# PROPOSED MASSACHUSETTS TAX EXPENDITURES
# EVALUATION SUMMARY

## EVALUATION YEAR: 2021-2022

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| **TAX EXPENDITURE TITLE** | Exemption for Regulated Investment Companies |
| **TAX EXPENDITURE NUMBER** | 2.703 |
| **TAX EXPENDITURE CATEGORY** | Entity exempt from taxation |
| **TAX TYPE** | Corporate & business excise tax |
| **LEGAL REFERENCE** | M.G.L. c. 63, § 68C(8); MG.L. c. 63, § 30 |
| **YEAR ENACTED** | July 1, 1992 (1992 Acts c. 133, § 398) |
| **REPEAL/EXPIRATION DATE** | None |
| **ANNUAL REVENUE IMPACT** | $400 million to $502 million annually. |
| **NUMBER OF TAXPAYERS** | Not available |
| **AVERAGE TAXPAYER BENEFIT** | Not available |

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| **Description of the Tax Expenditure:**<br>Regulated Investment Companies (RICs), also known as mutual funds, are investment vehicles that are eligible for favored tax treatment for federal tax purposes. Specifically, unlike most ordinary corporations, RICs may deduct dividends they pay to their shareholders for federal tax purposes. See Internal Revenue Code (the "Code") § 851. Massachusetts does not conform to the federal tax treatment of RICs, but in Massachusetts RICs are fully exempt from both the income and non-income measures of the corporate excise. | **Is the purpose defined in the statute?**<br>The statute does not explicitly state the purpose of this tax expenditure. |
| **What are the policy goals of the expenditure?**<br>DOR assumes that the tax expenditure is intended to promote the mutual fund industry and encourage investment, and to avoid taxing mutual fund income at both the entity and shareholder levels. | **Are there other states with a similar Tax Expenditure?**<br>Most states that impose a corporate income tax follow the federal tax treatment of RICs (i.e., they allow a deduction for dividends paid). These states include California, Connecticut, Maine, New Hampshire, New |

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| | York, and Vermont. Rhode Island imposes a low-rate gross receipts tax on RIC income. A minority of states exempt RICs from their corporate taxes completely. In addition to Massachusetts, these states include Delaware, New Jersey, and Texas. Finally, a few states tax RICs in the same manner as ordinary corporations. |

## INTRODUCTION

Regulated Investment Companies (RICs) are specialized corporations that serve as investment vehicles. RICs hold securities, receive earnings from those securities and pay out virtually all of their earnings to shareholders. They hire service providers for investment advice and administrative services. RICs are typically established by financial services corporations that sponsor the RIC, provide the RIC's corporate management, and market shares of the RIC to the investing public. The RIC's management decides whom to hire to provide investment advice and administrative services to the RIC. The service providers hired are frequently subsidiaries or affiliates of the financial services corporation that established the RIC. The RIC itself has no employees and no property other than the securities it holds and its own books and records. Federal tax and securities law imposes limitations on the type of assets RICs can hold and requires RICs to distribute at least 90% of their income as dividends to shareholders.

Federal tax law allows RICs a deduction for dividends paid, which is generally not available to other corporations. See Internal Revenue Code (the "Code") § 852(b). The Massachusetts exemption for RICs is a statutory provision that employs the federal definition of a RIC but is not otherwise tied to the federal deduction.

The Massachusetts corporate excise imposes a tax on a corporation's apportioned net income and a tax on the corporation's apportioned net worth or tangible property located in Massachusetts. See MG.L. c. 63, § 39. RICs are exempt from both taxes because they are not taxable corporations pursuant to MG.L. c. 63, § 68C(8). This exclusion constitutes a tax expenditure in Massachusetts because, absent the exclusion, RICs would be subject to the corporate excise.

## POLICY GOALS

DOR assumes that the tax expenditure is intended to promote the mutual fund industry and encourage investment. RICs provide a convenient way to invest for small investors and others that want to avoid the time and expense involved with picking individual stocks and maintaining brokerage accounts. Note that RIC shareholders pay tax on the dividends they receive from RICs. The tax expenditure eliminates the tax at the RIC level, reducing the cost of operations for the RIC and improving investor returns. Such cost reduction also encourages financial firms to locate and expand in Massachusetts.

## DIRECT COSTS

The estimated revenue loss (i.e., tax revenue the state could potentially collect if this tax expenditure were eliminated) from this tax expenditure is highly theoretical. The reason for this is that RICs could be formed and moved or relocated very easily and such revenue losses may never materialize. More specifically, if Massachusetts were to tax RICs as corporations, it is highly likely that the RICs in Massachusetts would move to low- or no-tax jurisdictions and significantly reduce their Massachusetts tax liability.

To estimate the hypothetical revenue loss impact of this tax expenditure, DOR examined IRS data based on RIC tax filings for tax years 2008 through 2018, and Massachusetts data based on informational returns filed with DOR by RICs for tax years 2017 and 2018.

*Apportioned net income:* In the absence of the tax expenditure RICs would be subject to the net income measure of the corporate excise and allowed a deduction for dividends paid. The aforementioned IRS and DOR data indicate a potential revenue gain from the tax on net income in the range of $10,000 to $1.6 million annually.

*Apportioned net worth or tangible property located in Massachusetts:* In the absence of the tax expenditure RICs would be subject to the net worth or property measure of the excise. The aforementioned data indicate a potential revenue gain from the tax on net worth or tangible property located in Massachusetts in the range of $400 million to $500 million annually.

Since these estimates should be considered hypothetical, they should be used with caution. As indicated above, if this tax expenditure were eliminated and net worth tax were nominally imposed on RICs, it is highly likely that these companies would move to low- or no-tax jurisdictions to avoid the Massachusetts tax liability.

## DIRECT BENEFITS

RICs can avoid double taxation through this tax expenditure. The direct beneficiaries of the tax expenditure include RIC sponsors and shareholders.

Although not subject to the corporate excise, RICs file informational returns with DOR. DOR annually receives about 4,000 such returns. These returns have very limited data on RIC income, which were not useful, but about 200-300 of these returns come with schedules that have balance sheet data. By using these balance sheet data, DOR was able to calculate a net worth distribution (see the table below). The table shows that, in 2018, roughly 23% of RIC filers reported more than $1 billion net worth each. These filers represented 79% of the total net worth of all RIC filers.

**2018 RIC Net Worth Distribution by Net Worth Range (*)**

| Net Worth Range | Count | Amount |
|---|---|---|
| Less Than $50M | 28% | 1% |
| $50M But Less Than $100M | 10% | 1% |
| $100M But Less Than $500M | 29% | 9% |
| $500M But Less Than $1B | 11% | 11% |
| $1B But Less Than $5B | 21% | 54% |
| $5B and Above | 2% | 25% |
| | 100% | 100% |

(*) Estimated using 2018 MA Informational returns filed by RICs

Attached publication by Investment Company Institute (ICI), *2021 Investment Company FACT BOOK: A Review of Trends and Activities in the Investment Company Industry*, provides aggregate data on investment company industry in the U.S, which RICs are part of. Data include, but not limited to, industry employment by state, household financial assets held in investment companies, number of investment companies by type and by year, investment company total net assets by type and by year, mutual fund ordinary dividend distributions, etc.

## EVALUATION: COMPARING COSTS AND BENEFITS

In the previous sections, we report the direct costs (to the Commonwealth, or to the residents and businesses who ultimately bear the costs when the Commonwealth cuts government spending or increases taxes to finance the exemption of RICs from corporate excise tax) and direct benefits (to RIC sponsors or shareholders) of this tax expenditure. Given that the direct costs of this tax expenditure may be minimal considering taxpayers' likely behavioral responses were the tax expenditure to be repealed (see discussion in the section of "direct costs" above), direct benefits likely far exceed direct costs.

Besides the direct costs and benefits, there are indirect and induced costs and benefits associated with this tax expenditure. Generally, the indirect impact (cost or benefit) is felt by the chain of businesses that provide intermediate products and services to the first impacted businesses. The induced impact (cost or benefit) occurs when an impacted business passes on the costs or benefits to households, such as those of its employees, in the form of lower or higher income, such as wages and salaries, who then in turn reduce or increase purchases of goods and services from other businesses. The total costs or benefits to the whole economy are larger than the initial direct impacts. This phenomenon is called the "Multiplier Effect".[1]

[1] For an illustration of "Multiplier Effect", see Slide 4 of: https://www.ilw.com/seminars/JohnNeillCitation.pdf

To measure these indirect and induced costs and benefits, economists often need to utilize complicated models, such as REMI (Regional Economic Models, Inc.) or IMPLAN (Impact Analysis for Planning) models. DOR did not attempt to use such models given their complexity and the data limitations present in this instance. However, given that the direct benefits may far exceed direct costs, the total benefits, including indirect and induced benefits, may also far exceed the total costs, including indirect and induced costs.

## Similar Tax Expenditures Offered by Other States

Most states that impose a corporate income tax follow the federal tax treatment of RICs (i.e., they allow a deduction for dividends paid, but earnings retained by the RIC are still taxable). These states include California, Connecticut, Maine, New Hampshire, New York, and Vermont. Rhode Island imposes a low-rate gross receipts tax on RIC income. Massachusetts is in the minority of states that exempt RICs from their corporate taxes completely. These states also include Delaware, New Jersey, and Texas. Finally, a few states tax RICs in the same manner as ordinary corporations.

# References


Internal Revenue Service. (2017). *Statistics of Income: 2017 Corporation Income Tax Returns Line Item Estimates .* Department of the Treasury . Retrieved from https://www.irs.gov/pub/irs-pdf/p5108.pdf.

Investment Company Institute. (2021). *2021 Investment Company FACT BOOK: A Review of Trends and Activities in the Investment Company Industry.* Retrieved from https://www.ici.org/system/files/2021-05/2021_factbook.pdf