



Analysis of Original Bill

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Sponsor:

Bill Number: AB 2731

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Introduced: February 15, 2018

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Related Bills: See Legislative
History

Subject: Tax Rates/Additional 17 Percent Tax on Income Derived From Investment
Management Services Interest

Summary

This bill would, under the Personal Income Tax Law (PITL), impose an additional tax on that portion of a taxpayer's taxable income derived from an investment management services interest.

Recommendation - No position.

Reason for the Bill

The reason for this bill is to reduce wealth inequity by creating parity in the state's tax structure.

Effective/Operative Date

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2018.

Federal/State Law

Federal law imposes different income tax rates on individuals using a graduated scale. For taxable year 2018 the tax rate starts at 10 percent and gradually increases to a top rate of 37 percent.

As of January 1, 2018, existing federal law¹, provides that in the case of partnership interests received in exchange for performance of services related to raising capital or investments related to specified assets (carried interest), any long-term capital gain will only be recognized as a long-term capital gain if the underlying asset has been held for at least three years.

¹ IRC section 1061.

These rules apply notwithstanding any election under IRC section 83, relating to the receipt of property for the performance of services, and in the case of any capital gain resulting from the sale of an asset that does not meet the three-year holding period requirement, such gain will be treated as short-term capital gain.

Federal law differentiates between short-term and long-term capital gains. A short-term capital gain under federal law is the gain from an asset held a year or less, and long-term capital gain is the gain from an asset held for more than one year. In the case of net capital gain the applicable tax rate may be less than the rate applied to ordinary income.

Existing state law imposes different personal income tax rates ranging from one percent to 12.3 percent. Additionally, there is an additional tax of 1 percent on the portion of a taxpayer's taxable income that exceeds \$1,000,000.² California taxes capital gains as ordinary income.

This Bill

For each taxable year beginning on or after January 1, 2018, this bill would impose an additional tax of 17 percent on that portion of a taxpayer's taxable income derived from an investment management services interest.

This bill would define the following terms:

- "Investment management services interest" means any interest in a business which is held by any individual, if that individual provides, directly or indirectly, in the active conduct of a trade or business, a substantial quantity of any of the following services to the business:
 - Advising the business (including a partnership, "S" corporation, or any other business entity) as to the advisability of investing in, purchasing, or selling any specified asset.
 - Managing, acquiring, or disposing of any specified asset.
 - Arranging financing with respect to acquiring specified assets.
 - Any activity in support of any service described above.
- "Specified asset" means securities defined in IRC section 475(c)(2) relating to security defined, real estate held for rental or investment, interest in partnerships, commodities; or as defined in IRC section 475(e)(2), relating to commodity, or option or derivative contracts to any of these.

² Revenue & Taxation Code section 17043.

A partner's or shareholder's interest would be specifically excluded from the definition of "investment management services interest" if at least 80 percent of the average fair market value of the specified assets of the business during the taxable year is real estate.

This bill would require the Franchise Tax Board (FTB) to report to the Legislature on the enactment of federal legislation that has the identical effect as this bill applicable to income earned in all U.S. states and territories. The report would be required to meet the submission requirements for reports to the Legislature as defined in section 9795 of the Government Code³. The Legislature would be required during the taxable year that a report is submitted to determine whether to repeal, make inoperative, or continue the tax imposed by this bill.

Implementation Considerations

Department staff has identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill uses terms that are undefined, i.e., "any interest in a business," "active conduct," "substantial quantity," and "any activity in support of any service." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this bill. For clarity and ease of administration, it is recommended that the bill be amended.

The additional tax would apply to all taxpayers subject to the PITL, including, individuals, estates, or trusts. If this is contrary to the author's intent, the bill should be amended.

Because the bill fails to specify otherwise, the FTB would be subject to the rulemaking procedures required under the Administrative Procedures Act (APA). Following these procedures may delay the immediate implementation of this bill. To prevent any delay, it is recommended that the author add a provision exempting the FTB from the APA when the FTB is prescribing rules, guidelines, or procedures to carry out the bill's purpose.

The bill is silent on the timing of the FTB's submission of a required report to the Legislature. To ensure consistency with the author's intent this bill should be amended.

If this bill is enacted in late September or October of 2018, the department would have developed the forms and instructions for the 2018 taxable year. Thus, the department may incur additional costs to develop alternative forms and instructions in the short time frame necessary to ensure they are available for taxpayers to comply with the reporting requirement.

³ Government Code section 9795 states that reports to the Legislature must be submitted instead to the Legislative Counsel, and makes specific requirements regarding its outline and presentation.

Legislative History

A review of the past five legislative sessions found no legislation similar to this provision.

Other States' Information

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. Although a review of *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* laws found no comparable tax, several states were found to have pending legislation that would impose a similar tax.

A bill recently introduced in *Illinois* (HB 4293, 1/22/2018) imposes a privilege tax on partnerships and S corporations engaged in the business of conducting investment management services. The tax is imposed at a rate of 20 percent applied to the performance of the investment portfolio and not the investment itself.

A *New York* bill (S. 7509, 1/25/2018) would impose a 17 percent tax on investment management services to a partnership, S corporation, or entity, for rendering investment advice, managing, acquiring, or disposing of any such asset, arranging financing with respect to the acquisition of such assets, and related activities in support of the above. The tax would be applied to any excess amount attributable to the investment management service.

A *Massachusetts* bill (SB 2050, 2017) which would have provided a surcharge of 24 percent on income from carried interest—the portion of an investment fund's returns that are paid to hedge fund managers, private equity, venture capitalists, and certain real estate investors—failed to pass out of the first house.

No current or pending legislation similar to this bill was identified for *Florida, Michigan, and Minnesota*.

Fiscal Impact

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved, but anticipate the costs to be significant.

Economic Impact

Revenue Estimate

This bill would result in the following revenue gain:

Estimated Revenue Impact of AB 2731 as Introduced February 15, 2018
For Taxable Years Beginning On or After January 1, 2018
Assumed Enactment after June 30, 2018

(\$ in Millions)

Fiscal Year	Revenue
2018-2019	\$700
2019-2020	\$450
2020-2021	\$470

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

Revenue Discussion

The bill language states investment management services means any interest in a business which is held by any individual that provides, directly or indirectly, a substantial quantity of any or any combination of - advising, managing, or arranging financing of specified assets, or any activity in support of such activities. This estimate assumes the majority of the income for these services would be provided for hedge funds and private equity funds.

Based on industry data, it is estimated that total profits from hedge funds located in California would be \$6 billion and total profits for private equity funds located in California would be \$4.7 billion in 2018. Based on information from the Federal Congressional Budget Office, the average profit share or "carried interest" for both these types of funds is commonly 20 percent. This would result in income derived from hedge fund profits of \$1.2 billion and private equity funds of \$0.9 billion for a total of \$2.1 billion. There is no data available on income derived from other management services interests other than hedge and private equity funds. Therefore, the estimate is increased by an assumed rate of 20 percent to account for this income. Applying a 17 percent tax rate results in a revenue gain of \$450 million in the 2018 taxable year.

This estimate is based upon historical fund performance and should not be construed as a prediction of future market performance. Past performance does not guarantee future results as such the actual revenue could vary widely.

The tax-year estimates are converted to fiscal-year estimates, and then rounded to arrive at the amounts shown in the above table.

Support/Opposition

Support: None provided.

Opposition: None provided.

Arguments

Proponents: Some would argue that the additional tax promotes fairness in the tax system.

Opponents: Others would argue that this tax could negatively impact long-term investment in this state by driving providers of investment management services away from California.

Policy Concerns

This bill would impose a tax on business entities subject to tax under the PITL (i.e. sole proprietorships, noncorporate partners of partnerships, limited partnerships, and limited liability companies not electing to be taxed as corporations, limited liability partnerships, and real estate mortgage investment conduits) that would not be imposed on other business entities such as corporations. Thus, this bill would provide differing treatment based solely on classification.

This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of changes in the tax law by the Legislature.

This bill would require the Legislature to re-evaluate this tax when the President signs legislation impacting all states and territories having the identical effect. If this measure goes into effect before the federal legislation is signed, long-term investment in California would be negatively impacted. States that have not signed similar legislation are likely to attract California providers of these services wishing to maintain their current income levels.

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