LAW OFFICES OF
NIELSEN, MERKSAMER, PARRINELLO, MUELLER & NAYLOR, LLP
A LIMITED LIABILITY PARTNERSHIP INCLUDING A PROFESSIONAL CORPORATION

MARIN COUNTY
591 REDWOOD HIGHWAY, #4000
MILL VALLEY, CALIFORNIA 94941
TELEPHONE (415) 389-6800
FAX (415) 388-6874

770 L STREET, SUITE 800
SACRAMENTO, CALIFORNIA 95814
TELEPHONE (916) 446-6752
FAX (916) 446-6106

SAN FRANCISCO
TWO EMBARCADERO CENTER, SUITE 200
SAN FRANCISCO, CALIFORNIA 94111
TELEPHONE (415) 389-6800
FAX (415) 388-6874

March 4, 2002

The Honorable Kathleen Connell
California State Controller
c/o Franchise Tax Board
9645 Butterfield Way
Sacramento, California 95827

Re: Opposition to Legislative Proposal 02-34

Dear Ms. Connell:

On behalf of a coalition of banks which would face a retroactive tax increase under Legislative Proposal 02-34, we respectfully urge the Franchise Tax Board to oppose the proposal as presented by staff.

The simple summary is that California law has been quite clear in excluding from corporate taxable income the dividends paid by a Registered Investment Company (RIC) to a California corporate shareholder that is unitary with the RIC. This is in contrast to the explicit provisions relating to intercorporate dividends paid by a real estate investment trust (REIT)(which are not excluded).

In reliance on that difference, and in full compliance with the letter of the law, a number of banks have established investment portfolios in controlled subsidiaries as a favored step in the process of raising core capital. Increasing core capital is an essential step in increasing a bank's lending capacity under federal banking regulations (for every dollar increase in core capital, a bank may lend as much as 20 additional dollars).

Legislative Proposal 02-34 would not only eliminate the dividend exclusion but would declare that rule to be operative beginning nine years ago, thus retroactively subjecting to taxation dividends from RICs which were established in reliance on current law.

We oppose this proposal on several grounds:

1. End run of tax audit and assessment process. If the FTB believes a taxpayer is not accurately reporting its income, there is a process for assessing additional taxes and for the taxpayer to dispute that assessment. SB 1660 attempts to have the Legislature intervene in that process with a "restatement of existing law." This, along with the retroactivity, would set a pernicious precedent in California tax policy.

2. Not a "restatement of existing law." The proposed change is clearly a change of law, since it adds references to three additional code sections to "modify" the tax treatment in Internal Revenue Code section 854. There is no way that these new references could be "read into" the law before the proposed change. In fact, the Legislature explicitly changed the REIT section (Rev. and Tax Code section 24782) to include these references in the same bill that simultaneously amended the RIC section in other ways(section 24781)(see chapter 878, 1993 Regular Session). The inference is the Legislature intended not to adopt the policy now being proposed as a mere clarification.

3. Retrospective application violates due process. We can provide detailed legal opinions to this effect. In sum, because the Legislature did not take prompt action (the substance of section 24781(e) has been untouched since 1989), and because there has been significant reliance on this section in establishing RICs and allocating assets for capital formation purposes, the proposal would not survive the tests of the U.S. Supreme Court barring "harsh and oppressive" retroactivity as a violation of the Due Process Clause.

4. Other states follow current policy. Many states, including New York (contrary to the staff analysis), allow RICs to deduct dividends paid in calculating RIC taxable income and further allow corporate shareholders to deduct some or all of the dividends received from a RIC when calculating their state corporate taxable income.

In sum, we urge the Franchise Tax Board to drop this proposal because it misrepresents itself as a clarification of existing law and in fact represents a tax increase which is questionable public policy if prospective and a violation of due process if applied retrospectively.

Please feel free to contact me at (916)446-6752 if you have any questions concerning this matter.

Sincerely,

Robert W. Naylor

cc: John Chiang
Tim Gage