Department of Legislative Services

Maryland General Assembly
2019 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 926 (Delegate Ivey)
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 5 days after determining that federal legislation with an identical effect has been signed into law. **The bill takes effect July 1, 2019, and applies to tax year 2019 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 $45.0 million annually beginning in FY 2020. General fund expenditures increase by $169,000 in FY 2020 for the Comptroller's Office. TTF expenditures increase by approximately $443,300 annually beginning in FY 2020.

($ in millions)	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024
GF Revenue	$40.4	$40.4	$40.4	$40.4	$40.4
SF Revenue	$4.6	$4.6	$4.6	$4.6	$4.6
GF Expenditure	$0.2	$0	$0	$0	$0
SF Expenditure	$0.4	$0.4	$0.4	$0.4	$0.4
Net Effect	$44.4	$44.6	$44.6	$44.6	$44.6

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

Local Effect: Local highway user revenues increase by approximately $443,300 annually beginning in FY 2020. Expenditures are not affected.

Small Business Effect: Meaningful.

Analysis

Bill Summary: Investment management services is a service 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 normally receive two types of compensation for managing a fund: a management fee tied to some percentage of the fund's assets and a profit share; or "carried interest," tied to some 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 income tax rates (the top federal income tax rate for individuals in 2019 is 37%) and self-employment tax on the federal level and is subject to the State individual income 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 in the same manner as the 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 the lower capital gains rate on the federal level (the top capital gains tax rate in 2019 is 20%, plus 3.8% net investment income tax). The Maryland income tax is based, after specified adjustments, on the federal adjusted gross income of the taxpayer, so taxation on the carried interest is deferred, but both forms of income are taxed at the same rate under the State income tax.

Under the bill, both the management fee and the realized carried interest are likely subject to the 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. Gains from the sale of assets held three years or less would be short term, taxed at a top rate of 40.8%. The Tax Policy Center advises that most private equity funds hold their assets for more than five years, so the longer holding period requirement may not affect them much.

State Revenues: General fund, TTF, and HEIF revenues increase significantly as a result of taxing income attributable to investment management services at 17%. Using estimates by the Congressional Budget Office (CBO) on taxing carried interest at ordinary federal income tax rates, the Comptroller's Office estimates State tax revenues would increase by approximately $45.0 million annually beginning in fiscal 2020, based on Maryland's share of the $1.4 billion CBO estimated annual federal revenue gain. Assuming 50% of the tax is paid by corporations and 50% is paid by individuals, general fund revenues increase by $40.37 million, TTF revenues increase by $3.28 million, and HEIF revenues increase by $1.35 million beginning in fiscal 2020. **Exhibit 1** shows the estimated State fiscal impacts resulting from the tax, assuming similar federal legislation is not enacted. If federal legislation with an identical effect is signed into law, the State would stop taxing income attributable to investment management services at 17%.

Exhibit 1
Fiscal Impact
($ in Millions)

	2020	2021	2022	2023	2024
General Fund	$40.37	$40.37	$40.37	$40.37	$40.37
HEIF	1.35	1.35	1.35	1.35	1.35
TTF	3.28	3.28	3.28	3.28	3.28
Total Revenues	**$45.00**	**$45.00**	**$45.00**	**$45.00**	**$45.00**
TTF Expenditures	**$0.44**	**$0.44**	**$0.44**	**$0.44**	**$0.44**

Source: Board of Revenue Estimates; Department of Legislative Services

DLS cautions that the overall impact could vary significantly from estimated. CBO notes general partners typically earn carried interest only when their fund generates a return in excess of a threshold, and their likelihood of earning that return depends 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 likelihood of some partnerships responding to a federal policy change by restructuring their 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.

To the extent that partnerships do not restructure their compensation agreements, State revenues could increase by more than $45.0 million beginning in fiscal 2020. However, it is more likely that State revenues increase by less than $45.0 million since this estimate does not take into consideration individuals altering behavior on the state level to avoid the 17% tax. DLS anticipates a significant number of taxpayers altering their behavior to avoid the 17% 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 2020 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.

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. Accordingly, TTF expenditures increase by $443,300 annually beginning in fiscal 2020 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 $443,300 annually beginning in fiscal 2020 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 82 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: None.

Cross File: None.

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

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