

**REPORT OF THE
CHIEF LEGISLATIVE ANALYST**

DATE: May 18, 2018

TO: Honorable Members of the Rules, Elections, and Intergovernmental Relations Committee

FROM: Sharon M. Tso 
Chief Legislative Analyst Council File No: 18-0002-S60
Assignment No: 18-05-0459

SUBJECT: Resolution (Harris-Dawson – Price) to support AB 2731 (Gipson)

CLA RECOMMENDATION: Adopt Resolution (Harris-Dawson – Price) to include in the City’s 2017 - 2018 State Legislative Program SUPPORT for AB 2731 (Gipson), which would close the carried interest loophole by levying an additional tax rate of 17% on the portion of a taxpayer’s taxable income derived from managing a hedge fund or private equity fund and would allocate the revenues to various education purposes.

SUMMARY

The Resolution (Harris-Dawson – Price), introduced on May 11, 2018, states that general partners at hedge funds and private equity funds receive carried interest in addition to an annual fee to manage the fund’s assets. Under federal tax law, carried interest is classified as capital gains, allowing it to be taxed at a lower rate than ordinary income. This enables hedge fund managers and private equity fund managers to pay reduced taxes on income earned from managing funds.

The Resolution states that AB 2731 (Gipson) would close this loophole in the State and deposit the revenue from the tax into a College, Career, and Community Ready Fund to pay for career technical education, early childhood education, and emotional and mental health support counselors. The Resolution therefore requests that the City support AB 2731.

BACKGROUND

Hedge funds and private equity funds pool capital from investors to make a variety of investments. Generally, the funds are structured to include a general partner (GP), who manages the fund and makes investment decisions, and limited partners (LPs), which provide investment capital. GPs may invest their own capital into the fund, but this is typically no more than 5% of the total investment capital.

Fund managers’ compensation has historically been structured on a “two and twenty” model, which includes a management fee and carried interest. The annual management fee, often 2% of the fund’s assets, covers the costs of operating the fund. GPs also receive a percentage of the fund’s profits, often set at 20%, with LPs splitting the remaining 80% of the profits. The percentage of the fund’s profits a GP receives is referred to as carried interest. Prior to a GP being permitted to take carried interest, the fund may be required to meet a specified return agreed upon by the GP and LPs, known as a hurdle rate.

The carried interest loophole, as it is often referred to, is a consequence of partnerships being structured as “pass-through” entities and the difference in taxation of capital gains and ordinary income. The term “carried interest” does not appear in the federal tax code. Hedge funds and private equity funds are structured as partnerships and for tax purposes, they are considered “pass-through” entities. Unlike a corporation, the funds do not pay taxes directly. Rather, the partners pay taxes on the income received from the fund. Federal tax rules allow carried interest to be classified as capital gains instead of ordinary income. Since capital gains are taxed at a lower rate than ordinary income, this allows fund managers to reduce their tax burden considerably.

Federal efforts to close this loophole have failed, but recent tax legislation slightly altered the current structure for taxing carried interest. Under the 2017 Tax Cuts and Jobs Act, enacted in December 2017, fund managers may continue to classify carried interest as capital gains, but must hold assets for three years instead of the typical one year to receive favorable tax treatment. Short-term capital gains continue to be taxed as ordinary income.

AB 2731 would impose an additional tax at the rate of 17% on the portion of a taxpayer’s income derived from an “investment management services interest.” The legislation defines an “investment management services interest” as any interest in a business which is held by an individual if that individual provides certain services, such as managing, acquiring, or disposing of any specified asset.

AB 2731 would also require the California Franchise Tax Board (FTB) to report to the Legislature if the federal government modifies the federal tax code to have an identical effect as this bill. Upon receiving this report, the Legislature would be required to determine whether to repeal, make inoperative, or continue in effect the tax imposed by this bill.

The State estimates that AB 2731 would generate \$700 million in revenue for 2018-19, \$450 million in 2019-20, and \$470 million in 2020-21. The legislation earmarks these revenues for education purposes. Fund revenues would be continuously appropriated to the California Department of Education for apportionment to local entities for career technical education, early childhood education, and staffing to provide counseling. 5% of the funds would supplement funding to the Agricultural Career Technical Education Incentive Program.

The FTB has identified implementation and policy challenges with AB 2731. Its implementation concerns focus on terms remaining undefined, a potentially broader applicability than intended, and rulemaking procedures. With regards to policy considerations, the FTB notes that the bill would provide differing tax treatment for entities subject to tax under the Personal Income Tax Law (e.g. sole proprietorships, limited partnerships, etc.) that would not apply to business entities such as corporations. FTB also raises concerns that California may be at a disadvantage for investment if AB 2731 goes into effect prior to any federal legislation that would have an identical effect.

Supporters of AB 2731 argue that when most individuals receive an incentive-based award (e.g. bonus, commission, etc.), the income is taxed at the person’s regular income tax rate. This legislation would bring fund managers in line with other professions. Opponents argue that a tax on financial services would increase the cost of financial advice and education for investors that need it most, including those preparing for retirement.

BILL STATUS

2/15/2018 Read first time. To print.
3/08/2018 Referred to Committee on Revenue and Taxation.
4/30/2018 From committee: Amend, and do pass as amended and re-refer to
Committee on Appropriations (7-3).
5/02/2018 Re-referred to Committee on Appropriations.
5/09/2018 In committee: Set, first hearing. Referred to Appropriations suspense file.



Tim Plummer
Analyst

SMT:tcp

Attachments: 1. Resolution (Harris-Dawson – Price)
2. AB 2731 (Gipson)

RESOLUTION

RULES, ELECTIONS & INTERGOVERNMENTAL RELATIONS

WHEREAS, any official position of the City of Los Angeles with respect to legislation, rules, regulations or policies proposed to or pending before a local, state or federal governmental body or agency must have first been adopted in the form of a Resolution by the City Council with the concurrence of the Mayor; and

WHEREAS, general partners at hedge funds and private equity funds manage clients' assets on an incentive-based compensation model; and

WHEREAS, in addition to an annual fee to manage the fund's assets, fund managers receive a cut of the profits beyond an agreed-upon expected rate of return, which is known as carried interest; and

WHEREAS, under federal tax law, carried interest is not taxed at the income tax rate, which is 37% for those in the top federal income bracket, but instead at the capital gains rate, which is 20% for top income earners; and

WHEREAS, this federal tax loophole allows some of the wealthiest Californians to pay reduced taxes on money they make as fund managers; and

WHEREAS, the California Franchise Tax Board estimates that closing this loophole at the State level could result in between \$450 million and \$700 million annually for the State; and

WHEREAS, AB 2731 (Gipson) would close this loophole by imposing an additional tax rate of 17% on the portion of a taxpayer's taxable income derived from management of a hedge fund's assets; and

WHEREAS, revenue from AB 2731 would be deposited into a College, Career, and Community Ready Fund to pay for career technical education, early childhood education, and emotional and mental health support counselors;

NOW, THEREFORE, BE IT RESOLVED, with the concurrence of the Mayor, that by the adoption of this Resolution, the City of Los Angeles hereby includes in its 2017 - 2018 State Legislative Program SUPPORT for AB 2731 (Gipson), which would close the carried interest loophole by levying an additional tax rate of 17% on the portion of a taxpayer's taxable income derived from managing a hedge fund or private equity fund and would allocate the revenues to various education purposes.

PRESENTED BY:

MARQUEECE HARRIS-DAWSON
Councilmember, 8th District

SECONDED BY:

MAY 11 2018

AMENDED IN ASSEMBLY MAY 1, 2018

CALIFORNIA LEGISLATURE—2017–18 REGULAR SESSION

ASSEMBLY BILL

No. 2731

Introduced by Assembly ~~Member Gipson~~ Members *Gipson and Bonta*

February 15, 2018

An act to add Section 17044 to the Revenue and Taxation Code, relating to taxation, ~~to take effect immediately, tax levy, and making an appropriation therefor.~~

LEGISLATIVE COUNSEL'S DIGEST

AB 2731, as amended, ~~Gipson. Income taxes: investment management services interest.~~ *interest: education funding.*

The Personal Income Tax Law imposes taxes based upon taxable income of individuals, estates, and trusts at specified rates from 1% to 9.3%, as provided.

This bill would impose a tax of 17% on that portion of an individual's taxable income derived from an investment management services interest, as defined. The bill would require the Franchise Tax Board to report to the ~~Legislature~~ *Legislature, no more than 30 days thereafter*, if the United States Congress passes and the President of the United States signs legislation having an identical effect as the above-described tax applicable to that income earned in all of the states and ~~territories~~ *territories*, and would further require the Legislature to determine whether to ~~make the~~ repeal, make inoperative, or continue in effect the tax. The bill would also ~~state the intent of the Legislature that the moneys derived from the imposition of the tax be used for education purposes.~~ *require the revenues derived from this tax to be deposited in*

the College, Career, and Community Ready Fund, which the bill would establish.

The bill would require the moneys deposited in the College, Career, and Community Ready Fund to be continuously appropriated to the State Department of Education for apportionment to local educational agencies for designated categories of programs, thereby making an appropriation. The bill would authorize the department to adopt regulations and procedures to implement these provisions of the bill relating to the distribution of the apportioned funds and to effectuate the intent of the Legislature as to the distribution of these funds among those categories. The bill would also authorize the Franchise Tax Board to prescribe rules, guidelines, or procedures necessary or appropriate to carry out the purposes of the bill, as specified.

The funds apportioned to local educational agencies pursuant to this bill for the specified purposes would be applied toward the minimum funding requirements for school districts and community college districts imposed by Section 8 of Article XVI of the California Constitution.

This bill would include a change in state statute that would result in a taxpayer paying a higher tax within the meaning of Section 3 of Article XIII A of the California Constitution, and thus would require for passage the approval of $\frac{2}{3}$ of the membership of each house of the Legislature.

~~This bill would take effect immediately as a tax levy.~~

Vote: $\frac{2}{3}$. Appropriation: ~~no~~ yes. Fiscal committee: yes.
State-mandated local program: no.

The people of the State of California do enact as follows:

- 1 SECTION 1. Section 17044 is added to the Revenue and
- 2 Taxation Code, to read:
- 3 17044. (a) For each taxable year beginning on or after January
- 4 1, 2018, in addition to any other taxes imposed by this part, an
- 5 additional tax shall be imposed at the rate of 17 percent on that
- 6 portion of a taxpayer's taxable income derived from an investment
- 7 management services interest.
- 8 (b) For purposes of this section:
- 9 (1) "Investment management services interest" means any
- 10 interest in a business which is held by any individual if that
- 11 individual provides, directly or indirectly, in the active conduct of
- 12 a trade or business, a substantial quantity of any of the following
- 13 services to the business:

1 (A) Advising the business, including a partnership, “S”
2 corporation, or any other business entity, as to the advisability of
3 investing in, purchasing, or selling any specified asset.

4 (B) Managing, acquiring, or disposing of any specified asset.

5 (C) Arranging financing with respect to acquiring specified
6 assets.

7 (D) Any activity in support of any service described in
8 subparagraphs (A) to (C), inclusive.

9 (2) “Specified asset” means securities, as defined in Section
10 475(c)(2) of the Internal Revenue Code, relating to security defined,
11 real estate held for rental or investment, interest in partnerships,
12 commodities; or as defined in Section 475(e)(2) of the Internal
13 Revenue Code, relating to commodity, or options or derivative
14 contracts to any of these.

15 (c) A partner or shareholder shall not be deemed to hold an
16 investment management services interest if at least 80 percent of
17 the average fair market value of the specified assets of the business
18 during the taxable year consists of real estate.

19 (d) (1) *Revenues derived from the tax imposed by this section*
20 *shall be deposited in the College, Career, and Community Ready*
21 *Fund, which is hereby created. Notwithstanding Section 13340 of*
22 *the Government Code, the moneys deposited in the College, Career,*
23 *and Community Ready Fund shall be continuously appropriated*
24 *without regard to fiscal year to the State Department of Education,*
25 *for apportionment, on the basis of average daily attendance, to*
26 *local educational agencies. The funds apportioned under this*
27 *subdivision shall only be expended by local educational agencies*
28 *to support programs relating to one or more of the following*
29 *purposes:*

30 (A) *Career technical education.*

31 (B) *Early childhood education.*

32 (C) *Staffing to provide counseling in social-emotional, mental,*
33 *physical, and academic health and positive behavior; and to*
34 *provide counseling and support for pupils, teachers, and staff in*
35 *trauma-informed and culturally responsive strategies.*

36 (2) *At least 5 percent of the moneys apportioned under this*
37 *subdivision shall be used to supplement, and not supplant, the*
38 *Agricultural Career Technical Education Incentive Program*
39 *established pursuant to Article 7.5 (commencing with Section*

1 52460) of Chapter 9 of Part 28 of Division 4 of Title 2 of the
2 Education Code.

3 (3) It is the intent of the Legislature that each of the categories
4 listed in subparagraphs (A) to (C), inclusive, of paragraph (1)
5 shall be allocated at least 10 percent, but no more than 50 percent,
6 of the moneys apportioned under this subdivision in each fiscal
7 year.

8 (4) The State Department of Education is authorized to adopt
9 regulations and procedures to implement this subdivision and to
10 effectuate the intent of the Legislature as expressed in paragraph
11 (3).

12 ~~(d)~~

13 (e) (1) The Franchise Tax Board shall report to the ~~Legislature~~
14 Legislature, no more than 30 days thereafter, if the United States
15 Congress passes and the President of the United States signs
16 legislation having an identical effect as this section applicable to
17 that income earned in all of the states and territories.

18 (2) Upon receipt of the report, the Legislature shall, in the same
19 taxable year as in which the report is made, determine whether to
20 repeal, make inoperative, or continue in effect the tax imposed by
21 this section.

22 (3) A report to be submitted pursuant to paragraph (1) shall be
23 submitted in compliance with Section 9795 of the Government
24 Code.

25 (f) The Franchise Tax Board may prescribe rules, guidelines,
26 or procedures necessary or appropriate to carry out the purposes
27 of this section. Chapter 3.5 (commencing with Section 11340) of
28 Part 1 of Division 3 of Title 2 of the Government Code shall not
29 apply to any rule, guideline, or procedure prescribed by the
30 Franchise Tax Board pursuant to this section.

31 ~~SEC. 2. It is the intent of the Legislature that the moneys~~
32 ~~derived from the tax imposed by Section 17044 of the Revenue~~
33 ~~and Taxation Code, as added by this act, will be used for education~~
34 ~~purposes.~~

35 ~~SEC. 3. This act provides for a tax levy within the meaning of~~
36 ~~Article IV of the California Constitution and shall go into~~
37 ~~immediate effect.~~

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