SB 361

Department of Legislative Services

Maryland General Assembly
2022 Session

FISCAL AND POLICY NOTE
First Reader

Senate Bill 361 (Senator Pinsky, *et al.*)
Budget and Taxation

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. 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, 2022, and applies to tax year 2022 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 $67.6 million in FY 2023 and by $48.3 million in FY 2027. General fund expenditures increase by $60,000 in FY 2023 for the Comptroller's Office. TTF expenditures increase by $666,100 in FY 2023 and by $338,300 in FY 2027.

($ in millions)	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027
GF Revenue	$60.7	$40.4	$40.4	$40.4	$43.3
SF Revenue	$7.0	$4.6	$4.6	$4.6	$5.0
GF Expenditure	$0.1	$0	$0	$0	$0
SF Expenditure	$0.7	$0.4	$0.3	$0.3	$0.3
Net Effect	$66.9	$44.6	$44.8	$44.8	$48.0

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

Local Effect: Local highway user revenues increase by approximately $666,100 in FY 2023 and by $338,300 in FY 2027. 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.

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

Current Law: 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 2021 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 2021 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.

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 2022. As a result, general fund, TTF, and HEIF revenues increase significantly beginning in fiscal 2023. Using estimates by the Congressional Budget Office (CBO) on taxing carried interest at ordinary federal income tax rates, State tax revenues increase by approximately $67.6 million in fiscal 2023 (which includes tax payments made retroactively for tax year 2022) and by $48.3 million in fiscal 2027. Assuming 50% of the tax is paid by corporations and 50% is paid by individuals, general fund revenues increase by $60.7 million, TTF revenues increase by $4.9 million, and HEIF revenues increase by $2.0 million in fiscal 2023. **Exhibit 1** shows the estimated State fiscal impacts resulting from the tax.

Exhibit 1
Fiscal Impact
($ in Millions)

	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027
General Fund	$60.7	$40.4	$40.4	$40.4	$43.3
HEIF	2.0	1.4	1.4	1.4	1.4
TTF	4.9	3.3	3.3	3.3	3.5
Total Revenues	**$67.6**	**$45.1**	**$45.1**	**$45.1**	**$48.3**
TTF Expenditures	**$0.7**	**$0.4**	**$0.3**	**$0.3**	**$0.3**

HEIF: Higher Education Investment Fund
TTF: Transportation Trust Fund

Source: Department of Legislative Services

DLS advises that the overall impact could vary significantly from the estimated amounts. 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. 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 this occurs cannot be quantified.

State Expenditures: The Comptroller's Office reports that it will incur a one-time expenditure increase of $60,000 in fiscal 2023 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 (9.6% beginning in fiscal 2025). Accordingly, TTF expenditures increase by $666,100 in fiscal 2023 and by $338,300 in fiscal 2027, 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. Local highway user revenues increase by $666,100 in fiscal 2023 and by $338,300 in fiscal 2027 as a result of additional corporate tax revenues.

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 95 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: Similar bills, SB 288 of 2021 and SB 216 of 2020, each received a hearing in the Senate Budget and Taxation Committee, but no further action was taken. The cross files, HB 215 of 2021 and HB 439 of 2020, each received a hearing in the House Ways and Means Committee, but no further action was taken. In addition, a similar bill was introduced in the 2019 session.

Designated Cross File: None.

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

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