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McGinley
cc: Smith
Sandusky, Legal

September 26, 1997

Via Telecopy (717) 772-1459 and U.S. Express Mail
Ms. Anita M. Doucette
Office of Chief Counsel
Pennsylvania Department of Revenue
Department 281061
Harrisburg, PA 17128-1061

Re: Notice of Proposed Rulemaking In August 30, 1997
Pennsylvania Bulletin With Respect to Reg.
§§103.12 and 155.30 - Definition of Net Profits
and Franchise Tax on Regulated Investment
Companies

Dear Ms. Doucette:

I would like to take this opportunity to comment on and express opposition to certain of the proposed changes to regulations published in the August 30, 1997 edition of the Pennsylvania Bulletin, and, in particular, the proposed changes to Reg. §103.12 dealing with "net profits" and Reg. §155.30 dealing with the capital stock/franchise tax on regulated investment companies. This firm represents numerous regulated investment companies currently paying the alternate capital stock/franchise tax which would be affected by the proposed changes to these regulations. It is submitted that the proposed changes not only violate the statutory provisions of Pennsylvania law they purport to interpret, but constitute bad tax policy that will discourage growth in this business sector.

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Overview

The proposed changes to the regulations are apparently designed to affect the taxation of regulated investment companies (also known as "mutual funds"). The principle Pennsylvania business tax on regulated investment companies is the alternate capital stock/franchise tax set forth in the Pennsylvania Tax Reform Code (the "TRC") at §602(f). Section 602(f) provides as follows:

Every domestic corporation and every foreign corporation (i) registered to do business in Pennsylvania; (ii) which maintains an office in Pennsylvania; (iii) which has filed a timely election to be taxed as a regulated investment company with the Federal government; and (iv) which duly qualifies to be taxed as a regulated investment company under the provisions of the Internal Revenue Code of 1954, as amended, shall be taxed as a regulated investment company and shall be subject to the capital stock or franchise tax imposed by section 602, in either case, for the privilege of having an office in Pennsylvania, which tax shall be computed pursuant to the provisions of this subsection in lieu of all other provisions of this section 602. The tax shall be in an amount which is the greater of three hundred dollars (\$300) or the sum of the amounts determined pursuant to clauses (1) and (2):

(1) The amount determined pursuant to this clause shall be seventy-five dollars (\$75) times that number which is the result of dividing the net asset value of the regulated investment company by one million, rounded to the nearest multiple of seventy-five dollars (\$75). Net asset value shall be determined by the adding the monthly net asset values as of the last day of each month during the taxable period and dividing the total sum by the number of months involved. Each such monthly net asset value shall be the actual market value of all assets owned without any exemptions or exclusions, less all liabilities, debts and other obligations.

(2) The amount determined pursuant to this clause shall be the amount which is the result of multiplying the rate of taxation applicable for purposes of the personal income tax during the

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same taxable year times the apportioned undistributed personal income tax income of the regulated investment company. For the purpose of this clause:

(A) Personal income tax income shall mean income to the extent enumerated and classified in section 303.

(B) Undistributed personal income tax income shall mean all personal income tax income other than personal income tax income undistributed on account of the capital stock or foreign franchise tax, less all personal income tax income distributed to shareholders. At the election of the company, income distributed after the close of a taxable year, but deemed distributed during the taxable year for Federal income tax purposes, shall be deemed distributed during that year for purposes of this clause. If a company in a taxable year has both current income and income accumulated from a prior year, distributions during the year shall be deemed to have been made first from current income.

(C) Undistributed personal income tax income shall be apportioned to Pennsylvania by a fraction, the numerator of which is all income distributed during the taxable year to shareholders who are resident individuals, estates or trusts and the denominator of which is all income distributed during the taxable period. Resident trusts shall not include charitable, pension or profit-sharing, or retirement trusts.

(D) Personal income tax income and other income of a company shall each be deemed to be either distributed to shareholders or undistributed in the proportion each category bears to all income received by the company during the taxable year.

Thus, the tax is comprised of two components, one computed on the basis of \$75 per million of net asset value, and one computed on the basis of "apportioned undistributed personal income tax

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income." The proposed regulations apparently relate to the undistributed personal income tax income portion of the tax.

The statute provides that "personal income tax income" means income to the extent enumerated and classified in §303 of the IRC. Those classes of income consist of (i) compensation, (ii) net profits, (iii) net gains from the disposition of property, (iv) net gains or income from or in the form of rents, royalties, patents and copyrights, (v) dividends, (vi) interest, (vii) gambling and lottery winnings other than prizes of the Pennsylvania State Lottery, and (viii) net gains derived through estates.

At present, regulated investment companies that are subject to the tax categorize their personal income tax income as "net profits" and that categorization has, as discussed below, been established as correct by both the Board of Finance and Revenue and the Board of Appeals in several cases addressing the issue, and has been accepted by the Department of Revenue as correct in the settlement of corporate tax reports of regulated investment companies. The proposed changes to the regulations appear to attempt to change this result by treating regulated investment companies as individuals (rather than as corporations) and to require that personal income tax income only be comprised of the categories of income consisting of interest, dividends and gains.

The Proposed Regulatory Changes Do Not Fairly or Legally Interpret the Statute

The attempt to artificially classify regulated investment companies as individuals is clearly inconsistent with the statutory provisions the regulations purport to interpret. The taxing statute in question -- the capital stock/franchise tax -- only applies to taxpayers classified as corporations. In order for such taxpayers to be subject to the tax, they must be "doing business" in Pennsylvania.

Regulated investment companies subject to the capital stock/franchise tax must therefore be engaged in business activities in Pennsylvania.¹ As such, their income is necessarily characterized as "net profits."

¹ For federal income tax purposes, Internal Revenue Code §852 contemplates that regulated investment companies fall within the scope of taxation as corporations and therefore compute their taxable income taking into account appropriate deductions for expenses.

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Section 303(a)(2) of the TRC (72 P.S. §7303(a)(2)) defines net profits as follows:

Net profits. The net income from the operation of a business, profession, or other activity, after provision for all costs and expenses incurred in the conduct thereof, determined either on a cash or accrual basis in accordance with the accepted accounting principles and practices but without deduction of taxes based on income.

As indicated above, the Board of Finance and Revenue has established that the appropriate characterization of income of a regulated investment company for purposes of computing "undistributed personal income tax income" is net profits and further determined that it is appropriate that a deduction be permitted for business expenses. That determination was set forth in the conclusions of law in numerous cases and was first expressed in the Interlocutory Order ("Order") mailed on December 16, 1994, by the Board of Finance and Revenue, Docket No. 25416, in In Re: Valley Forge Fund, Inc.²

The Board of Finance and Revenue concluded in Valley Forge Fund, Inc. that:

...[T]he "personal income tax income" to be used in calculating the second portion of ...[a regulated investment company's] capital stock tax is...[the regulated investment company's] net profit from the operation of its business. Not allowing the deduction of business expenses, in effect, means using gross income in the franchise tax calculation. The definitions of "income" and "net profits" applied to the statute at 72 P.S. §7602(f) does not support the use of gross income in this calculation. See 72 P.S. §7301(g); also see 72 P.S. §7303(2). Therefore,...[a regulated investment company's] personal income tax income portion of its capital stock tax is zero....

Of course, to the extent that a regulated investment company does not distribute all of its income, it will have a liability for the tax on apportioned undistributed personal income tax income.

² It should be noted that the Commonwealth of Pennsylvania (through the Department of Revenue) withdrew its Commonwealth Court appeal of the Order.

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On the basis of the foregoing, it is submitted that the proposed changes to the regulations, consisting, in particular, to the proposed changes reflected by the addition of subsection (c) to regulation 103.12 and all of the proposed changes to regulation 155.30, do not represent a fair or legal interpretation of the statute.

It should also be noted that most of the incorporated regulated investment companies subject to §602(f) of the TRC are foreign corporations. Thus, in order to be taxable in the Commonwealth at all, those entities must be doing business in the Commonwealth. If so, as indicated above, the appropriate category of income for purposes of determining personal income tax income is necessarily net profits.

By attempting to characterize regulated investment companies as individuals, the proposed regulations purport to establish that such entities are not doing business in the Commonwealth (and are not therefore deriving "net profits"). It is submitted that if such is the case, the taxpayers are not subject to Pennsylvania business taxes at all and have no tax filing requirements in the Commonwealth. That is because most if not all of such regulated investment companies have no tangible assets nor employees. The only assets are intangibles which, under these circumstances, would likely have as their situs the state of the taxpayers' incorporation. That being the case, there is no taxable nexus to Pennsylvania. Thus, the proposed changes to the regulations put the Commonwealth at risk for losing the revenue currently generated by the tax.

The Proposed Regulations Are Bad Tax Policy

Perhaps as important as the legal issues discussed above is the fact the taxation of regulated investment companies, and the position of the Commonwealth represented by the proposed changes to the regulations, constitutes bad tax policy. Pennsylvania is virtually the only state that imposes any significant amount of corporate level taxes on regulated investment companies. Regulated investment companies are provided with tax favored (flow-through) status for federal income tax purposes and in nearly every state (including New York, New Jersey, Delaware and Maryland) because they facilitate a strong social purpose by encouraging investment and enabling

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investors to achieve professional management of their assets and diversification of risk.³

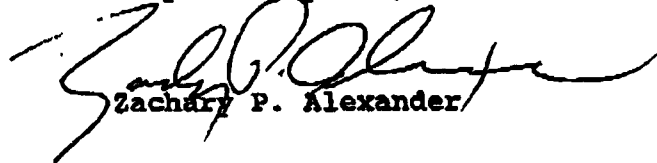
Taxation of regulated investment companies in Pennsylvania creates a chilling environment for such business. The management, distribution and administrative activities associated with the operation of regulated investment companies are significant and require the employment of substantial numbers of people. It is submitted that this type of service business is precisely the type of business that the Commonwealth should be trying to attract.

* * *

As discussed above, there are compelling legal and policy reasons why the Department of Revenue should withdraw the proposed changes to the regulations discussed herein.

Thank you for the opportunity to provide input on this matter. If you have any questions or comments, please do not hesitate to contact me.

Very truly yours,



Zachary P. Alexander

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³ Shareholders are generally taxable on the income from regulated investment companies.