: And I would like to have the comment period extended until two weeks after my receipt of that.

MR. JOSEPH: Okay.

MR. HARRIS: Any problem?

MR. JOSEPH: Well, only in that what was noticed was correct. It has been on the Web since October 27. So it has been there for quite a while already.

MR. HARRIS: Then I would like to note now that I have been relying upon you and your comments in our prior discussions and did not examine the text, and, in fact, until about five minutes ago, understood from you again that 50 percent point was in there on the narrower scope, and would renew my request.

MR. JOSEPH: Thank you.

Okay. The register at the back of the room will become part of the record of this hearing. I believe we've moved it up here, and there are additional sheets in the back.

If you have not already done so, we request that you sign into this register before you leave. We would also appreciate it if you would leave one of your business cards next to the register.

As required by the California Administrative Procedures Act, on October 27, 2006, a Notice of Hearing was mailed to members of the public requesting notice of Franchise Tax

Board regulation changes under Government Code Section 11346.4, and the notice was published on the Office of Administrative Law's Register of Regulatory Action. The notice and the proposed amendments of the regulation also appear on the Franchise Tax Board's website.

The purpose of this formal regulatory hearing is to receive comments from the public concerning the regulation. Each comment will then receive a formal written response from Franchise Tax Board as provided in the provisions of the Administrative Procedures Act.

Because we are tape recording the hearing, we will have to ask each of you who wish to make a comment to come to the microphone so that we can record them.

If you just have a question, we'll attempt to repeat that question so you won't need to come up to the microphone.

The proposed regulation, amendments to the regulation, are designed to address special industry problems related to mutual fund service providers. We have had a symposium on this item already. The mutual fund service provider community has provided information that they, in fact, are in need of such a regulation due to problems in applying the normal, the standard apportionment rules for assigning their income and fairly reflecting their activities in the state.

This hearing is being held pursuant to Government Code Section 11346.8, to allow members of the public to submit oral or written statements. The comments that are received today will all become part of the regulatory process. Any comments received orally will become part of the record and will be considered by FTB staff and addressed by publication on the Franchise Tax Board website no later than 15 days before submission to the Office of Administrative Law. It will include the rulemaking file submitted to the Office of Administrative Law as provided in the APA.

As of 5 o'clock on Friday, I believe we had gotten seven comments.

Is that correct?

MS. BERWICK: Yes, it is.

MR. JOSEPH: Okay.

At this point, I'd like to open up the floor to any individuals who would like to make a public comment.

MR. McBETH: Good morning. Before I begin, I want to commend the Franchise Tax Board legal staff for the professional way that this regulation process has been conducted. In particular, I want to comment favorably on the decision to hold the symposium --

MR. JOSEPH: Please identify yourself for the record.

MR. McBETH: I will.

MR. JOSEPH: Thank you.

MR. McBETH: -- to hold the symposium and collect input from industry before drafting the regulation that is the subject of this hearing. We appreciate having the opportunity on multiple occasions to participate in this process and to be allowed to give our input on both the need for Section 25137 regulation and the content of the regulation.

By way of introduction, I'm John McBeth, Senior Tax Counsel at Franklin Resources in San Mateo, California.

Franklin Resources is the parent corporation of a group of multistate companies that offer investment products to mutual fund shareholders and private accounts. The Franklin unitary group employs more than 6,400 individuals worldwide, with 2,400 employees in California.

Franklin has been an active participant in requesting alternative apportionment relief under Section 25137 for more than 16 years. It filed two petitions under Section 25137, and was granted relief in each instance.

When the Board called for a symposium in October of 2005 on the concept of a proposed regulation for mutual fund service providers, Franklin participated and submitted oral and written comments in support of proposed regulations.

When the Board posted draft regulation language in December of 2005, we responded in March 2006 with a letter offering proposed changes in the draft regulations.

When the Board heard the FTB staff request for permission to proceed with the formal regulatory process in

June of this year, we participated with oral and written testimony. And to complete the formal record of this testimony, we hereby submit at this hearing two copies of each of these written documents, and request that they be considered as part of the formal record.

MR. JOSEPH: Thank you.

MR. McBETH: In preparation for this hearing, we asked our outside counsel for state and local tax matters, Pillsbury Winthrop, to summarize in letter form the arguments that we have been making at each of these hearings and to submit this letter to Mr. Joseph on our behalf. That letter is one of the letters in the back of the room. And I want to take a couple of minutes to summarize our arguments in support of the regulation.

The first argument is the proposed regulation is necessary to address both the unique features of the mutual fund and asset management businesses and the distortion that now exists under the standard Cost of Performance mandated apportionment for receipts for these industries.

We have shown in two petitions that the Franchise Tax Board has accepted the fact that actionable distortion now exists for mutual fund service providers that are required to apportion receipts using Cost of Performance.

The mutual fund and the separate asset management industries are unique businesses that fit perfectly within the context, within the regulatory context Section 25137 was designed to address. The mutual fund industry in particular is highly integrated and highly regulated, making it ideally suited for a specialized solution under Section 25137.

Cost of Performance does nothing to address the market-based factors of business in the service industries in particular or in general and the mutual fund service businesses in particular. Cost of Performance results in California-based companies receiving a double-weighted receipts factor that duplicates their property and payroll factors, causing the resulting overall apportionment to California to be unreasonably skewed towards California, and results in a high level of distortion proven in our Section 25137 petitions.

The overwhelming majority of states with significant mutual fund businesses have already moved to shareholder-residency apportionment for receipts, as this regulation proposes to do. If California fails to match this trend, it will expose its mutual fund businesses to inconsistent apportionment and the threat of multiple taxation on the same receipts.

California simply cannot fail to get in step with other mutual fund states and must not fail to adopt shareholder-residency apportionment as suggested in this regulation.

The second argument that we have proposed is that throwbacks should not be applied to mutual fund and asset management receipts. There are two primary reasons for this:

One is that the throwback provision as contained in these regulations is clearly inappropriate for the sale of services. It is based on a provision that was designed for the sale of tangible personal property.

The second argument being that throwback provisions thwart the basic purpose of UDITPA and the provisions of this regulation since they are inconsistent with market-based apportionment. If receipts are to be apportioned to the situs of the market -- the mutual fund and asset management customers -- then they should not be thrown back to the state where Cost of Performance would otherwise require.

However, being realists, the third argument, if a throwback provision is to be included, then Finnigan, not Joyce, should be the throwback method adopted. There are multiple reasons for this:

One, the use of a Finnigan throwback rule is consistent with California's unitary business principles of income taxation, and it takes into account the unique features of the mutual fund and asset management businesses.

The Finnigan throwback rule will eliminate or significantly reduce the distortion that's been proven in Section 25137 cases filed with the Franchise Tax Board.

The adoption of a Joyce throwback rule will do nothing to reduce this proven distortion. In fact, it may increase the level of distortion in California-based mutual fund and asset management companies.

Under the scope of this regulatory process in Section 25137, there is nothing in the law that would require the adoption of a Joyce throwback rule or would even suggest that Finnigan could not be adopted as part of this regulation.

As outlined in our November 14th letter, Huffy did not overrule Finnigan, and the Franchise Tax Board is not bound by either Huffy or Joyce to adopt Joyce as a throwback rule in these Proposed Regulations.

Finally, if throwback must be applied, we can find no constitutional barriers to the adoption of a Finnigan throwback rule by the Franchise Tax Board. Both Citicorp and Deluxe Corp. cases fully support the application of the Finnigan rule of apportionment.

The Franchise Tax Board has the authority under Section 25137 to fashion a remedy that eliminates or significantly reduces proven distortion, and it is not bound in this process by either UDITPA or other general apportionment rules.

In summary, Franklin Resources strongly encourages the Franchise Tax Board to:

One, adopt shareholder-residency apportionment for mutual fund and asset management service providers; two, delete the throwback provisions contained in the existing Proposed Regulations; but, three, if a throwback provision is to be included, then Finnigan throwback, as outlined in the Proposed Regulations, is the appropriate throwback method that must be adopted to eliminate the proven distortion that exists.

Thank you very much for your consideration.

MR. JOSEPH: On the sign-up sheet, I can just go down the list if we'd like to go that way.

The first name on here is from Federated Investors. Are they here to make a comment? We'd ask that you do that at this time.

MR. HAMM: Thank you, Mr. Joseph.

My name is Bill Hamm. I'm a managing director of an international consulting film headquartered in Emeryville, California. It's LECG. I have a good deal of experience in analyzing the impact of proposed changes in California expenditure tax programs. This is a task I've performed for many years when I was the State's legislative analyst.

Federated has retained me to analyze the fiscal impact of the Proposed Regulation on the State's General Fund. I performed my analysis on a thoroughly objective basis and, as a consequence, my conclusions may or may not agree with the views of Federated.

The proposed regulation would increase corporation tax liabilities for some taxpayers and reduce them for other taxpayers, and five key variables will determine the net impact of these changes on the State's General Fund.

Number one, the share of the mutual fund servicing market held by California-based mutual fund service providers.

Number two, the percentage of total mutual fund shares owned by California residents.

Number three, the relative profitability of California-based mutual fund service providers and out-of-state mutual fund service providers.

Number four, the percentage of total mutual fund shareholders residing in California that are serviced by members of taxpaying groups lacking income tax nexus with California.

And, number five, the extent to which the FTB staff has allowed taxpayers to use alternatives to the standard methods set forth in the regulations for determining their sales factor.

Currently, FTB has regulations requiring mutual fund service providers to compute the sales factor in the manner prescribed by Uniform Division of Income for Tax Purposes Act. If we use as the basis for comparison the tax liabilities that would be generated by the current regulation, it is evident that the proposed regulation would significantly reduce General Fund revenues. And the reason for the reduction is actually quite simple.

California mutual fund -- California-based mutual fund service providers have a 24 percent market share, according to the Investment Company Institute, but California residents only own somewhere between 11½ to 12 percent of all mutual fund shares. Therefore, the standard method for calculating the sales factor reflects the revenues generated for servicing 24 percent of all mutual fund shares, but the Proposed Regulation would reduce the revenues reflected in the sales factor to, according to our best estimate, 11.7 percent. So there would be a reduction of more than 50 percent.

The second reason why the Proposed Regulation would reduce General Fund revenues relative to the revenues generated by the standard method is that it appears California mutual fund service providers are more profitable than their out-of-state competitors. For example, California's largest mutual fund service provider and the fourth largest mutual fund company in the U.S., Franklin Templeton, that you just heard from, in 2005 achieved an operating margin of nearly 51 percent. No out-of-state company in the top 50, among the top 50 mutual fund companies came even close to 51 percent. Generally those margins range from the high teens to the low 40's.

And, in addition, another factor that tends to make out-of-state mutual fund service providers as a group less profitable than California-based mutual fund service providers is the second largest provider in the U.S., the Vanguard Group, is essentially a break-even operation, at least when it comes to its mutual fund business. It's not shareholder owned. It's owned by its clients, and it seeks to manage its mutual fund operation in such a way as to minimize the investors' costs.

So almost certainly the Vanguard Group has an operating margin that is significantly below average, and given its sheer size, it's going to pull down the average profitability of the out-of-state mutual fund service providers significantly. I think that to a lesser extent that is also true of at least one other mutual fund service provider.

So what it appears is going to happen if this regulation is adopted is that the tax burden will be shifted from a group of corporations that are relatively more profitable to a group that is relatively less profitable and, as a consequence, General Fund revenues will go down.

I'm aware of the fact that the Board's staff has estimated that the net impact of the proposed regulation is to increase General Fund revenues by $10 million. And I'm not privy to the analysis that went into that, and so I can't give you a critique of that analysis. But what I can try to do, just for illustrative purposes, is to quantify the General Fund revenue loss that the Proposed Regulation would bring about, making an assumption about worldwide taxable income for all mutual fund service providers.

I don't have access to their tax returns, and I don't know what their worldwide income is. I don't think the Franchise Tax Board has access to all of the tax returns, and it doesn't know either, but I took the average return on -- pretax return on managed assets for the eleven publicly held mutual fund service providers that are large and tend to dominate the industry, at least the publicly-held sector of the industry, and I assume that their pretax return on managed assets was representative of the entire industry. I don't know that to be true.

But based on that assumption, I calculate that the Proposed Regulation relative to the standard method for determining the sales factor would bring about an annual revenue loss of approximately $370 million to the General Fund. To the extent that I have over- or underestimated the weighted average pretax return on managed assets, the General Fund revenue loss would be correspondingly higher or lower.

For example, if, instead of assuming a 70 basis point pretax return, I assume a 35 basis point pretax return for the industry as a whole, then the General Fund revenue loss would be roughly half of what I stated earlier, or about $185 million.

Now, a portion of the loss has already occurred as a result of the tax relief that the Board's staff has chosen to grant certain taxpayers in response to petitions for relief that they submitted. I understand that to date FTB staff have granted tax relief aggregating approximately $43 million. I don't know if that's a run rate or not, but it's an order of magnitude of the relief that has already been granted.

If my estimate of the General Fund revenue loss -- $370 million -- relative to the standard method is correct, and we take the $43 million in tax relief already granted as a run rate, then that would reduce the incremental impact of the Proposed Regulation, would reduce it to $327 million, a $327 million loss to the General Fund.

To put this amount in perspective, it would increase the structural deficit that, according to the legislative analysts, the State is looking at for fiscal year 2007-2008 by about 14 percent.

Thank you very much for allowing me to speak. And I'm happy to respond to any questions now or at any time in the future about my analysis. I believe you have a more lengthy written statement of my analysis.

Thank you again.

MR. JOSEPH: Would you like to comment at this time?
MR. TOMAN: Good afternoon, or good morning actually. My name is Brian Toman, that's T-o-m-a-n. I'm with Reed Smith, San Francisco, California, and I represent Federated Investors.
I have extensive experience with respect to formula apportionment and the substance to the formula, general formula under 25137. I have extensive experience with the Administrative Procedures Act and the Office of Administrative Law. And while I was chief counsel with the Franchise Tax Board, I dealt with APA and the Office of Administrative Law on a continuous basis.
My testimony today will speak to the provisions of a regulation not consistent with California law, and speak to the concept of uniformity.
First, the regulation in question does not conform to the standard apportionment formula with respect to attributing sales of intangibles to personal services. The standard formula specifically calls for a cost-of-production producing income approach, which is not set forth in the Proposed Regulation. And the Federated Investors' submittal in that regard is quite extensive, and I won't go into much detail beyond what I just said.
However, for the staff to deviate from the standard apportionment formula during the recent California Supreme

Court case of Microsoft versus the Franchise Tax Board, staff has to prove by clear and convincing evidence that such a deviation from the standard apportionment formula is appropriate. Shortly I will explain why staff has failed to meet that burden of proof.

The second item that is contrary to existing law is the Finnigan approach. I think at this point in time and nationwide there is only three states, if that many, to follow the Finnigan approach. The rest of the states follow the Joyce approach. So, consequently, the Finnigan approach with respect to this particular regulation is completely inconsistent with California law.

What's difficult to understand is that staff is attempting to equate the market-state approach under 25135 with respect to sales of tangible personal property with the sales of intangibles and services under 25136. The staff attempts to use the market-state approach for both types of sales, yet it attempts to use a different throwback rule.

It's inconsistent, it's illogical, and it's not consistent with California law.

Again, the submittal of Federated goes into great detail on that, and I won't go any further than to mention what I just mentioned. But, again, for staff to deviate from the standard apportionment formula, it never goes to the markets at all. It has to prove by clear and convincing evidence that such a deviation is appropriate.

Now, the clear and convincing evidence gets into more detail. For those of you who are not familiar with burden of proofs, it's the higher level, the highest level above preponderance. And the only level beyond clear and convincing is beyond a reasonable doubt. And since this regulation doesn't deal with the death penalty, it doesn't have to go that high.

The third element has to do with the concept of uniformity. Case law teaches us that with respect to the courts giving any credence to the argument of uniformity, there must be almost complete uniformity to begin with, for example, in Microsoft, dealing with whether net or gross go into the sales factor with respect to treasury functions.

The preponderance of the State either by definition defined net to go into the sales factor or by application of UDITPA Section 18 or California Section 25137, it goes without saying, itself.

In Microsoft, there was almost unanimity amongst all the states with respect to De Brazil, and that's what the California Supreme Court looked to in endorsing uniformity as a basis to hold for Franchise Tax Board.

In Citicorp North America versus the Franchise Tax Board, the Court again looked to the fact that out of 44 states, 40 of the states followed the Joyce approach to uphold the prospect of application of the Joyce rule in California.

In the case at hand, there is no super majority among the states. Some may argue there is a trend but, nevertheless, for the concept of uniformity to be argued with credibility with respect to any type of a regulation, there has to be an existing super majority of the states that take a particular approach that we do not have here.

Regardless of what staff does in terms of the approach with respect to Finnigan or Joyce, there is not going to be any uniformity unless the staff adopts the Joyce approach. Again, as I mentioned, at this point, probably 41 of the 44 states follow Joyce.

And the last thing I want to discuss is the burden of proof. As I alluded to previously, the California Supreme Court has recently held in Microsoft that FTB staff, or the taxpayer, whoever is attempting to implement 25137, has the burden of proof by clear and convincing evidence that deviation from the standard apportionment formula is appropriate. It's important to note that the Court did not specify whether these deviations are on an ad hoc, case-by-case basis or regulatory across the board.

The bottom line is, according to the California Supreme Court, whoever wants to deviate from the standard apportionment formula has the burden to prove by clear and convincing evidence under 25137 that 25137 is appropriately instituted.

Clear and convincing evidence has been defined as clear, explicit, and unequivocal, so clear as to leave no substantial doubt and substantially strong to command unhesitating assent of every reasonable mind.

So what type of evidence should staff be presenting to prove that the regulation it attempts to promulgate here today is appropriate?

Well, as a primary basis, staff should show and prove the difference between the standard apportionment formula sales factor and the sales factor the FTB staff is attempting to implement. The basis for this analysis is in the Merrill Lynch case. The Merrill Lynch case, as evidenced in the particular regulation before us now, dealt with a function that was a fundamental function of the business. Finding that, the Board of Equalization went out to do a numerical analysis like was just described, coming to a conclusion that the distortion that was attempted to be proven by the Franchise Tax Board was not, in fact, proven.

There are two other cases that are relevant here. One is the Microsoft case again, and the other is Pacific Telephone. However, in both Microsoft and Pacific Telephone, the jurisdictional bodies held that the activities of the treasury function in both cases was incidental, leaving at least some commentators to believe that there is an even less of a burden of proof when you have an incidental activity.

The Court, in Microsoft, followed specifically the Pacific Telephone analysis in coming to the conclusion that under Pacific Telephone, Microsoft should not be granted the relief that it sought under the standard apportionment formula and that the Franchise Tax Board was correct in asserting 25137, and went into additional analyses based on profit margin analyses.

Now, the case at hand, what type of evidence has Franchise Tax Board staff presented? Well, so far, it's been allegations. The first allegation is that 25136 with respect to mutual fund service providers, has broken down. Now, broken down is not the test of distortion. Broken down is not an evidentiary fact. It is a mere allegation.

Another allegation is 25136 does not reflect the market state. Well, 25136 does not represent the market state with respect to any taxpayer. It is not designed to reflect the market state. It is designed to reflect the location where the cost was incurred that produced income.

The third allegation is overtaxation can and will -- can result, but will not result. Again, there is no objective evidence that has been presented by staff to prove that allegation.

Again, the clear-and-convincing-evidence test calls for clear, exclusive, and unequivocal evidence, evidence so clear as to leave no substantial doubt, and evidence which is sufficiently strong to command an unhesitating assent of every reasonable mind. That type of evidence, we submit, has not been presented in this situation.

Furthermore, with respect to the Finnigan approach, that same type of information has not been presented. In fact, there is just a glaring inconsistency here where you have a market-state approach under two different types of sales and you have an inconsistent use of the throwback sales rule.

And that concludes my comments on this.

Are there any questions?

MR. JOSEPH: Just for clarification for myself, since one of the things you stated was that 25136 does not reflect the market, would your position require or at least suggest that the existing regulations under 25137 that also deals with companies that have activities that would be sourced under 25136, that those regulations are invalid or incorrect?

MR. TOMAN: I would say that maybe at the time it was passed, in those days the California Supreme Court had not clarified the level of burden of proof that whoever was instituting 25136 on an ad hoc basis or on a regulatory basis has the burden of proof. And that burden of proof now is clear and convincing. And so under today's rules, the evidence presented in this particular setting has not met that burden regardless of what's happened in the past.

MR. JOSEPH: In relation to what evidence you would like to see staff put forward in order to try to meet that burden that you say applies, what would you like to see staff put into the regulatory record in order to satisfy that burden?

MR. TOMAN: Well, the fundamental step would be to analyze the apportionment percentages.

MR. JOSEPH: The apportionment percentages of whom?

MR. TOMAN: Of the universe of mutual fund service providers --

MR. JOSEPH: Okay.

MR. TOMAN: -- under the standard apportionment formula sales factor, and then do the same analysis under the approach recommended by staff in the Proposed Regulation.

MR. JOSEPH: So, in order to do that, would staff need to contact all of the out-of-state taxpayers and have them perform a calculation as to what their percentage would look like if the regulation were to be applied to them?

MR. TOMAN: I think that staff would have to contact the universe of all entities affected by this regulation and attempt to secure that information.

MR. JOSEPH: Do you believe staff has the authority to ask them to do that?

MR. TOMAN: I think staff has the authority to ask whatever they want to ask whether or not the taxpayer is going to comply with it.

MR. JOSEPH: If the taxpayers choose not to comply, can staff ever meet your burden?

MR. TOMAN: Well, it all depends on -- this is all speculative depending upon what you get back. But I think what you have to do is do your best job to come up with this information to at least meet the foundational basis to do a distortion analysis.

MR. JOSEPH: Thank you.

MR. TOMAN: Thank you.

MR. JOSEPH: Before we move on, I had neglected to -- he's sitting over on my side -- we heard from Federated, also had Mr. Toman's as well as an economic analysis, and the economic analysis had come into us, I believe, on Thursday of last week?

MR. HAMM: Correct.

MR. JOSEPH: And our own folks who had done our own analysis had looked at what was provided. And I had one of them show up to give me some input on their look at what Mr. Hamm has provided.

Please just state your name for the record.

MR. SPILBERG: Phil Spilberg of the Economic and Statistical Research Bureau.

And, yes, I have had just an opportunity to take a look at Mr. Hamm's analysis, and I can spend a couple of minutes talking about how that differs from the analysis that was performed by the Franchise Tax Board.

Well, first, also let me say that there are basically two major differences in the result. There are differences in magnitude and differences in size. Mr. Hamm shows a revenue loss of $370 million. Our analysis came with a result of a $10 million revenue loss.

$370 million, by the way, is a pretty large number as you compare it to California corporate income tax revenues, franchise tax revenues. It's a little bit over 5 percent of income tax revenues from corporations. That's a pretty big result, and, indeed, it's possible that in fact between total filing companies in total do not pay that much.

Let me talk about approaches. The approach that the Franchise Tax Board took to this analysis is to select the tax returns of mutual fund service providers and do, in essence, a microanalysis of each of these tax returns.

Mr. Hamm's approach is a macro approach, that is, he starts off with data for the mutual fund industry and then works his way down to the effect on California.

With respect to magnitude, the reason that his magnitude may have come out substantially larger than ours is that there are basically two assumptions that are key. One is the gross receipts of the mutual fund service providers, and Mr. Hamm uses a .7 percent on assets as being what would be basically the receipts of mutual fund service providers.

That may be too large because it excludes certain expenses that mutual fund -- that basically are embedded in that .7 percent return rate. It doesn't include everything. For example, it doesn't include interest expense, and it also doesn't include a lot of the other indirect business expenses.

The second is the tax rate on that income, which Mr. Hamm uses a 4.42 percent, in essence, tax rate on that income. And that tax rate, again, could be substantially too large. The second part -- so this basically talks to the magnitude.

What we have found is that with respect to size, that if you take into account the corporations that have received 25137 relief, in fact, the size flips, and it goes from a loss to a gain. And, indeed, if you apply Mr. Hamm's methodology to the corporations that have received relief, the magnitude that you get for that relief is approximately ten times of the actual relief that was granted. So that sort of, again, talks to possible -- well, the fact that the two assumptions that Mr. Hamm uses in total provide too great a result.

So that basically is the difference, the reason for the difference. One is that the percentages that Mr. Hamm uses generate a magnitude which is way too large. And the second is that actually taking specifically into account the corporations that receive, have received relief is very important with respect to the overall finding.

MR. JOSEPH: Thank you very much.

Okay. Who would like to be our next speaker?

I could go down the list if you wish.

Next on the sign-up list is Fred Main.

MR. MAIN: Thank you, Mr. Joseph.

My name is Fred Main. I'm representing or with Manatt, Phelps & Phillips today, representing a group of out-of-state mutual fund companies. We have submitted comments to the Franchise Tax Board on our position on the regulation.

First, two questions or requests. First is is the intent to have the full Franchise Tax Board conduct a final hearing on this regulation? And we would make a request that be the case.

And then, second, is it the Franchise Tax Board's revenue estimates, are those part of the public record now?

I didn't see them.

MR. JOSEPH: Yes, they are. The Form 399 that Mr. Spilberg, his analysis is part of the record. You'll receive a copy of that, I believe.

MR. MAIN: Thank you.

With those points clarified, the coalition of companies that I represent does oppose the regulation in its current form. However, we would point out that the member companies would support a regulation that dealt with shareholder location as the appropriate method of allocating sales.

We believe, however, that the use of both Joyce and a throwback make the regulation violative of both the necessity and consistency standards for the Administrative Procedures Act.

In this position, we think that the regulation therefore is unfair to taxpayers, moves away from the consistency and uniformity that we believe California is committed to in their application of the tax laws.

There has been significant testimony about the movement or the use of shareholder location, and we do believe that it would be appropriate if the regulation only dealt with that.

Having said that, our members of the coalition, even with that, would actually face greater apportionment of income to California. But we think, based on the movement of other states to shareholder location, that that would be acceptable.

However, at the same time that the movement -- or the movement way from Joyce and the adoption of a Finnigan rule is counter to that movement towards uniformity, we also believe that it violates the current state of the law which is that Joyce is the appropriate method for apportioning, making that apportionment decision.

Finally, it's been a common statement amongst all of the testimony and the positions that we don't believe that a throwback rule is necessary, and it's inconsistent, it confuses the allocation between real property and intangible property, and we think that the Legislature didn't intend a throwback rule to apply under 25136 -- clearly knows how to draft one. They put one in 25135 -- and that it's unnecessary, then, as part of the 25137 relief that the staff is looking at to overrule that specific distinction that the Legislature has made.

In our comments we've also offered simply some comments and questions that in the future if the staff could respond to, and a request that there be a provision put in it for assets -- or for companies that have less than 50 percent of their factors, their gross income from the indirect or direct provision of management services, that they will not be subject to the new regulation.

With that, I thank you for the opportunity to present these comments.

MR. JOSEPH: Can I ask you one question for clarification's sake.

MR. MAIN: Certainly.

MR. JOSEPH: In the submittal that you've given us, one of the things that you say that was very interesting to me that I hope you can expand on a little bit was that even under a Joyce-type methodology, the members of your coalition would have increased apportionment factors than they have now. And I was hoping you could expand on that a little bit to give me an idea as to what sort of services they are doing that that would -- what exactly are you referring to there? Is it because they have distributional presence in the state, or do you know the --

MR. MAIN: They would have -- yes, they have distribution services. That is, if you move to shareholder location, that would increase their overall apportionment factors in the state.

MR. JOSEPH: Okay. And for purposes of analysis, without having any information on who the members of your coalition are, is there any way you can provide staff with any additional information about what that change would look like? In other words, are we going from a sale factor percentage of 1 to a sale factor percentage of 1½, or are we -- do you understand what I'm talking about?

I'm very interested in that, and I --

MR. MAIN: Certainly.

MR. JOSEPH: -- want to know more.

MR. MAIN: If the Board is extending the receipt of comments, we're in a position that we could provide an example to you to give a more detailed understanding of it.

MR. JOSEPH: Thank you very much.

MR. HARRIS: Please, would you -- are you now going to reconsider?

The reason I ask is because this is the first time I can imagine -- I can remember in all of the hearings that I have been to where that request was made and not immediately acceded to.

MR. JOSEPH: Oh, Richard, I did not intend to not accede to your demand. It's a question of time. And the way you had proposed your 14 days beyond --

MR. HARRIS: Yeah, receipt.

MR. JOSEPH: Yes. I merely, at the moment that you had asked the question, was not prepared to agree to that particular suggested time.

No, it is not my intention that we will not allow you time --

MR. HARRIS: So there will be some additional time beyond 5:00 p.m. today. It's only a question now of settling upon when?

MR. JOSEPH: Yes.

MR. HARRIS: Thank you. And we should be able to live within whatever time frame you provide --

MR. JOSEPH: Thank you very much.

MR. HARRIS: -- to provide additional information.

MR. JOSEPH: Thank you.

Okay. Mr. Doerr, you're next on the list. Do you wish to make a public comment?

(Mr. Doerr indicates he does not.)

Mr. Dronenburg, do you wish to make a comment?

(Mr. Dronenburg indicates he does not.)

MR. JOSEPH: Then the next on the list would be Jim Brown of Capital Group, Capitol Group Companies.

MR. BROWN: Good morning. My name is Jim Brown. I'm the senior vice president and principal financial officer of the Capital Group Companies.

Capital Group is a 75-year-old, privately-held company, investment management company headquartered in Los Angeles. Our only business is providing investment management through our services of our affiliates to the American Funds Group of mutual funds as well as institutional investors such as pension plans, foundations, endowments, and by individuals.

First, we want to thank the FTB for the opportunity to provide both written and oral comments on the Proposed Regulation 25137-14.

The Capital Group strongly supports and commends the FTB and their staff for the processes you follow, starting with first holding a symposium in 2005, right up to the actual drafting of the regulation which we are looking at today.

Capital participated in that symposium and has previously submitted two sets of comments in support of the FTB's efforts in this area. We are re-submitting those comments together with additional written comments today for your consideration.

I could summarize our support to these regulations quite succinctly. By using a market-base sales apportionment doctrine for a mutual fund service provider, quite simply, is just the right approach. The recognition of the equity of this approach is evidenced by the fact that more than a dozen other states have adopted similar approaches for apportioning the sales of a mutual fund service provider in recent years.

Also, working for a mutual fund service provider who has lived with Cost of Performance in this state for decades, we have experienced firsthand the degree of distortion attributable to that approach.

Mutual fund service providers are a highly integrated combination of companies, typically comprising investment manager, distributor, or transfer agency, and the income they generate is uniquely dependent upon the relationship with the mutual fund shareholders, the majority of which, the clear majority of which are outside the state of California.

The fee for investment management, distribution, and transfer agency services is based exclusively on the fund's ability to attract and retain investors. Application of the

Cost-of-Performance approach to sales apportionment is disproportionately taxed to sales activities that occur in other states by assigning receipts to the location where the income producing activity occurs, not the relationship where the customer is based nor where the sales activity occurs.

Market-based apportionment recognizes the reality of our business and significantly reduces distortion of the application of the Cost-of-Performance methodology.

To fully benefit from a market-based approach, we certainly believe there should be no throwback provision in this regulation. It's really fundamentally at odds with the proposal to adopt a special apportionment rule for the mutual fund industry which seeks to eliminate the distortion.

However, if throwback provisions are included in the final regs, we also believe that they must be determined in accordance with the principles of Finnigan.

As noted earlier, mutual fund service providers generally operate in a highly integrated, unitary business. By looking at the total activities of that business, severally, incorporated or not, they constitute a single unitary activity. The Finnigan approach upholds the purpose of the proposed special industry regulation.

So let me close by saying that the Capital Group supports, encourages, and urges the Franchise Tax Board to move forward with this regulation.

Thank you for your time.

MR. JOSEPH: At this point are there any other individuals who would like to make a comment at the hearing today?

MR. HARRIS: Are we at the end of the list?

MR. JOSEPH: I believe I am at the end of the list of people who wanted to talk.

MR. HARRIS: When you get to the end, I have some questions.

MR. JOSEPH: Mr. Harris, please.

MR. HARRIS: I can do it just from here if it's okay with you.

MR. JOSEPH: Okay.

MR. HARRIS: The first question I have is how many 25137 petitions have been filed by members of the group that you call these mutual fund service providers?

MR. JOSEPH: How many have been filed?

MR. HARRIS: Yes. How many have there been?

There have been some references to them.

MR. JOSEPH: Yes. Less than ten, I would say.

MR. HARRIS: Less than ten companies? Or less than ten petitions?

MR. JOSEPH: Less than ten petitions.

MR. HARRIS: And at what level were those petitions decided?

MR. JOSEPH: I'm sorry?

MR. HARRIS: At what level? Did they go to the full board?

MR. JOSEPH: I believe the three-member board has the authority to hear any FTB 137 petition that they choose to hear. And these were not heard in open session, if that's your question.

MR. HARRIS: Were they heard by the board? I mean, did the board make the decision on these petitions, or were they made at the staff level?

MR. JOSEPH: Staff made the board a recommendation as to what staff would like to do with the petitions, and the board did not overrule staff.

MR. HARRIS: Were all the staff recommendations to grant the petition, to grant relief under 25137?

MR. JOSEPH: Yes.

MR. HARRIS: During what period of time were these petitions filed and ruled upon, just historically?

MR. JOSEPH: It goes back awhile. I'm not sure of the exact date when the first one was filed. It's been a number of years.

MR. HARRIS: So there has been no -- if I understand you correctly -- no 25137 petition filed by a mutual fund service provider as to which a mutual fund service provider has not been able to obtain relief?

MR. JOSEPH: That is correct.
MR. HARRIS: Okay. And may I ask, then, next, with respect to the reg, there being a necessity requirement, is there -- what is the need that has been articulated by the staff for this reg if 25137, as it is functioning now, has been operating in the manner in which you have said?
Why is there a need?
MR. JOSEPH: The need is for all companies in this industry to be treated the same.
MR. HARRIS: Oh, I thought that 25137 was a taxpayer-specific --
MR. JOSEPH: No.
MR. HARRIS: -- petition. It says if the -- the statute itself talks about "the taxpayer."
MR. JOSEPH: Do you mean to suggest that all of the special industry regs under 137 are essentially incorrect in being included there?
MR. HARRIS: Well, you've now raised the question that comes up with the conversation you had with Brian Toman where he raises the very important issue of what the staff is required to do if the staff wishes to deviate from the standard apportionment. And the question comes up -- which, of course, this brings up the Fluor issue, which I'll get to in a moment -- how companies fit within the definition of mutual fund service provider as set forth in the Proposed

Regulation?

MR. JOSEPH: How many in total?

MR. HARRIS: Yes.

MR. JOSEPH: I don't know. I don't have that number off the top of my head.

MR. TOMAN: It may be in your economic impacts.

MR. JOSEPH: Yes.

MR. TOMAN: 160. I've got the statement here.

MR. JOSEPH: Thank you. I didn't have that off the top of my head.

MR. HARRIS: What was the definitional restriction that was in the prior reg proposal that was discussed?

MR. JOSEPH: Prior reg proposal?

MR. HARRIS: Yeah, the prior -- or the symposium version, the so-called 50 percent question.

MR. JOSEPH: There was no language given to the symposium participants. The language was developed after the symposium.

I believe what you're referring to was the suggestion that I made at the beginning of the process that a 50 percent threshold would be something that we should put in the reg. And as you see from the regulation that was noticed during the symposium, industry participants suggested that that was not necessary.

MR. HARRIS: Is there -- did you have any expression in the symposium or other places to an objection to putting in the 50 percent or some similar threshold requirement in the definition?

MR. JOSEPH: Yes, I believe we did.

MR. HARRIS: Are you able to identify the source of that?

MR. JOSEPH: Able to identify the source?

(Various comments made by unidentified speakers.)

MR. JOSEPH: So there were entities that --

MR. HARRIS: There were a couple of objections?

MR. JOSEPH: Yes.

MR. HARRIS: Can you inform us as to what the nature of the objection was.

MR. JOSEPH: I think they probably did a better job than myself in that regard, but I believe it has to do with just the mix of income to which their companies have in providing services for investors.

Is that correct?

MR. REILLY: There's over two hundred billion dollars --

MR. JOSEPH: Could you identify yourself, please.

MR. REILLY: Neal Reilly from Barclays Global Investors.

There is over two hundred billion dollars of exchange traded funds under management. In order to make up 50 percent of our active management -- we also manage pensions, in total about 1.7 trillion -- it is a significant source of revenue for us.

With a 50-percent rule, we would still be required to do Cost of Performance, which works on the --

MR. JOSEPH: Would --

MR. REILLY: -- which would put us at a competitive disadvantage to our peers.

MR. HARRIS: If it were some lower threshold amount. Right now --

MR. JOSEPH: Well, what would you like to propose?

MR. HARRIS: The reason I ask is this. Right now, as I read this, it suggests that if somebody derives one dollar of income, doesn't matter what the percentage is, but one dollar of income, they would fit into the definition.

MR. JOSEPH: They would assign that one dollar of income under the rules of the regulation.

What's your concern, Mr. Harris? Is your concern that a threshold is necessary in order to exclude companies that are not primarily in this business? Is that your concern?

MR. HARRIS: I think there is some lack of clarity here as to the scope, the intended scope, and that whereas the staff had proposed some method of addressing it before --

MR. JOSEPH: Yes. And I think you have heard that also today by at least one of the people who did make a public comment that they would request that we include a threshold of 50 percent.

So, yes, I believe that is the issue as to scope.

MR. HARRIS: One of the things that has -- there is, of course, the more fundamental question that has been raised by Brian, and these problems would all go away if the staff would acknowledge the fundamental difference between proposing a regulation under any provision other than 25137, and the special requirements when proposing a reg under 25137, and this is the Fluor issue. And with all due respect to any member of the State Board or former member of the State Board of Equalization who may be here and may have voted on that matter, Fluor is simply wrong and is complete dicta.

MR. JOSEPH: I understand.

MR. HARRIS: And the reason it is complete dicta is because of the very points that Brian mentioned, that there is a requirement with respect to 25137 that has not been satisfied in any of the 25137 hearings that have ever been proposed. And that the proper interpretation of a 25137 reg is that the Franchise Tax Board has articulated an alternate approach which, if any taxpayer follows, the Franchise Tax Board will accept. In other words, it's an announcement to the world that there is this alternative approach which you may use.

MR. JOSEPH: I think, Richard, I understand your position. I'm not so sure that it goes to the scope of the hearing that we are having today.

MR. HARRIS: Well, it does in the sense that -- in the sense that if -- if the Franchise Tax Board's position on Fluor were corrected with respect to the nature of 25137, then Brian wouldn't have to be concerned about this, because the 25137 regs would be as they were intended to be: options for the taxpayer; announcements by the Franchise Tax Board of what it would accept.

MR. JOSEPH: Yes. I understand your position.

MR. HARRIS: How -- with respect to each state that has adopted a reg, do any of the -- which of the states have thresholds in them in the regs?

MR. REILLY: Four. Four out of twelve.

MR. JOSEPH: And what are the thresholds?

MR. HARRIS: Mr. Reilly sounds like the expert.

MR. REILLY: 50 percent.

UNIDENTIFIED SPEAKER: What was the answer?

MR. JOSEPH: 50 percent was the question.

UNIDENTIFIED SPEAKER: Four of the twelve, 50 percent.

MR. HARRIS: What is in the current reg file now as it stands as of the date of this hearing?

MR. JOSEPH: Mr. Harris, I'd be more than happy to provide that reg file.

MR. HARRIS: Is Mr. Spilberg's in there?
MR. JOSEPH: Yes, his analysis is in there.
MR. HARRIS: Okay. That's all I have.
MR. JOSEPH: Okay. Thank you.
Is there anyone else who would like to make a comment today? Okay.
And, now, as to how long we should keep the record open so that Mr. Harris may chime in on his 50 percent threshold requirement and other matters.
MR. HARRIS: Or decide not to say anything at all.
MR. JOSEPH: Or decide not to say anything, if he wishes to do that.
MR. HARRIS: The question is can Ms. Berwick or somebody else get me a copy of the reg file as it exists --
MR. JOSEPH: Yes.
MR. HARRIS: -- in its totality?
MR. JOSEPH: What sort of time frame do you believe you would need to do that?
MS. BERWICK: Probably by the first of the year.
MR. JOSEPH: So you would like until perhaps January 15, then?
MR. HARRIS: That would be fine. And if it can be obtained --
MR. JOSEPH: Certainly, Mr. Harris, we would like to have your input in the regulation process. I will not in any

way shorten that by one day if it turns out that we have an issue where we need to extend.

MR. HARRIS: That would be fine, the 15th of January. And something sooner, if I could.

MR. JOSEPH: We will endeavor to make it as quick as possible.

MR. HARRIS: Great.

MR. JOSEPH: I will therefore open the comment period to January 15th.

Yes.

UNIDENTIFIED SPEAKER: Just for clarification.

Is that open, then, regardless of how soon there is a response --

MR. JOSEPH: Yes.

UNIDENTIFIED SPEAKER: -- it will be January 15?

MR. JOSEPH: Yes. I would certainly hope I --

MR. HARRIS: And it's open for everybody?

MR. JOSEPH: Absolutely, Richard.

UNIDENTIFIED SPEAKER: What would be the next step after that?

MR. JOSEPH: Well, once we have received the comments, then, under the guidelines of the Office of Administrative Law and the APA, I have to respond in the record to the comments that have been received. And at that point, since it has been requested that this goes back to the three-member board, certainly we will do so for the three-member board to approve.

If there are changes made in the regulation, those changes, depending upon the scope of change, will either require a 15-day notice, or if they are minor sorts of things, will not require additional notice time. Or, if it's a large, large change, it may require re-notification, but that depends on what we receive.

Certainly we will endeavor to move the process forward as quickly as we can.

Okay. Thank you very much for your attendance.

And that will conclude the hearing for today.

Thank you.

(At 11:14 a.m. the hearing is adjourned.)

---oOo---

REPORTER'S CERTIFICATE

STATE OF CALIFORNIA)
) ss.
COUNTY OF SACRAMENTO)

I, SANDRA VON HAENEL, certify that I was the official Court Reporter for the proceedings named herein, and that as such reporter, I reported in verbatim shorthand writing the named proceedings;

That I thereafter caused my shorthand writing to be reduced to typewriting, and the pages numbered 1 through 48, inclusive, constitute a complete, true, and correct record of said proceedings:

IN WITNESS WHEREOF, I have subscribed this certificate at Sacramento, California, on the 27th day of December, 2006.

____
SANDRA VON HAENEL
CSR No. 11407

Section 25137-14 is adopted to read:

§ 25137-14. Mutual Fund Service Providers and Asset Management Service Providers.

(a) Definitions.

As used in this section, unless the context otherwise indicates, the following terms have the following meanings:

(1) "Administration services" include, but are not limited to, clerical, fund or shareholder accounting; participant record-keeping, transfer agency, bookkeeping, data processing, custodial, internal auditing, legal, and tax services performed for a regulated investment company. Services qualify as administration services only if the provider of such service or services during the taxable year also provides, or is affiliated with a person that provides, management or distribution services to the same regulated investment company during the same taxable year.

(2) "Distribution services" include, but are not limited to, the services of advertising, servicing, marketing or selling shares of a regulated investment company. The services of advertising, servicing or marketing shares qualify as distribution services only when the service is performed by a person who is, or in the case of a closed-end company was, either engaged in the business of selling regulated investment company shares or affiliated with a person that is engaged in the service of selling regulated investment company shares. In the case of an open-end company, such service of selling shares must be performed pursuant to a contract entered into pursuant to 15 United States Code, Section 80a-15(b), as amended.

(3) "Management services" include, but are not limited to, the rendering of investment advice, directly or indirectly, to a regulated investment company, making determinations as to when sales and purchases of securities are to be made on behalf of the regulated investment company or providing services related to the selling or purchasing of securities constituting assets of a regulated investment company, and related activities. Services qualify as management services only when such activity or activities are performed pursuant to a contract with the regulated investment company entered into pursuant to 15 United States Code, Section 80a-15(a), as amended, for a person that has entered into such a contract with the regulated investment company or for a person that is affiliated with a person that has entered into such a contract with a regulated investment company.

(4) "Domicile" is defined as follows:

(A) The domicile of a shareholder of a regulated investment company is presumed to be the shareholder's mailing address on the records of the regulated investment company or the mutual fund service provider. If the regulated investment company or the mutual fund service provider has actual knowledge that the shareholder's primary residence or principal place of business is different than the shareholder's mailing address, the presumption does not control. Shareholders of record that own shares for the benefit of others are subject to the special rule contained in subsection (b)(1)(A)1 of this regulation.

(B) The domicile of a beneficial owner of assets managed by a mutual fund service provider shall be presumed to be the beneficiary's mailing address on the records of the entity for whom the asset management services are rendered, or on the records of the mutual fund service provider. If the entity for whom the asset management services are rendered, or the mutual fund service provider, has actual knowledge that the beneficiary's primary residence or principal place of business is different than the beneficiary's mailing address, the presumption does not control. Owners of record that are not the beneficial owner are subject to the special rule contained in subsection (b)(1)(B)1 of this regulation.

(5) "Mutual fund service provider" means any unitary business that derives income from the direct or indirect provision of management, distribution or administration services to or on behalf of a regulated investment company.

(6) "Regulated Investment Company" means a regulated investment company as defined in Section 851 of the Internal Revenue Code.

(7) "Asset management services" means the direct or indirect provision of management, distribution or administrative services to entities other than regulated investment companies, if those services would be management, distribution or administrative services within the meaning of subparagraphs (a)(1), (a)(2), or (a)(3) of this regulation, if provided directly or indirectly to a regulated investment company.

(b) Apportionment of Business Income. The property, payroll and sales factors of the apportionment formula for mutual fund service providers shall be computed pursuant to Sections 25128 through 25137 of the Revenue and Taxation Code and the regulations adopted pursuant thereto, except as provided in this regulation:

(1) Sales Factor. For purposes of determining the numerator of the sales factor:

(A) Receipts from the direct or indirect provision of management, distribution or administration services to or on behalf of a regulated investment company are assigned by the use of a shareholder ratio. This ratio is calculated by multiplying total receipts for the taxable year from each separate regulated investment company for which the mutual fund service provider performs management, distribution or administration services by a fraction, the numerator of which is the average of the number of shares owned by the regulated investment company's shareholders domiciled in the State at the beginning of and at the end of the regulated investment company's taxable year, and the denominator of which is the average of the number of the shares owned by the regulated investment company's shareholders everywhere at the beginning of and at the end of the regulated investment company's taxable year.

1. If the domicile of a shareholder is unknown to the mutual fund service provider because the shareholder of record is a person that holds the shares of a regulated investment company as depositor for the benefit of others, the mutual fund service provider may utilize any reasonable basis, such as the zip codes of underlying shareholders, in order to determine the proper location for the assignment of these shares. If no information is obtained such that a reasonable basis can be developed to determine the proper location for the assignment of these shares, then all of the shares held by the shareholder of record shall be disregarded in computing the shareholder ratio for the fund in issue.

2. The regulated investment company's taxable year for computing the shareholder ratio shall be either the taxable year that ends during the taxable year of the principal member of the mutual fund service provider's combined reporting group or the taxable year of the principal member of the mutual fund service provider's combined reporting group. Once a method for computing the shareholder ratio is chosen, that methodology should be applied consistently in later years.

(B) If a mutual fund service provider has receipts from performing asset management services, in addition to performing services for regulated investment companies, these services shall be assigned to this state if the domicile of the beneficial owner of the assets is located in this state.

1. In the case of asset management services directly or indirectly provided to a pension plan, retirement account or institutional investor, such as private banks, national and international private investors, international traders or insurance companies, receipts shall be assigned to this State to the extent the domicile of the beneficiaries of the plan, beneficiaries of the account or beneficiaries of the similar pool of assets held by the institutional investor, is in California. If the individual domiciles of the beneficiaries are not available, a mutual fund service provider may utilize any reasonable basis in order to determine the domiciles of the individual beneficiaries, including information based on zip codes or other statistical data.

2. In the event the domicile of the beneficiaries is not or cannot be obtained, and the taxpayer cannot devise a reasonable method to approximate this information, the receipts shall be disregarded for purposes of the sales factor.

(C) If a mutual fund service provider has non-taxpayer members that are providing management, distribution or administration services to or on behalf of a regulated investment company with shareholders in this State, or that are providing asset management services directly or indirectly for beneficiaries who are domiciled in this State, the receipts from these activities that are assigned to the numerator of the sales factor by virtue of this regulation shall be included in the numerator of the sales factor in determining the unitary group's business income apportionable to this State, even though the specific entity that performed the services in not a taxpayer in this State.

1. In lieu of the provisions contained in Regulation section 25106.5(c)(7)(B), the taxpayer member's property, payroll and sales factors are calculated as follows:

a. Each taxpayer member of the combined reporting group (and only the taxpayer members) determines its California property factor, payroll factor and sales factor.

b. The taxpayer member's California property factor is a fraction, the numerator of which is the California property of that member, and the denominator of which is the total property of the group everywhere. Property values are determined in accordance with Sections 25130 and 25131 of the Revenue and Taxation Code.

c. The taxpayer member's California payroll factor is a fraction, the numerator of which is that member's California payroll, determined under Section 25133 of the Revenue and Taxation Code, and the denominator of which is the total payroll of the group everywhere.

d. The taxpayer member's California sales factor is a fraction, the numerator of which is the California sales of that taxpayer member, determined under sections 25133 through 25137 of the Revenue and Taxation Code and the regulations adopted pursuant thereto and as modified by this regulation, and the denominator of which is the total sales of the group everywhere.

2. In lieu of the provisions contained in Regulation section 25106.5(c)(7)(C), the taxpayer member's California source combined report business income is then calculated as follows:

a. First, the taxpayer's California apportionment percentage is determined. It is the sum of that member's California payroll, property, and a doubled weighted sales factor (or a single weighted sales factor, if applicable), with that sum divided by either four or three (as applicable).

b. Next, the taxpayer member determines its intrastate apportionment percentage. That percentage is the ratio of the taxpayer member's California apportionment percentage to the sum of all of the California taxpayer members' California apportionment percentages.

c. Finally, the taxpayer member multiplies the group's California source combined report business income by its intrastate apportionment percentage to arrive at the taxpayer member's California source combined report business income.

(D) If the shareholder ratio calculated under section (b)(1)(A) or asset management services assigned under (b)(1)(B) of this regulation assign~~s~~ receipts to a state where no members of the mutual fund service provider's unitary group are taxable as defined in Section 25122, these receipts shall not be assigned to that state. Instead, these receipts shall be assigned to the location of the income producing activity that gave rise to the receipts, as determined under Revenue and Taxation Code section 25136.

(c) This regulation is applicable to taxable years beginning on or after January 1, 2007

Note: Authority cited: Section 19503, Revenue and Taxation Code.
Reference: Section 25137, Revenue and Taxation Code.

Supplemental Analysis of the Revenue Impact for Proposed Regulation Section 25137-14

At the December 18th, 2006, Franchise Tax Board (FTB) staff public hearing on proposed Regulation section 25137-14, William Hamm, of LECG, submitted, on behalf of Federated Investors, Inc., an alternative analysis of the revenue impact of this proposed regulation. He has subsequently submitted to the FTB on addendum to that analysis in January of 2007. Since the addendum contains an updated estimate, based on the same general methodology, I will refer, hereafter, to the analysis contained in Mr. Hamm's addendum. In that analysis Mr. Hamm determined that this regulation would result in a revenue loss of $106 million on an annual basis.

This number is different in magnitude, and is also negative, rather than positive, as compared to the estimate included in the Form 399 that FTB staff prepared for this proposed regulation. In that analysis, we determined that this regulation would have the impact of increasing state revenue by $10 million on an annual basis. Our analysis was based on a simulation of the impact of this regulation on a sample of tax returns filed by mutual fund service providers (MFSPs), both those located in California and located outside of California. For these returns, we compared the actual tax paid with a simulated calculation of the tax that would have been paid if sales were sourced based on location of customers instead of cost of performance. This approach, based on actual data from individual tax returns, is the preferred approach to estimating revenue impacts. When such tax return data are not available, other approaches can be used. However, these other approaches are generally considered to be methodologically inferior to the use of actual tax return information. We have carefully reviewed Mr. Hamm's analyses. We have also carefully reviewed our own analysis. Following are comments on the possible reasons for the differences between our analysis and those of Mr. Hamm.

Mr. Hamm's analysis was based on aggregate data for assets managed by MFSPs. In addition to this data, he used individual firm data for the amount of managed assets and pre-tax profit for a sample of MFSPs. These data were obtained from the Investment Company Institute and filings with the Securities and Exchange Commission (SEC). While the analysis in Mr. Hamm's addendum does show a substantial drop in his estimate of taxable income relative to the analysis he provided in December, his estimate of MFSP taxable income is still much higher, in aggregate, than the amounts being reported on California tax returns. One likely explanation for this difference is that his estimate of taxable income is derived from SEC information. The SEC information is based on book income. Since book income is calculated using different accounting rules than those used for tax accounting, there can be substantial differences between book income and income reported on tax returns.

A second difference between our analysis and the analyses of Mr. Hamm is that the tax rate on taxable income used by Mr. Hamm is greater than what we have observed on actual tax returns. Mr. Hamm uses the statutory rate of 8.84 percent. The rate that is actually paid by taxpayers can be lower than the statutory rate if a taxpayer has a stock of net operating loss carryovers, or has tax credits.

A third difference is that Mr. Hamm implicitly assumes that the sales factor, under current law, for every California-based MFSP is 100%. In fact, the actual sales factor percentage reported by California-based MFSPs is typically less than 100%. Similarly, Mr. Hamm implicitly assumes that the sales factor, under current law, for every out-of-state MFSP is zero, when, in fact, it tends to be slightly greater than zero. The net effect of the overstatement of the sales factor for California-based MFSPs and the understatement of the sales factor for out-of-state MFSPs is to overstate the revenue loss of this proposed regulation.

Finally, Mr. Hamm's analysis does not take into account, as did our analysis, the fact that the FTB has granted apportionment relief to some California-based MFSPs under current law. In our analysis we assume, based on discussions with our Legal Department, that relief would continue to be granted under current law. In his addendum, Mr. Hamm argues that our analysis makes asymmetric assumptions with respect to apportionment relief. He argues that, under the proposed regulation, out-of-state MFSPs would also be requesting apportionment relief. Mr. Hamm is correct to the extent that our analysis does not take into account any relief that may be provided to out-of-state MFSPs under this regulation. Furthermore, if such relief were sought and granted it would, as Mr. Hamm argues, have an impact on the revenue impact of this regulation. However, in discussions with our Legal Department, it was determined that it would be extremely unlikely that there would be conditions under which the granting of apportionment relief, under this regulation, to out-of-state MFSPs, would be warranted.

Summary

As mentioned above, the preferred approach to estimating the revenue impact of a change in law or a regulation is to use tax return information when available. We have presented several possible reasons why Mr. Hamm's estimates differ from ours in both magnitude and sign. We have carefully reviewed our own methodology and have not found a reason to change our previous conclusions.

STATE OF CALIFORNIA

ECONOMIC AND FISCAL IMPACT STATEMENT

(REGULATIONS AND ORDERS)

STD. 399 (Rev. 2-98)

See SAM Sections 6600 - 6680 for Instructions and Code Citations

DEPARTMENT NAME	CONTACT PERSON	TELEPHONE NUMBER
Franchise Tax Board	Colleen Berwick	(916) 845-3306
DESCRIPTIVE TITLE FROM *NOTICE REGISTER* OR FORM 400		NOTICE FILE NUMBER
Proposed Regulation 25137-14		Z

ECONOMIC IMPACT STATEMENT

A. ESTIMATED PRIVATE SECTOR COST IMPACTS *(Include calculations and assumptions in the rulemaking record.)*

1. Check the appropriate box(es) below to indicate whether this regulation:

- [X] a. Impacts businesses and/or employees
- [ ] b. Impacts small businesses
- [ ] c. Impacts jobs or occupations
- [ ] d. Impacts California competitiveness
- [ ] e. Imposes reporting requirements
- [ ] f. Imposes prescriptive instead of performance standards
- [ ] g. Impacts individuals
- [ ] h. None of the above *(Explain below. Complete the Fiscal Impact Statement as appropriate.)*

h. *(cont.)* ____________

(If any box in Items 1 a through g is checked, complete this Economic Impact Statement.)

2. Enter the total number of businesses impacted: 150 Describe the types of businesses *(Include nonprofits)*: Mutual Fund Service Providers and asset management service providers

Enter the number or percentage of total businesses impacted that are small businesses: negligible

3. Enter the number of businesses that will be created: 0 eliminated: 0

Explain: Proposal affects how businesses apportion income only.

4. Indicate the geographic extent of impacts: [X] Statewide [ ] Local or regional *(list areas)*: ____________

5. Enter the number of jobs created: 0 or eliminated: 0 Describe the types of jobs or occupations impacted: ____________

6. Will the regulation affect the ability of California businesses to compete with other states by making it more costly to produce goods or services here?

[ ] Yes [X] No If yes, explain briefly: ____________

B. ESTIMATED COSTS *(Include calculations and assumptions in the rulemaking record.)*

1. What are the total statewide dollar costs that businesses and individuals may incur to comply with this regulation over its lifetime? $ 0.00

a. Initial costs for a small business: $______ Annual ongoing costs: $______ Years: ______

b. Initial costs for a typical business: $______ Annual ongoing costs: $______ Years: ______

c. Initial costs for an individual: $______ Annual ongoing costs: $______ Years: ______

d. Describe other economic costs that may occur: ____________

ECONOMIC AND FISCAL IMPACT STATEMENT *cont. (STD. 399, Rev. 2-98)*

2. If multiple industries are impacted, enter the share of total costs for each industry: ______________________

3. If the regulation imposes reporting requirements, enter the annual costs a typical business may incur to comply with these requirements. *(Include the dollar costs to do programming, record keeping, reporting, and other paperwork, whether or not the paperwork must be submitted.)*: $__________

4. Will this regulation directly impact housing costs? ☐ Yes ☒ No If yes, enter the annual dollar cost per housing unit: $__________ and the number of units:__________

5. Are there comparable Federal regulations? ☐ Yes ☒ No Explain the need for State regulation given the existence or absence of Federal regulations: __________

Enter any additional costs to businesses and/or individuals that may be due to State - Federal differences: $__________

C. ESTIMATED BENEFITS *(Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.)*

1. Briefly summarize the benefits that may result from this regulation and who will benefit: This regulation proposes a less distortive and more fair method to apportion business income to California - See Statement I

2. Are the benefits the result of: ☐ specific statutory requirements, or ☒ goals developed by the agency based on broad statutory authority?

   Explain: See Statement II

3. What are the total statewide benefits from this regulation over its lifetime? $ See Statement I

D. ALTERNATIVES TO THE REGULATION *(Include calculations and assumptions in the rulemaking record. Estimation of the dollar value of benefits is not specifically required by rulemaking law, but encouraged.)*

1. List alternatives considered and describe them below. If no alternatives were considered, explain why not: The method contained in this regulation is the best approach for determining the situs of receipts of mutual fund service providers.

2. Summarize the total statewide costs and benefits from this regulation and each alternative considered:

Regulation:	Benefit: $ Negligible	Cost: $ Negligible
Alternative 1:	Benefit: $	Cost: $
Alternative 2:	Benefit: $	Cost: $

3. Briefly discuss any quantification issues that are relevant to a comparison of estimated costs and benefits for this regulation or alternatives: __________

4. Rulemaking law requires agencies to consider performance standards as an alternative, if a regulation mandates the use of specific technologies or equipment, or prescribes specific actions or procedures. Were performance standards considered to lower compliance costs? ☐ Yes ☒ No

   Explain: __________

E. MAJOR REGULATIONS *(Include calculations and assumptions in the rulemaking record.)*
Cal/EPA boards, offices and departments are subject to the following additional requirements per Health and Safety Code section 57005.

ECONOMIC AND FISCAL IMPACT STATEMENT *cont. (STD. 399, Rev. 2-98)*

1. Will the estimated costs of this regulation to California business enterprises exceed $10 million ? ☐ Yes (No) *(If No, skip the rest of this section)*

2. Briefly describe each equally as effective alternative, or combination of alternatives, for which a cost-effectiveness analysis was performed:

   Alternative 1: ____________________

   Alternative 2: ____________________

3. For the regulation, and each alternative just described, enter the estimated total cost and overall cost-effectiveness ratio:

Regulation:	$ Negligible	Cost-effectiveness ratio:	________
Alternative 1:	$ ________	Cost-effectiveness ratio:	________
Alternative 2:	$ ________	Cost-effectiveness ratio:	________

FISCAL IMPACT STATEMENT

A. FISCAL EFFECT ON LOCAL GOVERNMENT *(Indicate appropriate boxes 1 through 6 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years)*

☐ 1. Additional expenditures of approximately $________ in the current State Fiscal Year which are reimbursable by the State pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code. Funding for this reimbursement:

☐ a. is provided in (Item ________, Budget Act of ________) or (Chapter ________, Statutes of ________

☐ b. will be requested in the ________ (FISCAL YEAR) Governor's Budget for appropriation in Budget Act of ________.

☐ 2. Additional expenditures of approximately $________ in the current State Fiscal Year which are not reimbursable by the State pursuant to Section 6 of Article XIII B of the California Constitution and Sections 17500 et seq. of the Government Code because this regulation:

☐ a. implements the Federal mandate contained in ________

☐ b. implements the court mandate set forth by the ________

court in the case of ________ vs. ________

☐ c. implements a mandate of the people of this State expressed in their approval of Proposition No. ________ at the ________ (DATE) election;

☐ d. is issued only in response to a specific request from the ________

________, which is/are the only local entity(s) affected;

☐ e. will be fully financed from the ________ (FEES, REVENUE, ETC.) authorized by Section

________ of the ________ Code;

☐ f. provides for savings to each affected unit of local government which will, at a minimum, offset any additional costs to each such unit.

☐ 3. Savings of approximately $________ annually.

☐ 4. No additional costs or savings because this regulation makes only technical, non-substantive or clarifying changes to current law and regulations.

ECONOMIC AND FISCAL IMPACT STATEMENT *cont. (STD. 399, Rev. 2-98)*

[X] 5. No fiscal impact exists because this regulation does not affect any local entity or program.

[ ] 6. Other.

B. FISCAL EFFECT ON STATE GOVERNMENT *(Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)*

[ ] 1. Additional expenditures of approximately $________________in the current State Fiscal Year. It is anticipated that State agencies will:

[ ] a. be able to absorb these additional costs within their existing budgets and resources.

[ ] b. request an increase in the currently authorized budget level for the ______________fiscal year.

[ ] 2. Savings of approximately $___________________in the current State Fiscal Year.

[ ] 3. No fiscal impact exists because this regulation does not affect any State agency or program.

[X] 4. Other. See attached Statement III

C. FISCAL EFFECT ON FEDERAL FUNDING OF STATE PROGRAMS *(Indicate appropriate boxes 1 through 4 and attach calculations and assumptions of fiscal impact for the current year and two subsequent Fiscal Years.)*

[ ] 1. Additional expenditures of approximately $___________________in the current State Fiscal Year.

[ ] 2. Savings of approximately $___________________in the current State Fiscal Year.

[X] 3. No fiscal impact exists because this regulation does not affect any federally funded State agency or program.

[ ] 4. Other.

SIGNATURE S. Stanislau		TITLE Executive Officer
AGENCY SECRETARY [1] APPROVAL/CONCURRENCE		DATE 10/4/06
DEPARTMENT OF FINANCE [2] APPROVAL/CONCURRENCE	PROGRAM BUDGET MANAGER	DATE

1. *The signature attests that the agency has completed the STD. 399 according to the instructions in SAM sections 6600-6680, and understands the impacts of the proposed rulemaking. State boards, offices, or departments not under an Agency Secretary must have the form signed by the highest ranking official in the organization.*

2. *Finance approval and signature is required when SAM sections 6600-6670 require completion of the Fiscal Impact Statement in the STD. 399.*

ATTACHMENT FOR PROPOSED REGULATION SECTION 25137-14

Statement 1:

Under current California law, corporations apportion income to California based on the proportion of their total payroll, property, and sales that are located in California. Service providers, in general, are required to determine the situs of sales based on the location of the preponderance of the costs-of-performance (COP). The COP method does not fairly represent a taxpayer's sales in California for mutual fund service providers (MFSP) and asset management service providers (AMSP). For instance, a California MFSP that performs all of its management services in California, but has shareholders distributed nationwide, is required, under current law to source all of its sales to California. An out-of-state MFSP, on the other hand, that performs all of its management services outside of California is required, under current law, to source none of its service income to California. As a result, the California MFSP would have a higher sales factor, even if both MFSPs have identical income, geographical distributions of shareholders, and activities. In addition, many other states already adopted a different apportionment method that is based on the shares of the funds' shareholders residing in their states' shareholders ratios. Thus, the California MFSP may have more than 100% of its income sourced.

Due to the lack of fairness of the current apportionment method, a number of taxpayers had submitted petitions for tax relief in recent years. Their petitions had been granted. This situation sets up another level of unfairness, in that taxpayers who request relief are granted that relief, while similar taxpayers who do not request relief, do not get it.

Revenue and Taxation Code section 25137 authorized the Franchise Tax Board (FTB) to issue industry-specific regulations for exceptions to the general rules on apportioning income. The proposed regulation removes the lack of fairness of the current apportionment method by requiring the numerator of the sales factor of the MFSP and AMSP to be based on the California shareholders' ratios.

Statement 2:

Revenue and Taxation Code section 25137 authorizes the FTB to issue industry-specific regulations for exceptions to the general rules on apportioning income.

Statement 3:

This proposed regulation is intended to provide a better apportionment method for the MFSP and AMSP. Under this proposed apportionment method, some taxpayers would have lower sales factors, while others would have higher ones. After accounting for the fact that some taxpayers are already being granted tax relief, the net revenue impact of this proposed regulation is estimated to be a revenue gain of about $10 million per year.