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Keeping California Competitive Chapter 4: A Tax Break for Foreign Mutual Fund Corporations

Karen Vassilian

Code Section Affected
Revenue and Taxation Code § 23040.1 (amended).
SB 1239 (Burton); 2000 STAT. Ch. 4

I. INTRODUCTION

Incentive for foreigners, as well as Americans, to invest in United States financial markets is high.[1] Because of the high risks associated with investing in stocks, much attention has turned toward mutual funds.[2] Mutual funds are a portfolio of stocks created by investment companies that combine money from many investors and buy diverse securities on their behalf.[3]

Generally, the attraction to mutual funds can be attributed to their less risky nature.[4] For the individual investor, the risk of investing decreases because the investor's money, which is pooled with other investors' money, has much greater purchasing power and can contribute to the purchase of many diverse stocks.[5] This allows for increased security, because if one or two stocks plunge, the loss is commonly offset by gain in other stocks.[6] For the investment companies, the reduced risk comes in a different form.[7] Generally, mutual funds created by

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1. *See Welcome to Mutuals.com, available at* http://www.1800mutuals.com/pub/company/main.asp (last visited Aug. 18, 2000) (copy on file with the *McGeorge Law Review*) (noting that their Internet brokerage firm tracks and monitors all 10,600 mutual funds in the United States). *See also* Tim Quinson, *Pitch is Renewed for Foreign Funds*, CHI. SUN-TIMES, Jan. 4, 1999, at 44 (comparing the 17.3% annual rate increase of United States mutual funds with the low 7.3% increase of foreign funds over the last five years, but mentioning that in 1998 the gap between foreign and United States funds decreased with the average United States stock fund gaining 11.7% versus the foreign fund at 10.7%).
2. *See* Bill Barker, *The Truth About Mutual Funds, available at* http://www.fool.com/school/mutualfunds/basics/intro.htm (last visited Nov. 19, 2000) (copy on file with the *McGeorge Law Review*) (explaining how "buying a mutual fund provides instant holdings in several different companies, giving a level of stability to [an] investment").
3. ALBERT J. FREDMAN & RUSS WILES, HOW MUTUAL FUNDS WORK 6 (1993).
4. *Infra* note 5 and accompanying text.
5. *See* FREDMAN & WILES, *supra* note 3, at 10 (comparing the low risk in investing in mutual funds versus the higher risk of investing in individual stocks and explaining that this low risk nature of a mutual fund comes mainly from the fact that mutual funds are so diversified). Since "all of the investors eggs are not put into one basket", the investor has a greater chance of making money on his investment. *Id.*
6. Barker, *supra* note 2 and accompanying text.
7. *Infra* note 8 and accompanying text.

domestic investment companies act as 'pass through' vehicles.[8] In other words, taxes on the income of the funds are 'passed through' to the individual investors, and the fund itself is not taxed.[9] This reduces the burden and cost of creating and maintaining a mutual fund, which would otherwise be too great for many investment companies.[10] Although United States funds have always been able to enjoy freedom from federal and state taxation, foreign fund companies have not always been afforded this same advantage.[11] Until 1997, foreign fund companies managed in the United States paid federal income tax on their funds.[12] In 1997, when the federal government passed the Taxpayer Relief Act, foreign investment corporations managed in the United States were finally afforded the same federal tax treatment as American investment companies.[13] Although the burden was partly reduced by this exemption, the incentive for foreign corporations to manage their funds in the United States was still minimal, since they continued to be subject to state taxes.[14] Viewing this as an opportunity, a few states reacted quickly by enacting legislation exempting such investment corporations from state taxes.[15] California joins these states with the enactment of Chapter 4, exempting foreign investment corporations

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8. *See* WILLIAM J. BAUMOL ET AL., THE ECONOMICS OF MUTUAL FUND MARKETS: COMPETITION VERSUS REGULATION 15 (1990) (explaining that so long as these domestic investment "companies distribute at least 90 percent of their pre-tax income, they are allowed to pass the pretax income on to shareholders, avoiding the double taxation to which most corporations are subject").

9. *Id.*

10. *See* CHARLES SCHWAB, INC., PROPOSED FRANCHISE TAX LEGISLATION RELATING TO MUTUAL FUND COMPANIES 1 (arguing that if foreign fund companies continue to be taxed in California, they will choose instead to manage their funds from states such as New York and Massachusetts which do not tax foreign fund companies separately); *see also* FRANCHISE TAX BOARD ANALYSIS OF SB 1239, at 2 (Apr. 2, 1999) (explaining how the federal government enacted the Taxpayer Relief Act of 1997, providing tax exemptions for foreign fund companies in order to "promote increased investment in United States capital markets").

11. *See* Letter from Alan Stevenson, Vice President of Taxation, Charles Schwab Inc., to Senator Wesley Chesbro at 1 (Mar. 31, 1999) [hereinafter Stevenson Letter] (copy on file with the *McGeorge Law Review*) (explaining the "pass through" nature of mutual funds and how this benefit is enjoyed by domestic fund companies but was not granted by the federal government to foreign fund companies until January 1998); INT. REV. CODE § 7701(a)(5) (West 2000) (defining a foreign corporation as a non-United States corporation, organized under the laws of a foreign country). Generally, foreign corporations are taxed by the federal government on all income that is effectively connected with a trade or business in the United States. *Id.*; *see also* INT. REV. CODE § 864 (b)(2)(A)(ii) (West 1988) (noting that prior to January 1, 1998, a foreign corporation whose sole purpose in the United States was to trade securities for its own account was exempt from taxation on income derived from such trading, so long as the corporation did not have its principle office within the United States); TREAS. REG. § 1.864-2(c)(2)(iii) (indicating that although "principle office" was not defined in the Code, if most of the administrative functions of the company were performed outside of the United States, then the company was not deemed to have a principle office in the United States); TREAS. REG. § 1.864-2(c)(2)(iii) (listing the ten administrative functions, known as the ten commandments, that should not be carried out in the office located in the United States).

12. INT. REV. CODE § 864(b)(2)(A)(ii) (West 1988).

13. *See id.* (effective January 1, 1998, by the Taxpayer Relief Act of 1997, and deleting any discussion of principal office, thus allowing foreign corporations to manage their funds in the United States, without being taxed on the income they gain through trading of securities).

14. *See* Stevenson Letter, *supra* note 11, at 1 (explaining that after the change in the federal law, a few states decided to change their laws and allow for the same tax exemption).

15. *See infra* note 37 and accompanying text (identifying New York, Massachusetts and Connecticut as the states which enacted such legislation).

from California state taxes.[16] Chapter 4 will hopefully serve to attract and keep big businesses in California by offering attractive tax exemptions for foreign investment corporations.

II. LEGAL BACKGROUND

The catalysts for Chapter 4 were the recently enacted federal Taxpayer Relief Act and the California tax exemption for investment partnerships.[17] Prior to the Taxpayer Relief Act, there was a federal tax exemption for foreign corporations not engaged in a trade or business in the United States, but who received income from trading securities in the Unites States for their own account.[18] The tax exemption only applied if the foreign corporation did not maintain its principal office in the United States.[19] The Taxpayer Relief Act loosened these requirements, allowing foreign investment groups to maintain an office anywhere in the United States without being subject to federal income tax.[20] The Act, however, is limited only to corporations and not partnerships.[21] Thus, when California enacted the tax exemption for investment partnerships, a company falling within the scope of one exemption did not fall under the other.[22] For example, a foreign corporation investing in American stocks would have been subject to California state tax and exempt from federal tax, while a foreign investment partnership would have been subject to federal tax but exempt from California tax. Foreign fund companies that were not fully exempt under both state and federal laws grew discontent.[23] Much like previous tax exemptions enacted by the California Legislature, Chapter 4 was adopted when the threat of brokerage firms fleeing the state and conducting their securities business elsewhere came close to reality.[24] The Legislature's objective was

16. SENATE RULES COMMITTEE, COMMITTEE ANALYSIS OF SB 1239, at 4 (Feb. 15, 2000) (indicating that California brokerage firms have threatened to leave California, and without enactment of this bill, will be forced to open offices in other states). *See* CHARLES SCHWAB, INC., PROPOSED FRANCHISE TAX LEGISLATION RELATING TO MUTUAL FUND COMPANIES (noting that California brokerage firms such as Schwab gain business from foreign investment corporations that invest through their firms). But such corporations will not do so if they can invest in another state that will not tax them. *Id.*

17. *See* FRANCHISE TAX BOARD, ANALYSIS OF SB 1239, at 4 (Apr. 2, 1999) (noting that enactment of Chapter 4 "would essentially conform California law to federal law") the federal law being the Taxpayer Relief Act; *see id.* (stating that policy considerations for this bill include giving similar treatment to both investment partnerships, which are already afforded this treatment, and to foreign investment corporations).

18. INT. REV. CODE § 864 (b)(2)(A)(ii) (West 1988).

19. *Id.*

20. INT. REV. CODE § 864 (b)(2)(A)(ii)

21. *See* ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF SB 1239, at 1 (June 23, 1999) (mentioning that under federal law, these foreign businesses receiving the tax exemption must be formed as corporations for federal tax purposes).

22. REV.& TAX. CODE § 23040.1 (amended by Chapter 4).

23. *Supra* note 10 and accompanying text.

24. *See* SENATE REVENUE & TAXATION COMMITTEE, COMMITTEE ANALYSIS OF SB 1239, at 3 (Mar. 24, 1999) (discussing the California Legislature's history of granting special tax treatment when big businesses threatened to move; including tax exemptions for international banking facilities, bunker fuel, and investment

to ensure that jobs and opportunities created by brokerage firms and foreign fund businesses would remain in California.[25]

III. CHAPTER 4

Chapter 4 conforms California law to the recently enacted Federal Taxpayer Relief Act and provides corporations with treatment similar to that given to partnerships.[26] Specifically, this legislation applies to investment corporations whose sole activity in California is trading securities for their own account.[27] The California law exempts them from taxation on the income derived from selling securities, and applies whether or not the corporation maintains a principle office in California.[28] However, Chapter 4 does not apply to dealers in stocks and securities.[29] Thus, if a corporation is not a dealer in stocks or securities but invests in them for its own account, any gain from such an investment is not deemed "income derived from or attributable to California sources."[30] Chapter 4 uses this language in order to avoid taxation under either the Corporate Franchise Tax or the Corporate Income Tax.[31] The Corporate Franchise Tax applies to corporations "doing business" in California.[32] Because Chapter 4 clearly states that a foreign corporation whose sole purpose in California is trading stocks and securities is not "doing business," such corporations would undoubtedly be exempt from the Corporate Franchise Tax.[33] The Corporation Income Tax applies to corporations that are "not doing business" in California but which derive income from California sources.[34] Although a corporation whose sole activity is trading securities may not be "doing business" in California, it may be gaining income from California sources; thus, it would remain

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partnerships).

25. *See* SENATE THIRD READING, ANALYSIS OF SB 1239, at 2 (May 31, 2000) (stating that the enactment of Chapter 4 would allow California to be competitive and keep businesses that would otherwise go to Massachusetts and New York, in California).

26. *See supra* note 17 and accompanying text.

27. REV. & TAX CODE § 23040.1 (amended by Chapter 4).

28. *See* REV. & TAX. CODE § 23040.1 (a)(2) (amended by Chapter 4) (stating that the trading can be done either by the "corporation, employees, or through a resident broker, commission agent, or custodian").

29. *Id*; *see also* INT. REV. CODE § 475(c)(1) (West 2000) (defining a dealer in securities as a "taxpayer who (A) regularly purchases from or sells securities to customers in the ordinary course of trade or business; or (B) regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business").

30. REV. & TAX. CODE § 23040.1(a).

31. FRANCHISE TAX BOARD, ANALYSIS OF SB 1239, at 3-4 (Apr. 2, 1999).

32. *See id.* at 4 (stating that "doing business" is defined in the code as "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit"). A foreign investment corporation trading securities in California would likely fall under this definition if Chapter 4 was not enacted. *Id.*

33. REV. & TAX. CODE § 23040.1(c) (amended by Chapter 4).

34. *See* FRANCHISE TAX BOARD, ANALYSIS OF SB 1239, at 4 (Apr. 2, 1999) (explaining that even if a corporation is not organized in or qualified to do business in California, it may still be subject to an 8.84 % corporation income tax just for income received from California sources).

subject to the 8.84% tax absent the enactment of Chapter 4.[35] With the enactment of Chapter 4, these investment corporations are not only exempt from any income tax in California but are also exempt from the Federal Income Tax, making California as competitive as states with similar legislation.[36]

IV. SIMILAR LEGISLATION ENACTED IN OTHER STATES

Apart from California's desire to attract foreign investment, the driving force behind the enactment of Chapter 4 was the adoption of similar legislation in New York, Massachusetts, and Connecticut.[37] A corporation trading millions of dollars, faced with the decision of trading in California with an 8.84% income tax or in New York with an exemption from all income tax, would most likely choose New York.[38] Even a state such as Massachusetts, charging a minimum excise tax of $456, is preferable over a state that bases taxation on the percentage of income gained.[39] To stay competitive with these states, California enacted Chapter 4, granting total tax exemptions to investment corporations whose sole activity in California is trading securities.[40]

V. ANALYSIS OF CHAPTER 4

Chapter 4 has not been very controversial.[41] It simply conforms California law to the federal law and grants the same treatment to foreign investment corporations that has been given to non-California investment partnerships.[42] Because Chapter 4 is very similar to both federal law and the state investment partnership exemption, and is practically duplicative of laws passed in other states, the support for Chapter 4 has been unanimous.[43] The majority of support for Chapter 4 has come from its

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35. *Id.*

36. *See* SENATE THIRD READING, ANALYSIS OF SB 1239, at 2 (May 31, 2000) (stating that the enactment of Chapter 4 would allow California to be competitive and keep business that would otherwise go to Massachusetts and New York, in California).

37. *See* NEW YORK TAX LAW § 209(2)(a) (West Supp. 2000) (amending prior corporation tax provisions and granting state tax exemptions for foreign mutual funds); *see also* MASS. TAX CODE, G.L. c. 63 § 38B (West Supp. 2000) (giving security corporation classification and a tax exemption to foreign corporations engaged exclusively in trading of securities on their own behalf but still subjecting them to a minimum excise tax of $456 dollars); CONN. GEN. STAT. ANN. § 12-214 (West 2000) (granting a similar tax exemption to Chapter 4).

38. *See* FRANCHISE TAX BOARD, ANALYSIS OF SB 1239, at 5 (Apr. 2, 1999) (stating that without this legislative exemption from taxation of foreign funds, such funds would not be managed from California).

39. *See* MASS. TAX CODE, G.L. c. 63 § 38B (West Supp. 2000) (giving security corporation classification and a tax exemption to foreign corporations engaged exclusively in trading of securities on their own behalf but still subjecting them to a minimum excise tax of $456 dollars).

40. *Supra* note 16 and accompanying text.

41. *Infra* note 43 and accompanying text.

42. *Supra* note 17 and accompanying text.

43. *See* SENATE RULES COMMITTEE, COMMITTEE ANALYSIS FOR SB 1239, at 4 (Feb. 15, 2000) (indicating that there are no arguments in opposition to the bill); ROLL CALL, SENATE FLOOR, at 1 (Mar. 13, 2000); ROLL CALL, ASSEMBLY FLOOR, at 1 (Feb. 28, 2000). *See supra* note 37 and accompanying text (discussing the enactment of

sponsor, Charles Schwab, Inc.[44] Since Schwab is a major stock brokerage firm, headquartered in San Francisco, it has a great interest in managing foreign funds in California, rather than New York, Connecticut or Massachusetts.[45] If California did not offer a tax exemption, Schwab indicated a willingness to leave California and open up offices in other states to remain competitive.[46] If Schwab was forced to relocate, the loss of employment would be a great disadvantage to California.[47] Hence, California has a big incentive to offer foreign investment companies tax exemptions, in hopes of drawing more business into California and keeping brokerage firms, such as Schwab, from departing.[48]

Apart from the advantages of keeping businesses in California, Chapter 4 will likely have a negligible fiscal impact on the state.[49] Prior to Chapter 4, foreign investment companies avoided operating in California since no tax incentive was offered to them.[50] Because foreign mutual funds were not actively managed in California, the state did not profit from taxation of foreign investors.[51] Thus, California will not lose revenue from repealing the tax.[52] California, however, does stand to benefit from Chapter 4, by attracting foreign funds to California and keeping brokerage firms within the state.[53] The benefits will come in the form of employment opportunities created by foreign fund management in California.[54]

Despite the benefits and unanimous support for the tax exemption, Chapter 4 has received slight criticism. The Department of Finance has expressed concern that it may favor foreign corporations, by giving them a tax advantage; thus, disfavoring non-California domestic investment corporations.[55] Although Chapter 4 will not have much of an effect on domestic investment corporations located in states with

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similar laws in New York, Massachusetts and Connecticut).

44. *See* SENATE RULES COMMITTEE, COMMITTEE ANALYSIS FOR SB 1239, at 4 (Feb. 15, 2000) (explaining that all California brokerage firms would benefit from the passage of this legislation, but only naming Charles Schwab, Inc. as the sponsor)

45. *See* Stevenson letter, *supra* note 11, at 1 (stating that Charles Schwab has over 5,000 California employees and operates 66 branches in the state).

46. *See* SENATE RULES COMMITTEE, COMMITTEE ANALYSIS FOR SB 1239, at 4 (Feb. 15, 2000) (noting that Schwab, the only sponsor, has indicated that it would leave California and open offices in other states with similar legislation already implemented).

47. *See* FRANCHISE TAX BOARD, ANALYSIS OF SB 1239, at 5 (Apr. 2, 1999) (noting that, because of the large number of people employed and branches owned in California, any relocation of Schwab offices would harm the state and the Schwab employees that live there).

48. *Id.*

49. *Id.*

50. *See* SENATE RULES COMMITTEE, COMMITTEE ANALYSIS FOR SB 1239, at 4 (Feb. 15, 2000) (arguing that without a tax exemption, foreign investment corporations will not conduct business in California).

51. FRANCHISE TAX BOARD, ANALYSIS OF SB 1239, at 5 (Apr. 2, 1999).

52. *Id.*

53. SENATE THIRD READING, ANALYSIS OF SB 1239, at 2 (May 31, 2000).

54. *See* SENATE RULES COMMITTEE, COMMITTEE ANALYSIS FOR SB 1239, at 4 (Feb. 15, 2000) (explaining that if the California legislature chooses not to enact Chapter 4, California will lose jobs and opportunities that foreign funds will bring with them).

55. *See* DEPARTMENT OF FINANCE, ANALYSIS OF SB 1239, at 1 (Apr. 5, 1999) (questioning whether this bill would be interpreted by other states in a negative way).

similarly enacted legislation, domestic investment corporations in states without such legislation might be at a disadvantage.[56]

VI. CONCLUSION

If the year 2000 was any indicator of what is to come ahead, then most likely foreign corporations will continue to invest in American stocks.[57] Hence, states continuing to tax these corporations will continue to be at a disadvantage.[58] With the enactment of Chapter 4, California has given itself a competitive edge over 46 other states.[59] Hopefully, that competitive edge will serve to keep California brokerage firms, and the employment they provide, within the State.[60]

56. *Id.*

57. *See* Thomas S. Mulligan, *Wall Street, California: Foreign Funds Remain in Good Stead Despite Shaky First Half*, L.A. TIMES, July 11, 2000, at C6 (contrasting the United States fund market with foreign funds, and noting that the foreign stock mutual fund had a net loss of 4.6 % in the first half of the year 2000; while, the domestic diversified stock fund gained 3.7 %).

58. *See Charles Schwab, Inc., supra* note 10 and accompanying text (indicating that investment in the United States and in California could decrease without the passage of Chapter 4 and similar legislation).

59. *See supra* Part IV (noting that California has joined the ranks of New York, Massachusetts and Connecticut with the passage of Chapter 4).

60. *Supra* note 25 and accompanying text.

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