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THE MARYLAND HOUSE OF DELEGATES
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Testimony in Support of HB 215
Income Tax – Carried Interest – Additional Tax

This bill would close the "carried interest loophole," which is a tax break for hedge fund and private equity managers.

What Is Carried Interest?

Hedge fund managers receive two types of compensation for managing their clients' investments:

- a *management fee* equal to 2% of the assets invested in their fund. This fee is subject to payroll and income taxes.
- a 20% share of the profits from the fund, which is known as *carried interest*. Carried interest is taxed as capital gains, which are subject to a much lower tax rate than ordinary income.[1]

Carried Interest Should be Taxed Like Ordinary Income

Treating carried interest as a capital gain is fundamentally wrong. The capital gains tax rate is lower than income tax rates by design: to spur economic growth by encouraging people to take the risk of investing their hard-earned money in other segments of the economy. Hedge fund managers who take advantage of the carried interest loophole do not personally take on this financial risk since it is not their money that is at stake.

Because carried interest isn't taxed as ordinary income, money managers pay a lower tax rate than any other profession. Not even do investment bankers—who also manage the money of others—receive this level of special treatment.

This bill would treat carried interest like other forms of performance-based compensation, such as bonuses, royalties, and most stock options.

[1] The top tax rate for carried interest is 20%, as compared to a top tax rate of 37% for ordinary income.

According to the Congressional Budget Office, this legislative approach "would equalize the tax treatment of income that general partners received for performing investment management services and the income earned by corporate executives who do similar work. (For example, many corporate executives direct investment, arrange financing, purchase other companies, or spin off components of their enterprises, yet profits from those investment activities are not counted as individual capital gains for those executives and are therefore not taxed at preferential rates.)"[2]

Closing the carried interest loophole is an idea that is supported by politicians that span the political spectrum, including President Obama, President Trump, Bernie Sanders, and Hillary Clinton.

Why This Bill Is Needed

Carried interest is a growing problem; the amount of money invested in private equity and hedge funds has grown by 40% over the past four years.[3]

By closing this loophole, we can provide the state with much-needed revenue at a time we are facing a multibillion dollar deficit. The fiscal note for the 2020 bill estimated that it would generate $47.7 million in FY 2021 and $44.6 million annually thereafter.

This bill closes the carried interest loophole by enacting a 17% tax on pass-through income that is attributed to investment management services in the state. This change would only impact a small number of wealthy taxpayers, and it would not apply to entities whose assets in a given tax year are composed of at least 80% real estate holdings. Additionally, the 2021 version of the bill includes language to make clear that the tax only applies to performance-based compensation for hedge fund managers and that it does not apply to all financial advisors.

In short, the carried interest loophole is problematic for three main reasons:

- It allows similar investment activities to be taxed at arbitrarily different rates.
- It shifts the tax burden away from those most able to pay onto those least able.
- It costs our communities millions of dollars that would otherwise be spent on education, transportation, public health, and other essential investments.

This legislation would eliminate this special tax break and ask wealthy fund managers to pay their fair share.

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[2] https://www.cbo.gov/budget-options/2018/54795
[3] Congressional Research Service, "Taxation of Carried Interest," July 2020. https://crsreports.congress.gov/product/pdf/R/R46447