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# State legislative developments in response to federal tax reform for asset and wealth management

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## *In brief*

As states continue to analyze how federal tax reform legislation (the Act) will impact their revenues and their citizens, they are beginning to propose legislation intended to mitigate the adverse impact of certain provisions of the new federal law. The following highlights various proposed legislative developments that target the effects of federal tax reform on the asset and wealth management industry and its various stakeholders, with specific focus on partnership issues and certain individual items.

Updates and analysis of significant legislative developments will be provided as enacted in key states.

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## *In detail*

### **Carried interest**

The Act includes a provision relating to the long-discussed tax treatment of 'carried interest,' generally provide that to obtain long-term capital gain treatment for 'applicable partnership interests,' the asset holding period must be greater than three years. The new rule applies, effective for tax years beginning after December 31, 2017, with respect to partnerships interests transferred to or held by the taxpayer (or a related person) in connection with the performance of 'substantial services' by the taxpayer in an 'applicable trade or business.' A number of states are drafting

their own proposals to address the issue of carried interest.

### *Arizona*

On February 6, 2018, [HB 2639](#) was introduced and would impose a 20% excise tax on any partnership, including investment partnerships, or S corporations engaging in a business of conducting investment management services. Individuals who provide such services as a partner of a business that conducts such services also would be liable for the tax in the partner's separate or individual capacity. The tax would be calculated based on fees that are determined by reference to the performance of the investment management of the portfolio

and not from the investment itself.

### *California*

On February 15, 2018, [AB-2731](#) was introduced and would impose an additional tax of 17% on that portion of an individual's taxable income derived from an investment management services interest, defined as any interest in a business which is held by any individual who provides investment management services. Certain real estate activities would not trigger the tax. Specifically, a partner or shareholder would not be deemed to hold an 'investment management services interest' if at least 80% of the average fair

market value of the specified assets of the business during the taxable year consists of real estate. The bill provides that the legislation would be repealed if the Franchise Tax Board reports that federal legislation is enacted that has an identical effect.

As this is a revenue-raising bill, a two-thirds majority vote will be required in both the California State Assembly and the California State Senate to pass the legislation. The bill may have an uphill battle given that the Democrats recently lost their supermajorities in both the Assembly and Senate.

[Access PwC's previously published Insight here.](#)

### *District of Columbia*

On February 20, 2018, [DC B 701](#) was introduced and would provide that for tax years beginning after December 31, 2018, a 19% surtax would be imposed on “taxable income derived from an investment management services interest in an unincorporated business, whether domestic or foreign, until a time when a federal law having an identical effect is applicable to such income earned in all of the states and territories.” Partners or shareholders of unincorporated entities would not be deemed to hold an investment management services interest if at least 80% of the average fair market value of the specified assets consists of real estate.

### *Illinois*

On February 14, 2018, [H 4293](#) was introduced and would impose a privilege tax on partnerships and S corporations engaged in the business of conducting investment management services. The tax would be imposed at the rate of 20% of the fees calculated by reference to the performance of the investment portfolio funds and not to the investment itself.

‘Investment management services’ would be defined to include a business that is held by any person if such person provides, directly or indirectly, in the conduct of a trade or business, any of the following services to the business: advising in the investment in, purchasing or selling a specified asset; managing acquiring or disposing of a specified asset, arranging financing with respect to acquiring a specified asset; or any act to support any of these services.

The term ‘specified asset’ means securities, real estate held for rental or investment, interests in partnerships, commodities, or options or derivatives contracts. However, a partner or shareholder would not be deemed to hold an investment management services interest if at least 80% of the average fair market value of the specified assets of business during the taxable year consists of real estate.

### *New Jersey*

On January 8, 2018, [Senate Bill 64](#) was introduced that would provide for a 19% ‘carried interest fairness fee,’ a surtax on income received during the taxable year from investment management services provided to a partnership, S corporation, or other entity. Income from investment management services would be characterized as service income that would be sourced to the location where the service is performed, rather than applying the current gross income and corporation business tax rules, which, in certain cases, provide for different sourcing treatment. For example, current gross income tax rules source the income to the state of residency for certain nonresident partners, notwithstanding service may be performed in New Jersey. Similar to Illinois, a carve out provision is provided for assets if at least 80% of the average fair market value of the specified assets consist of real estate.

Last year the New Jersey Assembly passed A3868 on June 8, 2017, which is substantially similar to the current Senate version. That bill was referred to the Senate Budget and Appropriations Committee on June 12, 2017.

### *New York*

On January 16, 2018, New York Governor Andrew Cuomo released his FY 18-19 Executive Budget (Budget). The budget includes a proposal that would impose a 17% ‘carried interest fairness fee’ on income from investment management services. As in other state bills, investment management services interest does not include assets if at least 80% of the average fair market value of the specified assets of business during the taxable year consists of real estate. Access PwC’s Insight on the New York budget proposal [here](#) and the Insight addressing the 30-day Amendments to the budget [here](#).

### *Rhode Island*

On January 18, 2018 [Senate Bill 2072](#) was introduced that would establish a 19% carried interest fairness fee for ‘investment management services’ in order to tax the carried interest income of hedge fund and private equity investors as traditional ordinary earned income. A partner or shareholder will not be deemed to hold an investment management services interest if at least 80% of the average fair market value of the specified assets of business during the taxable year consists of real estate.

It should be noted that the carried interest proposals in New Jersey, New York, and Rhode Island will only become effective upon the enactment of similar legislation in surrounding states.

[Access PwC's previously published Insight here.](#)

### **Mitigating the state tax deduction through charitable contributions to state funds**

Under the Act, individual taxpayers are limited in the aggregate amount of state and local taxes they can deduct as itemized deductions when calculating federal taxable income, what was previously an unlimited deduction is now limited to \$10,000. Consequently, taxpayers in states that impose a higher individual income tax rate will be significantly impacted by this change as they will lose a portion of their previously allowed deduction.

States where the deduction limitation will have the largest impact, such as California, New York and Connecticut, are considering proposals that would allow individuals to make voluntary contributions to state-run charitable funds, often being named 'Excellence Funds', and then allow the individuals a credit against their state income tax liability. Such proposals are intended to create a charitable contribution that would be allowed as an itemized deduction for federal income tax purposes, which in effect would bypass the state and local tax deduction limitation. If the intended result can be accomplished for federal tax purposes, the state and federal tax impact of the loss of the state tax deduction for the individual may be significantly mitigated.

While initial proposals were described as 'ridiculous' by Treasury Secretary Steven Mnuchin in January of this year, various proposals continue to be introduced by state lawmakers. The following outlines the particular proposals in each of the states to date.

#### **California**

On January 30, 2018, [S.B. 227](#) was passed by the Senate and was

introduced in the Assembly. This proposal would allow an 85% individual income tax credit for contributions to the California Excellence Fund. All amounts in the fund would be used for 'public purposes' as specified under IRC Section 170, which provides the federal itemized deduction for charitable deductions.

#### **Illinois**

On January 11, 2018, [H 4237](#) was introduced that would provide tax credits to individuals for contributions to the Illinois Education Excellence Fund and the county fund for charitable purposes. The bill also would provide that counties in Illinois could establish separate funds to accept contributions for exclusively public purposes (as specified under IRC Section 170) and could provide a credit against the taxpayer's property tax liability equal to the amount of the contribution. These funds would be used exclusively for public education purposes. The income tax credit would apply for taxable years ending after December 31, 2017 and before January 1, 2026.

In addition, proposed bill [H 4563](#) would amend the Invest in Kids Act to provide that contributions to a school district foundation also would be qualified contributions. Taxpayers who make contributions to a school district foundation would be eligible for a property tax credit.

#### **New Jersey**

On February 15, 2018, [S1893](#) was introduced and would allow local units, consisting of a municipality, county, or school district, to establish one or more charitable funds, each for a specific public purpose, and would permit property tax credits in association with certain donations. Once a charitable fund is established, the bill would allow anyone to donate to it. If a donation is made on behalf

of a real property within the jurisdiction of the local unit, the property could be entitled to a property tax credit on the next property tax bill assessed after the donation is processed.

The bill directs municipal tax collectors to allow a local property owner a credit to be applied to property taxes in association with certain charitable donations. A credit generally would equal to 90% of the amount of donations contributed on behalf of the owner's specified parcel of property to a charitable fund within the local unit.

S1893 passed the Senate on February 26 and was introduced in the Assembly on March 5. A similar bill, [A3499](#), was introduced in the Assembly on March 5.

#### **New York**

The 30-day amendments to New York's FY 19 budget propose creating a new charitable gifts trust fund with two separate accounts: (1) a health charitable account and (2) an elementary and secondary education charitable account. Beginning in 2019, individual taxpayers would be allowed a personal income tax credit equal to 85% of the amounts contributed to these two accounts during the previous tax year. The proposals outline procedures for local governments to set up applicable charitable funds and would authorize local governments to offer property tax credits for fund contributions.

#### **Rhode Island**

Introduced on February 1 and February 9, 2018, respectively, identical bills ([S. 2216](#) and [H. 7550](#)) would create the Rhode Island Ocean State Fund, which would accept monetary contributions for the legislature to appropriate for public purposes. Individuals who make contributions would be allowed a

credit against personal income tax otherwise due.

### *Washington*

Introduced on January 18, 2018, [H.B. 2853](#) would create a Washington excellence fund to which taxpayers could donate and receive in return a retail sales tax exemption equal to the monetary donation amount. The exemption, which would expire after five years could be used “to reduce or eliminate the person's state tax liability . . . on purchases of taxable goods or services over” \$150,000.

### ***Additional state-specific proposals to mitigate the effect of federal tax reform***

#### *Connecticut governor proposes tax on partnerships, among other changes*

Governor Dannel P. Malloy recently released his FY19 budget adjustment proposal containing several provisions to protect Connecticut residents and businesses from potential adverse effects of the federal government's new tax law enacted at the end of 2017 in addition to shoring up the state's revenue projections.

Some of the proposals include, maintaining the corporate surcharge at 8% for the 2019 tax year; introduction of a pass-through entity level tax; and removing the \$2.5 million cap on unitary filings for non-manufacturers.

Of particular note to our practice is the pass-through entity level tax. This new tax, which is intended to be revenue neutral, is specifically targeted to provide relief to individuals who are disallowed from deducting their state and local taxes in excess of \$10,000.

The governor's proposal would in theory shift the individual's non-deductible income tax to a deductible business tax on pass-through entities (e.g., sole proprietorships,

partnerships, limited liabilities companies, and S corporations). The tax would allow for the pass-through's owners to claim a credit against the Connecticut personal income tax imposed on the owner's pass-through income. Neutralizing the double taxation.

Interestingly, the governor has proposed to decouple from the new section 199A deduction providing a 20% federal income deduction against an owner's pass-through income.

One final highlight is the proposal for local municipalities to create and establish charitable organizations in support of town services. This approach is to facilitate a local property tax credit through a donation made to the new organization.

#### *New York proposed optional employer tax*

Under the proposed 30-day amendments to New York's FY19 budget, an Employer Compensation Expense Tax (ECET) would be imposed on the payroll expense paid by electing employers to covered employees during the calendar quarter at the rate of 1.5% in 2019, 3% in 2020, and 5% in 2021 and thereafter. The ECET would apply only on the payroll expense paid during the calendar year in excess of \$40,000. Employers would be prohibited from deducting from an employee's wages or compensation any amount that represents the ECET. ECET payments would be due at the same time personal income tax withholding payments are remitted.

The election to be taxed under the ECET must be made by (1) unanimous consent of all owners of the employer at the time of the election, if the employer is not a corporation; (2) any officer or manager of the employer who is authorized to make the election, if the employer is a corporation; (3) unanimous consent

of all trustees, if the employer is a trust; or (4) the chief executive officer, if the employer is a government entity. The election must be made by October 1 and will take effect for the immediately succeeding calendar year. Elections made after October 1 would take effect in the second succeeding calendar year.

The proposal would provide a personal income tax credit for an employee equal to the product of (a) the employee's taxable wages and compensation in excess of \$40,000 received from the employer, (b) 1.5% (for 2019), and (c) the result of one minus a fraction, the numerator of which is the New York State personal income tax imposed on the employee (before application of any credits) and the denominator of which is the employee's state taxable income. The rate under (b) would increase to 3% in 2020 and to 5% for 2021 and thereafter.

### ***The takeaway***

States will continue to examine and respond to the impact of federal tax reform over the next several months as new legislative sessions start. The impact on the asset and wealth management industry is significant and we will continue to monitor and report as additional proposals emerge.

## ***Let's talk***

If you would like to have a deeper discussion on how these developments may affect your company, please contact:

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