Approved: March 05, 2002
Date

MINUTES OF THE SENATE COMMITTEE ON COMMERCE.

The meeting was called to order by Chairperson Senator Karin Brownlee at 8:00 a.m. on February 15, 2002 in Room 123-S of the Capitol.

All members were present except:	Senator Brungardt (Excused) Senator Steineger (Excused) Senator Wagle (Excused)
Committee staff present:	April Holman, Legislative Research Debra Hollon, Legislative Research Norman Furse, Revisor of Statues Sherman Parks, Revisor of Statues
Conferees appearing before the committee:	Bob Marcusse, President & CEO Kansas City Area Development Council Richard Cram, Department of Revenue Steve Kelly, Department of Commerce & Housing Ed O'Malley, Overland Park Chamber of Commerce
Others attending:	See attached list

April Holman, Legislative Research gave an overview on the interim committee report from the special committee on Assessment and Taxation regarding investment service companies (Attachment 1). The interim committee studied this issue after **HB 2061** failed to pass. The committee recommended that new legislation be developed that would provide favorable tax treatment for investment fund service companies with a provision that phases in the fiscal impact over two years, effective for tax year 2002. The phased in provision will be 50% for the first year and will go into full force tax year 2003. The Department of Revenue stated it will cost two million dollars in lost revenues the first year for fiscal year 2003, four million dollars in fiscal year 2004 and all fiscal years thereafter.

Senator Brownlee asked April how does this compare with previous fiscal notes on this legislation. April stated it is slightly higher than last year.

Robert J. Marcusse, President/CEO, Kansas City Area Development Council testified in support of **SB 501** (Attachment 2). Mr. Marcusse stated that when **HB 2061** failed to pass, Waddell and Reed began to look at Missouri and Texas as alternative sites for their headquarters and operations. Such a move would remove 600 high paying jobs in Kansas and the Department of Revenue estimates the fiscal impact at full implementation to be between \$3.8 million and \$4.0 million. Supporting this bill will keep a viable and attractive company in Kansas and will help to recruit new financial fund companies to the area.

Senator Jordan asked Mr. Marcusse to comment on the status of the dealings with Kansas City, Missouri regarding the earnings tax exemption. Mr. Marcusse stated there are efforts underway to make an adjustment in the legislation on the Missouri side. Missouri has very favorable legislation but also requires an annual certification. Waddell and Reed is concerned that they would make a very significant move and be certified one year and then potentially not be certified the next year.

Steve Kelly, Director of Business Development for the Kansas Department of Commerce & Housing, testified in support of **SB 501** (Attachment 3). Passage of this bill will have a significant impact on Kansas opportunities to attract investment service companies.

Ed O'Malley, Government Relations Manager for Overland Park Chamber of Commerce, testified in support of **SB 501** (Attachment 4).

Richard Cram, Director, Department of Revenue, testified in support of **SB 501** with proposed amendments to clarify and make it more practical to administer the law for investment fund service companies (Attachment 5).

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

MINUTES OF THE SENATE COMMITTEE ON COMMERCE at on February 15, 2002 in Room 123-S of the Capitol.

Senator Barone requested that Richard Cram look at the definitions of the bill and the Department of Revenues proposed amendments for unintended consequences.

Chairperson Brownlee stated that she may place **SB 501** in a subcommittee due to the number of proposed amendments.

John E. Sundeen, Senior Vice President with Waddell & Reed, submitted written testimony in support of **SB 501** (Attachment 6).

Meeting adjourned at 9:30 a.m.

The next meeting is scheduled for February 18, 2002 at 8:30 a.m.

SENATE COMMERCE COMMITTEE
GUEST LIST
DATE: February 15, 2002

NAME	REPRESENTING
Richard Cram	KDOR
Mike Reecht	KS GOVT. CONSULTING
Steve Kelly	KDOCH
Ed O'Malley	OP. Chamber
Erik Sartorius	City of Overland Park
Stuart Little	Western Energy
Bob Marcusse	KCADC
John Frederick	The Boeing Company
John Peterson	American Century
Stephanie Buchanan	DOB

Special Committee on Assessment and Taxation

Investment Service Company Apportionment

Conclusions and Recommendations

The Committee recommends that the Legislature approve new legislation being developed by the Department of Revenue and proponents of HB 2061 that would provide, effective for tax year 2002, favorable tax treatment for investment fund service companies but with a provision that phases in the fiscal impact over two years.

Proposed Legislation: None

Background

The Legislative Coordinating Council approved the request for an interim study on the subject matter of 2001 HB 2061. That bill would provide an exception to the three-factor income apportionment formula for investment funds service companies. (The three-factor formula is based on property, payroll, and sales.) The bill would allow such companies to elect to have income apportioned to Kansas based on the number of shares owned by resident shareholders at the end of the year divided by the total number of shares owned by all shareholders. Proponents said that HB 2061 was based on a similar law in effect in Missouri for investment fund service companies.

After an initial public hearing, the bill was referred by the House Taxation Committee to a subcommittee chaired by Representative Peggy Palmer.

Based on input from the Department of Revenue, the subcommittee asked that a number of issues with respect to the original bill be addressed by proponents relative to differences between the legislation and Missouri's law. (The proponents subsequently responded with suggested amendatory language to address these concerns, though such changes were never forwarded by the subcommittee for adoption by the full committee prior to the end of the session.) Some of those issues included:

- The Department of Revenue noted that the definition of such companies in HB 2061 includes no restriction as to the percentage of total business activity, income, or gross receipts from providing management, distribution, advisement, or administration services to or on behalf of investment companies, while Missouri's law limits such income to 50 percent.
- The Department also said that Missouri's law uses the average number of shares throughout the year rather than the number owned at the end of the year.

Senate Commerce Committee
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- The Department said that Missouri's law excludes certain nonqualifying income of such companies from the special apportionment option, while HB 2061 does not.

- The Department said that the bill contains no details as to how or when the election could be made by the taxpayer.

The Department also noted that current language in KSA 79-3288 authorizes investment service fund companies to petition the Secretary of Revenue for relief to the extent that the current apportionment formula does not fairly represent the extent of their business activity in Kansas.

The Department of Revenue and the Budget Division indicated that the original bill would have a fiscal note of $3.84 million.

Committee Activities

The Special Committee held a public hearing on the issue in August. A representative of Waddell and Reed indicated that a letter from the Secretary of Revenue had indicated that he felt it was beyond his scope of authority to grant tax relief administratively. Proponents of HB 2061 also said that the mutual fund industry was highly competitive and that Kansas' tax structure did not compare favorably with the aforementioned provisions of law in Missouri.

The Department of Revenue reiterated its belief that the fiscal impact would be $3.84 million and said that it would continue to work with Waddell and Reed on some of the issues identified in the subcommittee discussion.

In October, the Committee reviewed its policy options and heard additional testimony from Waddell and Reed. Two proposed amendments distributed at that time would bring HB 2061 into greater conformity with the Missouri apportionment law.

Conclusions and Recommendations

The Committee agrees that Kansas should remain competitive with Missouri and other states relative to the taxation of investment fund service companies.

The Committee therefore recommends that the 2002 Kansas Legislature give favorable consideration to new legislation similar to HB 2061, with several amendments. The new bill should have changes suggested by the Department of Revenue that would bring it into closer conformity with Missouri's law for investment fund service companies; should be effective for tax year 2002 in lieu of tax year 2001; and should contain a mechanism by which the fiscal impact is phased in over two years. The new legislation should be introduced as soon as the Department of Revenue and proponents of the change in the income apportionment formula have agreed to language that would accomplish this recommendation.

Senate Commerce Committee Testimony

February 15, 2002

Robert J. Marcusse, President/CEO
Kansas City Area Development Council

Madame Chairperson and members of the committee,

My name is Bob Marcusse. I am a resident of Lenexa, KS. I am here today in my capacity as president of the Kansas City Area Development Council, a regional economic development organization that serves the 16 counties in both Kansas and Missouri that compose the Kansas City Area. Our core business is recruiting major companies to our market, retaining companies of regional significance, and, in general, growing the regional economy of Greater Kansas City. Thank you for the opportunity to testify today in support of SB 501.

Senator Brownlee, thank you for your early efforts to support the changes detailed in this bill, changes that will help to keep over 600 highly compensated persons employed in Kansas.

I know that this is a difficult time for the State of Kansas. There are many plans to both cut spending and raise revenue, all with the intent of balancing our state budget. At a time like this, it is often initially difficult to consider plans that might appear to sacrifice some existing revenue short-term but lead to the long term retention of a major revenue source AND position Kansas to be much more attractive to Investment Fund Services Companies than is currently the case.

By way of brief background, the financial services company Waddell and Reed is currently based in Kansas. The firm employs over 600 persons in Kansas with a payroll in excess of $67M. It pays property and corporate income tax in Kansas and its employees pay property and personal income tax here too. I don't have the amount of taxes Waddell & Reed currently pays in Kansas, but the *Johnson County Sun* is quoted as saying that the current corporate tax paid to Kansas is about $5,000,000. And, based on payroll data and an effective tax rate of 7%, we can compute that employees pay personal income tax of almost $4,700,000. Additionally, Waddell and Reed visitors generate over 6000 hotel room nights and spend liberally in area restaurants. The company spends tens of millions of dollars in the local economy for goods and services and is an active participant in civic and charitable organizations. We can conservatively estimate a total annual state tax payment attributable to Waddell and Reed of over $10,000,000.

Of course, local property taxes that support Kansas's cities, schools, libraries, community colleges, and other governmental bodies are not even included here. The same is true for sales taxes generated by the activities named earlier.

Last year Waddell and Reed asked the legislature to pass legislation that would allow it to be taxed on Kansas source revenue rather than nationwide revenue. This change would mean that the business climate in Kansas for this type of company would be the same as in Missouri, along with nine other states, including Texas, ...and would eliminate the location disadvantage currently confronting the company in Kansas.

When the legislation did not pass, Waddell and Reed began to look at Missouri and Texas as alternative sites for their headquarters and operations. For the Kansas City area, a move to Missouri would be neutral. However, it is very possible that the company will move to Texas, land of no corporate income tax AND favorable treatment for Investment Fund Services Companies. Such a move would erase over 600 high paying jobs in Kansas; remove from Kansas the headquarters and operations of a clean, growing, financial services company, and all for what purpose? Some will say that this proposed change will cost the state some previously available revenue. That is correct. The Department of Revenue estimates the fiscal impact at full implementation to be between $3.8M and $4.0 M.

However, failure to make the change will cost the state ALL previously available revenue AND will send the message that at the same time we talk about stimulating our Kansas economy, we are willing to lose what will be a huge win for Dallas.... the kind of win that makes national headlines.

I have seen the Texas proposal. It is extremely aggressive.... so aggressive that if we were competing head to head, if we each had in place the necessary legislation, and without the built in advantage we have because the company is already here, we would not, could not, win.

At KCADC we have had a great track record of success in recruiting companies to Kansas City. To place the potential loss of Waddell & Reed in perspective, we must realize how unlikely it would be that we could readily replace Waddell & Reed with an employer of similar economic impact coming to Kansas from outside our area. The last company that we recruited to Kansas City of similar impact was Quintiles, the medical research organization. They employ 900 persons in Missouri with a payroll close in size to that of Waddell & Reed. That occurred in 1998 and we haven't seen an opportunity of similar magnitude since then. And, the city of Kansas City, Missouri and the state of Missouri gave millions in incentives to attract Quintiles. We have not had an opportunity of similar magnitude in Kansas since the attraction of the Kansas Speedway.....and you all know what it took to win in that case.

Today, in the Kansas City area, only the Missouri side is competitive and Kansas as a state is non-competitive. Conversely, if SB 501 is approved, Kansas immediately becomes competitive for Waddell & Reed and nationally competitive for this type of financial services firm.

Testimony to the Senate Commerce Committee
Hearing on Senate Bill 501
Senator Brownlee--Chair
February 15, 2001

Chairperson Brownlee, members of the committee. I am pleased to be with you today to testify in support of Senate Bill 501. I am Steve Kelly, Director of Business Development for the Kansas Department of Commerce & Housing.

I come before you today to speak in support of Senate Bill 501, a measure which seeks to modify existing statute to allow the income of certain financial services firms to be apportioned for Kansas income taxes in a manner that would make Kansas a more attractive location for such companies. Kansas currently has difficulty in attracting such firms, primarily due to state tax policies that place us at a distinct disadvantage when comparisons are made between our state and other states in our region and in the nation. Our difficulties in attracting and retaining this sort of operation, are made all the more troubling by the knowledge that these are the very types of companies and jobs that Kansans seek – opportunities with high wages, good working environments and growth potential. Our agency has worked from time-to-time with such firms that were seriously considering Kansas for a facility location. Ultimately those facilities locate in other locations, because over a multi-year operations period, the tax differential simply cannot be overcome.

This is an industry where Kansas has potential for growth. Several companies of this type are already part of the employment base in neighboring states. We believe that there are a number of firms that would give Kansas serious consideration, were we not disadvantaged by our existing tax methodology. Passsage of this bill would have a significant impact on Kansas opportunities to attract and grow these types of operations.

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OVERLAND PARK
CHAMBER OF COMMERCE

Testimony for the Senate Commerce Committee on SB 501
February 15, 2002

Ed O'Malley
Government Relations Manager
Overland Park Chamber of Commerce

Madam Chair and members of the committee, my name is Ed O'Malley. I am the Government Relations Manager for the Overland Park Chamber of Commerce. I appreciate the opportunity to speak with you about the Kansas tax policy for mutual fund companies.

During a time when quality job creation and retention is seen as the key to economic recovery, Overland Park is struggling with the Kansas tax policy on mutual fund companies. In short, mutual fund companies headquartered in Kansas must pay income tax on all income, not just income generated in Kansas. This is contrary to the tax policy in many other states, including our neighbor Missouri.

As you know, Overland Park, and Johnson County as a whole, compete with Missouri for companies and quality jobs. The Kansas tax policy for mutual fund companies puts us at a disadvantage to Missouri when trying to recruit and retain the quality jobs provided in the mutual fund industry. Johnson County's educated workforce, affordable housing, plentiful shopping, superb K-12 education system and an overall high quality of life are enough to lure many companies to our county. However, this is apparently not enough to recruit and retain the high paying jobs of the mutual fund industry.

The Overland Park Chamber of Commerce supports the 2001 Kansas interim committee recommendation to phase-in source state taxation for investment service fund companies. Keeping in mind banks and insurance companies, who offer many of the same products and services as mutual fund companies, already enjoy this favorable tax policy, we encourage the Legislature to level the playing field for investment fund companies. The law for banks and insurance companies has resulted in significant growth in Johnson County in those two financial sectors.

Waddell & Reed has publicly stated it is looking to relocate outside of Kansas because of this policy. This was not a problem when Waddell & Reed first moved 400 employees to Overland Park in the 1980s because it was not yet a headquarters

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operation. We were pleased when it became a headquarters a few years ago, but were also concerned about our ability to keep the company in Kansas. Waddell & Reed currently employs 600 people in Overland Park with an average salary of $100,000.

Another mutual fund company had been strongly considering a move to Overland Park, but recently decided to locate elsewhere because of this tax policy. That company has 400 jobs with an average salary of $100,000 and wanted to make a capital investment of $8-12 million. Again, when quality job creation and retention is seen as the key to economic recovery, we are disappointed and concerned that Overland Park and Kansas are unable to retain and recruit these quality jobs. Attracting headquarters operations of this type has been greatly hindered by this policy.

Madam Chair, thank you for allowing me to address the committee.

STATE OF KANSAS
Bill Graves, Governor

DEPARTMENT OF REVENUE
Stephen S. Richards, Secretary

Office of Policy & Research
Richard L. Cram, Director
915 SW Harrison St.
Topeka, KS 66625

(785) 296-3081
FAX (785) 296-7928
Hearing Impaired TTY (785) 296-6461
Internet Address: www.ksrevenue.org

Office of Policy & Research

February 15, 2002

To: Senator Karin Brownlee, Chair
Senate Committee on Commerce

From: Richard Cram

Re: Department of Revenue Suggested Amendments to Senate Bill 501

Attached hereto are proposed amendments to Senate Bill 501. This bill, which evolved from 2001 House Bill 2061, was the subject of study by the Special Committee on Assessment and Taxation last summer and fall. The Committee recommended:

> that the 2002 Kansas Legislature give favorable consideration to new legislation similar to HB 2061, with several amendments. The new bill should have changes suggested by the Department of Revenue that would bring it into closer conformity with Missouri's law for investment fund service companies; should be effective for tax year 2002 in lieu of tax year 2001; and should contain a mechanism by which the fiscal impact is phased in over two years. The new legislation should be introduced as soon as the Department of Revenue and proponents of the change in the income apportionment formula have agreed to language that would accomplish this recommendation.

Last fall, pursuant to the Committee's recommendations, the Department reviewed the corresponding Missouri statute applicable to investment funds service corporations (IFSC), Mo. Stat. § 143.451 *et seq*., and suggested a draft proposal (using the Missouri statute as a starting point for the draft) to Waddell and Reed, along with a list of questions about some of the provisions. This draft appears to have been used in the development of Senate Bill 501. Upon review of Senate Bill 501, the Department proposes the following amendments, which are intended to clarify the bill and make it easier and more practical to administer, should it be enacted.

Senate Bill 501 would enable certain IFSCs to apportion their qualifying business income (QBI) using a single factor formula that is based on the number of shares in the IFSC held by shareholders residing in Kansas. This bill raises several legal concerns that can be addressed with amendments.

Section 1 of the bill would amend K.S.A. 79-3271 by adding subsection (k), which includes a definition of "investment company." However, K.S.A. 79-3271(d) already provides that an "investment company" is included in the definition of "financial organization." This overlap in terminology could result in confusion when construing references to "investment company" and "financial organization" that appear in Uniform Division of Income for Tax Purposes Act, K.S.A. 79-3271 *et seq.* The term "investment company" should be deleted from the definition of "financial organization" in K.S.A. 79-3271(d), at Lines 34-35 of Page 1.

Qualifying taxpayers must elect to use the single factor apportionment formula. The election must be made at the time of filing the "original return." See Section 2(a)(5). In the past, disputes have arisen with regard to whether taxpayers have properly made an election and whether a return is the "original return," particularly where returns have been filed on both a separate and combined basis. Without more specific language in the bill, it is possible that similar disputes may arise in the future with IFSC returns. A definition for "original return" should be inserted between Lines 2-3 on Page 2 to add new paragraph (g) to K.S.A. 79-3271 as follows: "'original return' means the first return filed to report the income of a taxpayer for a taxable year or period, irrespective of whether such return is filed on a single entity basis or a combined basis."

"Qualified business income"(QBI) consists of income derived from the providing of certain specific services, such as "administration services," "distribution services," and "management services," terms which are specifically defined in Section 1. However, these definitions are vague in certain respects and could be difficult to construe and administer. For example, QBI is income derived from the provision "directly or indirectly" of these enumerated services. The term "indirectly" would give rise to differences of opinion as to whether certain income is QBI. The definition of "administration services" is "not limited to" those services expressly set forth in Section 1 (k) (1). In order to add clarity to the bill and avoid use of open-ended and vague terms, the phrases "directly and indirectly" and "not limited to" should be deleted where used at Lines 22 and 26, Page 2, Lines 1-2, 6-7, and 18 of Page 3.

Subsection 1(k)(4) of the bill defines "investment funds service corporation" to include corporations or S corporations headquartered in this state that derive more than 50% of their gross income from the provision of management, distribution or administration services to or on behalf of an investment company "or from trustees, sponsors and participants of employee benefit plans which have accounts in an investment company." Providing management, distribution or administration services to trustees, sponsors and participants of employee benefit plans having accounts in an investment company, appears to go beyond the scope of services that Waddell and Reed currently provides. Thus, the Department would request that the quoted language above be deleted from the bill at Lines 3-5 and 19-21 of Page 3, in order to narrow its focus.

Section 1(k)(7) of the bill would allow an investment funds service corporation to estimate the percentage of Kansas shareholders to total shareholders if they do not have access to the investment company's records. Similarly, the phrase "reasonable methods" in referring to attempts by IFSCs to establish the residence of the shareholders can be subject to differing interpretations. The investment funds service corporation should be required to provide the Department access during audit to the actual address records. Thus, the Department believes that "residence" should be simply defined as "the fund shareholder's primary residence or principal place of business," at Lines 22-31, and the other provisions in Section 1(k)(7) should be deleted.

Section 2 (b) (5) (B) provides that QBI derived from the provision of services to investment companies shall be multiplied by the respective "percentage" of each fund, as calculated pursuant to paragraph (A). However, paragraph (A) refers to the multiplication of QBI by a "fraction." If the legislative intent is that the terms "percentage" and "fraction" are synonymous, it is recommended that consistent terminology be used to avoid confusion. This provision should be revised at Page 5, Lines 17-20, as follows: "A separate computation shall be made to determine the qualifying business income from each fund of each investment company. The qualifying business income from each investment company shall be multiplied by the fraction calculated pursuant to paragraph (A) for each fund of such investment company."

Section 2(b)(5)(C) provides that to the extent an IFSC has business income that is not QBI, such business income shall be apportioned to Kansas "without regard to this subsection." This is intended to mean that business income other than QBI must be apportioned pursuant to the standard three-factor formula, which is set forth at K.S.A. 79-3279(b)(1). The Department suggests that this provision be clarified at Page 5, Line 23, by replacing the phrase "without regard to this subsection" with the language "pursuant to K.S.A. 79-3279(b)(1)."

Section 2(b)(5)(D) of the bill, the transitional provision for tax year 2002, refers to the tax liability of an IFSC "from the apportionment of business income pursuant to paragraph (5)." However, since this bill draws a clear distinction between the apportionment of "qualifying business income" and the apportionment of "business income that is not qualifying business income," it is unclear which type of business income is being referred to in Section 2 (b) (5) (D). This language could be read to refer to business income that is not QBI, resulting in excluding QBI from taxation – which appears contrary to legislative intent. Further, subparagraph (D) does not specify whether its terms are applicable to all IFSCs or only those that elect to use the single factor apportionment method. The language used could be read to require all IFSCs -- even those that do not make the election -- to comply with its terms. For clarity, this provision should be revised at Page 5, Lines 24-29, as follows: "For tax year 2002, the tax liability of an investment funds service corporation that has elected to apportion its business income pursuant to paragraph (5) shall be increased by an amount equal to 50% of the difference of the amount of such tax liability if determined pursuant to K.S.A. 79-3279(b)(1) less the amount of such tax liability determined with regard to paragraph (5)."

A special apportionment formula (based on the ratio of shares owned by Kansas residents to total shares) is applied to the qualifying business income of an investment funds service corporation. The standard apportionment formula is used against the non-qualifying income of an investment funds service corporation. How is the apportionable (net) income of an investment funds service corporation divided between the two? More importantly, if an investment funds service corporation is a member of a unitary group, how is the combined apportionable income divided between the investment funds service corporation(s) and the rest of the unitary group?

As contemplated in Section 2 (b) (5) (C), there may be circumstances in which not all of an IFSC's business income is QBI. In such cases, it appears that the non-QBI business income is to be apportioned pursuant to K.S.A. 79-3279(b)(1) [the three-factor formula consisting of property, payroll and sales], although this is not specifically stated in the bill. This would cause difficulty, inasmuch as there are practical problems in using two different formulae to apportion the income of one taxpayer. Further, similar difficulties would be encountered if an IFSC is a member of a unitary group of corporations, all or many of which use a different statutory method to apportion their income. Some method of "pre-apportionment" is required before the different formulae could be applied. Kansas statutes currently provide no guidance in this area.

The following are suggested additions to Senate Bill 501 to resolve these issues:

Add at the end of Line 29, Page 5, new subparagraph (E) to Section 2(b)(5):

When an investment funds service corporation is part of a unitary group, the business income of the unitary group attributable to the investment funds service corporation shall be determined by multiplying the business income of the unitary group by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three. The property factor is a fraction, the numerator of which is the average value of the investment funds service corporation's real and tangible personal property owned or rented and used during the tax period and the denominator of which is the average value of the unitary group's real and tangible personal property owned or rented and used during the tax period. The payroll factor is a fraction, the numerator of which is the total amount paid during the tax period by the investment funds service corporation for compensation, and the denominator of which is the total compensation paid by the unitary group during the tax period. The sales factor is a fraction, the numerator of which is the total sales of the investment funds service corporation during the tax period, and the denominator of which is the total sales of the unitary group during the tax period.

Add to the beginning of Section 2(b)(5)(C) at Line 21, Page 5:

The qualifying portion of total business income of an investment funds service corporation shall be determined by multiplying such total business income by a fraction, the numerator of which is the gross receipts from the provision of management, distribution and administration services to or on behalf of an investment company, and the denominator of which is the gross receipts of the investment funds service company.

5.4

Session of 2002

SENATE BILL No. 501

By Committee on Assessment and Taxation

2-4

AN ACT relating to income taxation; concerning the apportionment of business income of certain investment funds service companies; amending K.S.A. 79-3271 and 79-3279 and repealing the existing sections.

Be it enacted by the Legislature of the State of Kansas:

Section 1. K.S.A. 79-3271 is hereby amended to read as follows: 79-3271. As used in this act, unless the context otherwise requires: (a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations, except that for taxable years commencing after December 31, 1995, a taxpayer may elect that all income derived from the acquisition, management, use or disposition of tangible or intangible property constitutes business income. The election shall be effective and irrevocable for the taxable year of the election and the following nine taxable years. The election shall be binding on all members of a unitary group of corporations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Financial organization" means any bank, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, credit union, cooperative bank, ~~investment company~~, or any type of insurance company, but such term shall not be deemed to include any business entity, other than those hereinbefore enumerated, whose primary business activity is making consumer loans or purchasing retail installment contracts from one or more sellers.

(e) "Nonbusiness income" means all income other than business income.

(f) "Public utility" means any business entity which owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons,

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or the production, storage, transmission, sale, delivery, or furnishing of electricity, water, steam, oil, oil products or gas.

(g) "Original return" means the first return filed to report the income of a taxpayer for a taxable year or period, irrespective of whether such return is filed on a single entity basis or a combined basis.

h ~~(g)~~ "Sales" means all gross receipts of the taxpayer not allocated under K.S.A. 79-3274 through 79-3278, and amendments thereto.

i ~~(h)~~ "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

j ~~(i)~~ "Telecommunications company" means any business entity or unitary group of entities whose primary business activity is the transmission of communications in the form of voice, data, signals or facsimile communications by wire or fiber optic cable.

k ~~(j)~~ "Distressed area taxpayer" means a corporation which: (1) Is located in a county which has a population of not more than 45,000 persons and which, as certified by the department of commerce *and housing*, has sustained an adverse economic impact due to the closure of a state hospital in such county pursuant to the recommendations of the hospital closure commission; and (2) which has a total annual payroll of $20,000,000 or more for employees employed within such county.

l ~~(k)~~ *For the purposes of this subsection and subsection (b)(5) of K.S.A. 79-3279, and amendments thereto, the following terms are defined:*

(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 an investment company;

(2) "distribution services" include, ~~but are not limited to,~~ the services of advertising, servicing, marketing, underwriting or selling shares of an investment company, but, in the case of advertising, servicing or marketing shares, only where such service is performed by a person who is, or in the case of a closed end company, was, either engaged in the services of underwriting or selling investment company shares or affiliated with a person who is engaged in the service of underwriting or selling investment company shares. In the case of an open end company, such service of underwriting or selling shares must be performed pursuant to a contract entered into pursuant to 15 U.S.C.§80a-15(b), as in effect on the effective date this act;

(3) "Investment company", means any person registered under the federal Investment Company Act of 1940, as in effect on the effective date of this act, or a company which would be required to register as an investment company under such act except that such person is exempt to such registration pursuant to§80a-3(c)(1) of such act;

(4) "investment funds service corporation" includes any corporation or S corporation headquartered in and doing business in this state which

derives more than 50% of its gross income from the provision ~~*directly or indirectly*~~ *of management, distribution or administration services to or on behalf of an investment company* ~~*or from trustees, sponsors and participants of employee benefit plans which have accounts in an investment company;*~~

(5) "management services" include ~~*but are not limited to*~~*, the rendering of investment advice* ~~*directly or indirectly*~~ *to an investment company making determinations as to when sales and purchases of securities are to be made on behalf of the investment company, or the selling or purchasing of securities constituting assets of an investment company, and related activities, but only where such activity or activities are performed:*

(A) Pursuant to a contract with the investment company entered into pursuant to 15 U.S.C. §80a-15(a), in effect on the effective date of this act; or

(B) for a person that has entered into such contract with the investment company;

(6) "qualifying business income" is business income derived from the provision ~~*directly or indirectly*~~ *of management, distribution or administration services to or on behalf of an investment company* ~~*or from trustees, sponsors and participants of employee benefit plans which have accounts in an investment company*~~*; and*

(7) "residence" ~~*is presumptively the fund shareholder's mailing address on the records of the investment company. If, however, the investment company or the investment funds service corporation has actual knowledge that*~~ *the fund shareholder's primary residence or principal place of business* ~~*is different than the fund shareholder's mailing address such presumption shall not control.*~~ ~~*To the extent an investment funds service corporation does not have access to the records of the investment company, the investment funds service corporation may employ reasonable methods to determine the investment company fund shareholder's residence.*~~

is

Sec. 2. K.S.A. 79-3279 is hereby amended to read as follows: 79-3279. (a) All business income of railroads and interstate motor carriers of persons or property for-hire shall be apportioned to this state by multiplying the business income by a fraction, in the case of railroads, the numerator of which is the freight car miles in this state and the denominator of which is the freight car miles everywhere, and, in the case of interstate motor carriers, the numerator of which is the total number of miles operated in this state and the denominator of which is the total number of miles operated everywhere.

(b) All business income of any other taxpayer shall be apportioned to this state by one of the following methods:

(1) By multiplying the business income by a fraction, the numerator

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of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three; or

(2) at the election of a qualifying taxpayer, by multiplying the business income by a fraction, the numerator of which is the property factor plus the sales factor, and the denominator of which is two.

(A) For purposes of this subsection (b)(2), a qualifying taxpayer is any taxpayer whose payroll factor for a taxable year exceeds 200% of the average of the property factor and the sales factor. Whenever two or more corporations are engaged in a unitary business and required to file a combined report, the percentage comparison provided by this subsection (b)(2) shall be calculated by using the payroll factor, property factor and sales factor of the combined group of unitary corporations.

(B) An election under this subsection (b)(2) shall be made by including a statement with the original tax return indicating that the taxpayer elects to apply the apportionment method under this subsection (b)(2). The election shall be effective and irrevocable for the taxable year of the election and the following nine taxable years. The election shall be binding on all members of a unitary group of corporations. Notwithstanding the above, the secretary of revenue may upon the request of the taxpayer, grant permission to terminate the election under this subsection (b)(2) prior to expiration of the ten-year period.

(3) At the election of a qualifying telecommunications company, by multiplying the business income by a fraction, the numerator of which is the information carrying capacity of wire and fiber optic cable available for use in this state, and the denominator of which is the information carrying capacity of wire and fiber optic cable available for use everywhere during the tax year.

(A) For purposes of this subsection (b)(3), a qualifying telecommunications company is a telecommunications company that is a qualifying taxpayer under paragraph (A) of subsection (b)(2).

(B) A qualifying telecommunications company shall make the election under this subsection (b)(3) in the same manner as provided under paragraph (B) of subsection (b)(2).

(4) At the election of a distressed area taxpayer, by multiplying the business income by the sales factor. The election shall be made by including a statement with the original tax return indicating that the taxpayer elects to apply this apportionment method. The election may be made only once, it must be made on or before December 31, 1999 and it shall be effective for the taxable year of the election and the following nine taxable years for so long as the taxpayer maintains the payroll amount prescribed by subsection (j) of K.S.A. 79-3271.

(5) *At the election of the taxpayer made at the time of filing of the original return, the qualifying business income of any investment funds*

5.8

service corporation organized as a corporation or S corporation which maintains its primary headquarters and operations in this state and has any investment company fund shareholders residenced in this state shall be apportioned to this state as provided in this subsection, as follows:

(A) By multiplying the investment funds service corporation's qualifying business income from administration, distribution and management services provided to each investment company by a fraction, the numerator of which shall be the average of the number of shares owned by the investment company's fund shareholders residenced in this state at the beginning of and at the end of the investment company's taxable year that ends with or within the investment funds service corporation's taxable year, and the denominator of which shall be the average of the number of shares owned by the investment company's fund shareholders everywhere at the beginning of and at the end of the investment company's taxable year that ends with or within the investment funds service corporation's taxable year.

from

(B) A separate computation shall be made to determine the qualifying business income from each investment company. The qualifying business income ~~for~~ each investment company shall be multiplied by the ~~respective percentage of each fund, as~~ calculated pursuant to paragraph (A).

fund of each

fraction

for each fund of such investment company

(C) To the extent an investment funds service corporation has business income that is not qualifying business income, such business income shall be apportioned to this state ~~without regard to this subsection~~.

pursuant to K.S.A. 79-3279(b)(1)

(D) For tax year 2002, the ~~amount of~~ tax liability of an investment funds service ~~company resulting from the apportionment of~~ business income pursuant to paragraph (5) shall be increased by an amount equal to 50% of the difference of the amount of such tax liability if determined ~~without regard to paragraph (5)~~ less the amount of such tax liability determined with regard to paragraph (5).

corporation that has elected to apportion its

pursuant to K.S.A. 79-3279(b)(1)

Insert 1 (attached)

New Sec. 3. The provisions of this act shall be applicable to all taxable years commencing after December 31, 2001.

Sec. 4. K.S.A. 79-3271 and 79-3279 are hereby repealed.

Sec. 5. This act shall take effect and be in force from and after its publication in the statute book.

Insert 2 (attached)

Insert 1 (after Line 29, Page 5 of SB 501)

Add new subparagraph (E) to Section 2(b)(5): When an investment funds service corporation is part of a unitary group, the business income of the unitary group attributable to the investment funds service corporation shall be determined by multiplying the business income of the unitary group by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three. The property factor is a fraction, the numerator of which is the average value of the investment funds service corporation's real and tangible personal property owned or rented and used during the tax period and the denominator of which is the average value of the unitary group's real and tangible personal property owned or rented and used during the tax period. The payroll factor is a fraction, the numerator of which is the total amount paid during the tax period by the investment funds service corporation for compensation, and the denominator of which is the total compensation paid by the unitary group during the tax period. The sales factor is a fraction, the numerator of which is the total sales of the investment funds service corporation during the tax period, and the denominator of which is the total sales of the unitary group during the tax period.

Insert 2 (at Line 21, Page 5 of SB 501)

Add to the beginning of Section 2(b)(5)(C): The qualifying portion of total business income of an investment funds service corporation shall be determined by multiplying such total business income by a fraction, the numerator of which is the gross receipts from the provision of management, distribution and administration services to or on behalf of an investment company, and the denominator of which is the gross receipts of the investment funds service company.

WADDELL & REED Financial, Inc.

JOHN E. SUNDEEN, JR., CFA
Senior Vice President
Chief Financial Officer and Treasurer

6300 Lamar Avenue
Post Office Box 29217
Shawnee Mission, KS 66201-9217
913-236-1810 Fax 913-236-1799
Email jsundeen@waddell.com

February 12, 2002

The Honorable Karen Brownlee
Chairperson
Senate Committee on Commerce
Room 136 North
State Capitol Building
Topeka, Kansas 66612

Re: SB 501

Dear Senator Brownlee:

Waddell & Reed apologizes that it will not be able to testify before the Senate Commerce Committee, this Friday morning Feb. 15th, when the committee holds its hearing on SB 501.

Kansans will appreciate the committee taking the time to consider the legislation and the merits of making Kansas a more attractive place for mutual fund companies to locate. Clearly SB 501 is in the best interest of the State of Kansas, because it makes Kansas competitive with ten other states that already have similar mutual fund legislation. In our opinion, the characteristics of the mutual fund industry are very attractive to any community. They are fast growing, offer quality jobs for highly educated taxpayers, and have a positive impact on their surrounding community. With this legislation, Kansas could attract mutual fund companies to the state and encourage the growth of those already located there.

SB501 appears to be very similar to the existing statutes in the State of Missouri and as such should be very competitive from the standpoint of a tax paying company. Enclosed is a copy of a research paper recently completed that describes the success of the mutual fund industry since the time of Missouri's passage of "Source State" legislation.

Sincerely,

John E. Sundeen Jr.

John E. Sundeen Jr.

enclosure

Senate Commerce Committee
Feb. 15, 2002
Attachment 6-1

PRICEWATERHOUSECOOPERS

THE IMPORTANCE OF THE MUTUAL FUND INDUSTRY TO THE MISSOURI ECONOMY

Prepared on behalf of

MISSOURI COALITION FOR SOURCE-STATE TAXATION

January 2002

National Economic Consulting NEC

6-2

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Executive Summary

The mutual fund industry makes a significant economic contribution to the Missouri economy.[1] In terms of employment, Missouri mutual fund industry has climbed from sixth largest in the country in 1992 to fourth largest in 1999. Several states have enacted tax legislation to attract and retain mutual fund firms and still other states have taken similar steps to encourage industry growth. Recent studies show that a carefully targeted tax provision, such as the Missouri special mutual fund apportionment, effective in 1998, can be the most cost-effective measure.

Current State Tax Treatment of Mutual Fund Companies
Generally, state allocation and apportionment rules determine the amount of business income attributable to and, therefore, taxable by each state. Prior to 1998 under Missouri corporate income tax law, the nationwide income of mutual fund companies located or having operations in Missouri was apportioned to and taxed in Missouri under one of two methods: (i) based on a percentage of the company's property, payroll, and sales located in Missouri; or (ii) based solely on a percentage of the company's sales attributable to Missouri. However, in either case, Missouri prior apportionment rules generally treated 100 percent of Missouri-based mutual fund companies' nationwide sales as Missouri-sourced sales. Because most of the sales (were and still are) made to non-residents, Missouri-based firms generally faced a higher tax liability than mutual funds located in competing states that do not apply such onerous rules.

In 1997, Missouri reformed the taxation of mutual fund companies by enacting legislation (effective January 1, 1998) that allows mutual fund companies to elect a single factor apportionment method, apportioning sales on the basis of the residence of the mutual fund shareholder. Mutual fund companies domiciled in Missouri are now able to reduce their operating costs attributable to lower state income tax to effectively compete with companies domiciled in jurisdictions that provide for similar tax treatment.

Since 1989, ten other states have enacted tax legislation to encourage continued growth of the mutual fund industry. Maryland (1998), New Jersey (1989), New York (1989), and Utah (1992) tax mutual funds on the basis of a customer residence test and a percentage of the company's property, payroll, and sales. Connecticut (1996), Kentucky (1992), Maine (2001), Massachusetts (1997), Rhode Island (1996), and Texas (1992) tax mutual fund companies on the basis of a customer residence test and a single sales factor. In terms of employment, these ten states account for approximately 49 percent of the entire U.S. mutual fund industry.[2]

With enactment of the 1997 legislation, the Missouri mutual fund industry, in general, has attained equilibrium in taxation with the other ten states that tax mutual fund companies on the basis of a customer residence test and/or single sales factor. Maintaining this balance will help

[1] Generally, the "mutual fund industry" refers to investment management companies, private investment companies ("hedge funds"), and the investment management subsidiaries of banks or companies principally dedicated to providing administrative or distribution services to such firms. However, see Appendix A, which provides a description of "connected" and "potential" mutual fund operations, which are also included in the mutual fund sector for the purpose of analyzing the economic and tax impact of the special Missouri apportionment provision.

[2] Including Missouri, the eleven states that have enacted tax reform legislation account for 55 percent of U.S. mutual fund employment.

Missouri mutual fund companies keep operational costs in line with out-of-state companies and compete for the business of cost-conscious customers. In turn, a competitive mutual fund industry, along with its well-compensated workforce, is conferring significant economic benefits on the state.

The Mutual Fund Industry's Contribution to the Missouri Economy

We estimate Missouri's mutual fund industry employs almost 12,000 professionals who directly administer approximately $100 billion in fund assets and process over 70 million mutual fund shareholder accounts. In addition, mutual fund companies employ approximately 2,000 workers who are engaged in non-mutual fund activities, such as, real estate, data processing, and printing. In total, almost 14,000 workers of all types are employed by the Missouri mutual fund industry.

Based on 1999 federal government data, Missouri mutual fund industry employees averaged more than $77,000 in annual salary, considerably above the Missouri private sector average of less than $30,000. A PwC survey conducted as part of this study found that between 1997 and 2000 Missouri mutual fund firms' employment rose by over 27 percent; by contrast, overall statewide employment growth increased only about 4 percent.

Although the industry's direct employment accounts for less than one percent of the state's private sector labor force, its impact on economic activity is considerably greater. Based on the most recent available information, the mutual fund sector's contribution to Missouri Gross State Product — one measure of economic activity tracked by the U.S. Commerce Department — rose at an annual rate of about 6 percent (adjusted for inflation) over the period 1987 to 1999. By contrast, overall Missouri Gross State Product increased by only 2.8 percent (adjusted for inflation) over the same interval and other industries, such as the combined wholesale and retail trade sector and the manufacturing sector, grew by only 2.3 percent and 1.9 percent, respectively.

The mutual fund industry has a highly-educated and well-paid workforce that is complementary to the state's objectives of retaining in-state trained college graduates. The industry's presence generates other significant indirect benefits to the state as well. According to the Minnesota IMPLAN group, each mutual fund industry job generates more than one additional position elsewhere in the state economy. Thus, based on current employment levels, over 30,000 private sector jobs can now be traced to the economic activity generated by Missouri mutual fund firms.

State Tax Revenue Implications

In examining the revenue implications of mutual fund taxation, it is important to bear in mind the relatively small share that corporate tax revenues comprise of total state tax collections. Based on current tax collection data and law, Missouri corporate income tax collections account for about 3 percent of total tax receipts. By contrast, individual income taxes and general sales taxes make up about 42 percent and 32 percent, respectively, of state collections. Thus, an evaluation of the corporate tax revenue affected by legislation favorable to an industry must also take into consideration any reduction in individual income tax and sales tax revenue that could result in the absence of such changes. This consideration is particularly important for the mutual fund industry, because about 75 percent of the industry's value added — the market value of the services it produces — is paid out in the form of compensation to employees and, thus, is ultimately reflected in the state's personal income tax base.

Based on recent industry and federal government data, Missouri mutual fund firm employees pay, on average, about $2,300 in state income tax and $500 in sales taxes annually. We rely on these figures and on recent rates of industry growth in Missouri to project the amounts of revenue at risk if future mutual fund growth were to occur outside rather than within the state. Over the period 2002 to 2004, mutual fund *growth* will generate 2,500 new mutual fund industry jobs, additional individual income taxes of about $14 million, sales taxes of about $7 million, and local earnings taxes of about $5 million. Additional local property taxes paid by the firms will come to over $2 million.

When we also consider the effect on other Missouri industries dependent on the state's mutual fund sector, the projected employment and revenues are still greater. We estimate overall *growth* from the mutual fund and related sectors for the three years 2002, 2003, and 2004 to be 5,500 employees and $56 million in revenue— $21 million from individual income taxes, $15 million from sales taxes, $7 million from local earnings taxes and almost $13 million from business real estate taxes. Even this estimate understates the overall revenue potential since it does not account for all affected revenue sources, such as franchise taxes, which would also decline relative to current trends if the mutual fund industry were not to expand further in Missouri.

Conclusion

In addition to supporting Missouri's existing mutual fund industry and positioning the state to attract mutual fund growth, the current mutual fund apportionment method is consistent with forward-looking public policy. Economic researchers have shown that state tax policies are likely to be most cost-effective when targeted toward industries that export their goods and services, expanding industries and those reducing the state economy's susceptibility to business cycle disruptions. Tax proposals designed to enhance the mutual fund industry's position meet these requirements: Missouri mutual fund companies provide the bulk of their services to out-of-state customers. Additionally, at a time when other in-state industries have either contracted or restructured, the mutual fund industry and related sectors have thrived.

The current Missouri tax structure provides, in general, equitable tax treatment for its mutual fund industry relative to that provided by its most important competitor states, thereby allowing Missouri companies to effectively compete for cost-conscious customers. A growing mutual fund industry significantly contributes to the state not only directly from the industry itself, but also from the many related industries. Employment, compensation, personal income tax, sales taxes, and property taxes all are positively influenced by the current mutual fund tax regime.

I. Introduction

PricewaterhouseCoopers (PwC) is providing this report in response to a request by the Missouri Coalition for Source-State Taxation (MOCOSST). The report provides an analysis of the Missouri mutual fund industry's contribution to the state in terms of employment, compensation, and taxes. The analysis is, in effect, an updating of a similar study performed by Coopers & Lybrand, L.L.P. in March 1997. The previous study was based on historical information available at the time the analysis was conducted, primarily 1989-1995 data, and on a survey of the mutual fund industry that requested information for 1995 and 1996. This report relies on more recent historical information (*i.e.*, primarily through 1999) and on a survey of the industry that requested data for 1997 through 2000.

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II. Background on the Missouri Mutual Fund Industry

In recent years, the mutual fund industry has assumed increasing importance in financial markets nationally and around the world. Mutual fund assets have grown from \$3.5 trillion in 1996 to about \$7 trillion in 2000, an annual average increase of more than \$850 billion.[3] Among the states, Missouri has attained a significant share of the mutual fund business. Indeed, as measured by the Investment Company Institute — the mutual fund industry's trade organization that monitors economic data trends — Missouri climbed from sixth largest in the country in 1992 to fourth largest in 1999 in terms of mutual fund employment.[4]

The presence of the mutual fund industry in Missouri confers many benefits. Large amounts of investment capital are attracted from outside the state, and these imported assets are managed and serviced within the state. Yet, as a service provider, the activities of the mutual fund industry have virtually none of the drawbacks (*e.g.*, pollution and occupational safety) associated with certain other industries. Since mutual fund companies have expanded operations as other in-state industries have contracted or stagnated, that expansion has helped to smooth some of the effects of reductions in other sectors on the Missouri labor force as well as the state and local government revenue base.

For example, between October 2000 and October 2001, private sector employment in Missouri dropped by 1.7 percent,[5] largely attributable to a decline in durable manufacturing (-8.6 percent) and non-durable manufacturing (-7.2 percent). During the period, the only sector in Missouri to experience an increase in employment was the Finance, Insurance, and Real Estate sector (1.2 percent growth). Most important, the industry attracts workers who are educated, highly-skilled and well-compensated — an excellent fit with the colleges and universities concentrated in the state.[6]

Chart A relies on data from *County Business Patterns*, U.S. Census Bureau, to show that mutual fund industry employees in Missouri are better paid, on average, than other Missouri private sector workers. For 1999, the most recent year for which information is available, average compensation in the Missouri mutual fund industry was over two and one-half times as high as the figure for all industries.

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[3] Source: Investment Company Institute statistical releases.

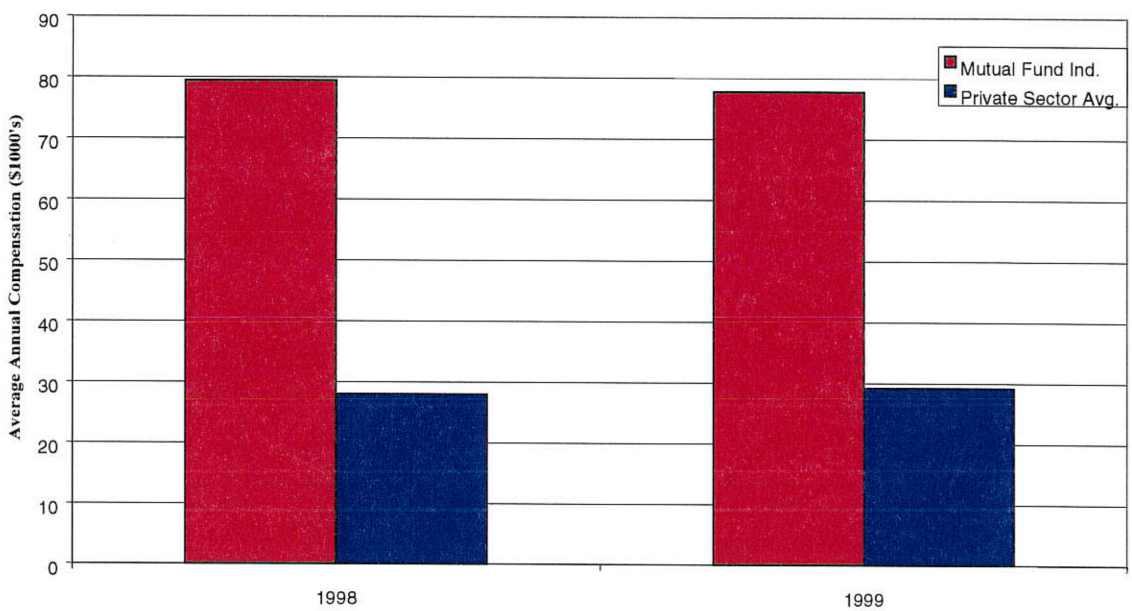
[4] Includes mutual fund company employment and employment from transfer agents and other direct providers of services to mutual funds. In terms of mutual fund industry employment, the top ten states are, in order, Massachusetts, New York, Pennsylvania, Missouri, Texas, Minnesota, California, New Jersey, Illinois, and Colorado. Also see Table 4.

[5] Source: Federal Reserve Bank of Kansas City, *Regional Economic Update*, December 1, 2001.

[6] This takes on particular importance, since Missouri is alone among the Midwestern states in the changes it is experiencing in the demographic mix of employees. According to the most recent information available from the U.S. Census Bureau, between 1985 and 1990, the state underwent a net out-migration of college graduates and advanced degree holders, while at the same time gaining migrants with high school diplomas or less schooling. See G. Miller, "People on the Move: Trends and Prospects in District Migration Flows," Economic Review, Federal Reserve Bank of Kansas City, Third Quarter 1994, pp. 39-54.

6.8

CHART A. Average Annual Compensation in the Missouri Mutual Fund Indusry 1998-1999



Source: U.S. Census Bureau, *County Business Patterns,* July 2000 and April 2001.

As part of this study, PwC conducted a survey of Missouri mutual fund firms to obtain up-to-date information on the industry and to supplement other industry information obtained from government and trade sources. (See Appendix C for the PwC mutual fund industry survey form and instructions.) This survey provides a snapshot of expenditures incurred over the four-year period 1997 to 2000 and, thus, reflects the industry's most current information.[7] More significantly, the PwC study underscores the overall economic contribution the industry makes to the state and local economies by quantifying the resources the industry purchases from other service providers and manufacturers.

Based on the survey data, the Missouri mutual fund companies obtained a range of goods and services from related industries located in Missouri. Chart B shows the breakdown of the industry's expenses in 1999 among key suppliers of goods and services. The principal sectors are: (1) printing and stationery, (2) legal, accounting and consulting services, (3) food and entertainment, (4) software and computer hardware, (5) construction, (6) advertising and marketing, (7) utilities, and (8) "other". The broad scope of coverage signifies the major impact

[7] Survey responses were received from all six MOCOSST member companies. Based on a comparison of survey results with data from Bureau of Labor Statistics and from the Investment Company Institute, we estimate that in terms of employment MOCOSST members constitute approximately 60 percent of the Missouri mutual fund industry.

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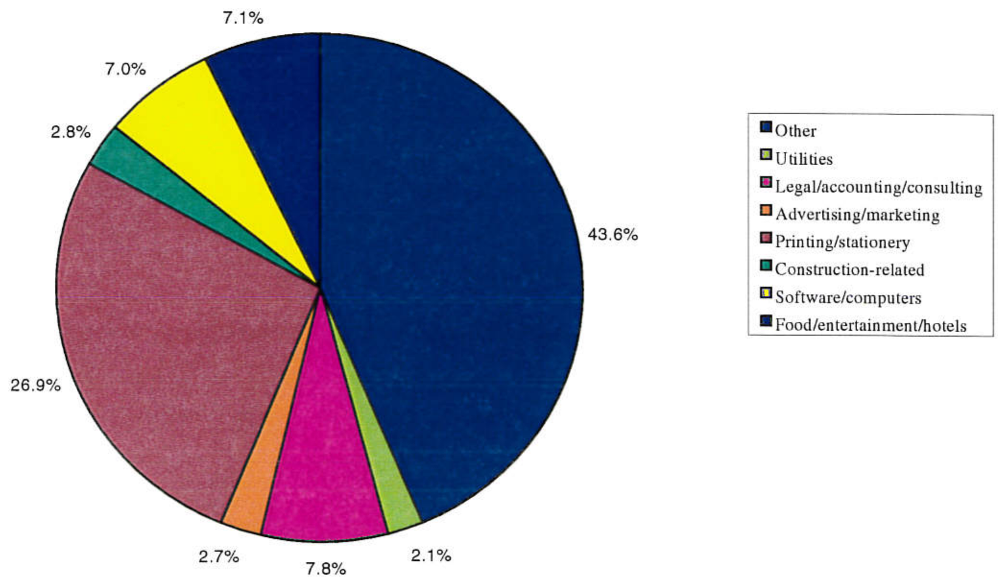
CHART B. Distribution of Payments by Mutual Funds to Related Industries in Missouri, 1999



Source: PricewaterhouseCoopers Survey of Missouri Mutual Fund Industry.

the mutual fund industry has within the state; blue collar and white collar workers, technical workers and those with more general skills all benefit from the industry's presence. Although not shown in the chart, respondents to the survey reported for 2000 payments of $3.1 million in property taxes and occupation of 2.0 million square feet of leased or owned office space within the state.

The survey permits us to examine the industry's rate of growth from several different perspectives. Numbers of employees in the Missouri mutual fund industry rose by 8.5 percent between 1999 and 2000 as compared with an overall statewide growth of 1.2 percent.[8] Mutual fund industry payroll increased by 31.3 percent and payments to Missouri-based suppliers grew by 15.9 percent (See Chart C). The survey indicates that withholding taxes paid to Missouri increased by 39.1 percent and that personal and real estate taxes paid to Missouri cities and towns grew by 5.8 percent between 1999 and 2000.[9]

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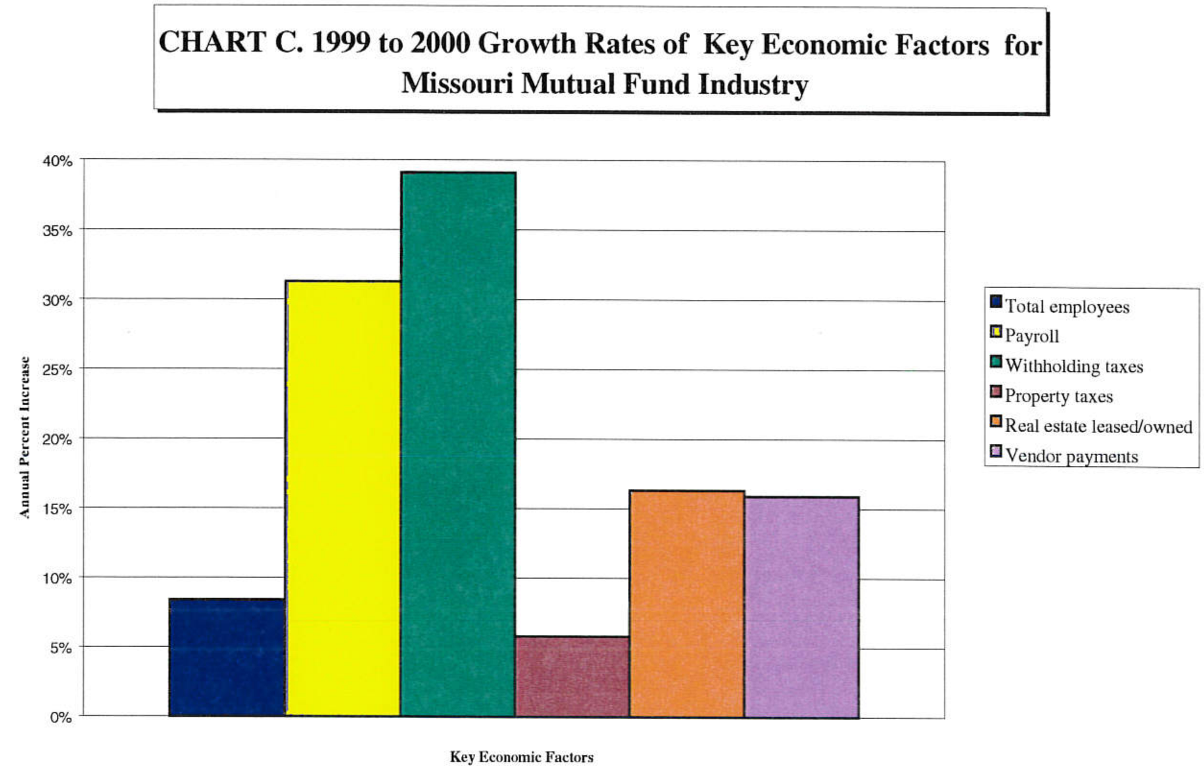
[8] Source: U.S. Bureau of Labor Statistics, Current Employment Statistics Survey.

[9] Survey results for the 1995-1996 period, as reported in the 1997 study, also demonstrated strong mutual fund industry growth. The 1995-1996 survey showed that mutual fund employment grew by 8.7 percent (compared to a overall state growth of 1.7 percent), mutual fund industry payroll increased by 12.9 percent, payments to Missouri-based suppliers grew by 10.2 percent, withholding taxes grew by 9 percent, and real estate taxes increased by nearly 30 percent.

6.10



Source: PricewaterhouseCoopers Survey of Missouri Mutual Fund Industry.

Economic projections for future decades further support these growth trends. As the baby boom generation approaches the stage in its life cycle when family incomes exceed household expenses, a larger share of income will be saved[10] and invested in mutual funds and similar products. For similar reasons, retirement accounts, including 401(k) plans, are growing at a rapid rate. Mutual fund companies manage and service a larger number of these plans than any other type of financial institution.[11] In short, the mutual fund industry in Missouri has the potential to generate high levels of job growth and related economic activity for the next few decades.

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[10] There is considerable evidence from government population surveys that supports this thesis. See, for example, Lieberman and Wachtel, "Age Structure and Personal Saving Behavior," in Social Security Versus Private Saving, ed. Von Furstenberg.

[11] See The Future of Money Management in America, 1995 Edition, by Sanford C. Bernstein & Co., Inc.

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III. The Missouri Tax Environment for the Mutual Fund Industry

As in many states, the Missouri tax structure relies on many different revenue sources to fund state and local programs. The bulk of the state's tax collections is derived from two sources: (1) the individual income tax and (2) general sales and gross receipts taxes. Traditionally, corporate net income taxes comprise a relatively small share of total state tax revenues. Table 1 shows that the corporate net income tax share in Missouri over the period fiscal years 1999-2000 is about 3 percent.

Table 1. Missouri State Tax Collections

($ Millions)

Tax Source	Fiscal Year 1999	Fiscal Year 2000	'99-00' Share of Total
Individual income	$3,627	$3,550	41.9%
General sales and gross receipts	2,716	2,788	32.1%
Selective sales taxes [a]	1,202	1,244	14.3%
Licenses	603	576	6.9%
Corporation net income	277	265	3.2%
Other taxes [b]	138	149	1.7%
Total [c]	$8,564	$8,572	100.0%

[a] Selective sales taxes currently include taxes levied on alcoholic beverages, amusements, insurance premiums, motor fuels, public utilities, tobacco, and other selective sales.

[b] Other taxes include property taxes, death and gift, severance, and "other".

[c] Details may not add to totals because of independent rounding.

Source: State Government Tax Collections Survey of the U.S. Census Bureau, Governments Division.

If local property taxes and other local taxes in Missouri are taken into account, the corporation income tax's share of Missouri taxes is even smaller. Including local taxes is appropriate since these are another cost to business that may vary across locations and among competitors. Property and general sales taxes constitute the largest proportion of local Missouri taxes. When these and other local sources of tax revenue are combined with state tax revenues, corporation income taxes amount to about 2 percent of Missouri state and local taxes combined, as shown in Table 2.

6.12

Table 2. Missouri State and Local Tax Collections, Fiscal Year 1999
($ Millions)

Tax Source	State Taxes	Local Taxes	Total State and Local [a]	
			Amount	Share of Total
General sales	$2,716	$1,210	$3,926	28.0%
Individual income	3,627	228	3,856	27.5%
Property	17	3,288	3,305	23.6%
Selective sales [b]	1,202	474	1,676	11.9%
Other taxes [c]	724	264	988	7.0%
Corporation net income	277	0	277	2.0%
Total [d]	$8,564	$5,464	$14,028	100.0%

[a] Duplicative intergovernmental transactions are excluded.

[b] Selective sales taxes currently include taxes levied on alcoholic beverages, amusements, insurance premiums, motor fuels, public utilities, tobacco and other selective sales.

[c] Other taxes include licenses, death and gift, severance, and "other".

[d] Details may not add to totals because of independent rounding.

Source: State and Local Government Finance Survey of the U.S. Census Bureau, Governments Division.

The role corporate income taxes play relative to other types of state taxes is particularly significant when analyzing the mutual fund industry's overall tax payments to Missouri. As compared with other industries, a much higher percentage of this industry's value added — the market value of its goods and services less costs — is paid out to employees as compensation.[12] As shown in Table 3, over 75 percent of the industry's economic income is ultimately reflected in the state's personal income tax base. By contrast, across all private industries in the U.S., compensation amounts to about 55 percent of value added. Put another way, for every $100 of business income, private industries pay $55 to their employees on average, but the securities industry pays over $75 — over one third more.

[12] This figure is based on national information available for the securities industry and includes wages and fringe benefits as compensation.

6.13

Table 3. Missouri Compensation of Employees as a Share of Value Added: Selected Industries, 1990-99

Industries [a]	Compensation share
Private industries [b]	55.5%
Security and commodity brokers	75.9%
Construction	69.6%
Business,miscellaneous professional, and other services	65.1%
Insurance [c]	61.3%
Manufacturing	59.5%
Legal services	56.9%

Notes:
[a] Industries are classified according to the 1987 SIC system.
[b] Private industries comprises all industries minus government.
[c] Insurance industry includes insurance carriers and insurance agents, brokers, and service.

Source:
"Gross Domestic Product by Industry and the Components of Gross Domestic Income, Current Dollar Estimates for 1947-99," Bureau of Economic Analysis: http://www.bea.doc.gov/bea/dn2/gpo.htm, and PricewaterhouseCoopers calculations.

Prior to 1998, the nationwide income of mutual fund companies located or having operations in Missouri was apportioned to and taxed in Missouri under one of two methods: (i) based on a percentage of the company's property, payroll, and sales located in Missouri; or (ii) based solely on a percentage of the company's sales attributable to Missouri. Missouri's rules generally treated 100 percent of Missouri-based mutual fund companies' nationwide sales as Missouri-sourced sales. Because most sales were probably made to non-residents, however, Missouri-based firms generally faced a higher tax liability than did mutual fund companies located in competing states.

In 1997, Missouri reformed the taxation of mutual fund companies by enacting legislation (effective January 1, 1998) that allows mutual fund companies to elect a single factor apportionment method apportioning sales on the basis of the residence of the mutual fund shareholder. Mutual fund companies domiciled in Missouri are able to reduce their operating costs attributable to lower state income tax to effectively compete with companies domiciled in jurisdictions that provide for similar tax treatment.

Since 1989 ten other states have enacted tax legislation to encourage continued growth of the mutual fund industry. Maryland (1998), New Jersey (1989), New York (1989), and Utah (1992) tax mutual funds on the basis of a customer residence test and a percentage of the company's

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property, payroll, and sales. Connecticut (1996), Kentucky (1992), Maine (2001), Massachusetts (1997), Rhode Island (1996), and Texas (1992) tax mutual fund companies on the basis of a customer residence test and a single sales factor.

The ten other states that have enacted tax reform legislation have attracted the largest amount of mutual fund employment.[13] For example, Massachusetts is first and New York is second, while Missouri and Texas rank fourth and fifth. (Among the top five states, only Pennsylvania has yet to enact mutual fund tax reform.) In fact, almost 49 percent of total U.S. mutual fund employment is concentrated within the other ten states that have enacted legislation.[14] Furthermore, based on statistics from the U.S. Bureau of the Census, between 1997 and 2000 mutual fund employment in the ten states has increased on average at a rate almost two times the average for all other states. Table 4 summarizes the apportionment rules for the ten states that recently reformed the taxation of mutual fund companies and shows the national ranking in terms of mutual fund industry employment.

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[13] Mutual fund state-by-state employment data are from ICI, special tabulation based on its 1999 survey of U.S. mutual fund industry.

[14] Approximately 55 percent when including Missouri.

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TABLE 4. Apportionment Rules for Mutual Fund Service Companies and National Rank In Certain Other States

State	National Rank*	Status	Factors Used	Basis for Sourcing Sales	Effective Date
Massachusetts	1	Current	Single sales factor	Customer residence test	7/1/97
		Prior to reform	50% sales, 25% property, 25% payroll	Where services are performed	
New York	2	Current	50% sales, 25% property, 25% payroll	Customer residence test	1/1/89
		Prior to reform	33.3% sales, 33.3% property, 33.3% payroll	Where services are performed	
Texas	5	Current	Single sales factor	Customer residence test	1/1/92
		Prior to reform	Single sales factor **	Where services are performed	
New Jersey	8	Current	50% sales, 25% property, 25% payroll	Customer residence test	8/21/89
		Prior to reform	33.3% sales, 33.3% property, 33.3% payroll	Where services are performed	
Maryland	11	Current	50% sales, 25% property, 25% payroll	Customer residence test	1/1/98
		Prior to reform	50% sales, 25% property, 25% payroll	Where services are performed	
Utah	17	Current	33.3% sales, 33.3% property, 33.3% payroll	Customer residence test	1/1/92
		Prior to reform	33.3% sales, 33.3% property, 33.3% payroll	Where services are performed	
Kentucky	22	Current	Single sales factor	Customer residence test	6/30/92
		Prior to reform	50% sales, 25% property, 25% payroll	Where services are performed	
Rhode Island	27	Current	Single sales factor	Customer residence test	7/1/96
		Prior to reform	33.3% sales, 33.3% property, 33.3% payroll	Where services are performed	
Connecticut	29	Current	Single sales factor	Customer residence test	1/1/96
		Prior to reform	Single factor or three factor depending on circumstances	Where services are performed	
Maine	43	Current	Single sales factor	Customer residence test	1/1/2001
		Prior to reform	50% sales, 25% property, 25% payroll	Where services are performed	

Unless otherwise noted information is from PricewaterhouseCoopers, LLP, as of May 2001.

* = National rank in terms on employment. Source: Investment Company Institute, based on its 1999 survey of the U.S. mutual fund industry.
** = Prior to 1992, Texas has a capital-based tax.

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IV. Future Economic Activity Affected by the Special Apportionment

The mutual fund industry is similar to other competitive industries. Firms regularly review all costs of operation with an eye toward the bottom line. Competition is particularly intense because mutual fund prospectuses must disclose all fees, calculated to the 1/100th of 1 percent, paid to investment advisors and other service providers. The expense ratios of mutual funds have a substantial impact on customer returns, especially in money market and bond funds. Mutual fund firms also compete to attract skilled employees. As noted above, based on U.S. Commerce Department data, the percentage of value added paid out in compensation by the mutual fund industry is generally much higher than the percentage paid out by most other industries.

An important cost of doing business, which directly affects the bottom line, is the state tax on corporate income. As service providers with a nationwide customer base, mutual fund companies are less dependent on a particular location in order to operate and, when required to, can relocate facilities and employment in response to various business considerations, including differential state tax rates on corporate income. In contrast to manufacturers, mutual fund companies do not have huge investments in fixed plant and machinery; they depend heavily on telecommunications equipment and computers that can be located almost anywhere. Indeed, mutual fund companies have the capacity to locate their service facilities virtually anywhere in the country.

To quantify the industry's impact on the Missouri economy that would likely continue to be felt under the existing special apportionment for mutual funds, PwC constructed a model which estimates the mutual fund sector's contribution to the state in terms of employment and tax revenue. For this analysis, we treat the level of economic activity in 2001 as a benchmark and consider only the additional growth attributable to the industry's continued expansion. According to the U.S. Census Bureau, *County Business Patterns* (CBP), the Missouri mutual fund industry employed 11,300 employees in 1999 (the latest year for which CBP data are available). To this we add two related categories of employees: (1) "connected" employment, *i.e.*, employees of operations whose location in Missouri is determined by the mutual fund operations; and (2) "potential" employment, *i.e.*, employment attributable to companies that are assumed to re-locate to Missouri if the special apportionment were continued.[15] We estimate core and connected employment for 1999 to be 13,200. "Potential employment" is not added to the core and connected employment until 2002, the year of assumed relocation to Missouri.

Projected employment and average compensation totals were developed for 2000 through 2004. In general we assume that until 2004 employment will grow by its long-term growth rate, 4.9 percent per year, and average compensation will grow by its long-term growth rate, 4.4 percent per year. The long-term growth rate for employment is identical to the average annual growth rate in employment for 1988 to 1999. The long-term growth rate for average compensation is identical to the average annual growth rate implicit in the forecasts of population made by the U.S. Bureau of the Census and of GDP made by the Congressional Budget Office. However, to account for the recent slow down in the overall U.S. economy, we conservatively assume no

[15] See Appendix A for a full description of "connected' and "potential" mutual fund company operations.

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growth for 2000 to 2001, and one-half the long-term growth for 2001 to 2002.[16] Table 5 provides our employment and average compensation projections through 2004.

Table 5. Projected New Employment and Compensation in the Mutual Fund Industry

Year	Employees	Average Compensation
1999	13,200	$77,800
2000	13,800	81,200
2001	13,800	81,200
2002	14,800	83,000
2003	15,500	86,600
2004	16,300	90,500
2001 to 2004 Increase:	2,500	NA

Note: Employment figures and compensation amount are rounded.

NA = Not applicable.

Increases in employment and compensation in the Missouri mutual fund industry would lead to additional "supporting" employment, resulting from two effects: (1) additional goods and services from businesses that supply the mutual fund industry[17] and (2) additional demand for services on the part of increased number of mutual fund employees. To measure the additional supporting employment resulting from the mutual fund industry growth, we use an input-output structure developed by IMPLAN.[18]

Using IMPLAN multipliers, we find for every new finance industry job created in Missouri, more than one additional job will be generated in supporting sectors. Altogether, about 3,000 new positions would be created by the additional employment in related sectors during the 2002-2004 period. When considered along with the new positions projected for the mutual fund industry over the three-year period, 2002 to 2004, the total is around 5,500 new jobs, as shown in Table 6.

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[16] See Appendix Table A for a description of the methodology used.

[17] See Chart B for a list of the important sectors supplying goods and services to the Missouri mutual fund industry.

[18] See Appendix B for a description of IMPLAN.

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Table 6. Projected New Employment in the Mutual Fund Industry and Supporting Industries

Calendar Year	Mutual Fund Industry Employees	Supporting Industry Employees	Total
1999	13,200	15,600	28,800
2000	13,800	16,300	30,100
2001	13,800	16,300	30,100
2002	14,800	17,500	32,300
2003	15,500	18,400	33,900
2004	16,300	19,300	35,600
2001 to 2004 Increase:	2,500	3,000	5,500

Note: Employment figures are rounded. Details may not add to totals due to rounding.

Another way of ascertaining the ripple effect of changes in the mutual fund industry is to calculate the earnings base of new jobs in the mutual fund industry and in supporting industries. In making such a calculation, we rely on projected compensation for mutual fund industry jobs shown in Table 5 and on the IMPLAN income multiplier, which relates Missouri finance industry earnings to earnings in supporting industries benefiting from expansion of the mutual fund companies. This approach implies average compensation in supporting industries will increase from about $37,600 in 2002 to about $40,900 in 2004.[19]

Chart D shows the increasing earnings base from 2001 to 2004 resulting from projected growth in the mutual fund industry and in supporting industries. The annual increase in aggregate compensation from the new jobs within the mutual fund industry and in related sectors rises from about $160 million in 2002 to over $500 million by 2004.

[19] For this analysis we assume average compensation for supporting jobs grow at the same rate as that for the mutual fund industry over the 2002-2004 projection period.

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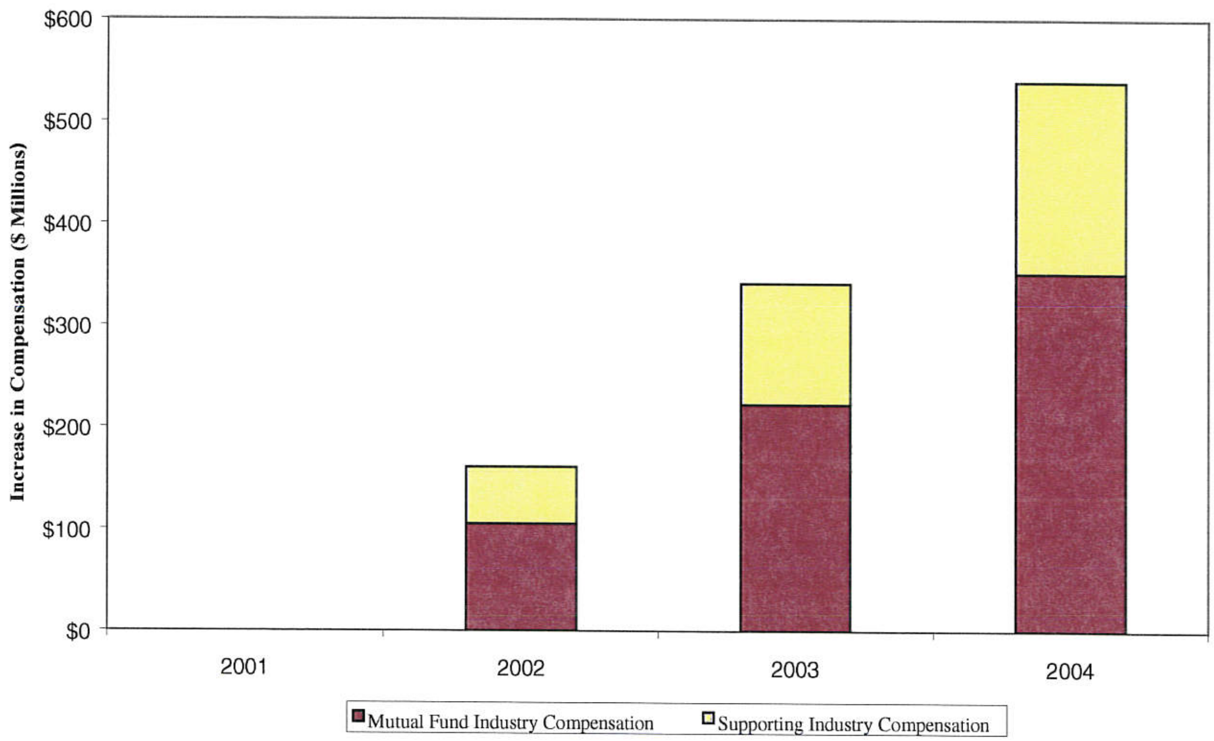
CHART D. Increasing Compensation Resulting from Mutual Fund Industry Growth



6.20

V. Future Tax Revenue Affected by the Special Apportionment

It is important to consider the broader economic implications of providing a competitive tax climate for Missouri mutual fund companies. Such an assessment requires that the increased revenue from other tax sources (to which mutual fund firms, their suppliers and their employees contribute) be weighed against the cost of any tax incentives directed toward the industry. *In the following analysis, we considered only the tax revenue attributable to projected industry expansion from 2001 onward.*

The largest revenue sources to be evaluated in such an analysis are the individual income taxes paid by new employees in the mutual fund industry and sales taxes paid by the mutual fund companies and their employees. Although property taxes are levied at the local level, these too should be considered if the overall impact on the Missouri economy is to be evaluated. Finally, since many suppliers to the mutual fund companies may reasonably be expected to be affected by changes to their customers' profitability, the tax consequences from these supporting sectors should also be taken into account.

Income Taxes

Relying on the average compensation amounts for industry personnel projected above, Table 7 shows projected employment and average taxable income for new employees in the mutual fund industry over the 2002-2004 period. To project tax receipts, we applied a 2.7 percent tax rate, the average rate for Missouri residents whose 1999 adjusted gross income was between $50,000 and $100,000. We assume unearned income is taxed at the same rate. Based on these assumptions, additional Missouri personal income taxes from new mutual fund employees are estimated to rise from $2.5 million in 2002 to $6.9 million by 2004 and to total $14.0 million over the three-year period.[20]

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[20] Our estimate of Missouri individual income tax revenue attributable to the future growth in the Missouri mutual fund industry is based on the following information: (i) the number of employees working in Missouri and (ii) the average amount of wages and salaries received by these employees. The Appendix describes the methodology underlying these projections. Our preliminary assumption, based on 1990 U.S. Census population figures for the Missouri and Kansas counties within the Kansas City, MO-KS Metropolitan Statistical Area ("MSA") and the Missouri and Illinois counties within the St. Louis, MO-IL MSA, is that 90 percent of all mutual fund industry employees live in Missouri and that the balance live out of state, primarily either in Kansas or Illinois. To determine total income for Missouri residents, we relied on published information from federal income tax returns to establish a relationship between wage and salary income and sources of unearned income (See Table 7). An average tax rate, which accounts for exemptions, deductions, and tax credits taken by taxpayers, was derived from 1999 Missouri Department of Revenue returns data on state residents whose Missouri adjusted gross income was between $50,000 and $100,000. This yielded a 3.3 percent tax rate, which was adjusted to 2.7 percent to account for non-taxable compensation. For Missouri residents, we applied this 2.7 percent average tax rate to total income — wage and salary income plus unearned income. For out-of-state residents, we applied the 2.7 percent tax rate only to Missouri wage and salary income.. None of these estimates takes into consideration any lag in payments between withholding and final payments and abstracts from calendar year-fiscal year differences.

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Table 7. Incremental Employment and Projected Income Taxes Attributable to Growth in the Missouri Mutual Fund Industry

Calendar Year	Increase in Industry Employment	Average Compensation*	Average Unearned Income**	Income Tax Liability ($ Millions)
2002	1,000	$83,000	$10,790	$2.5
2003	1,700	86,600	11,258	4.5
2004	2,500	90,500	11,765	6.9
Total	NA	NA	NA	$14.0

* Average compensation includes both taxable and non-taxable amounts.

** Unearned income includes taxable amount only.

Note: Details may not add to totals due to rounding.

NA = Not applicable.

Table 8 shows that $7.0 million of additional income tax may come from new employees in sup[porting industries.[21] Combined, the tax revenue from the mutual fund sector and related industries could equal $21.0 million, consistent with the prominent role income taxes play in the state budget.

Table 8. Projected Increases in State Individual Income Tax Revenue Attributable to Future Growth in the Mutual Fund Industry ($ Millions)

Calendar Year	Mutual Fund Industry Employees	Supporting Industry Employees	Total Income Tax Liability
2002	$2.5	$1.3	$3.8
2003	4.5	2.3	6.8
2004	6.9	3.5	10.4
Total	$14.0	$7.0	$21.0

Note: Details may not add to totals due to rounding.

[21] Since we assume average compensation for related industry employees is somewhat lower than the compensation received by mutual fund industry employees, we have based our estimate of the individual income tax revenue attributable to related industry employees on an average tax rate of about 2.5 percent applicable to state residents with adjusted gross incomes of between $30,000 and $50,000.

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Earnings Tax

An additional 1 percent tax on wages is imposed by Kansas City ("wage earners earnings tax") and St. Louis ("individual earnings tax") on employees residing or working in the two cities. Based on information in Tables 7 and 8, we calculate additional revenue of $7.1 million from these sources.[22] The amount of the tax for the mutual fund industry and supporting industries is shown separately in Table 13, below.

Sales Taxes

Sales taxes are paid: (1) by the industry for the purchase of any goods and certain services from business suppliers and (2) by employees of the mutual fund industry and related industries for household products and some services. To project the sales tax amounts associated with growth in the mutual fund industry, we determined Missouri sales taxes per capita by relying on Census Bureau projections of the state population between 2000 and 2004 and on 1999 sales tax collections.[23] These per capita amounts include taxes from sales of final products to households as well as from sales of intermediate products to businesses. Mutual fund industry employees were assumed to have an average household comprising 2.5 individuals. As shown in Table 9, additional sales taxes attributable to new employees in the mutual fund industry rise from approximately $1.3 million in 2002 to more than two and one-half times that amount by 2004.[24]

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[22] Although the revenue received by St. Louis and Kansas City from this tax would not be considered in accounting for state revenue, the condition of municipal finances could affect state expenditures to these two jurisdictions in some cases.

[23] Projected from 1999 to 2004 consistent with the latest forecasts made by the Congressional Budget Office, U.S. Congress.

[24] We assume for the analysis that employees who are out-of-state residents spend half of their taxable consumption in Missouri and the remainder out-of-state.

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Table 9. Projected Increases in Sales Tax Collections Attributable to New Industry Employee Households

Calendar Year	Missouri Population (Millions)	Sales Taxes Per Capita	New Employee Household Members	New Employee Households' Sales Taxes ($ Millions)
2002	5.6	539	2,500	$1.3
2003	5.6	563	4,200	2.2
2004	5.6	587	6,200	3.5
Total	NA	NA	NA	$7.0

Note: Details may not add to totals due to rounding.
NA = Not applicable.

Table 10 provides: (1) sales taxes attributable to new employees in supporting industries, and (2) combined sales taxes from the mutual fund industry (Table 9) and supporting industries due to mutual fund industry growth in Missouri. This total would be $15.4 million by 2004 — more than double the projected sales taxes attributable to new mutual fund industry employees alone.

Table 10. Total Projected Increases in Sales Tax Collections Attributable to Mutual Fund Industry Growth

Calendar Year	New Supporting Industry Employees	Supporting Industry Household Members	Supporting Industry Households' Sales Taxes ($ Millions)	Combined Mutual Fund and Supporting Industry Households' Sales Taxes ($ Millions)
2002	1,200	3,000	$1.5	$2.8
2003	2,100	5,200	2.8	5.0
2004	3,000	7,400	4.1	7.6
Total	NA	NA	NA	$15.4

Note: Details may not add to totals due to rounding.
NA = Not applicable.

Real Estate and Personal Property Taxes

PwC's survey of the Missouri mutual fund industry reports information about leased and owned office space by mutual fund companies in Missouri as well as about personal property taxes and

6.24

real estate property taxes paid to local jurisdictions. To quantify how property tax collections would be affected by mutual fund industry growth, we assume that property tax rates and assessment practices do not differ among locations in the state and that office space per employee from the survey is an acceptable standard for determining office space requirements for new employees. Table 11 shows the derivation of the projection for industry workers and Table 12 presents similar information for both new mutual fund employees and for those in related industries. The increased revenues shown for related industries in Table 12 also take into consideration taxes paid on property leased by the mutual fund industry. The increase in total property taxes would be $12.5 million by 2004.

Table 11. Projected Increases in Property Tax Collections from Mutual Fund Firms Attributable to New Growth

Calendar Year	New Industry Employees	Square Feet Per Employee	Owned Office Space as a Share of Total Office Space	Property Taxes per Square Foot of Owned Office Space	Property Taxes Related to Industry Growth ($ Millions)
2002	1,000	285	33.1%	$4.66	$0.4
2003	1,700	285	33.1%	4.66	0.7
2004	2,500	285	33.1%	4.66	1.1
Total	NA	NA	NA	NA	$2.3

Note: Details may not add to totals due to rounding.
NA = Not applicable.

Table 12. Projected Increases in Overall Property Tax Collections Attributable to Industry Growth ($ Million)

Calendar Year	Property Taxes Related to Industry Employees	Property Taxes from Supporting Industries*	Total Additional Property Taxes
2002	$0.4	$2.0	$2.4
2003	0.7	3.4	4.1
2004	1.1	4.9	6.0
Total	$2.3	$10.3	$12.5

* Property taxes with respect to real estate industry leased by the mutual fund industry are treated as supporting industries' property taxes.

Note: Details may not add to totals due to rounding.

Summary

Multiple state and local revenue sources will be affected by mutual fund industry employment growth inside the state. Although the impact of withheld income taxes is likely to predominate, sales taxes and property tax collections change significantly as well. Table 13 shows that, without taking into consideration the tax ripple effects from new employment growth in related sectors, state and local revenues generated directly from additional economic activity in the mutual fund industry could amount to $27.8 million over the three-year period 2002 to 2004. Including the taxes paid by industry suppliers could raise the overall total to $56.0 million.

Table 13. Projected Overall Increases from Selected Revenue Sources Attributable to Industry Growth ($ Million; 2002-2004)

Revenue Source	Mutual Fund Industry	Supporting Industries	Total
Individual income taxes	$14.0	$7.0	$21.0
Earnings taxes	4.6	2.5	7.1
Sales taxes	7.0	8.4	15.4
Property taxes	2.3	10.3	12.5
Total	$27.8	$28.2	$56.0

Note: Details may not add to totals due to rounding.

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VI. Policy Implications

In a review of two decades of economic research published in 1995, Professor Keith Ihlanfeldt identified ten guidelines for state and local economic development.[25] Among Ihlanfeldt's conclusions are that tax incentives, when provided, are more likely to be cost-effective if they: (1) are targeted toward firms in industries that export their goods and services outside the state; (2) are consistent with state objectives such as job creation and industry diversity (to reduce business cycle instability); and (3) attract high technology firms.

Tax proposals designed to foster further growth of the mutual fund industry are consistent with each of these objectives. Missouri mutual fund companies provide the overwhelming portion of their services to out-of-state customers. Additionally, at a time when other in-state industries have either contracted or restructured, the mutual fund industry has expanded and related sectors dependent upon this sector have also thrived. Finally, the types of services provided by mutual fund companies are consistent with the general thrust by state development authorities toward high-paying jobs with large value-added components.[26]

Although there may be costs in foregone state corporate tax revenue from helping the mutual fund industry in Missouri remain competitive with firms operating in other states and with other financial competitors, there are substantial benefits in the form of new jobs, economic activity and resulting individual income, property and sales taxes from the mutual fund industry and in related economic sectors. Over the 2002- 2004 period, the amounts foregone in annual corporate tax revenue by Missouri would be overshadowed by the roughly $28 million in individual income, earnings, property and sales taxes that can be attributed to the mutual fund industry's continuing growth.[27] Moreover, such foregone corporate tax revenue is dwarfed by the more broad-scale economic activity and $56 million in tax revenue stemming from mutual fund growth and the growth of related sectors between 2002 and 2004.

The current Missouri tax structure provides, in general, equitable tax treatment for its mutual fund industry relative to that provided by its most important competitor states, thereby allowing Missouri companies to effectively compete for cost-conscious customers. A growing mutual fund industry significantly contributes to the state directly and indirectly by stimulating growth in many related industries. Employment, compensation, personal income tax, sales taxes, and property taxes all are positively influenced by the current mutual fund tax regime.

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[25] See "Ten Principles for State Tax Incentives," K. Ihlanfeldt, Economic Development Quarterly, November 1995.

[26] See also "The Distribution Effects of Local Labor Demand and Industrial Mix: Estimates Using Individual Panel Data," T. Bartik, Journal of Urban Economics, 1996, pp. 150-178, which finds further evidence that the growth in "wage premium" industries has greater beneficial effects on the local economy.

[27] These results are also consistent with "consensus" tax elasticities (or sensitivities) Wasylenko reported from a review of two decades of research. He concluded that for manufacturing industries, a 10 percent reduction in taxes "will raise employment, investment or firm births about six percent." For industries in which resources are more mobile (such as the mutual fund industry), "[i]t appears that the tax elasticities... are within double or triple." See "Taxation and Economic Development: The State of the Economic Literature," M. Wasylenko, Symposium on The Effects of State and Local Public Policies on Economic Development sponsored by the Federal Reserve Bank of Boston, October 14, 1996.

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APPENDIX A. Employment and Average Wage Data

Sources and Definitions

The report identifies economic activity that would be affected if the Missouri special mutual fund apportionment tax provision were repealed. We have identified three types of operations to be included in the analysis:

1. **Core mutual fund operations**. These companies are investment management companies, private investment companies ("hedge funds"), and the investment management subsidiaries of banks or companies principally dedicated to providing administrative or distribution services to such firms

2. **Connected operations.** These companies are connected to core mutual fund companies, but do not engage in mutual fund operations. They may engage, for example, in real estate, data processing, and printing. Connected operations are included as part of the analysis because we assume they locate in the same state as their core mutual fund company.

3. **Potential operations.** These are mutual fund companies that are assumed to relocate to Missouri in 2002 as a result of the special mutual fund apportionment provision.

Together the three types of operations constitute total mutual fund operations for the purpose of the analysis. The data sources used to determine the employment and earnings associated with each type of operation are described below:

Core Mutual Fund Operations. We obtained data related to core mutual fund operations in Missouri from the Bureau of Census, *County Business Patterns* ("CBP"). CBP data is collected once every five years (on those years ending with "2" and "7") from businesses to obtain data on the number of employees and size of the payroll during the pay period that includes March 12. These data are supplemented with an annual Census Bureau sample of multi-establishment firms and with data for single establishment firms derived from Internal Revenue Service and Social Security Administration program reports.

The resulting data are classified so as to provide information on industry employment at the county level for many industries, although information permitting the identification of specific firms is not disclosed. Prior to 1998, CBP data was published in accordance with the 1987 Standard Industrial Classification System (SIC) system. Beginning in 1998, CBP data has been published in accordance with the North American Industrial Classification System (NAICS),[28] which replaced the SIC system of classification for most uses.[29] In 1999, the latest year for which data are available, employment in Missouri core mutual fund operations (using NAICS) was 11,300 and the average (mean) compensation was $77,753.

[28] See footnote 1 of Appendix Table A-1 for a description of the NAICS codes that constitute the core mutual fund sector.

[29] See below for a description of other employment and wage data series, some of which are based on the SIC classification system.

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Connected Operations. We obtained employment data related to connected operations from section III of the PwC Survey of the 1997-2000 Missouri Mutual Fund Industry. The survey shows that for 1999 survey respondents, connected operations plus core operations were 16.8 percent higher than for core operations alone. We calculate Missouri connected employment to be 1,897.[30] We assume average compensation for connected employment to be $77,753, the same as that for core mutual fund operations.

Potential Operations. We obtained employment data related to potential operations from section II of the PwC 1997-2000 Survey of the Missouri Mutual Fund Industry provided by out-of-state respondents. Based on the survey results, we estimate that employment from potential operations would account for about 5.5 percent of core mutual fund employment. Accordingly, we include 626 employees in 2002 to account for potential operations. We assume the average compensation for employees of potential operations to be $77,753, the same as that for core mutual fund operations.

Total Mutual Fund Operations. For the purpose of calculating the economic impact and the tax effect of the special apportionment rule, we define total mutual funds operations as consisting of core operations, connected operations, and potential operations. For 1999, we calculate total mutual fund employment to be 13,197 and average compensation to be $77,753. Potential employment is added to core and connected employment in 2002, the year that relocation to Missouri is assumed to occur.

<u>Projections</u>
We project total Missouri mutual fund employment and average compensation from 1999 to the 2000 to 2004 period based on the historical data.

1. **Employment.** In general, we project Missouri total mutual fund employment from 1999 to the 2000-2004 period based on the historical (1988 to 1999) long-term average annual growth rate (4.9 percent) of the mutual fund industry as reported (on a SIC basis) by the Bureau of Labor Statistics, *Employment and Wages*.[31] However, for 2000 to 2001 and for 2001 to 2002 we make two adjustments:
   - **A.** 2000-2001: To account for a general softening in the national economy and in accord with recent notices regarding Missouri mutual fund reductions in force, we assume there will be no growth in employment between 2000 and 2001.
   - **B.** 2001-2002: To account for an assumed continued slowdown in the national economy in 2002, we increase employment by one-half of the long-term growth rate in 2002, or about 2.5 percent. (We also assume potential employment will take place in 2002, which will add 626 new jobs.)
2. **Average Compensation.** In general, we project average compensation from 1999 to the 2000-2004 period based on the average annual per capita nominal GDP (4.4 percent), as projected by the Congressional Budget Office for the 1999 to 2004 period. However, for 2000 to 2001 and for 2001 to 2002 we make two adjustments:

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[30] Equals 11,300 times 16.8 percent.

[31] Prior to 1988, mutual fund industry data from the BLS *Employment and Wages* was classified according to the 1972 SIC system rather than the 1987 SIC system. Based on that, we conclude that over the 1980 to 1987 period the Missouri mutual fund industry grew at a 14.9 percent average annual growth rate.

A. 2000-2001: To account for a general softening in the national economy and in accord with recent notices regarding Missouri mutual fund reductions in force, we assume average compensation will not grow between 2000 and 2001.

B. 2001-2002: To account for an assumed continued slowdown in the national economy in 2002, we increase average compensation in 2001 by one-half of the long-term growth rate for 2002, or about 2.2 percent.

Appendix Table A-1 shows total projected Missouri mutual fund employment and average compensation used in the analysis.

Appendix Table A-1. Derivation of Missouri Mutual Fund Industry Employment and Compensation, 1999-2004

Calendar Year	Number of Employees: Core Operations	Connected Operations	Potential Operations	Total	Average Compensation
1999	11,300	1,897	NA	13,197	$77,753
2000	NA	NA	NA	13,848	81,184
2001	NA	NA	NA	13,848	81,184
2002	NA	NA	626	14,815	82,975
2003	NA	NA	NA	15,545	86,637
2004	NA	NA	NA	16,312	90,460
2001-2004 increase:	NA	NA	NA	2,464	NA

Notes:

1. The mutual fund industry ("core operations") is defined by the following NAICS codes:

523110	Investment banking & securities dealing
523120	Securities brokerage
523920	Portfolio management
523930	Investment advice
525910	Open-end investment funds
525990	Other financial vehicles

2. The 1999 figures are based on Census Bureau's County Business Patterns data and PwC's survey of the Missouri mutual fund industry. The average compensation for 1999 is only for the core operations of the mutual fund industry. Average compensation data for connected and potential operations are not available.

3. Projections for the 2000-2004 period are based on the following assumptions: For 2000, average compensation increases at the same annual rate as that for the per capita nominal GDP forecasted by the Congressional Budget Office (CBO), 4.4 percent, and the mutual fund industry employment grows at the overall annual rate of industry growth which prevailed during the 1988-1999 period, 4.9 percent. For 2001, the average compensation and industry employment are held at the same level as in 2000. In 2002, both average compensation and industry employment grow only at one-half of the growth rates for 2000. In addition, 626 jobs from potential operations have been added to the industry total for 2002. For the 2003-2004 period, average compensation and industry employment grow at the long-term rates of 4.4 percent and 4.9 percent, respectively.

4. NA = Not available.

6.30

Comparison to Sources Used in 1997 Report

The employment and average compensation data used in this analysis differ from those used in the March 1997 predecessor report. The present analysis relies on an NAICS-based definition of mutual funds, as described above, while the 1997 report relied on three sets of data,[32] two of which were SIC-based. The three types of data used in the March 1997 predecessor report were:

1. **BLS data (SIC-based).** The Bureau of Labor Statistics, *Employment and Earnings*, made available SIC-based employment and average compensation data for 1989 through 1995. BLS continues to compile data on a SIC basis. The most recent data show Missouri mutual fund industry employment increasing from 12,505 in 1988 to 21,231 in 1999 and average compensation increasing from $39,127 in 1988 to $67,768 in 1999.

2. **Investment Company Institute data.** The ICI periodically conducts surveys of the mutual fund industry. The 1997 report provided ICI's 1992 mutual fund employment collected from the survey and, based on the survey data, our estimate for 1995. Since 1992, ICI has conducted one additional survey of mutual funds, for 1999, which shows employment to be 10,804. The ICI does not collect average compensation data by state.

3. ***County Business Patterns* data (SIC-based).** The 1997 report provided CBP employment and average compensation data for 1990 to 1993 on an SIC-basis. CBP continued to provide data on a SIC-basis until 1997, after which the data were provided only on an NAICS-basis. The 1989-1997 SIC-based CBP data show mutual fund employment increasing from 13,143 in 1990 to 19,770 in 1997 and average compensation increasing from $38,780 in 1990 to $58,307 in 1997.[33]

Appendix Table A-2 shows employment and average compensation for the three data sources from 1989 through 1999 (where available).

[32] Missouri mutual fund industry employment was derived for the 1997 report using essentially an average (for all three sources) of the three-year moving average.

[33] The 1998-1999 NAICS-based data show Missouri employment increasing from 9,957 in 1998 to 11,300 in 1999 and average compensation decreasing from $79,477 in 1998 to $77,753 in 1999.

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Appendix Table A-2. Missouri Mutual Fund Industry Employment and Compensation from Different Sources, 1989-1999

	BLS Employment & Wages (SIC-based)		ICI	County Business Patterns (SIC-based)	
Calendar Year	Number of Employees	Average Compensation		Number of Employees	Average Compensation
1988	12,505	$39,127	NA	NA	NA
1989	13,021	38,552	NA	NA	NA
1990	13,581	40,219	NA	13,143	$38,780
1991	13,381	43,776	NA	13,623	40,528
1992	14,122	48,910	8,890	13,588	47,072
1993	15,089	51,565	NA	14,725	50,382
1994	16,297	49,634	NA	17,918	47,604
1995	16,594	49,999	NA	17,448	50,897
1996	17,297	54,545	NA	18,041	55,029
1997	17,619	59,383	NA	19,770	58,307
1998	19,095	66,980	NA	NA	NA
1999	21,231	67,768	10,804	NA	NA

Notes:

1. For the purpose of BLS and CBP data, the mutual fund industry is defined by the following 4-digit SIC codes:

6211	Security brokers, dealers and flotation companies
6282	Investment Advice
6289	Security/commodity services, nec
6719	Holding companies, nec
6722	Management investment, open-end
6726	Unit investment trusts and closed-end management investment offices, nec
6799	Investors, nec

2. NA = Not available.

Source: Bureau of Labor Statistics; Census Bureau's County Business Patterns; and survey findings prepared by the Investment Company Institute ("ICI").

We use the NAICS-based data rather than the SIC-based data[34] or the ICI data as the basis for our analysis for three principal reasons:

[34] However, because the SIC-based data series is the only one that provides reliable data over a long historical period, we use the 1989-1999 (SIC-based) average annual growth rate to project (NAICS-based) mutual fund employment from 1999 to 2004.

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1. Indications are the NAICS classification approach provides a more precise definition of mutual fund operations than does the SIC system. Neither NAICS nor the SIC system provide a precise definition of mutual fund industry. Instead both definitions result in mutual fund operations being included under categories that contain non-mutual fund operations. However, in this regard the NAICS provides the best definition. Using the SIC system as the basis for mutual fund employment could result in an overstatement of the effect that the mutual fund industry has on Missouri.
2. Because the CBP no longer compiles data on a SIC-basis (*i.e.*, for years after 1997), recent SIC-based CBP data on the mutual fund industry are not available. CBP mutual fund data for 1998 and 1999, by contrast, are available on a NAICS basis.
3. ICI collects information on employment but not on compensation. CBP provides consistent data on employment and average compensation. Because our analysis requires internally consistent employment and compensation data, we are unable to use the ICI data.

Comparison of Historical 1999 Data to 1999 Projections in 1997 Report

The 1997 report came close in forecasting 1999 compensation of Missouri mutual fund industry employees . The report projected $1.1 billion of compensation and the actual amount was $1.0 billion. However, due to changes in the federal categorization of industrial activities and to other factors, the 1997 report contemplated a larger number of employees (20,113 projected, 13,197 actual) being compensated at a smaller average annual amount ($56,507 projected, $77,753 actual).

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APPENDIX B. IMPLAN Multiplier Analysis

The estimates of supporting employment and income that result from the Missouri mutual fund industry come from the Impact Analysis for Planning (IMPLAN) modeling system[35]. The model generates input-output (I-O) multipliers that translate changes in economic inputs, such as new employment in the mutual fund industry, into economy-wide effects of these initial changes.

Input-output models describe the functioning of the economy by tracing the flow of goods and services through the economy. For each industry, these models provide estimates of the inputs necessary to produce a given level of output. An increase in the output of a particular industry will cause an increase in demand for all the inputs to that industry. The suppliers of those inputs will increase production to meet their increased demand. In turn, these suppliers will increase demand for the inputs they use in their production. This process would continue down the production ladder as each supplier reacted to the increased demand for its output by increasing demand for its inputs. I-O multipliers measure the total impact of these increases in output at each stage of the production cycle.

The multipliers measure the total economic effects in terms of the direct effects and two indirect effects, the indirect industry effects and the induced effects:

- **Direct effects** represent the economic impacts brought about by the initial change. In this case, the additional mutual fund employment and associated wages are the direct effects.
- **Indirect effects** reflect the impacts of the relationships between the directly-effected industry and the other industries in the economy. In this case, the increased demand by the mutual fund suppliers for the inputs they require for production are a form of the indirect industry effects.
- **Induced effects** represent the changes in spending by households resulting from the changes in production. In this case, the purchases of consumer goods and property by households that result from the changes in income caused by the increased mutual fund employment are the induced effects.

The total effect of the additional employment from the mutual fund industry is the sum of these three pieces. For the purposes of this report, the final two effects are combined under the title of "supporting".

These multipliers are calculated on a regional basis using national I-O relationships adjusted to incorporate regional differences and constraints. Essentially, the multipliers come from regional I-O models.

Employment multipliers and income multipliers are the final output from the model. Given information on the increase in employment in a particular area in a particular industry, the

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[35] Minnesota IMPLAN Group, Inc.

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employment multiplier translates the initial new employment into the total amount that employment will rise in the area (which includes both the direct and indirect effects). Likewise, given the income of these new employees, the income multiplier generates the total addition to incomes in the area.

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APPENDIX C: PwC 1997-2000 Missouri Mutual Fund Industry Survey Form and Instructions

Much of the analysis included in this report is based on data collected through a survey of mutual fund companies located in Missouri. In October 2001 PwC with the assistance of MOCOSST, mailed survey forms to six Missouri MOCOSST member mutual fund companies, all of which provided responses for the analysis. The survey instructions and survey forms are included on the following pages.

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Coalition for Source-State Taxation
Missouri Mutual Fund Survey, 1997-2000
Instructions

Composition of Survey

The survey consists of three sections, *I. Name/Contact Information, II, Mutual Fund Operations, Non-Mutual Fund Operations*:

Section I. Provide the company name and contact information.

Section II. Report information ONLY for your mutual fund operation located in Missouri. Do not report amounts for your company's non-mutual fund operation, if significant, in Section II. (See Section III.)

Section III. If your company had a significant non-mutual fund operation located in Missouri, and it was located in Missouri solely because the mutual fund operation for your company was located in Missouri, report the amounts in Section III. If the non-mutual fund operation would have been located in Missouri regardless of the location of your mutual fund operation, leave Section III blank. Also leave Section III blank if your company had no significant non-mutual fund operations of any sort.

Detailed Instructions

Units. Report dollar amounts (Parts I.B., II., IV., V., and VI.) in whole dollars rounded to the nearest dollar. For example, report "$1,234,567.89 as "1,234,568". Report numbers of employees (Part I.A.) and square feet (Part III.) in units. For example, for one thousand, three hundred forty-five permanent employees, report "1,345".

Payroll. The survey requests three values related to payroll:

Total. Report the amount of wages, salaries, bonuses, *etc.*, prior to deductions for 401(k), life insurance, *etc.*

Mean. Report the result of total payroll (Part I.B.1.) divided by total employees, that is, the sum of permanent employees (Part I.A.1.) and temporary employees (Part I.B.2).

Median. Report the median payroll for your company, that is, the value below and above which falls the same number of employees for your company.

Questions

If you have questions about the survey, call John Martin at (816) 218-1778.

Due Date/Addressee

Return the completed survey form by **Friday, November 2, 2001**, to:

John C. Martin
PricewaterhouseCoopers, LLP
1055 Broadway
10th Floor
Kansas City, MO 64105

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Coalition for Source-State Taxation
Missouri Mutual Fund Survey, 1997-2000 *
Please submit survey results to PwC in Kansas City by November 2, 2001

Section I. Name/Contact Information

Company name ____________________

Company contact information

Name ____________________
Title ____________________
Telephone ____________________
Fax ____________________
Email address ____________________

Section II. Mutual Fund Operations (ONLY)*

Item	1997	1998	1999	2000
I. Employees/Payroll				
A. Missouri employees (as of Dec. 31)				
1. Permanent				
2. Temporary				
3. Contractors				
B. Missouri payroll*				
1. Total				
2. Mean	N.A.	N.A.		
3. Median	N.A.	N.A.		
II. Taxes				
A. Withholding taxes paid to Missouri	N.A.	N.A.		
B. Real and personal property taxes paid to Missouri cities and towns	N.A.	N.A.		
C. Book value of property, plant and equipment located within Missouri	N.A.	N.A.		
III. Missouri real estate (as of Dec. 31)				
A. Leased (square feet)	N.A.	N.A.		
B. Owned (square feet)	N.A.	N.A.		
IV. Payments to Missouri-based vendors				
A. Food/entertainment/hotels	N.A.	N.A.		
B. Software and computers	N.A.	N.A.		
C. Construction related	N.A.	N.A.		
D. Printing and stationery	N.A.	N.A.		
E. Advertising/marketing	N.A.	N.A.		
G. Legal, accounting and consulting	N.A.	N.A.		
H. Utilities	N.A.	N.A.		
I. Other	N.A.	N.A.		
V. Charitable contributions to Missouri-based organizations	N.A.	N.A.		
VI. Gross revenues	N.A.	N.A.		

* *See enclosed instructions.*
N.A. = Not applicable, i.e., not data requested.

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Missouri Mutual Fund Survey, 1997-2000, Continued

Section III. Non-Mutual Fund Operations (COMPLETE ONLY IF APPLICABLE)*

Item	1997	1998	1999	2000
I. Employees/Payroll				
A. Missouri employees (as of Dec. 31)				
1. Permanent				
2. Temporary				
3. Contractors				
B. Missouri payroll*				
1. Total				
2. Mean	N.A.	N.A.		
3. Median	N.A.	N.A.		
II. Taxes				
A. Withholding taxes paid to Missouri	N.A.	N.A.		
B. Real estate taxes paid to Missouri cities and towns	N.A.	N.A.		
III. Missouri real estate (as of Dec. 31)				
A. Leased (square feet)	N.A.	N.A.		
B. Owned (square feet)	N.A.	N.A.		
IV. Payments to Missouri-based vendors				
A. Food/entertainment/hotels	N.A.	N.A.		
B. Software and computers	N.A.	N.A.		
C. Construction related	N.A.	N.A.		
D. Printing and stationery	N.A.	N.A.		
E. Advertising/marketing	N.A.	N.A.		
G. Legal, accounting and consulting	N.A.	N.A.		
H. Utilities	N.A.	N.A.		
I. Other	N.A.	N.A.		
V. Charitable contributions to Missouri-based organizations	N.A.	N.A.		
VI. Gross revenues	N.A.	N.A.		

** See enclosed instructions.*

N.A. = Not applicable, i.e., not data requested.

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