Department of Legislative Services

Maryland General Assembly
2020 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 439 (Delegate Mosby, *et al.*)
Ways and Means

Income Tax - Carried Interest - Additional Tax

This bill imposes a 17% State income tax on the distributive share or pro-rata share of a pass-through entity's (PTE) taxable income that is attributable to investment management services provided in the State. This tax does not apply if, during the taxable year, at least 80% of the average fair market value of the specified assets of the entity consist of real estate. The Comptroller must notify the Department of Legislative Services (DLS) within five days after determining that federal legislation with an identical effect has been signed into law. **The bill takes effect July 1, 2020, and applies to tax year 2020 and beyond until 30 days after DLS is notified by the Comptroller of enacted federal legislation.**

Fiscal Summary

State Effect: General fund, Transportation Trust Fund (TTF), and Higher Education Investment Fund (HEIF) revenues increase by an estimated $48.3 million in FY 2021 and by $45.1 million annually thereafter. General fund expenditures increase by at least $169,000 in FY 2021 for the Comptroller's Office. TTF expenditures increase by approximately $475,800 in FY 2021 and by $315,800 in FY 2025.

($ in millions)	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025
GF Revenue	$43.3	$40.4	$40.4	$40.4	$40.4
SF Revenue	$5.0	$4.6	$4.6	$4.6	$4.6
GF Expenditure	$0.2	$0	$0	$0	$0
SF Expenditure	$0.5	$0.4	$0.4	$0.4	$0.3
Net Effect	$47.7	$44.6	$44.6	$44.6	$44.8

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate increase; (-) = indeterminate decrease

Local Effect: Local highway user revenues increase by approximately $475,800 in FY 2021 and by $315,800 in FY 2025. Expenditures are not affected.

Small Business Effect: Meaningful.

Analysis

Bill Summary: Investment management services are services provided by a partner or shareholder to a partnership, an S corporation, or any other entity if the services provide a substantial amount of:

- advising as to the advisability of investing in, purchasing, or selling a specified asset;
- managing, acquiring, or disposing of a specified asset;
- arranging financing with respect to acquiring a specified asset; or
- any activity in support of any of the above services.

Specified asset means securities, real estate held for rental or investment, interests in partnerships, commodities, or options or derivatives contracts.

Current Law/Background: Investment funds – such as private equity and hedge funds – are often organized as partnerships. These partnerships typically have two types of partners: general partners and limited partners. General partners manage the fund, while limited partners typically only contribute capital to the partnership. General partners can receive two types of compensation: a management fee tied to a percentage of the fund's assets and a profit share; or "carried interest," tied to a percentage of the profits generated by the fund. In a common compensation agreement, general partners receive a management fee equal to 2% of the invested assets plus a 20% share in profits as carried interest.

The management fee, less the fund's expenses, is subject to ordinary federal and State income tax rates (the top federal income tax rate for individuals in 2020 is 37%) and the federal self-employment tax. However, taxation of the carried interest is deferred until profits are realized on the fund's underlying assets, when at such time, the carried interest is taxed as investment income received by the limited partners. Thus, if the investment income consists solely of capital gains, the carried interest is taxed only when those gains are realized and at a lower capital gains rate on the federal level (the top capital gains tax rate in 2020 is 20%, plus a 3.8% net investment income tax). State taxation on the carried interest is also deferred, but all of the income is taxed at the same rate.

Under the bill, both the management fee and the realized carried interest are likely subject to a 17% tax.

The federal Tax Cuts and Jobs Act of 2017 requires an investment fund to hold assets for more than three years, instead of one year, to treat any gains allocated to its investment managers as long term. Otherwise, an asset sale is short term and taxed at a top rate of 40.8%. The Tax Policy Center advises that most private equity funds hold assets for more than five years; therefore, the requirement may not have a significant impact.

The federal Tax Cuts and Jobs Act of 2017 also decreased the top federal corporate income tax rate. Several private equity firms (KKR, Ares Management, and Blackstone) have recently restructured from publicly traded partnerships to C corporations, even though corporations are typically subject to the double taxation of income. Organizing as a corporation can increase their market value by attracting investments from mutual funds and other institutional investors who do not typically invest in publicly traded partnerships. A firm that restructures to a C corporation would also not be subject to the additional tax imposed under the bill.

State Revenues: The bill generally imposes a 17% State income tax on income attributable to investment management services beginning in tax year 2020. As a result, general fund, TTF, and HEIF revenues increase significantly beginning in fiscal 2021. Using estimates by the Congressional Budget Office (CBO) on taxing carried interest at ordinary federal income tax rates, State tax revenues increase by approximately $48.3 million in fiscal 2021 and by $45.1 million annually thereafter, based on Maryland's share of the CBO estimated annual federal revenue gain of $1.5 billion in 2021 and $1.4 billion annually thereafter. Assuming 50% of the tax is paid by corporations and 50% is paid by individuals, general fund revenues increase by $43.3 million, TTF revenues increase by $3.5 million, and HEIF revenues increase by $1.4 million in fiscal 2021. **Exhibit 1** shows the estimated State fiscal impacts resulting from the tax.

Exhibit 1
Fiscal Impact
($ in Millions)

	2021	2022	2023	2024	2025
General Fund	$43.3	$40.4	$40.4	$40.4	$40.4
HEIF	1.4	1.4	1.4	1.4	1.4
TTF	3.5	3.3	3.3	3.3	3.3
Total Revenues	**$48.3**	**$45.1**	**$45.1**	**$45.1**	**$45.1**
TTF Expenditures	**$0.48**	**$0.44**	**$0.44**	**$0.44**	**$0.32**

HEIF: Higher Education Investment Fund
TTF: Transportation Trust Fund
Source: Department of Legislative Services

DLS advises that the overall impact could vary significantly from estimated. CBO notes general partners must typically generate a return in excess of a threshold to earn carried interest, and this is dependent on economic conditions. Additionally, there is uncertainty about the degree to which general partners would be able to employ strategies, such as the use of nonrecourse loans to avoid recognizing carried interest as ordinary income.

The CBO estimate reflects the impact of some partnerships responding to a federal policy change by restructuring compensation agreements so that the general partner's 20% share of profits continues to be taxed at the lower capital gains tax rates. If carried interest was taxed as ordinary income, CBO expects some limited partners to provide an amount equivalent to 20% of the fund to the general partner as an interest-free nonrecourse loan, with the requirement that the borrowed capital be invested in the fund. The foregone interest on the loan would be taxed at ordinary income tax rates and, thus, generate new tax revenue, but if the general partner sells the assets of the investment fund for a profit, the gains realized by the general partner would still be taxed at the lower tax rates.

It is likely that State revenues will increase by less than estimated, as it does not take into consideration individuals' altering behavior on the state level to avoid the tax. DLS anticipates a significant number of taxpayers altering their behavior to avoid the tax, but the extent to which taxpayers do so cannot be quantified.

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of $169,000 in fiscal 2021 to add a new line to the individual, PTE, and corporate income tax returns. This includes data processing changes to the income tax return processing and imaging systems and systems testing. The Comptroller's Office is transitioning from its SMART system to a new integrated tax system, the Compass project. It is expected that the corporate income tax will transition to the new system during the first quarter of 2021. Thus, there could be additional programming expenses to add the tax to the new system.

A portion of TTF revenues are used to provide capital transportation grants to local governments. Thus, any increase in TTF revenues from corporate tax revenues results in a 13.5% increase in TTF expenditures to local governments (9.6% beginning in fiscal 2025). Accordingly, TTF expenditures increase by $475,800 in fiscal 2021 and by $315,800 in fiscal 2025, as shown in Exhibit 1. TTF revenues also fund the State capital program; thus, an increase in TTF revenues increases expenditures for the State capital program.

Local Revenues: Local governments receive a portion of corporate income tax revenues as local highway user revenues through capital transportation grants. Under this bill, local highway user revenues increase by approximately $475,800 in fiscal 2021 and by $315,800 in fiscal 2025 as a result of corporations paying the additional tax.

Small Business Effect: Small businesses that are private equity or hedge fund firms are adversely affected by the bill. The American Investment Council reported that there are 80 private equity firms headquartered in Maryland, so their shareholders who actively manage investment management services would incur a 17% tax on those services. It is unknown how many of these private equity firms are small businesses. Hedge fund firms are likewise affected.

Additional Information

Prior Introductions: A similar bill, HB 926 of 2019, was withdrawn after being referred to the House Ways and Means Committee.

Designated Cross File: SB 216 (Senator Pinsky, *et al.*) - Budget and Taxation.

Information Source(s): Comptroller's Office; American Investment Council; Congressional Budget Office; Tax Policy Center; Department of Legislative Services

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