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Written Statement—Opposed
filed by
Investment Company Institute
for the
March 2, 2020 Hearing
on
HB 1628—Sales Tax on Services

EXECUTIVE SUMMARY

The Investment Company Institute[1]—on behalf of its Maryland-based members, all investment funds registered under the Investment Company Act of 1940,[2] and all Maryland residents who save through these funds—strongly opposes HB 1628 for three reasons.

- First, services tax should not be imposed on fund shareholders and the act of saving.
- Second, Maryland-based fund managers should not be placed at a competitive disadvantage.
- Third, subjecting the fund industry to a services tax would be most problematic.

Services Tax Should Not Be Imposed on Fund Shareholders and the Act of Saving

- Imposing a sales tax on the services provided to funds and their investors will increase the cost of saving for retirement and other long-term needs.
- More than half of all American households have become mutual fund investors and now depend on these investments to reach their financial goals.
- The legislature should be creating incentives to *encourage* rather than *discourage* saving.

[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$25.2 trillion in the United States, serving more than 100 million US shareholders, and US$7.0 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] Mutual funds are the most common type of fund registered under the Investment Company Act of 1940 (the "1940 Act"). All references in this letter to "mutual funds" refer to all 1940-Act registered funds.

Maryland-Based Fund Managers Should Not Be Placed at a Competitive Disadvantage

- Extending the sales tax to services consumed by Maryland-based fund managers could place them at a distinct competitive disadvantage vis-à-vis fund managers located elsewhere.
- Fund advisers and their well-educated employees are mobile and locate virtually anywhere.
- As fund managers provide exactly the kind of good-paying jobs that states covet, the legislature should be incentivizing fund managers to locate in, rather than outside of, Maryland.
- Because fund managers purchase services at multiple levels of their operations, the ultimate (compounded) tax impact would be much greater than the stated 5% rate.

Subjecting the Fund Industry to a Services Tax Would Be Most Problematic

- The bill does not address how the tax would be applied to the fund industry. Because both funds and their shareholders are spread across the country, the tax cannot be applied evenhandedly or in an administrable manner. In short, application of the tax to the fund industry implicates difficult policy questions—*for which careful study is needed.*
- Identification issues would arise as to the location of the fund investor—as many individuals invest through intermediaries that do not share their customers' identities with advisers.

Recommendations

- The Institute strongly recommends that the sales tax *not* be extended to any services consumed by funds and their advisers.
- A *comprehensive study* must be conducted, before any services tax proposal advances, to prevent fund investors and their advisers from suffering unintended consequences.

DISCUSSION

Background

A 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 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 stated investment objective and help investors achieve financial goals such as capital appreciation or current income.

Funds typically are distributed nationally. Investors often purchase their shares through intermediaries (*e.g.,* brokers) rather than directly from the fund. Shares purchased through an intermediary often are registered with the fund in the intermediary's name in a so-called "street name" account. Funds often will have little or no information about the intermediary's customers holding through these accounts.

Funds with a common investment adviser (sometimes called a "manager") are often referred to as a mutual fund "family" or "complex." Competition between fund complexes and their advisers is intense.

This competition has led to a steep drop in fees that managers charge for investment advisory services.[3] As a result, managers are increasingly sensitive to state and local taxes that may place them at a competitive disadvantage.

Services Tax Should Not Be Imposed on 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. The typical fund investor is a middle-class American with a median household income of $100,000 and modest holdings.[4] 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 the investment advisory services provided to 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.

Maryland-Based Fund Managers Should Not Be Placed at a Competitive Disadvantage

Fund advisers can be (and in fact are) located virtually anywhere. Many important ones have operations, or purchase services, in Maryland. The two most important requirements for managing a fund are well-educated employees and ready access to modern technology. Physical plant requirements are minimal/non-existent.

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 Maryland-based fund managers could place them at a distinct competitive disadvantage vis-à-vis fund managers located elsewhere. 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 Maryland-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 Maryland. Extending the sales tax to the purchase of services by fund managers operating in Maryland could have the opposite effect.

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[3] Asset-weighted average expense ratios for equity, bond, and hybrid mutual funds fell in 2018 to their lowest levels in at least 20 years. For example, in 2018, the expense ratios that fund shareholders paid for holding equity mutual funds were, on average, 44 percent lower than in 2000. https://www.icifactbook.org/ch6/19_fb_ch6.

[4] The most recent ICI data show median mutual fund assets of $150,000 per household in four accounts. https://www.icifactbook.org/ch7/19_fb_ch7, Figure 7.2.

Subjecting the Fund Industry to a Services Tax Would Be Most Problematic

First, significant difficulties likely would arise in collecting tax from fund managers located outside of Maryland. Among other things, substantial uncertainty remains regarding (1) the scope of taxable nexus generally, (2) how taxable nexus would be determined in a services tax context, and (3) whether taxable nexus in the fund industry context is properly determined at the fund or investor level.

Second, fund managers often do not know the residence states of their funds' shareholders. Determining residence would result in additional costs—all of which would be borne by the funds' individual shareholders.

Third, because of these investor residence identification difficulties, easily-collectible tax might be limited to those Maryland investors who purchase fund shares directly from Maryland-based managers. This result would be bad for Maryland because it would disadvantage Maryland-based fund managers vis-à-vis fund managers located elsewhere.

Finally, even if the tax could be charged to, and collected from, every fund manager nationwide based upon their Maryland resident investors, the tax would not be borne only by the Maryland residents. Funds, unlike partnerships, cannot "specially allocate" expenses based upon residence—unless all such residents are members of a single share class; funds, however, do not create separate classes for shareholders based upon residence. Although the tax might be "charged" for services "provided" in Maryland, the tax burden would fall equally on all investors—irrespective of the state or country in which they reside.

Recommendations

All of the above considerations support our strong recommendation that the sales tax *not* be extended to any services consumed by funds and their advisers. Moreover, a *comprehensive study* must be conducted, before any services tax proposal advances, to prevent fund investors and their advisers from suffering unintended consequences.

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The Institute appreciates your consideration of our concerns. Please do not hesitate to contact the Investment Company Institute if you have any questions regarding this written statement or would like any additional information regarding the fund industry.

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