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March 29, 2012

The Honorable Alyson Huber  
California State Assembly  
State Capitol, Room 2117  
Sacramento, CA 95814

RE: Opposition to the Sales Tax on Saving

Dear Assembly Member Huber:

The Investment Company Institute<sup>1</sup> -- on behalf of its California-based members and all California-resident shareholders in investment companies (*e.g.*, mutual funds) -- strongly opposes the provisions of AB 1963 that would extend the sales tax to all services, with limited exceptions.<sup>2</sup> If enacted, this sales tax on saving could:

- impose additional costs on California investors seeking to save for their retirement and other long-term needs through mutual funds;
- place California-based mutual fund firms operating in this nationwide industry at a competitive disadvantage; and
- be extraordinarily difficult (if not impossible) to administer efficiently and fairly.

As we do not believe a tax can be crafted that would eliminate (or even reduce) any of these significant deficiencies, we urge you to reconsider this sales tax on saving.

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.98 trillion and serve over 90 million shareholders.

<sup>2</sup> The exceptions contained in AB 1963 do not include investment management or other financial services.

## **Background**

A mutual fund pools money from individuals and invests in a diversified portfolio of stocks, bonds or other securities in the United States and around the world. Each investor in a mutual fund is a shareholder of the fund. Each share represents a proportionate ownership in all the fund's underlying securities. The securities are selected by a professional investment adviser to meet a specified financial goal, such as growth or income.

Mutual funds typically do not have employees of their own. Instead, their services are performed by outside service providers, such as the fund's investment adviser. Funds with a common investment adviser (sometimes called a "manager") are often referred to as a mutual fund "family" or "complex." Competition between mutual fund complexes and their advisers is intense.

## **Sales Tax Should Not Be Imposed on Mutual Fund Shareholders and the Act of Saving**

Mutual funds, the investment vehicle of choice for moderate-income investors, have democratized our capital markets in ways that could not have been imagined just a generation or two ago. More than half of all American households have become investors as a result of mutual funds and now depend on their mutual fund investments to buy a home, finance a child's education, support aging parents or extended family, and prepare for retirement.

Imposing a sales tax on mutual funds and their shareholders will increase the cost of saving for retirement and other long-term needs. Given the increased responsibility that individuals have for ensuring their own retirement security, the legislature should be creating incentives to *encourage* rather than *discourage* saving.

## **California-Based Fund Managers Should Not Be Placed at a Competitive Disadvantage**

Mutual fund advisers can be (and in fact are) located virtually anywhere. The two most important requirements for managing a mutual fund are well-educated employees and ready access to modern technology. Physical plant requirements are minimal. Currently there are more fund management companies based in California than any other state; California-based companies represent 25% of the national market. The mutual fund industry is an important part of the California economy, as it pays more than \$300 million per year in state taxes and provides high-wage jobs for over 13,000 California citizens.

The potential market for a fund manager's products is nationwide in scope. Because investors can communicate with a mutual fund manager through the mail, over the phone, or electronically, a mutual fund's shareholders can be (and generally are) located in all 50 states. A "local" mutual fund manager has no inherent advantage over "non-local" managers in attracting new investor dollars.

Extending the sales tax to services consumed by California-based fund managers could place them at a distinct competitive disadvantage vis-à-vis fund managers located throughout the rest of the United States. These flaws in the sales tax cannot be corrected by technical modifications to the legislation; imposing a sales tax on the mutual fund industry would *always* have this anti-competitive effect. As California-based fund managers in this highly mobile business provide exactly the kind of good jobs that states covet, the legislature should be creating incentives to *encourage* fund managers to locate in California. Extending the sales tax to financial services could have the opposite effect.

### **Subjecting the Mutual Fund Industry to a Sales Tax on Saving Would Be Most Problematic**

A sales tax on services *theoretically* could be assessed either against the mutual fund itself or against the fund's individual shareholders. Presumably, the tax would be assessed based upon the location of (1) the fund manager, if the fund were treated as the consumer, or (2) the fund shareholder, if the shareholder were treated on a look-through basis as the consumer.

In *practice*, however, such a tax cannot be applied either fairly or in an administrable manner. Because both funds and their shareholders are spread across the country, the tax cannot be applied evenhandedly against either the fund or the fund's shareholders. Moreover, regardless of whether the tax were assessed against the fund or its shareholders, California-based fund managers would be disadvantaged vis-à-vis fund managers located elsewhere because the California tax authorities would face significant obstacles in seeking compliance from out-of-state firms.

#### The Tax Cannot Fairly Be Assessed Against Mutual Funds Themselves

A mutual fund's costs, as fund-wide expenses, are spread proportionately across all of its shareholders. Individual fund shareholders are not, and indeed cannot be, charged separately for any services performed for the fund.

If a sales tax were assessed against the mutual fund, it would effectively be assessed against all of the fund's shareholders -- both those resident in California and those resident in other states. Any fund-level tax would be spread inappropriately across all investors, rather than assessed just against California residents.

Collection of the tax, however, could be ensured only from funds whose managers are located in California, where the state has ready access to the enforcement mechanisms that could be utilized to ensure compliance. Thus, the sales tax would negatively impact the investment returns only of California-managed funds, thereby placing these funds at a competitive disadvantage in the nationwide mutual fund industry.

### The Tax Cannot Fairly Be Assessed Against Fund Shareholders Resident in California

If a sales tax, alternatively, were assessed only against California residents invested in a mutual fund, it would be nearly impossible to implement. First, as discussed above, mutual fund-wide expenses are assessed against the mutual fund itself, rather than against the fund's individual shareholders. Funds today do not determine any fund shareholder's allocable portion of any fund-level expense. Thus, the records do not exist that would permit the fund or any of its shareholders to determine the amount of tax that would be assessed against any individual shareholder based on that shareholder's allocable portion of any fund-wide expense.

Second, even in the most unlikely event that shareholder-specific recordkeeping systems for fund expenses could be developed at reasonable cost, it would be difficult, if not impossible, to ensure that out-of-state firms would either (1) determine any California shareholder's allocable share of the fees on which sales tax would be assessed or (2) actually collect the tax and remit it to California. And, even if a non-California-based firm were willing to voluntarily calculate the tax for its shareholders, timely self-reporting by California shareholders could not be assured. Absent widespread compliance with the rules, the overall confidence in (and compliance with) the tax system could erode.

Thus, even if shareholder-specific recordkeeping systems could be developed, a sales tax most likely could be collected only from those California investors who purchase shares of funds managed by California-based managers. Thus, such a tax also would have the effect of disadvantaging California-based fund managers vis-à-vis fund managers located elsewhere.

### **Recommendation**

The Institute strongly recommends, on behalf of its California-based members and all California-resident shareholders, that the sales tax *not* be extended to any services consumed within the investment company industry. The three principal reasons for our recommendation are that:

- additional costs could be placed on California residents seeking to save and invest to meet their long-term needs, which could have the unintended (and most unfortunate) consequence of discouraging adequate saving by California residents;
- our California members, who strongly value their relationship to the state and appreciate the stable and qualified workforce available to help their businesses flourish, could be placed at a competitive disadvantage vis-à-vis their out-of-state competitors; and
- imposition of tax on these services would be extraordinarily difficult (if not impossible) to administer efficiently and fairly.

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The Institute appreciates your consideration of our concerns. Please do not hesitate to contact the undersigned at (202) 371-5432 if you have any questions regarding this letter or would like any additional information regarding the organization, operation, or taxation of investment companies and/or their shareholders.

Sincerely,

*/s/ Karen L. Gibian*

Karen Lau Gibian  
Associate Counsel

cc: The Honorable Henry Perea  
The Honorable Jim Beall, Jr.  
The Honorable Gilbert Cedillo  
The Honorable Felipe Fuentes  
The Honorable Brian Nestande  
The Honorable Diane Harkey  
The Honorable Charles Calderon  
The Honorable Nathan Fletcher  
The Honorable Richard Gordon