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Individual Investors Will Be Harmed by Financial Transaction Taxes

By Keith Lawson

A fundamental tenet of the argument for a financial transaction taxes (FTTs) is that individuals would not be harmed. Those pushing the European Commission's FTT proposal (under the "enhanced cooperation" procedure), for example, assert that the tax is imposed only on financial institutions. Similarly, the sponsors of FTT legislation in the United States—Senator Tom Harkin (D-IA) and Congressman Peter DeFazio (D-OR)—maintain that their proposal "would not harm ordinary middle-class investors or long-term investing."

These contentions reflect a fundamental misunderstanding of the proponents' own proposals and today's financial markets.

Mutual Funds Are a Target of the FTT

Mutual funds would be taxable parties under both the European Commission and U.S. (Harkin/DeFazio) proposals.

- **European Commission proposal**: A fund expressly is identified as a financial institution. As such, a fund would be taxed each time it bought or sold securities issued by a company with a participating member state connection. The fund also would be taxed each time one of its individual investors with a permanent address in a participating member state redeemed shares in the fund.
- **U.S. (Harkin/DeFazio) proposal**: A fund would be taxed each time a fund investor redeemed shares, as the fund is "purchasing" its shares from the redeeming shareholder. The fund also would be taxed each time it bought securities for its portfolio, including with new cash invested by individuals in the fund.

The extent of a mutual fund's FTT liability would depend, in part, on whether an FTT has extraterritorial or only national application.

- **European Commission proposal**: The European Commission's proposal has unprecedented extraterritorial scope. Specifically, the FTT would be imposed in all cases without regard to where a fund is organized. A Hong Kong fund, for example, would owe the FTT to Germany if a German investor residing outside of Germany (but with a permanent address in Germany), redeemed shares of the Hong Kong fund. Likewise, a Canadian fund would owe tax to France if it bought shares of a French company on a stock exchange, even if the exchange were located outside of France.
- **U.S. (Harkin/DeFazio) proposal**: The FTT proposed in the United States is only national in scope. Specifically, the tax would be imposed only on transactions occurring in the United States and involving U.S. persons. Thus, a U.S. fund buying shares of a U.S. company would be a taxable transaction.

The FTT Falls Directly on the Fund's Investors

While mutual funds would "pay" the tax, it would be borne *solely* by the fund shareholders. After all, a mutual fund is merely a vehicle through which investors pool their resources. A mutual fund's investors are the *only* owners of the fund.

Any FTT incurred by a fund reduces dollar-for-dollar (or euro-for-euro) the value of the fund's assets. Consequently, each investor incurs directly—in the form of a smaller account balance—his or her proportionate share of the tax, based upon his or her proportionate interest in the fund. The FTT would have the same impact on a pension fund, which likewise is a taxable party under both the European and the U.S. proposals.

The Tax Due Would Be Substantial

FTT proponents claim that ordinary long-term investors would not be harmed because the tax rate is “low.” Yet, according to these same FTT proponents, this “small” tax would raise enormous sums.

- **European Commission proposal**: The tax of 10 basis points (0.1 percent) on the purchase price of a stock or bond is estimated to raise €31 billion a year.
- **U.S. (Harkin/DeFazio) proposal:** The Harkin/DeFazio tax of 3 basis points (0.03 percent) is estimated to raise perhaps $350 billion over 10 years. Other proposals under consideration in the United States—with far higher rates—would raise substantially more.

The amount of tax imposed on any one transaction (such as a €1 tax on a €1,000 stock purchase) is not determinative of the tax’s impact. The cumulative effect of this transaction-by-transaction tax on a fund investor must be considered. For several reasons, this impact would be considerable.

First, funds—whether actively or passively managed—buy and sell their portfolio securities to meet investor share purchases and redemptions. Flows into and out of funds are substantial.

Moreover, all funds rebalance their portfolios. These transactions, depending on the specific FTT proposal, typically would incur at least some (and sometimes multiple levels of) tax.

- Actively managed funds buy and sell portfolio securities for many reasons including the financial condition of a company, an attractive price for another security, and changing market conditions.
- Index funds modify their portfolios as securities are added to or withdrawn from an index.
- Money market funds constantly buy securities as securities in their portfolios mature.

Finally, fund investors routinely buy shares (including through reinvested dividends); they also sell shares to meet changing investment needs or to pay expenses, particularly in retirement. Depending on the specific proposal, some or all of these shareholder-initiated transactions would be taxable.

Learn more about FTTs at our resource center.

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