GIBSON DUNN

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MARYLAND INTRODUCES NEW CARRIED INTEREST TAX LEGISLATION

To Our Clients and Friends:

In January of 2020, the Maryland House and Senate introduced identical bills — HB0439 in the House and SB0216 in the Senate (together, the "Proposed Legislation") — that would apply an additional 17% state income tax to (i) carried interest and management fee income attributable to certain investment management services provided in the state of Maryland and (ii) carried interest and management fee income earned by residents of Maryland, regardless of where the investment management services giving rise to the income are performed.[1]

Maryland joins California, Connecticut, the District of Columbia, Illinois, Massachusetts, New Jersey, New York, and Rhode Island in proposing some version of an additional tax on carried interest. Like Maryland, many of those states have included an exception for real estate businesses and an expiration provision should a federal bill with an identical effect become law (each as discussed below). However, Maryland's Proposed Legislation departs from many of its predecessors in that its effectiveness is not contingent on the same or similar legislation passing in other states. This may provide a significant incentive for Maryland private equity and venture funds to leave the state and, potentially, for Maryland businesses seeking private equity or venture capital funding to move to neighboring jurisdictions. The Proposed Legislation, if adopted, could also encourage individuals who are currently Maryland residents and derive substantial income from the provision of non-Maryland investment management services to relocate to another state. To date, only New Jersey has adopted carried interest legislation, and that legislation remains inoperative because New York, Connecticut, and Massachusetts have not adopted similar legislation. Accordingly, no state has adopted legislation that would be similar in scope and effect to the Proposed Legislation.

We summarize the provisions of the Proposed Legislation below.

Income Subject to the Tax

Under current tax law, an owner of an interest in a passthrough entity is taxed on the owner's allocable share of the passthrough's taxable income. Moreover, the character of that income to the owner generally is the same as it is to the passthrough entity. In contrast, fees paid to an owner of an interest in a passthrough entity for services performed for the entity typically are treated as "guaranteed payments" and are taxed at ordinary income rates. The Proposed Legislation would create a special rule that applies an additional 17% surtax to taxable income from certain investment management services, including both management fees (typically taxed as ordinary income) and "carried interests" (typically taxed at lower capital gains rates).

The 17% surtax would apply only to income generated by "Investment Management Services" provided by a partner or shareholder in a partnership, S corporation, or other entity (such as a limited liability company). Investment Management Services include those services a "substantial quantity" of which are (i) advising on whether an investor should invest in, purchase, or sell Specified Assets (defined below), (ii) managing, acquiring, or disposing of a Specified Asset, (iii) arranging financing with respect to acquiring a Specified Asset, or (iv) any activity in support of any of the services described in clauses (i) through (iii) of this paragraph.

The Proposed Legislation defines "Specified Assets" as securities, real estate property held for investment or rental, partnership interests, commodities, options, or derivative contracts. Although Investment Management Services include those performed by S corporation shareholders, the definition of Specified Asset in the Proposed Legislation omits shares in an S corporation. Thus, those shareholders or partners performing Investment Management Services with respect to investments that are interests in S corporations (including limited liability companies that have elected to be S corporations) may not be captured by the current draft of the Proposed Legislation.

Because the deductibility of state and local taxes is currently limited under U.S. federal tax law, certain management fee income of Maryland residents (which is already taxed at ordinary U.S. federal income and state tax rates) would be subject to combined tax rates of up to 59.75% under the Proposed Legislation. Carried interest income of Maryland residents (typically taxed at lower long-term capital gains rates at the federal level) would be subject to combined tax rates of up to 48.90%.

Real Estate Exception

Notably, the Proposed Legislation excepts from the 17% surtax those partners or shareholders holding an interest in a partnership, S corporation or other entity owning primarily real estate assets. Specifically, to qualify for the exception, the Proposed Legislation requires that 80% of the "average fair market value" of the partnership, S corporation or other entity consist of real estate. This exception would be expected to apply to certain real estate businesses, such as real estate investment trusts.

Application to Maryland Residents

The Proposed Legislation provides that those corporations or individuals (including spouses of applicable individuals filing a joint return) who are Maryland residents must pay the 17% surtax on income attributable to Investment Management Services even if the income is not derived from Investment Management Services performed in Maryland. All Maryland residents who derive income from Investment Management Services provided as a partner or shareholder in a passthrough entity could therefore be subject to the 17% surtax, unless the real estate exception applies.

Application to Nonresidents

Nonresidents of Maryland also would be subject to the Proposed Legislation's 17% surtax to the extent they receive income generated by Investment Management Services performed in Maryland, unless the real estate exception applies. The tax could apply to any private equity fund or venture capital fund that

invests in a Maryland business, regardless of where the investing fund is located. It also may apply to income derived from a fund's investment in a portfolio company located in Maryland.

Effective Date and Status

If the Proposed Legislation were to be enacted in this Session of the Maryland General Assembly, it would apply to the current (2020) tax year. If Congress passes and the President signs legislation with an identical effect applied at the federal level, the Proposed Legislation (assuming it had been enacted) would be rendered ineffective shortly after the Maryland Department of Legislative Services receives notice of the new federal law.

As of the date of this client alert, the bills have been referred to review by Maryland's House Ways and Means Committee and Senate Budget and Taxation Committee. A similar bill was proposed in the Maryland House in February of 2019 and was subsequently withdrawn after an unfavorable report by the Ways and Means Committee.

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[1] The Proposed Legislation is similar in certain respects to (but materially different from) the federal rules applicable to certain carried interest gains that became law on December 22, 2017. Pub. L. 115–97, title I, § 13309(a)(2), Dec. 22, 2017, 131 Stat. 2054.

The following Gibson Dunn lawyers prepared this client update: Benjamin Rippeon, Eric Sloan, Virginia Blanton and Collin Metcalf.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these developments. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Tax or Private Equity practice groups, or the following authors:

Benjamin Rippeon - Washington, D.C. (+1 202-955-8265, brippeon@gibsondunn.com)
Eric B. Sloan - New York (+1 212-351-2340, esloan@gibsondunn.com)

Please also feel free to contact any of the following practice leaders and members:

Tax Group:
Jeffrey M. Trinklein - Co-Chair, London/New York (+44 (0)20 7071 4224 /+1 212-351-2344), jtrinklein@gibsondunn.com)
David Sinak - Co-Chair, Dallas (+1 214-698-3107, dsinak@gibsondunn.com)
Brian W. Kniesly - New York (+1 212-351-2379, bkniesly@gibsondunn.com)
Eric B. Sloan - New York (+1 212-351-2340, esloan@gibsondunn.com)
Edward S. Wei - New York (+1 212-351-3925, ewei@gibsondunn.com)
Benjamin Rippeon - Washington, D.C. (+1 202-955-8265, brippeon@gibsondunn.com)

Daniel A. Zygielbaum - Washington, D.C. (+1 202-887-3768, dzygielbaum@gibsondunn.com)
Dora Arash - Los Angeles (+1 213-229-7134, darash@gibsondunn.com)
Paul S. Issler - Los Angeles (+1 213-229-7763, pissler@gibsondunn.com)
Lorna Wilson - Los Angeles (+1 213-229-7547, lwilson@gibsondunn.com)
James Chenoweth - Houston (+1 346-718-6718, jchenoweth@gibsondunn.com)
Scott Knutson - Orange County (+1 949-451-3961, sknutson@gibsondunn.com)
Sandy Bhogal - London (+44 (0)20 7071 4266, sbhogal@gibsondunn.com)
Benjamin J. Fryer - London (+44 (0)20 7071 4232, bfryer@gibsondunn.com)
Jérôme Delaurière - Paris (+33 (0)1 56 43 13 00, jdelauriere@gibsondunn.com)
Hans Martin Schmid - Munich (+49 89 189 33 110, mschmid@gibsondunn.com)

Private Equity Group:
George P. Stamas - Washington, D.C./New York (+1 202-955-8280/+1 212-351-5300, gstamas@gibsondunn.com)
Mark D. Director - Washington, D.C./New York (+1 202-955-8508/+1 212-351-5308, mdirector@gibsondunn.com)
Steven R. Shoemate - New York (+1 212-351-3879, sshoemate@gibsondunn.com)
Sean P. Griffiths - New York (+1 212-351-3872, sgriffiths@gibsondunn.com)
Scott Jalowayski - Hong Kong (+852 2214 3727, sjalowayski@gibsondunn.com)
Ari Lanin - Los Angeles (+1 310-552-8581, alanin@gibsondunn.com)