



## States revive previous attempts to tax carried interest

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In 2017, several states considered legislation that would impose additional tax on carried interest. Last May, we [addressed](#) such efforts in Illinois and New Jersey. Now, the Tax Foundation is commenting on renewed attempts in these and two additional jurisdictions, Maryland and New Jersey. California is yet another with a new bill in the works.

While there has been energy behind these proposals in the past, these new endeavors are, in part, a response to the federal 2017 Tax Cuts and Jobs Act, enacted in December 2017. Under current federal tax law, investment managers earning a share of investment profits (or “carried interest”) are taxed on these profits at a top income tax rate for capital gains of 20 percent. Some commentators argue, however, that carried interest is, in essence, compensation for investment management services and should be taxed as other wages and salaries at a top marginal tax rate of 37 percent. The Tax Cuts and Jobs Act maintained capital gains treatment for carried interest, but requires investment managers to hold assets for at least three years to obtain capital gain tax treatment.

### ILLINOIS

HB 4293, introduced on Jan. 22, 2018, would impose the “privilege tax” that we described in our article last year. The tax levies an additional 20 percent on “partnerships and S corporations engaged in the business of conducting investment management services.”

### NEW YORK

In the Empire State, a mid-January press release announced Gov. Andrew Cuomo’s latest proposal to “fix and equalize the tax treatment of income for private equity investors. Currently, investors pay lower tax rates than ordinary New Yorkers on their income by way of the preferential carried interest treatment. The so-called ‘Fairness Fix’ could raise nearly \$1.1 billion annually.”

The governor justified this move by accusing the federal government of “stack[ing] the deck in favor of the wealthy and corporations at the expense of the middle class, [so] we are taking action to protect hardworking New Yorkers and ensure fairness and equality. Closing this [allegedly] egregious loophole will further this administration’s efforts to promote economic justice and establish a fair tax code for working men and women across New York.” The bill, A3554, “aims to close the Carried Interest Tax Loophole on the State level by taxing the Carried Interest Income of hedge fund and private equity investors as traditional ordinary earned income.”

Initially, the A3554 bill sought a 19 percent fix to close the gap between the “fundamentally unfair” 20 percent tax rate imposed on these hedge fund and private equity taxpayers, and the 39 percent tax rate applicable to ordinary income earners. But because the federal tax rate on ordinary income ended up at 37 percent, the Fairness Fix seeks just 17 percent.

Gov. Cuomo touted lawmakers’ “comprehensive, regional approach to addressing the carried interest issue.” The legislation would take effect “only if Connecticut, New Jersey, Massachusetts and Pennsylvania enact legislation having substantially the same effect as this bill.”

The Tax Foundation opines that the provision concerning Connecticut, New Jersey, Massachusetts and Pennsylvania weakens the proposal, because it does not define “what would constitute a ‘same effect.’” Moreover, A3554 “may be overly broad, applying the 17 percent surtax on carried interest to C corporations that act as investment managers and to investment management services owned by C corporations. This does not make conceptual sense, because C corporations face the same tax rate on their ordinary income and on their capital gains, so cannot be said to benefit from preferential treatment of carried interest.”

The group notes that the plans in New Jersey, by way of a 19 percent tax set forth in Senate Bill 64, and in Illinois, “suffer from similar statutory language challenges.”

### CALIFORNIA

The Golden State is another that wants to close the loophole. Assembly Bill 2731 would impose a tax of 17 percent on that portion of an individual’s taxable income derived from an investment management services interest. AB 2731, introduced on Feb. 15, 2018, and referred to the Committee on Revenue and Taxation on March 8, 2018, would also require the Franchise Board to report to lawmakers if the federal government were to pass legislation having an “identical effect.” Lawmakers, in turn, would be required to determine whether repeal the 17 percent tax or not.

Any additional revenue that AB 2731 raises would be deployed for educational purposes. Because the measure increases taxes, California law requires 2/3 of the legislature to vote in its favor to take effect.

### MARYLAND

This state’s bill is different from the others, asserts the Tax Foundation. The title, “Higher Education Degree and Job Certification Without Debt Act of 2018,” hints at why. It, too, levies a 19 percent tax on “certain income that is attributable to investment management services,” but the group notes that this stands out as a unique “key funding vehicle for its higher education reform package [that] includes free community college for those with less than \$150,000 in federal adjusted gross income.”

The fiscal note estimates a dwindling revenue stream: in fiscal years 2019-2023, the tax could generate \$78 million, \$75 million, \$72 million, \$70 million, and \$58 million, respectively. The Tax Foundation warns Maryland to “proceed cautiously; funding a new government program, such as free community college, from a declining revenue source is a risky strategy.”

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### ANOTHER POTENTIAL FLAW

The Tax Foundation, citing an "an excellent paper by Donald Marron of the Tax Policy Center," observes that "if carried interest income is categorized as labor compensation when received by investment managers, it should also count as a deductible business expense when paid by investors."

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DAVID KALL

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