The Honorable Guy Guzzone
Chairman, Senate Budget and Taxation Committee
3 West Miller Senate Office Building
Annapolis, Maryland 21401

January 29, 2019

Re: Oppose Senate Bill 216

Dear Chairman Guzzone and Members of the Committee:

Managed Funds Association ("MFA") welcomes the opportunity to submit this written statement in opposition to SB 216, *Income Tax – Carried Interest – Additional Tax*. MFA represents the world's largest alternative investment funds and is the primary advocate for sound business practices for hedge funds, funds of funds, managed futures funds, and service providers. MFA's members manage a substantial portion of the approximately $3 trillion invested in hedge funds around the world. Our members serve pensions, university endowments, and charities, among others, including many Maryland-based institutional investors.

MFA's members are a valuable component of the capital markets. They provide liquidity and price discovery to capital markets, capital to companies seeking to grow or improve their businesses, and important investment options to investors seeking to increase portfolio returns with less risk, such as pension funds trying to meet their future obligations to plan beneficiaries. Our members' skills help their customers plan for retirement, honor pension obligations, and fund scholarships, among other important goals.

MFA supports fair taxation of all businesses and investors and opposes discriminatory taxes that impose punitive tax rates on specific businesses for reasons other than sound tax policy. Policymakers may believe that SB 216 seeks to address perceived gaps in the tax treatment of carried interest income. However, the bill instead would increase the combined marginal tax rates on hedge fund managers from the current 49.75 percent to 66.75 percent by applying the surtax to income that is already subject to the highest federal tax rates. Further, while the bill title suggests the proposed 17 percent surtax would be applied to carried interest income, the bill instead imposes a surtax on investment management services income that is unrelated to carried interest income, including fee income that is already taxed as ordinary income at the federal and state level.

As a result, the bill would impose an uneconomical 66.75 percent combined marginal tax rate on hedge fund managers, making the business uneconomical for Maryland-based hedge fund managers. Because the bill would apply to non-Maryland residents with respect to income attributable to Maryland, many out-of-state hedge fund managers will face the same uneconomic tax rate on the services they provide to Maryland investors, which could significantly limit the investment options for Maryland pensions, endowments, foundations, and other institutional investors. If Maryland were to enact the bill, it would be the first state in the country to impose this kind of surtax on the investment management industry, putting the state at a significant competitive disadvantage to other states. Ultimately, the negative economic consequences of enacting SB 216 will outweigh the perceived tax revenue of the surtax.

In considering the likely effects of SB 216, it is important for policymakers to understand the federal tax treatment of the income earned by hedge fund managers. Hedge fund managers typically earn fee income (either based on assets under management or performance-based), which is taxed as ordinary income at the federal and state level, and carried interest income. Despite the rhetoric, carried interest income is not automatically taxed at the lower long-term capital gains rate at the federal level. Indeed, for most hedge fund managers, their carried interest income is taxed at ordinary income tax rates. Under federal tax law following enactment of the Tax Cuts and Jobs Act, investment managers only pay long-term capital gains rates on their carried interest if the funds they manage own investments that generate capital gains income and the fund holds those investments for at least three years. Hedge funds generally are short-term trading and investment vehicles, therefore, unlike other types of private funds, hedge funds typically do not hold investments for the three-year period necessary to generate long-term capital gains. As a result, the carried interest earned by hedge fund managers generally is taxed at ordinary income rates up to 37 percent at the federal level.

SB 216 would apply the 17 percent surtax on (1) investment management services income regardless of the federal tax rate paid on that income and (2) investment management services income that is unrelated to carried interest. Hedge fund managers already typically pay federal taxes on their carried interest and other investment management services income at ordinary rates up to the top 37 percent rate at the federal level, in addition to other taxes, such as net investment income tax or self-employment tax, and state and local taxes. Combined with these existing taxes, SB 216 would increase the combined marginal tax rate from 49.75 percent to 66.75 percent for hedge fund managers. Because SB 216 would impose this punitive tax rate in a discriminatory manner with respect to hedge fund managers, MFA opposes enactment of the bill and encourages policymakers to oppose the bill.

Sincerely,

Louis Costantino Jr.
Executive Vice-President and Managing Director, Government Relations
Managed Funds Association

Cc: The Honorable Paul Pinsky

MARYLAND

Hedge Funds in Maryland

Hedge funds help provide a range of benefits to pension funds and other institutional investors in Maryland, including **diversification and risk-adjusted returns to help deliver reliable returns over time.**

Across Maryland, hedge funds help support retirement security, college education, and the important work done by non-profits and charities.[1]

Specifically, over **80 institutional investors in Maryland use hedge funds** to help achieve their unique investment objectives, including more than **20** foundations and non-profit organizations, **25** public and private pension funds, and at least **9** colleges and universities.[2]

While certain states are making a concerted effort to attract investment firms, including hedge funds, to their lower-taxed jurisdictions, Maryland currently has 39 active hedge fund managers.[3]

1 Preqin's alternative asset database as of September 2018.
2 Preqin's alternative asset database as of September 2018.
3 Preqin Special Report: Hedge Funds in the U.S., July 2018.

IN NUMBERS

39
Number of active Maryland-based hedge fund managers.

$21.5bn
Size of the Maryland hedge fund industry.

83
Number of Maryland-based institutional investors active in hedge funds.

$1BN

6
Number of Maryland-based hedge fund managers with over $1bn in AUM.

14.17%
Average current allocation to hedge funds of Maryland-based institutional investors active in the asset class.

Source: Preqin, the leading source of data on the alternative asset management industry.

Hedge Funds and Their Role in Capital Markets

What is their purpose?

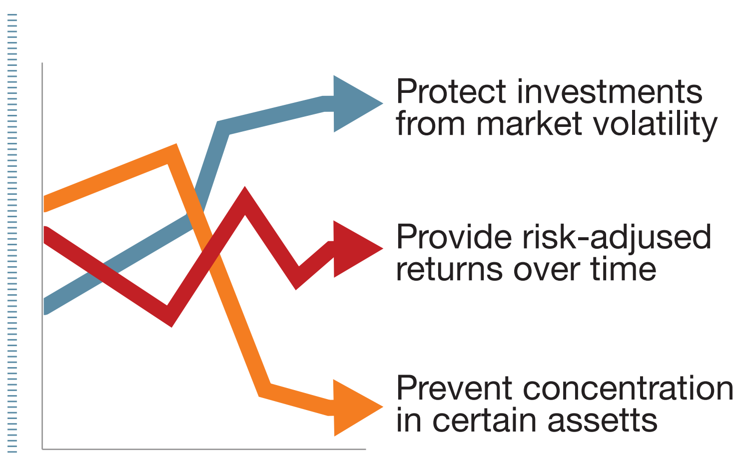
Hedge funds employ a wide range of investment and trading activities to maximize return while minimizing risk.

PORTFOLIO DIVERSIFICATION

OPPORTUNITIES FOR ASSET GROWTH

RISK MANAGEMENT

Portfolio diversification helps...



Who benefits?

These investments benefit local communities and residents in ways that are not always explained or well-understood. Institutions partner with hedge funds to help:

...Fund retiree benefits and ensure retirement security for 25 major public and private pension plans in MD.

...9 major MD colleges and universities fund investments that provide scholarships, research funding and operating income.

...Fund the work of 20+ foundations and non-profit organizations and endowments in Maryland

Carried Interest Tax Treatment of an Investment Manager with More Than $500,000 in Income with Short-Term Capital Gains (assets held less than 3 years)

37%
Federal Ordinary Income or Short-Term Capital Gains Tax

3.8%
Federal Net Investment Income Tax

5.75%
State Individual Income Tax

3.2%
Local Income Tax*

49.75%
Total Current Tax Rate

+

17%
Proposed MD State Surcharge

=

66.75%
Total Proposed Combined Federal, State and Local Marginal Tax Rate

Carried Interest Tax Treatment of an Investment Manager with More Than $500,000 in Income with Long-Term Capital Gains (assets held longer than 3 years)

20%
Federal Long-Term Capital Gains Tax

3.8%
Federal Net Investment Income Tax

5.75%
State Individual Income Tax

3.2%
Local Income Tax*

32.75%
Total Current Tax Rate

+

17%
Proposed MD State Surcharge

=

49.75%
Total Proposed Combined Federal, State and Local Marginal Tax Rate

*Note: local income taxes vary by jurisdiction; minimum taxes are at least 1% of Maryland taxable income, and no more than 3.2%