

## COMMENT LETTER

October 24, 2007

# ICI Letters Regarding Michigan Services Tax (pdf)

October 23, 2007 Senator Nancy Cassis, Chair Representative Steve Bieda, Chair Senate Finance Committee House Tax Policy Committee Michigan State Senate S0789 House Office Building P.O. Box 30036 Michigan House of Representatives Lansing, MI 48909-7536 P.O. Box 30014 Lansing, MI 48909-7514 RE: Repeal the Sales Tax on Savings Dear Senator Cassis and Representative Bieda: The Investment Company Institute<sup>1</sup>, on behalf of its Michigan-based members and all Michigan shareholders in investment companies (e.g., mutual funds), strongly urges that Michigan repeal the portion of P.A. 93 that imposes sales tax on services that promote savings. Specifically, subsection 3d.(1)(e) of P.A. 93 will impose a services tax on “investment advice services, as described in NAICS industry code 52393.” This tax, which would discourage Michigan residents from seeking financial advice to ensure their retirement security, will harm Michigan residents. The Institute also strongly urges that the sales tax not be extended to tax any services consumed within the investment company industry. Such a tax would:

- impose additional costs on Michigan investors seeking to save for their retirement and other long-term needs through mutual funds;
- place Michigan-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.

<sup>1</sup> ICI members include 8,889 open-end investment companies (mutual funds), 675 closed-end investment companies, 471 exchange-traded funds, and 4 sponsors of unit investment trusts. Mutual fund members of the ICI have total assets of approximately \$11.339 trillion (representing 98 percent of all assets of US mutual funds); these funds serve approximately 93.9 million shareholders in more than 53.8 million households. Investment Company Institute Letter Re: 2007 P.A. 93 October 23, 2007 Page 2 of 5 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 among 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 Michigan legislature should be creating incentives to encourage rather than discourage saving. Michigan-Based Fund Managers Should Not Be Placed at a Competitive Disadvantage Mutual fund advisers can be (and in fact are) located virtually anywhere. Many important ones are located in Michigan. 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. 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 Michigan-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 a sales tax on savings 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 Michigan-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 Michigan. Extending the sales tax to investment advisory and brokerage 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, Michigan-based fund managers would be disadvantaged vis-à-vis fund managers located elsewhere because the Michigan 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 Michigan and those resident in other states. Any fund-level tax would be spread inappropriately across all investors, rather than assessed just against Michigan residents. Collection of the tax, however, could be ensured only from funds whose managers are located in Michigan, 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 Michigan-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 Michigan If a sales tax, alternatively, were assessed only against Michigan residents invested in a mutual fund, it would be nearly impossible to implement. First, as discussed above, mutual fund-wide expenses

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Re: 2007 P.A. 93 October 23, 2007 Page 4 of 5 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,<sup>2</sup> it would be difficult, if not impossible, to ensure that out-of-state firms would either (1) determine any Michigan shareholder's allocable share of the fees on which sales tax would be assessed or (2) actually collect the tax and remit it to Michigan. And, even if a non-Michigan-based firm were willing to voluntarily calculate the tax for its shareholders, timely self-reporting by Michigan 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 Michigan investors who purchase shares of funds managed by Michigan-based managers. Thus, such a tax also would have the effect of disadvantaging Michigan-based fund managers vis-à-vis fund managers located elsewhere. Recommendation The Institute strongly recommends, on behalf of its Michigan-based members and all Michigan shareholders, that P.A. 93's sales tax on certain investment advice services be repealed and 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 Michigan 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 Michigan residents; • our Michigan 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 2 Suggestions that funds be required to disclose a shareholder's allocable share of fund expenses have been strongly opposed by the fund industry because of concerns that the proposals would impose unreasonably high costs on the funds' shareholders. In its review of a recent personalized expense disclosure proposal, the staff of the Securities and Exchange Commission noted that these compliance costs, "which ultimately would be borne by fund shareholders, may be considerable." Securities and Exchange Commission Division of Investment Management's Report on Mutual Fund Fees and Expenses, p. 70 (January 11, 2001). Investment Company Institute Letter Re: 2007 P.A. 93 October 23, 2007 Page 5 of 5 • imposition of tax on these services would be extraordinarily difficult (if not impossible) to administer efficiently and fairly. \* \* \* \* \* The Institute appreciates your consideration of our concerns. Please do not hesitate to contact the undersigned at (202) 326-5835 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/ Lisa Robinson Lisa Robinson Associate Counsel - Tax Law cc: Sen. Michael Bishop Sen. Cameron Brown Sen. Bruce Patterson Rep. Andy Dillon Rep. Dan Acciavatti October 19, 2007 Governor Jennifer M. Granholm P.O. Box 30013 Lansing, Michigan 48909 RE: Repeal the Sales Tax on Savings Dear Governor Granholm: The Investment Company Institute<sup>1</sup>, on behalf of its Michigan-based members and all Michigan shareholders in investment companies (e.g., mutual funds), strongly urges that Michigan repeal the portion of P.A. 93 that imposes sales tax on services that promote savings. Specifically, subsection 3d.(1)(e) of P.A. 93 will impose a services tax on "investment advice services, as described in NAICS industry code 52393." This tax, which would discourage Michigan residents from seeking financial advice to ensure their retirement security, will harm Michigan residents. The Institute also strongly

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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 among 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 Michigan legislature should be creating incentives to encourage rather than discourage saving. Michigan-Based Fund Managers Should Not Be Placed at a Competitive Disadvantage Mutual fund advisers can be (and in fact are) located virtually anywhere. Many important ones are located in Michigan. 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. 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 Michigan-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 a sales tax on savings cannot be corrected by technical modifications to the legislation; imposing a sales tax on the mutual fund industry would always have this anti- Investment Company Institute Letter Re: 2007 P.A. 93 October 19, 2007 Page 3 of 5 competitive effect. As Michigan-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 Michigan. Extending the sales tax to investment advisory and brokerage 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, Michigan-based fund managers would be disadvantaged vis-à-vis fund managers located elsewhere because the Michigan 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 Michigan and those resident in other states. Any fund-level tax would be spread inappropriately across all investors, rather than assessed just against Michigan residents. Collection of the tax, however, could be ensured only from funds whose managers are located in Michigan, 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 Michigan-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 Michigan** If a sales tax, alternatively, were assessed only against Michigan 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

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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,<sup>2</sup> it would be difficult, if not impossible, to ensure that out-of-state firms would either (1) determine any Michigan shareholder's allocable share of the fees on which sales tax would be assessed or (2) actually collect the tax and remit it to Michigan. And, even if a non-Michigan-based firm were willing to voluntarily calculate the tax for its shareholders, timely self-reporting by Michigan 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 Michigan investors who purchase shares of funds managed by Michigan-based managers. Thus, such a tax also would have the effect of disadvantaging Michigan-based fund managers vis-à-vis fund managers located elsewhere.

**Recommendation** The Institute strongly recommends, on behalf of its Michigan-based members and all Michigan shareholders, that P.A. 93's sales tax on certain investment advice services be repealed and 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 Michigan 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 Michigan residents;
- our Michigan 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. 2 Suggestions that funds be required to disclose a shareholder's allocable share of fund expenses have been strongly opposed by the fund industry because of concerns that the proposals would impose unreasonably high costs on the funds' shareholders. In its review of a recent personalized expense disclosure proposal, the staff of the Securities and Exchange Commission noted that these compliance costs, "which ultimately would be borne by fund shareholders, may be considerable." Securities and Exchange Commission Division of Investment Management's Report on Mutual Fund Fees and Expenses, p. 70 (January 11, 2001). Investment Company Institute Letter Re: 2007 P.A. 93 October 19, 2007 Page 5 of 5 \* \* \* \* \* The Institute appreciates your consideration of our concerns. Please do not hesitate to contact the undersigned at (202) 326-5835 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/ Lisa Robinson Lisa Robinson Associate Counsel - Tax Law

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