It's Time for Wealthy Investment Managers to Pay their Fair Share

Position Statement Supporting Senate Bill 605

Given before the Senate Budget and Taxation Committee

Like thousands of other Maryland workers, from authors to restaurant servers, private equity and hedge fund managers are paid partly on the basis of their performance. Unlike other workers, wealthy fund managers pay a special, low tax rate on this income. This special treatment violates core principles of effective tax policy by taxing similar activities at different rates, shifting tax responsibility away from those who can best afford to pay, and costing billions of dollars nationwide that could be used to support vital public investments. The Maryland Center on Economic Policy supports Senate Bill 605, which would eliminate this special tax break and ask wealthy fund managers to pay their fair share.

Investors in private equity and hedge funds see better returns when the funds perform well and worse returns when the funds perform poorly. The managers of these funds do too, thanks to carried interest—the share of profits they receive as performance pay. Unlike investors, though, fund managers do not put their own money at risk. They are simply paid a larger or smaller amount for their work, depending on how well the fund performs.

However, the federal government taxes carried interest at the capital gains rate, which is ordinarily reserved for investors who risk their own money. This allows many highly paid investment managers to pay much less in taxes than other workers.[i] With a historically high share of income going to those at the very top, it does not make sense to give special tax breaks to wealthy finance professionals. Senate Bill 605 would close this loophole by allowing the state to collect revenue from Maryland taxpayers that would go to the federal government if it accurately classified carried interest as ordinary income.

The special treatment given to private equity and hedge fund managers weakens the economy by creating an inflated incentive to work in these industries. We do not give special tax breaks to doctors, engineers, or other highly skilled professionals, despite the essential work they do. Even other finance professionals pay ordinary income tax rates on bonuses and other types of performance pay, not the lower capital gains rate. This is why experts across the political spectrum have recommended closing the carried interest loophole.[ii]

Closing this loophole would also bring in badly needed revenue, allowing the state to address the many needs left unmet in Maryland's current budget. The Department of Legislative Services estimates that Senate Bill 605 would raise upwards of $50 million per year. Taxing wealthy investment managers accurately would mean more money for Maryland schools, roads, and hospitals. It is also likely to increase economic activity in Maryland, as money invested in public services immediately flows back into the economy. Wealthy fund managers, on the other hand, are more likely to sit on extra income that they have few uses for.[iii]

While many beneficiaries of the carried interest loophole are opposed to closing it, the arguments they offer do not hold water:

- Fund managers are not unique in receiving pay that varies over time and therefore carries risk. Restaurant servers who work for tips, authors who earn royalties, and even other finance professionals who are paid bonuses all pay income taxes on their performance pay—not a special capital gains rate.
- Funds cannot easily pass taxes on to investors by charging higher fees. As the high fees associated with alternative investments have come under increasing scrutiny in recent years, the large institutional investors that dominate the market have become less willing to pay large sums without a clear benefit.[iv]
- There is no reason to expect funds' performance to suffer because investment managers are taxed accurately. Managers will still be paid largely on the basis of performance, and market competition will still direct business to the highest-performing funds.
- Senate Bill 605 includes a provision to automatically cancel the corrective tax it creates if the federal government closes the loophole, so there is no risk of taxing financial services twice in the future.
- While some investment managers would likely look for ways to avoid paying the corrective tax, this is a good reason to ensure the law is enforced appropriately—not a reason to exempt them from their responsibility to pay taxes.

The carried interest loophole allows wealthy investment managers to pay a lower tax rate on their income than the majority of workers, weakening the economy and costing billions of dollars in revenue nationwide each year. It's time to ask fund managers to pay their fair share by passing Senate Bill 605.

For these reasons, the Maryland Center on Economic Policy respectfully asks that the Senate Budget and Taxation Committee make a favorable report on Senate Bill 605.

---

[i] For example, Mitt Romney, a private equity financier, famously paid only 14 percent of his $22 million income in federal taxes in 2010. Lori Montgomery, Jia Lynn Yang, and Philip Rucker, "Mitt Romney Releases Tax Returns," *The Washington Post*, January 24, 2012, https://www.washingtonpost.com/politics/2012/01/23/gIQAj5bUMQ_story.html?utm_term=.6e61ef350161.

[ii] For example, conservative economist Greg Mankiw has written against the carried interest loophole. N. Gregory Mankiw, "The Taxation of Carried Interest," *Greg Mankiw's Blog*, 2007, http://gregmankiw.blogspot.com/2007/07/taxation-of-carried-interest.html.

[iii] Tullio Jappelli and Luigi Pistaferri, "Fiscal Policy and MPC Heterogeneity," American Ecnonomic Journal: Macroeconomics 6(4): 107–136, https://web.stanford.edu/~pista/MPC.pdf.

[iv] Suzanne Barlyn and Svea Herbst-Bayliss, "Mismanagement Cost NY Pension $3.8 Billion over Eight Years: Regulator," *Reuters*, October 17, 2016, http://www.reuters.com/article/us-new-york-pensions-idUSKBN12H210.