HB 915

Department of Legislative Services

Maryland General Assembly
2017 Session

FISCAL AND POLICY NOTE
First Reader

House Bill 915 (Delegate Tarlau, *et al.*)
Ways and Means

Income Tax - Carried Interest - Additional Tax

This bill imposes a 19% 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 bill takes effect July 1, 2017, and applies to tax year 2017 and beyond until federal legislation that has an identical effect is enacted.

Fiscal Summary

State Effect: General fund, Transportation Trust Fund (TTF), and Higher Education Investment Fund (HEIF) revenues increase significantly, potentially by an estimated $79.0 million in FY 2018 and by $58.0 million in FY 2022, as a result of imposing a 19% tax on investment management services. General fund expenditures increase by $162,000 in FY 2018 for one-time tax form changes and computer programming modifications at the Comptroller's Office.

Local Effect: Local highway user revenues could increase significantly. Expenditures are not affected.

Small Business Effect: Meaningful. Small businesses that provide investment management services or receive income that is attributable to investment management services are adversely affected by paying a 19% tax on that income.

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 2017 is 39.6%) 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 2017 is 20%). 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 19% tax.

Taxation of Pass-through Entities

A PTE is a business structure that avoids the double taxation imposed on an ordinary corporation. A corporation's income generally is taxed at the corporate level and taxed again at the individual level when income is distributed as dividends (cash) to the owners or shareholders. Unlike for a corporation, income recorded by a PTE flows through and is allocated to the owners of the entity. The owners of the PTE pay income tax at the individual level on this amount (as shown in **Exhibit 1**). Owners may choose the type of entity to form for a variety of reasons, including the number of owners, liability protection, profit distribution, ease of formation, and tax treatment.

Exhibit 1
Maryland State Income Tax Rates
Current Law

Single, Dependent Filer, Married Filing Separate		Joint, Head of Household, Widower	
Rate	**Maryland Taxable Income**	**Rate**	**Maryland Taxable Income**
2.00%	$1-$1,000	2.00%	$1-$1,000
3.00%	$1,001-$2,000	3.00%	$1,001-$2,000
4.00%	$2,001-$3,000	4.00%	$2,001-$3,000
4.75%	$3,001-$100,000	4.75%	$3,001-$150,000
5.00%	$100,001-$125,000	5.00%	$150,001-$175,000
5.25%	$125,001-$150,000	5.25%	$175,001-$225,000
5.50%	$150,001-$250,000	5.50%	$225,001-$300,000
5.75%	Excess of $250,000	5.75%	Excess of $300,000

Source: Department of Legislative Services

In order for a business to be treated as a PTE, the entity must organize under State law and make an election to do so on the entity's federal income tax return. PTEs generally fall within one of five categories: sole proprietorship; general partnership; limited partnership; limited liability company; or S-corporation (a corporation that is taxed as a PTE). Each type of entity has different characteristics that make it more or less desirable depending on the type of business being established. PTEs have grown in popularity and make up the vast majority of businesses and almost half of net business income nationally. In addition, PTEs account for significant portions of the private-sector workforce and payroll.

State Revenues: General fund, TTF, and HEIF revenues increase significantly as a result of taxing income attributable to investment management services at 19%. While the bill would increase State individual and corporate income tax revenues, the total fiscal impact cannot be reliably estimated at this time. The overall impact depends on the number of taxpayers who file in Maryland and have income attributable to investment management services.

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 $60.0 million annually beginning in fiscal 2018, based on Maryland being a wealthy state and therefore likely having a 3% share of the $2.0 billion CBO estimated annual federal revenue gain.

The U.S. Department of the Treasury (Treasury) estimates that taxing carried interest as ordinary income would generate approximately $2.6 billion of federal tax revenue in fiscal 2018 and $1.9 billion in fiscal 2022. Based on the Treasury estimate, the Department of Legislative Services estimates that State tax revenues would increase by $79.0 million in fiscal 2018 and by $58.0 million in fiscal 2022 from taxing investment management services at a 19% tax rate, as shown in **Exhibit 2**.

Exhibit 2
Revenue Impact under the Bill
Fiscal 2018-2022
($ in Millions)

	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
Revenue Estimate	$79.0	$76.0	$73.0	$71.0	$58.0

Source: U.S. Department of the Treasury; Department of Legislative Services

The CBO and Treasury estimates reflect 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 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 $79.0 million beginning in fiscal 2018. However, it is more likely that State revenues increase by less than $79.0 million since this estimate does not take into consideration individuals altering behavior to avoid the 19% tax. The Department of Legislative Services does anticipate a significant number of taxpayers altering their behavior to avoid the 19% 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 $162,000 in fiscal 2018 to add a new line to the individual, PTE, and corporate income tax returns. This includes data processing changes to the SMART income tax return processing and imaging systems and systems testing.

Local Revenues: Local governments receive a portion of corporate income tax revenues to support the construction and maintenance of local roads and other transportation facilities. Under this bill, local highway user revenues could increase significantly.

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 69 private equity firms headquartered in Maryland in 2015, so their shareholders who actively manage investment management services would incur a 19% 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: SB 605 (Senator Pinsky, *et al.*) - Budget and Taxation.

Information Source(s): Comptroller's Office; State Department of Assessments and Taxation; Congressional Budget Office; U.S. Department of Treasury; American Investment Council; Department of Legislative Services

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