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SB216 Closing the Carried Interest Loophole

Carried interest is a loophole in the tax code that allows the managers of hedge funds to pay a lower rate than most individuals.

A hedge fund manager takes 20 percent of all gains on the fund's investments. The tax code treats that income as a "long-term capital gain," which is taxed at a lower rate than ordinary income (which is 39.6% at the maximum).

This income really should be taxed at the normal rate 39.6% because it is not a capital gain (selling stocks, etc. at a gain). Congress was supposed to fix this loophole but has not done so and it is unclear whether they will plug the loophole. This bill (which is supported by the New York Times) would have these funds taxed at the normal rate 39.6% in Maryland until Congress moves ahead with plugging the loophole. According to the fiscal note It would raise over $70 million in extra revenue in Maryland.

Donald Trump, Hillary Clinton, Bernie Sanders, and Jeb Bush all called for closing a tax break known as the "carried interest loophole."

First: What is a hedge fund? Hedge funds are alternative investments using pooled funds that employ numerous different strategies to earn returns, for their investors. Hedge funds are aggressively managed with the goal of generating high returns. It is important to note that hedge require less regulations than mutual funds and other investment vehicles.

Hedge fund and private equity funds are structured as partnerships. The fund manager is the general partner of the funds, and the investors are limited partners. Investors supply the capital, and the fund manager supplies investment expertise. For the services the investment manager provides, he/she charges certain fees.

In both hedge funds and private equity funds, the standard fee structure is "2 and 20". Two percent of the fund assets per year are taken as the management fee, which covers operating costs. Twenty percent of all gains are taken by the fund manager as the performance fee.

The problem comes from how that twenty percent performance fee is treated for tax purposes. It is clear that this twenty percent fee is compensation for services. According to the Tax Policy Center, the vast majority of tax analysts share this view.

But the hedge fund and private equity industries treat this investment advice as "carried interest" fees, a unique type of income for tax and accounting purposes – not a service income. If we treated the performance fee as a fee for services, it would be federally taxed at the ordinary income level, where the highest marginal tax rate is currently 39.6%

Instead   fund managers treat this fee using the carried interest loophole claim as a capital gain. It clearly it is not. It is investment advice. They are managing other people's money.   The tax on capital gains is 20% not 39.6%. The difference of 19.6% may not sound like a lot of money, but it is estimated the tax revenue loss from the carried interest loophole is over $18 billion per year.

State loophole-closing legislation aims to "repatriate" the revenue lost to the loophole back to the states where "carried interest" investment fees were assessed.

The simple method: a state-level 19.6% "carried interest fairness fee" that makes up for the federal-level revenue loss, with the money going to fund essential in-state needs. It is important to note that this bill just covers those entities that categorize their income as capital gains when it is really investment advice and should be taxed at the rate for individual income.

This tax would sunset on the effective date when and if the federal government decides to close the carried interest loophole