Path to Prosperity

Published by The Maine Heritage Policy Center

Issue Eighteen November 16, 2010

The Economic Impact of an Enterprise Value Tax on Maine

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In legislation backed by Congressional Democratic leadership this past spring, there was an attempt to more than double the taxation on the sale of many businesses.[1] A provision in that legislation, known as the "Enterprise Value Tax," would have changed the federal taxation on a sale of any business structured as a partnership from a capital gains rate of 15 percent to ordinary income rates. Under the proposed legislation, entrepreneurs, and family members owning small businesses, other than family farms, would no longer qualify for the 15 percent capital gains treatment upon the sale of their business if the entity held any form of partnership interest, interest income, investment real estate or securities.

The Enterprise Value Tax, or EVT, passed in the House of Representative as part of "H.R. 4213: American Jobs and Closing Tax Loopholes Act of 2010" and is still under consideration in the U.S. Senate.[2] The adoption of an Enterprise Value Tax would be especially damaging to Maine's businesses and economy for the following key reasons:

- A large portion of Maine's small businesses are structured as partnerships.
- The imposition of an EVT will potentially extract around $55 million annually from Maine's economy, working capital that would be better used by Maine's current and future partnerships to expand an already anemic economy.
- Maine is currently experiencing a "capital flight" with the ratio of interest, dividend and capital gains income per taxpayer dropping significantly against the national average.
- Maine policymakers have been working on reducing state-level capital gains taxes through tax reform—an effort to reduce the volatility of the state's revenue base that would be thwarted by an Enterprise Value Tax imposed at the federal level.

For these reasons, Maine's state and local policymakers, as well as its Congressional delegation, should continue to oppose a federal EVT due to the economic damage it would inflict on Maine's local businesses and residents.

Table 1
Tax Impact of the Enterprise Value Tax
Calendar Year 2010
in Millions of Dollars

Top Capital Gains Tax Rate (a)		Capital Gains Taxes Paid		Capital Gains Taxes Paid Under Enterprise Value Tax		Net Tax Increase	
		National	Maine	National	Maine	National	Maine
Current Law	30.0%	$19,380	$56	$38,760	$112	$19,380	$56
With Expired Bush Tax Cuts	34.7%	$25,840	$74	$44,832	$129	$18,992	$55
With Expired Bush Tax Cuts and Medicare Investment Surtax	38.5%	$30,749	$89	$49,742	$143	$18,992	$55

(a) The top capital gains tax rate is a blended rate weighted 25 percent toward the capital gains rate and 75 percent toward the ordinary income tax rate.

Source: See "Methodology" section.

Introduction

Partnerships are an important segment of America's economic and business landscape. According to business data from the United States Internal Revenue Service (IRS), in 2007 there were 3.1 million partnerships consisting of 18.5 million partners with $20.4 trillion in assets and nearly $10 trillion of equity.[3] By 2010, the IRS estimates the number of partnerships will swell to 3.8 million, of which 11,800 will be owned by Mainers.[4]

According to the United States Department of Treasury, the original intention of a capital gains tax was to take into account that an entrepreneur's income is not guaranteed but rather it is subjected to certain risks that the individual must bear.[5] The U.S. Congress' proposed EVT legislation would no longer take into account this entrepreneurial risk and would significantly increase the tax burden on most partnerships when they are sold. The EVT provision proposed last spring, and likely to be taken up again in the Senate this fall, is written so broadly that it would sweep up partnerships and most family businesses, many of which are unaware they are facing a potentially large, new tax on the accumulated value of their working careers.

This study examines the nature of the EVT, its tax impact nationally, as well as its magnified effect in Maine. This study also explores the economic and political ramifications of the EVT in Maine. Finally, the study provides a methodological discussion of the model used to estimate the tax impact of the EVT.

The Enterprise Value Tax

The EVT is a derivative and substantial extension of the proposal to increase the tax rate on "carried-interest" income for partnerships.[6] Proponents of the Enterprise Value Tax, in an attempt to claw-back any prior favorable treatment of "carried-interest" income (the name for an accounting practice used to distribute revenue to general partners of certain types of partnerships), worried that general partners of businesses may try to sell their interests and capitalize on existing favorable tax treatment. Carried interest, however, has nothing to do with the sale of a business, the vast majority of which view capital gains treatment of carried interest income as purely incidental and irrelevant to the value of the business itself. However, this tenuous link to carried interest has obfuscated the effect of the EVT, which casts a far broader net.

The EVT would tax the gain of a partnership at the time of sale at a blended federal ordinary income tax rate that is much higher than the capital gains rate of 15 percent. As the provision was written, the EVT would be triggered by the sale of any partnership interest that at any point generated even $1 in carried-interest income. As a result, many unsuspecting partnerships will be ensnared by the EVT.

Under current law, most of the gains from the sale of a partnership are taxed at the capital gains rate consistent with the general rule that business interests should be treated as capital assets. The EVT, if adopted, would limit the amount taxable under the capital gains rate to between 25 percent (for assets held 5 years or less) and 50 percent (for assets held more than 5 years) with the remainder being taxed at ordinary income tax rates. This represents a very substantial jump in tax rates, a jump that will be much higher under already scheduled future income tax rate changes, as seen in Table 2.

For short-term holdings under the EVT of 5 years or less, the sale of partnerships will face a federal tax rate of 30 percent under current law.[7]

Furthermore, as we move beyond 2010, the blended rate could go much higher if the Bush tax cuts expire as scheduled, resulting in a blended rate of 34.7 percent.[8]

And, under the new federal health care bill passed this year, a 3.8 percent Medicare tax will be levied against taxpayers' investment income.[9] As a result, the blended Federal rate will be much higher at 38.5 percent in 2013 and beyond when this new Medicare investment surtax kicks in.[10]

Table 2
Blended Rate Scenarios

	Current Law	Under Expired Bush Tax Cuts	Under Medicare Investment Surtax
Blended Rates (a)	30.0%	34.7%	38.5%

(a) Assumes Long-Term Capital Gains Rate (over 1 year) and Short-Term EVT Holding Period (less than 5 years).

Table 3
Net Tax Impact of the Enterprise Value Tax by Industry
Calendar Year 2010
in Millions of Dollars

Industry	Current Law		With Expired Bush Tax Cuts		With Expired Bush Tax Cuts and Medicare Investment Surtax	
	National	Maine	National	Maine	National	Maine
Forestry, fishing, and related activities	$303.2	$4.7	$297.1	$4.6	$297.1	$4.6
Mining	$1,389.8	$0.1	$1,362.0	$0.1	$1,362.0	$0.1
Utilities	$86.0	$0.2	$84.3	$0.2	$84.3	$0.2
Construction	$236.2	$0.9	$231.5	$0.9	$231.5	$0.9
Manufacturing	***$1,953.8***	***$7.6***	***$1,914.7***	***$7.4***	***$1,914.7***	***$7.4***
Wholesale Trade	$450.0	$1.3	$441.0	$1.3	$441.0	$1.3
Retail Trade	$244.8	$1.3	$239.9	$1.3	$239.9	$1.3
Transportation and Warehousing	$421.6	$1.4	$413.1	$1.3	$413.1	$1.3
Information	$3,297.1	$7.0	$3,231.2	$6.9	$3,231.2	$6.9
Finance and Insurance	***$4,060.4***	***$11.9***	***$3,979.2***	***$11.6***	***$3,979.2***	***$11.6***
Real Estate and Rental and Leasing	***$5,114.6***	***$13.3***	***$5,012.3***	***$13.1***	***$5,012.3***	***$13.1***
Professional, Scientific, and Technical Services	$866.3	$2.1	$848.9	$2.1	$848.9	$2.1
Management of Companies and Enterprises	$69.1	$0.2	$67.7	$0.2	$67.7	$0.2
Administrative and Waste Services	$132.0	$0.4	$129.4	$0.4	$129.4	$0.4
Educational Services	$22.7	$0.1	$22.3	$0.1	$22.3	$0.1
Health Care and Social Assistance	$225.6	$1.3	$221.1	$1.3	$221.1	$1.3
Arts, Entertainment, and Recreation	$122.2	$0.5	$119.8	$0.4	$119.8	$0.4
Accommodation and Food Services	$338.7	$1.4	$332.0	$1.4	$332.0	$1.4
Other Services, except Public Administration	$45.9	$0.2	$45.0	$0.2	$45.0	$0.2
Total	$19,379.9	$55.9	$18,992.3	$54.7	$18,992.3	$54.7

Source: See "Methodology" section.

The Tax Impact: Real Estate, Finance and Manufacturing Hit the Hardest

Table 1 shows the tax impact of the EVT nationally and for Maine under three different capital gains tax rates—“Current Law,” “With Expired Bush Tax Cuts” and “With Expired Bush Tax Cuts and Medicare Investment Surtax (see “Methodology” section below for more details of the model).[11] Although each of these tax rates apply to different time-periods, for comparative purposes, this analysis shows them as if they were in effect for 2010.

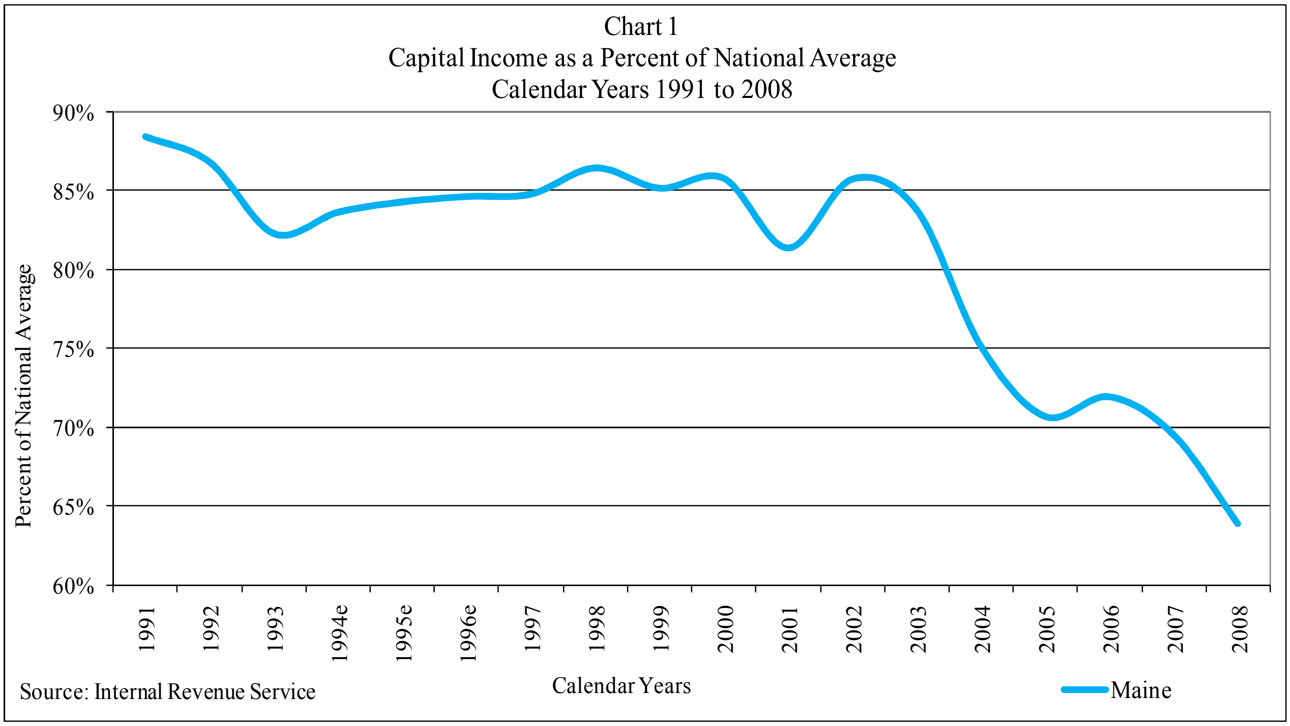
Nationally, under current law, partnerships anticipated to become subject to the EVT currently pay $19.4 billion in federal capital gains taxes, annually. Under the EVT, federal taxes paid on capital gains paid would double to $38.7 billion. Adding the impact of the expiration of the Bush tax cuts, federal capital gains tax on these partnerships would rise to $44 billion and to $50 billion when the Medicare investment surtax is added.

In Maine, under current law, partnerships that would become subject to the EVT currently pay $56 million in capital gains taxes, annually. Had the EVT been in effect during the 2009 tax year, capital gains paid by Maine partnerships would have doubled to $112 million, $129 million without the Bush tax cuts and $143 million if the Medicare surtax were to be included.

Table 3 shows the distribution of the EVT by industry. Nationally and in Maine, the three industries hit the hardest are “Real Estate and Rental and Leasing” (net increase around $5 billion nationally and $13 million in Maine), “Finance and Insurance” (net increase around $4 billion nationally and $12 million in Maine) and “Manufacturing” (net increase around $2 billion nationally and $8 million in Maine).

The Economic Impact on Maine

While the EVT applies nationally, its economic impact will vary by state. Its impact on Maine is particularly worrisome due to the fact that Maine is already in the midst of a “capital flight” with the level of capital income (interest, dividends and capital



gains) declining dramatically relative to the national average.

Chart 1 shows that in 2008, according to income data from the IRS, Maine's capital income per return ($17,822) was only 64 percent of the U.S. average capital income per return ($27,885).[12] More disturbingly Maine's ratio to the U.S. average has plummeted by one-fourth, from 86 percent in 2002 to 64 percent in 2008.

The most likely explanation for this drop in capital income is that this income is leaving Maine for other states. Many Mainers, as they grow older, morph into "snow-birds," moving their residency to Florida (or other warm weather, lower tax states) while still living in Maine for part of the year. This shift in residency also shifts the destination of capital income.

In fact, according to migration data published by the IRS, Florida is the number one destination for out-going Mainers.[13] Between 1995 and 2007, 11,799 Mainers (net) left for Florida taking with them almost $600 million income—including the above-mentioned dividends, interest and capital gains.

Any shift in national policy that further burdens capital income will encourage this trend and so have a severe impact on Maine's economy, one already suffering under capital flight. Additionally, lower levels of capital income will negatively impact state coffers since much of this income is taxed at the highest marginal income tax rate (8.5 percent).

The Political Impact on Maine

For Maine's policymakers, the EVT presents a major conundrum because it is the exact opposite of what they attempted to achieve in recent tax reform legislation enacted in 2009.[14] The tax reform package was designed to lower the top marginal income tax rate from 8.5 to 6.5 percent while expanding the sales tax base to pay for it.[15] Since Maine taxes capital gains at ordinary income tax rates, the lowering of the top state rate would have also reduced the combined federal and state capital gains tax.

Despite the tax reform package's defeat at the polls, Maine's policymakers have clearly come to realize the negative economic impact of imposing higher capital gains taxe on an already anemic economy. Yet, if the EVT becomes law, it would dramatically increase the capital gains tax burden because of Maine's high 8.5 percent top marginal income tax rate—creating a combined tax rate of 38.5 percent under current federal law, or as high as 47 percent under the expired Bush tax cuts and Medicare investment surtax.

How will Maine's policymakers react to the presence of a federal EVT? To stay economically competitive, the state may have to unilaterally cut the capital gains tax rate at a significant cost to state coffers. If they do nothing, the EVT will accelerate the capital flight out of Maine discussed previously as taxpayers become even more motivated to seek out states offering the highest after-tax returns due to lower income tax rates. Both choices mean less tax revenue for Maine.

Appendix I

Tax Impact of the Enterprise Value Tax with ***40 percent of Enterprise Value*** Impacted or ***4 percent Turnover*** in Assets

Calendar Year 2010

in Millions of Dollars

Top Capital Gains Tax Rate (a)		Capital Gains Taxes Paid		Capital Gains Taxes Paid Under Enterprise Value Tax		Net Tax Increase	
		National	Maine	National	Maine	National	Maine
Current Law	30.0%	$15,504	$45	$31,008	$89	$15,504	$45
With Expired Bush Tax Cuts	34.7%	$20,672	$60	$35,866	$103	$15,194	$44
With Expired Bush Tax Cuts and Medicare Investment Surtax	38.5%	$24,600	$71	$39,793	$115	$15,194	$44

(a) The top capital gains tax rate is a blended rate weighted 25 percent toward the capital gains rate and 75 percent toward the ordinary income tax rate.

Source: See "Methodology" section.

Conclusion

The implementation of a federal Enterprise Value Tax will extract around $55 million from Maine's economy every year, capital that would be better used by Maine's partnerships to continue to expand their real estate, finance and manufacturing businesses, including natural resource-based industries such as timber and other commodities crucial to an already anemic economy. Adoption of an EVT would also exacerbate a worrying capital flight out of Maine that not only negatively affects the economy but also state coffers. Finally, the proposed EVT is at odds with the recent attempt by Maine's policymakers to reform their tax code which would have lowered the state income tax on capital gains.

Overall, Maine's state and local policymakers, as well as its Congressional delegation should oppose a federal EVT due to the economic damage it would inflict on Maine's businesses and citizens.

Methodology

The model created to estimate the tax impact of the EVT draws primarily from data from the IRS, U.S. Department of Commerce's Bureau of Economic Analysis (BEA) and Bloomberg. The IRS data provides extensive details of partnerships by industry (NAICS) for calendar year 2007. The data was extrapolated to 2010 using the inflation forecast from the Congressional

Appendix II

Tax Impact of the Enterprise Value Tax with ***60 percent of Enterprise Value*** Impacted or ***6 percent Turnover*** in Assets

Calendar Year 2010

in Millions of Dollars

Top Capital Gains Tax Rate (a)		Capital Gains Taxes Paid		Capital Gains Taxes Paid Under Enterprise Value Tax		Net Tax Increase	
		National	Maine	National	Maine	National	Maine
Current Law	30.0%	$23,256	$67	$46,512	$134	$23,256	$67
With Expired Bush Tax Cuts	34.7%	$31,008	$89	$53,799	$155	$22,791	$66
With Expired Bush Tax Cuts and Medicare Investment Surtax	38.5%	$36,899	$106	$59,690	$172	$22,791	$66

(a) The top capital gains tax rate is a blended rate weighted 25 percent toward the capital gains rate and 75 percent toward the ordinary income tax rate.

Source: See "Methodology" section.

Budget Office.

The total enterprise value based on "partners capital accounts" is $10.4 trillion for 2010. The model conservatively assumes that businesses comprising half of this value (50 percent) would be subject to the EVT, or $5.2 trillion. Given that the EVT would only apply when a partnership is sold, the model assumes an annual 5 percent turnover rate. Using price-book data from Bloomberg (as of August 3, 2010), the total taxable gain on sales (sale value minus enterprise value) would be $259 billion, each year.

Maine's share of taxable gain on sales was estimated based on Maine's share of private earnings by industry. This data has been published by the BEA. Maine's estimated taxable gain on sales is $372 million for 2010.

The estimated increase in the capital gains tax liability under current law and the EVT was derived by multiplying the taxable gain on sales by the blended rate under the two scenarios and taking the difference.

The estimated tax impact of the EVT is dependent on the validity of the assumptions used in the model. As such, the tables "Appendix I" and "Appendix II" show the sensitivity of the tax impact estimates to changes in the assumptions. Appendix I shows that a 10 percentage point decrease in the enterprise value impacted, or a one percentage point decrease in turnover, yields a decrease in the tax impact of $3.8 billion to $15.5 billion.

Appendix II shows that a 10 percentage point increase in the enterprise value impacted, or a one percentage point increase in turnover, yields an increase in the tax impact of $3.8 billion to $23.3 billion.

Appendix III shows that holding the percent of enterprise value constant (50 percent), but changing the turnover to 1 percent, more clearly shows that the net increase due to the EVT is $3.8 billion. As such, using Appendix III can quickly yield the net difference of any turnover assumption by multiplying the net tax increase by the turnover rate—for example, a turnover rate of 3 percent yields a net tax increase of $11.6 billion ($3.876 billion times 3).

End Notes

[1] *See* H.R. 4213, the "American Jobs and Closing Tax Loopholes Act of 2010" sponsored by Senator Max Baucus (MT) and Representative Sandy Levin (MI).

[2] On May 28, 2010, the House passed H.R. 4213, the "American Jobs and Closing Tax Loopholes Act of 2010," by a vote of 245-171. On June 16, 2010, by a vote of 45-52, Senate Leadership failed to garner enough votes on a procedural motion to waive a budget point of order to move forward with consideration of Senate Finance Committee Chairman Max Baucus's substitute amendment to H.R. 4213. Following the failed procedural motion to waive a budget point of order, Chairman Baucus introduced a modified version of the substitute amendment. For a summary of Modifications and Additions Made to the Baucus Substitute Amendment to H.R. 4213 dated June 16, 2010 as well as the Legislative Text of the Senate Substitute Amendment to H.R. 4213 dated June 16, 2010 *see* http://finance.senate.gov/legislation/details/?id=1c237e70-5056-a032-52e9-ef5f959b7a76

Appendix III
Tax Impact of the Enterprise Value Tax with ***50 percent of Enterprise Value*** Impacted and ***1 percent Turnover*** in Assets
Calendar Year 2010
in Millions of Dollars

Top Capital Gains Tax Rate (a)		Capital Gains Taxes Paid		Capital Gains Taxes Paid Under Enterprise Value Tax		Net Tax Increase	
		National	Maine	National	Maine	National	Maine
Current Law	30.0%	$3,876	$11	$7,752	$22	$3,876	$11
With Expired Bush Tax Cuts	34.7%	$5,168	$15	$8,966	$26	$3,798	$11
With Expired Bush Tax Cuts and Medicare Investment Surtax	38.5%	$6,150	$18	$9,948	$29	$3,798	$11

(a) The top capital gains tax rate is a blended rate weighted 25 percent toward the capital gains rate and 75 percent toward the ordinary income tax rate.

Source: See "Methodology" section.

[3] U.S. Internal Revenue Service (IRS) business data and economic characteristics on partnerships can be found here: http://www.irs.gov/taxstats/bustaxstats/article/0,,id=97127,00.html

[4] IRS projections for partnership filings can be found here: http://www.irs.gov/pub/irs-soi/d6149.pdf

[5] Testimony of Eric Solomon: "Unlike employees and independent contractors, a partner has a stake in the business with rights and obligations that vary depending upon the terms of the partnership agreement. While compensation of employees and independent contractors is typically fixed and payable regardless of the success of the business, a partner's distributive share of partnership income is subject to the entrepreneurial risks of the partnership's business." http://www.ustreas.gov/press/releases/hp489.htm

[6] For more information on taxation of "carried interest," see: Holtz-Eakin, Doug, "The Tax Treatment of Carried Interest," American Action Forum, June 2010. http://americanactionforum.org/files/TaxTreatmentCarriedInterest.pdf

[7] [(25% x 15% capital gains rates) + (75% x 35% ordinary income tax rate)]

[8] [(25% x 20% capital gains rates) + (75% x 39.6% ordinary income tax rate)]

[9] Single taxpayers who earn more than $200,000 and married taxpayers with combined income of more than $250,000 would face the new tax on their investment gains starting in 2013.

[10] [(25% times 23.8% capital gains rates) + (75% x 43.4% ordinary income tax rate)]

[11] The Medicare investment surtax applies a 3.8 percent tax rate on investment income over $250,000 for a married filer or $200,000 for single filer. The surtax was included as part of the recently enacted federal health care legislation.

[12] IRS state income data can be found here: http://www.irs.gov/taxstats/article/0,,id=171535,00.html

[13] IRS state migration data can be found : http://www.irs.gov/taxstats/article/0,,id=212683,00.html

[14] Maine's tax reform was ultimately repealed by a "People's Veto" by a 61 to 39 percent margin. The defeat was due to the proposed expansion of the sales tax that was meant to pay for the lower income tax rates making the plan "revenue neutral." However, the concern of a higher sales tax burden on Maine's small businesses, combined with a recessionary economy, led to the defeat of the tax reform plan.

[15] The top income tax rate under the tax reform plan can go as high as 6.85 percent when a tax surcharge is included for taxpayers earning more than $250,000.