

# The Federal Tax Reform Act's cap on deductions of state income taxes has turned Proposition 80 into an economic time bomb for Massachusetts



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## Introduction

Recent passage by Congress of the Tax Cuts and Jobs Act of 2017 (TCJA) has dramatically altered the economic landscape surrounding the Proposition 80 initiative petition that will appear on the Massachusetts ballot this fall by placing a cap on itemized deductions of state income and local property taxes at \$10,000 in total. The proposed amendment would impose an additional 4 percent tax on that portion of Massachusetts residents' annual taxable income in excess of one million dollars from wages, capital gains, investment income, pass-through business income, or any other source. Specifically, the 4 percent surtax would be in addition to the current 5.1 percent state income tax rate.

### Dalio's warnings are relevant to Massachusetts where voters are poised to make a historic change to the state constitution

As recently noted by many economists, the limitation of state income and local property tax deductions will have disproportionately adverse economic consequence for states with high marginal state tax rates, including California, New Jersey, Ore-

gon, Minnesota, Maine, Iowa, New Jersey, the District of Columbia, Vermont and New York. If Massachusetts adopts Proposition 80, its tax rate for high-income filers will jump from 5.1 percent to 9.1 percent, ranking it among the nation's highest.

As explained in this analysis, the effect of Proposition 80 and the TCJA's newly instituted limitation on the deductibility of state income taxes would more than double the effective Massachusetts income tax rate for the average taxpayer with an adjusted gross income of \$1 million or more. Pioneer Institute's analysis of data promulgated by the Internal Revenue Service on components of federal tax returns filed by Massachusetts taxpayers demonstrates that the average state income taxes paid by a taxpayer in this income category would more than double (after adjustment for the value of federal tax itemized deduction including Pease limitations) from \$153,152 to \$318,095.

A recent analysis published by Ray Dalio, founder, chairman, and chief investment officer of Bridgewater Associates, L.P., the world's biggest hedge fund firm,<sup>1</sup> concludes that curtailing state income tax deductions is likely to increase the migration of high-earning taxpayers away from states with high income taxes to those with lower rates. His analysis, "Watch Out for the Effects of Tax Reform on Tax Migration, the Fiscal Conditions of Affected States and Cities, and Polarity in America," published on December 5, 2017<sup>2</sup>, explains that, for high earners, limiting the state income deduction on federal personal income taxes increases the effective state tax rate.

Dalio's observations are worth considering. He is a proven

financial expert, ranked by Forbes in 2017 as the 26<sup>th</sup> wealthiest person in America, and a philanthropist who, together with his wife Barbara, joined Bill Gates and Warren Buffett's Giving Pledge, vowing to donate more than half of their fortunes to charitable causes within their lifetimes.<sup>3</sup>

Dalio's concludes, "[E]verything points toward states like New York, Connecticut, New Jersey, California, and Illinois being the most vulnerable, and states like Florida, Texas, Nevada, Washington, and Arizona benefiting the most from this shift."

Dalio's warnings are relevant to Massachusetts, where voters are poised to make an historic change to the state constitution and establish the commonwealth's top marginal tax rate as fifth highest in the nation. If Proposition 80 is adopted, Massachusetts would join Dalio's warning list in a most prominent way.

Limiting the federal deduction for state and local taxes could hinder state efforts to enact a surtax on high earners. In December, Brian J. Rebhun, U.S. asset management tax leader at PricewaterhouseCoopers agreed with Dalio, telling Bloomberg News that under the new tax law, wealthy individuals would have less of an incentive to remain in a state that is pursuing a surtax on high earners.

The recently enacted TCJA limits itemized deductions for state and local income and real estate taxes to a total of \$10,000. While this limit may not be relevant to most taxpayers, it is highly significant to those with high incomes. Internal Revenue Service statistics of income (SOI) data for tax year 2015<sup>4</sup> reveal that 16,100 Massachusetts residents with adjusted gross incomes (AGIs) of \$1 million or more filed federal personal income tax returns with an average AGI of \$3.49. Of these filings, 97.5 percent (15,690 returns) included itemized deductions for state and local income taxes that averaged \$218,436 per return. Of these 16,100 returns, 94.9 percent (15,280 returns) included itemized deductions for real estate taxes averaging \$29,158 per return.

**A subsequent adoption of Proposition 80 will produce a "double-whammy effect."**

Because of the TCJA, adopting Proposition 80 would produce a "double-whammy" effect on high-income Massachusetts taxpayers. The first part is that they would be required by Proposition 80 to pay an additional tax on the portion of their taxable income over \$1 million. In the example above, a taxpayer with \$3.49 million in taxable income would owe an additional \$99,660 in state income taxes ( $\$3.49\text{M} - \$1\text{M} \times 4\%$ ), bringing the average total state and local income taxes of taxpayers in this income category to \$318,095 ( $\$218,435 + \$99,660$ ).

The “double-whammy” side-effect of the TCJA is that these high-income taxpayers would no longer be able to deduct state and local income taxes, including the additional Proposition 80 taxes, on federal tax returns.

According to IRS statistics, Massachusetts residents with AGIs of \$1 million or more paid an average of \$29,158 in real estate taxes in tax year 2015, which exceeds the \$10,000 state and local taxes (SALT) deduction cap. Thus, high-income taxpayers would be unable to deduct any state income taxes, including new Proposition 80 taxes. For this reason, the TCJA will substantially increase the after-tax effect of Proposition 80 on Massachusetts taxpayers with AGIs of more than \$1 million.

To illustrate, in tax year 2015 the average Massachusetts taxpayer who earned over \$1 million had an AGI of \$3.49 million and paid \$218,436 in state and local income taxes. The value to the taxpayer of these \$218,436 in state and local taxes as itemized deductions was reduced by Pease Limitations on Itemized Deductions, as explained below, to \$164,858. After application of the 39.6 percent value of the federal itemized deduction for state and local income taxes, the average effective state and local income tax was \$153,152 for the average Massachusetts taxpayer with an AGI of more \$1 million.

If Proposition 80 is adopted in addition to the TCJA, a taxpayer with an AGI of \$3.49 million would see his state and local taxes increase to \$318,095 and no longer be deductible. The combined effect of Proposition 80 and the TCJA’s SALT limitation would more than double the after-tax amount these high earners would pay in state and local income taxes (after-federal tax itemized deduction including Pease limitations) from \$153,152 to \$318,095.

The limitation of deductibility of SALT expenses would be offset in whole or in part by other elements of the TCJA that impact taxpayers differently depending upon specific components of their tax returns. These elements include a reduction in the top marginal tax rate from 39.6 percent to 37 percent for couples filing jointly, a reduction in rates in lower tax brackets, an exemption of up to 20 percent of income from pass-through entities such as LLCs and Subchapter S corporations, and other changes to current provisions included in the TCJA. Two additional components of the TCJA are relevant: amendments to the alternative minimum tax (AMT) and repeal of the Pease Limitation on Itemized Deductions.

For approximately one out of five taxpayers in Massachusetts with AGIs of more than \$1 million, the SALT limit won’t have as much of an impact because under pre-reform tax rules only one-out-of-five Massachusetts taxpayers (in tax year 2015) had to pay AMT that effectively negated some or all of the tax benefit of the SALT itemized deduction, according

to IRS data. According to the Tax Policy Center, “[t]he reason millionaires don’t pay AMT is because their regular tax liabilities are so high that they drastically exceed their AMT liabilities. The top AMT rate is 28 percent, but for millionaires, much of their income is taxed at the 35 percent regular rate.”<sup>5</sup> IRS data shows that in tax year 2015, only 20.4 percent of Massachusetts residents with AGIs of \$1 million or more paid AMT (3,280 out of 16,100 total returns) with an average AMT payment of \$78,275.

For the four fifths of high-income taxpayers who did not have to pay the alternative minimum tax, the SALT limitation will have a big impact. The AMT requires filers with AGIs above an established limit to calculate how much their AGI would have been if certain preferential tax deductions were excluded, including state and local taxes. The AMT then imposes either a 26 or 28 percent tax on the difference between the taxable income amount as calculated under ordinary income tax rules and taxable income calculated after excluding the preferential deductions.

As discussed earlier, the TCJA repealed the so-called Pease Limitation on Itemized Deductions. Under pre-reform 2018 tax rules, the Pease limitation reduced the value of a taxpayer’s itemized deductions by 3 percent for every dollar of taxable income above \$266,700 for single filers and \$320,000 for joint filers. This reduction continued until the Pease limitation was phased out at 80 percent of itemized deductions.<sup>6</sup> According to IRS data, the average amount of itemized deductions reported on joint tax returns for tax year 2015 filed by Massachusetts taxpayers with AGIs of more than \$1 million was

\$387,906. The Pease limitation formula reduced the value of those deductions by \$95,144 (\$3.49 million average AGI minus \$320,000 Pease Limit x 3 percent). In effect, under pre-reform tax rules the Pease Limitation on Itemized Deductions could be considered to have diminished the value of itemized state income tax deductions by approximately 24.5 percent.

While the proposed tax increase would make Massachusetts’ top nominal tax rate the fifth highest[i] in the country at 9.1 percent, its effective tax rate could rank even higher because Massachusetts does not allow taxpayers to take many itemized deductions offered by the four states with higher nominal tax rates, i.e. California (13.3 percent), Maine (10.15 percent), Oregon (9.9 percent), and Minnesota (9.85 percent).<sup>7</sup> Oregon, Minnesota, and California, for example, allow their state

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income taxpayers to deduct home mortgage interest while Massachusetts does not.<sup>8</sup> Minnesota, the state with the fifth highest nominal state income tax rate currently, allows taxpayers to deduct federal taxes on their state income tax returns, thereby decreasing its effective tax rate by a substantial amount. While Proposition 80 would make Massachusetts' top nominal tax rate the fifth highest in the nation, its effective tax rate could actually rank higher because Massachusetts would become the only state among the top four highest income tax states that do not link state income taxes to either federal adjusted gross income or federal taxable income.<sup>9</sup> The following list includes major deductions allowed by federal income tax code that are not allowed for Massachusetts code:

- Home mortgage interest
- Domestic production activities deduction allowed under I.R.C. § 199
- IRA deduction allowed under I.R.C. § 219
- Contributions to I.R.C. § 501(c)(18)(D) pension plans
- Contributions to Self-Employed SEP, SIMPLE, and qualified plans allowed under I.R.C. § 404
- Depreciation first-year bonus deduction allowed under I.R.C. § 168(k) qualified property
- Deductible part of self-employment tax allowed under I.R.C. § 164(f)
- Forfeitures due to premature withdrawal of funds deduction allowed under I.R.C. § 165
- Net operating loss deduction allowed under I.R.C. § 172 to either carry back or carry forward any unused net operating loss.

In addition to these adjustments that effectively increase the nominal tax rate, Massachusetts is the sole state with a separate and higher rate for short-term capital gains applicable to sales of securities within 12 months of purchase. If Proposition 80 is adopted, Massachusetts will have the highest marginal tax rate in the nation on such trades at 16 percent.

Under pre-reform 2018 tax rules, the Pease limitation reduced the value of a taxpayer's itemized deductions by 3 percent of every dollar of taxable income above a threshold (\$266,700 for single filers and \$320,000 for joint filers) to effectively eliminate up to 80 percent of itemized deductions.<sup>1</sup> Another pre-Tax Cuts and Jobs Act (TCJA) limitation on itemized deductions is the federal alternative minimum tax. Subsequent analysis will include deeper examination of the TCJA impact on these limitations.

i. The state of Maine recently adopted a 3 percent surcharge tax on income in excess of \$200,000, resulting in a top bracket of 10.15%.

## What is Proposition 80?

Proposition 80 is an initiative petition scheduled to appear on the November 2018 general election ballot that proposes to amend Article 44 of the Massachusetts constitution. A coalition of plaintiffs have brought a lawsuit before the commonwealth's Supreme Judicial Court to prevent Proposition 80 from appearing on the 2018 ballot.

The intended purpose of Proposition 80, in the words of its sponsors, Raise Up Massachusetts, a grassroots coalition of community organizations, religious groups, and labor unions, is:

The Fair Share Amendment would amend the Massachusetts Constitution to create an additional tax of four percentage points on annual income above one million dollars, so only those with the highest incomes would pay a little more. The new revenue generated by this tax could only be spent on quality public education, affordable public colleges and universities, and for repair and maintenance of roads, bridges, and public transportation. To ensure that the tax continues to apply only to the highest income residents, who have the ability to pay more, the one million dollar threshold would be adjusted each year to reflect cost-of-living increases.<sup>10</sup>

The constitutional provision that the initiative petition seeks to amend is Article 44 of the Massachusetts constitution, which was ratified in 1915.<sup>11</sup> It provides:

Full power and authority are hereby given and granted to the general court to impose and levy a tax on income in the manner hereinafter provided. Such tax may be at different rates upon income derived from different classes of property, but shall be levied at a uniform rate throughout the commonwealth upon incomes derived from the same class of property. The general court may tax income not derived from property at a lower rate than income derived from property, and may grant reasonable exemptions and abatements. Any class of property the income from which is taxed under the provisions of this article may be exempted from the imposition and levying of proportional and reasonable assessments, rates and taxes as at present authorized by the constitution. This article shall not be construed to limit the power of the general court to impose and levy reasonable duties and excises

Specifically, Proposition 80 proposes to amend Article 44 by adding at the end thereof the following paragraph.

To provide the resources for quality public education and affordable public colleges and universities, and for the repair and maintenance of roads, bridges and public transportation, all revenues received in accordance with this paragraph shall be expended, subject to appropriation, only for these purposes. In addition to the taxes on

income otherwise authorized under this Article, there shall be an additional tax of 4 percent on that portion of annual taxable income in excess of \$1,000,000 (one million dollars) reported on any return related to those taxes. To ensure that this additional tax continues to apply only to the commonwealth's highest income residents, this \$1,000,000 (one million dollar) income level shall be adjusted annually to reflect any increases in the cost of living by the same method used for federal income tax brackets. This paragraph shall apply to all tax years beginning on or after January 1, 2019.

The sponsors of Proposition 80 often refer to it as a “millionaires’ tax,” suggesting that the measure will impact consistently high earners. Yet the initiative’s wording would make the higher tax rate applicable to “one-time millionaires” as well, including taxpayers who realize a one-time gain from the sale of their long-operated small business or of their personal residence.

History shows that state income tax hikes targeting the wealthy can disrupt the underlying state economy and impact many more people than just the very affluent. The long-term economic well-being of Massachusetts is at risk should this tax hike pass, as more of the state’s population and businesses would be motivated to move to states such as New Hampshire and Florida, which have no state income tax. Others would be deterred from locating or expanding businesses in Massachusetts.

Although the optics of Proposition 80 make it more palatable for voters to support the measure in theory, a closer look at historic trends in wealth migration should cause voters to

## A closer look at historic trends in wealth migration should cause voters to reject the notion that they will not be impacted.

reject the notion that they will not be impacted. Tax policy that targets the wealthy can risk galvanizing a damaging trend of migration from high-tax states to no-tax states.

For the purpose of this paper, migration is defined as the entrance and exit of taxpayers from one state to another. The presentation and conclusions are drawn primarily from analyzing and interpreting migration of wealth data

from the Internal Revenue Service’s Statistics of Income (SOI) Division and the Massachusetts Department of Revenue.

The analysis proceeds from the important assumption that Massachusetts and other states vigorously compete to attract and retain businesses and residents to maintain a healthy revenue stream and economic stability. For this reason, it is valuable to consider available federal data that tracks migration of Massachusetts taxpayers, including high-income taxpayers, to and from other states.

## Understanding Migration Analytics

Massachusetts has become a perennial net loser to other states when it comes to taxpayer migration of high-income taxpayers, according to data reported by the IRS. Beginning with the 2011–2012 data, the SOI methodology also began to include new tabulations that show aggregate migration flows by size of AGI and age of the primary taxpayer (Pierce, 2015).<sup>12</sup>

IRS migration data are based on year-to-year address changes reported on individual income tax returns filed with the IRS.<sup>13</sup> The 2014–15 Migration Data Users guide describes migration data as follows:

Migration data are based on the population of Forms 1040 that were filed and processed by the IRS during calendar years 2014 and 2015. The bulk of returns the IRS received in 2014 represent income that was earned in 2013 and the migration data correspond to returns filed for Tax Year 2013. The bulk of returns the IRS received in 2015 represent income that was earned in 2014 and the migration data correspond to returns filed for Tax Year 2014. For the calendar years 2014 and 2015, the bulk of returns filed with the IRS were for Tax Years 2013 (received in calendar year 2014) and Tax Year 2014 (received in calendar year 2015); however a number of individuals did file returns that represented prior tax years. For matching purposes, prior year returns are not used in the migration data. The address shown on the tax return is a mailing address that may not reflect the taxpayer’s actual residence. In addition, the address may not reflect the location of the taxpayer when the income was earned, as a taxpayer may move during the course of a tax year. Thus the income may have been earned in two locations. In addition, a taxpayer may move after the end of the tax year but file their return on time up to nine months later from another location....

The State-to-State outflow migration files represent the migration flows from the origin state, in year 1, to the destination state, in year 2. There are 51 files for each state plus the District of Columbia. Included in the list of outflow states are the number of returns that migrated to a foreign location. Each file tabulates the number of returns, number of exemptions, and adjusted gross income (AGI) by state and is available as a MS Excel spreadsheet or as a CSV (comma separated) file. The number of exemptions and adjusted gross income are based on the year 2 tax return...

The State-to-State inflow migration files represent the migration flows into the destination state, in year two, from the origin state, in year one. There are 51 files for

each state plus the District of Columbia. Included in the list of inflow states are the number of returns that migrated from a foreign location [4]. Each file tabulates the number of returns, number of exemptions, and adjusted gross income (AGI) by state and is available as a MS Excel spreadsheet or as a CSV (comma separated) file. The number of exemptions and adjusted gross income are based on the year 2 tax return.

The following examples demonstrate how the IRS Statistics of Income (SOI) Division reports Inflow, Outflow, and Non-Migrant Returns:

*Example 1: An Individual Filer with an AGI of \$110,000.* The IRS receives a 2013 Form 1040 Individual Tax Return filed on April 15, 2014 listing a Massachusetts home address and reporting \$110,000 in AGI with a total of three exemptions: two personal exemptions for the taxpayer, a married couple filing jointly, and one exemption for a dependent. If the IRS processes the taxpayers' 2013 Form 1040 calendar year tax return during calendar year 2014, the IRS' SOI division attempts to determine whether the IRS had processed the same tax filer's Form 1040 during the preceding year. In this hypothetical example, SOI determines that the IRS had processed a 2012 Form 1040 Individual Tax Return for the same taxpayer during 2013, the preceding year, and that the taxpayer had stated on the completed return that his "home address" was in Massachusetts and that the taxpayer reported \$110,000 in AGI and two exemptions.

*The manner in which this 2013 Form 1040 tax return is categorized by the IRS SOI Division:* In its SOI data for 2013–14, the IRS lists a "non-migrant return" from Massachusetts with AGI of \$110,000 and three exemptions in the 2013–14 period. It also reports the taxpayer's age and income category (this income data started in the 2011–12 calendar year.)

*Example 2: The same filer in 2014 with an AGI of \$120,000.* The same taxpayer files a 2014 Form 1040 Individual Tax Return on April 15, 2015 using a Florida home address that reports \$120,000 in AGI with four personal exemptions: two for the taxpayer, a married couple filing jointly, and two for dependents. If the IRS processes the taxpayer's 2014 Form 1040 calendar year tax return in calendar year 2015, the IRS' SOI division attempts to determine whether the IRS had processed the same tax filer's Form 1040 during the preceding year, 2014. The IRS determines that it had processed the taxpayer's Form 1040 in 2014.

*The manner in which this 2014 Form 1040 tax return is categorized by the IRS SOI Division:* In its SOI data for 2014–15, the IRS lists an "inflow return" to Florida and an "outflow return" from Massachusetts with AGI of \$110,000 and 4 exemptions in the 2014–15 period. It also reports the taxpayer's age and income category.

*IRS Migration Data: What the numbers mean.*<sup>14</sup>

The IRS' 2014–2015 Migration Data Users Guide provides the an explanation of IRS SOI data that is<sup>15</sup>

IRS Migration data for the United States are based on year-to-year address changes reported on individual income tax returns filed with the IRS. They present migration patterns by State or by county and are available for inflows—the number of new residents who moved to a State or county and where they migrated from, and outflows—the number of residents leaving a State or county and where they went. The data also include tabulations on the number of non-migrant returns within a State or county. . . Migration data are based on the population of Forms 1040 that were filed and processed by the IRS during calendar years 2014 and 2015. The bulk of returns the IRS received in 2014 represent income that was earned in 2013 and the migration data correspond to returns filed for Tax Year 2013. The bulk of returns the IRS received in 2015 represent income that was earned in 2014 and the migration data correspond to returns filed for Tax Year 2014.

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## No Income Tax States: The Allure of 0 Percent

IRS migration data demonstrate that states with low taxes have benefited enormously from net migration of high-income taxpayer migration over the past four years while states with the high taxes have suffered. This is demonstrated by a comparison of net AGI migration in eight states with no income tax with that of eight states with the highest state income tax rates.

The eight states with no state income tax are Arkansas, Florida, Nevada, New Hampshire, South Dakota, Texas, Washington and Wyoming.<sup>16</sup> From 2011–12 to 2014–15, these states



cumulatively experienced net positive migration of AGI from high-income taxpayers (those earning more than \$200,000) of \$40.25 billion. In addition, these eight states had in-migration of \$24.74 billion over this period from in-migrants earning less than \$200,000, for a total net positive AGI migration of \$64.99 billion. More than 60 percent of the net in-migration of AGI to these eight states came from taxpayers with AGIs of \$200,000 or more.

Conversely, the eight states with the highest marginal income tax rates— California (13.3 percent), Oregon (9.9 percent), Minnesota (9.85 percent), Iowa (8.98 percent), New Jersey (8.97 percent), District of Columbia (8.95 percent), Vermont (8.95 percent) and New York (8.82 percent) cumulatively had net negative AGI migration of \$26.57 billion from taxpayers earning more than \$200,000 between 2011–12 and 2014–15. In addition, these states had net out-migration of \$16.66 billion over this period from migrants earning less than \$200,000, for a total net negative AGI migration of \$43.23 billion, more than 60 percent of which was attributable to net out-migration of high-income taxpayers. Figure 1 compares the starkly different AGI migration results experienced by no-tax states and high-tax states from 2011–12 to 2014–15. (Data for Figure 1 is presented in Appendix A.)

### Massachusetts Net AGI Out-Migration

Figure 2 presents IRS data showing Massachusetts’ net migration of AGI from 1992–93 to 2014–15 for all tax returns regardless of income level. It shows that Massachusetts experienced a cumulative net outflow of \$15.9 billion in AGI over this period to other states and nations. Income tax-free Florida and New Hampshire were the biggest beneficiaries; together they accounted for 74 percent of Massachusetts’ net out-migration of AGI over this period. Massachusetts had a net out-migration of AGI to Florida of \$7.5 billion, representing 47.4 percent of Massachusetts’ total AGI net out-migration.<sup>17</sup> The migration of a relatively small number of high-income taxpayers from Massachusetts to Florida has had a disproportionately large impact on Massachusetts’ loss of taxable income to the Sunshine state. According to records of the Massachusetts Department of Revenue, one-third of all taxable income that migrated from Massachusetts to Florida between 2011 and 2014 was attributable to just 250 Massachusetts taxpayers (0.8 percent of total out-migrants to Florida) with taxable incomes of \$3.04 million on average. Over this same time period, 8.0 percent of all Massachusetts out-migrants to Florida (2,497 of 31,264) accounted for 55 percent of total out-migrated taxable income (\$1.24 billion of \$2.25 billion). The commonwealth

Figure 1. AGI migration experienced by no-tax and high-tax states, 2011–12 to 2014–15

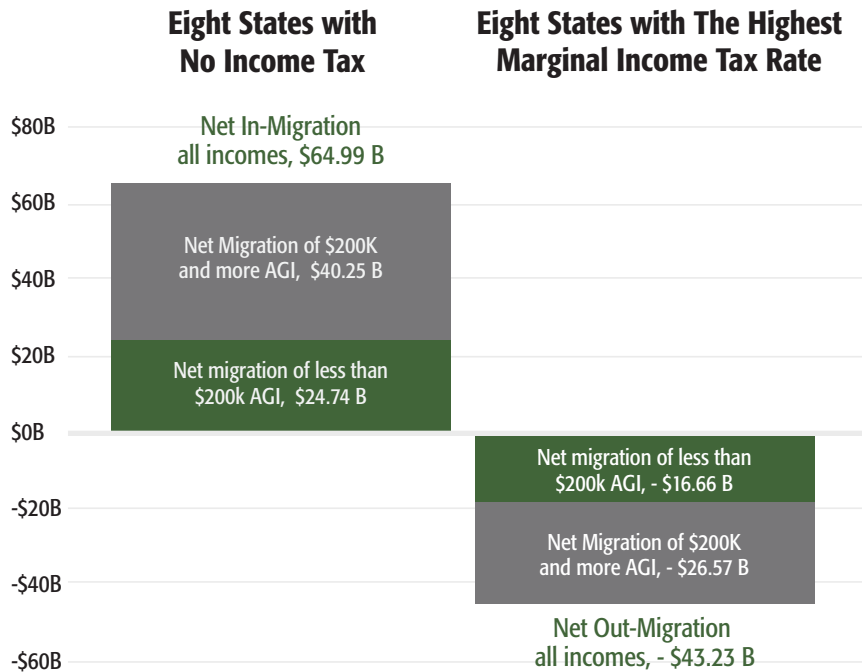


Figure 2. Massachusetts Cumulative Net AGI Inflow/Outflow, 1992–93 to 2014–15

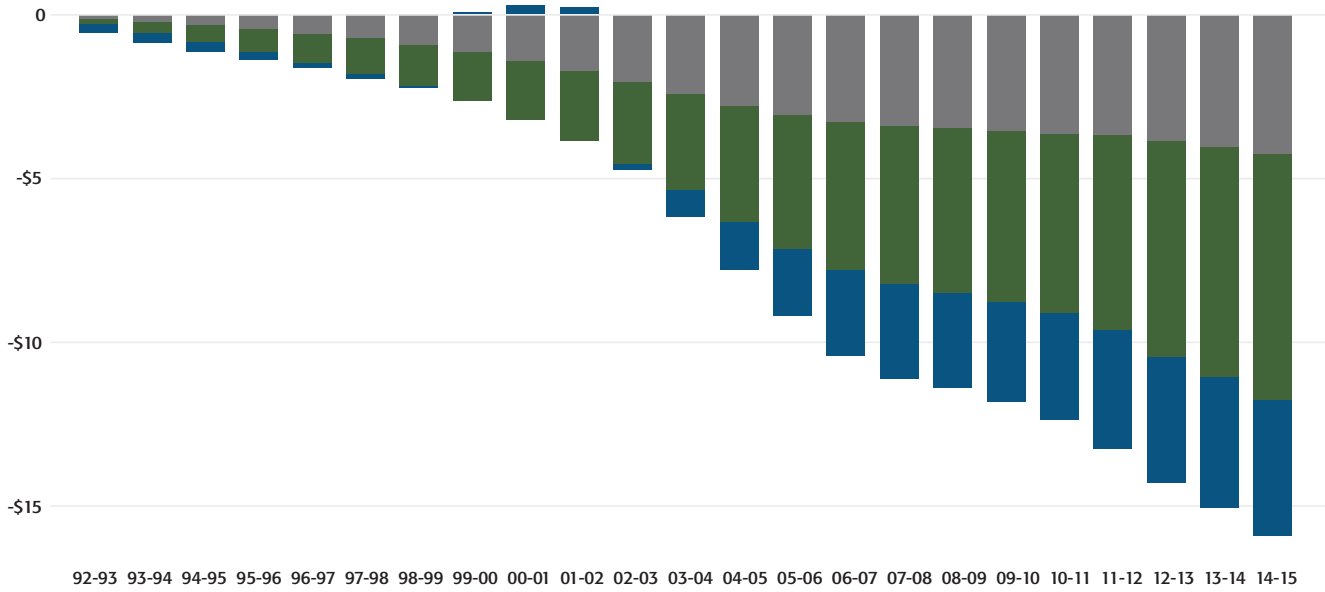
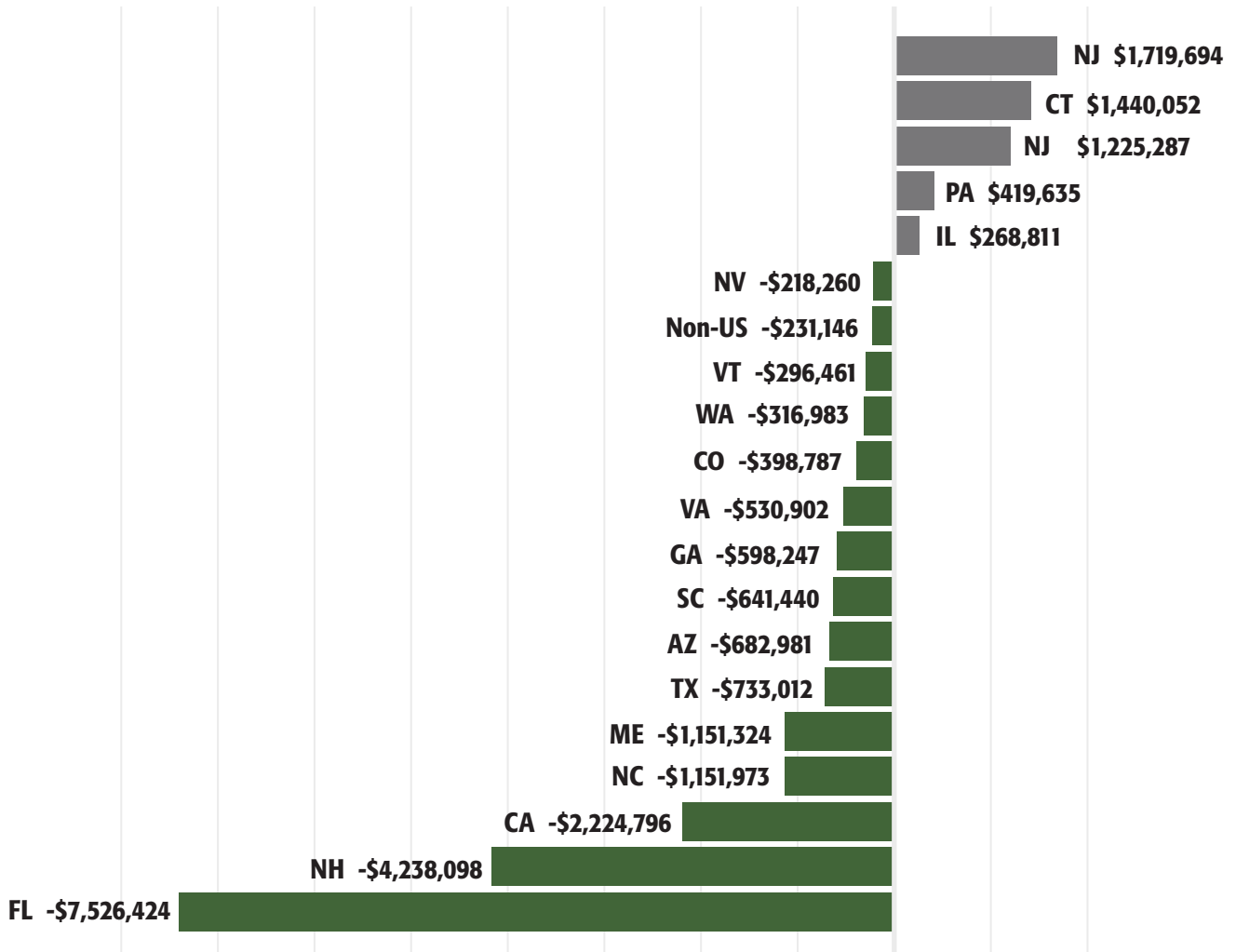


Figure 3. 20 states with which Massachusetts had significant net positive or negative AGI migration, 1992–93 to 2014–15



had net out-migration of AGI to New Hampshire of \$4.2 billion, or 26.7 percent of Massachusetts' total AGI net out-migration. Other states and nations accounted for the remaining \$4.1 billion of Massachusetts' net AGI out-migration, representing 26.0 percent of its total net loss over this period.

Figure 3 shows the 20 states with which Massachusetts had the most significant net positive or net negative AGI migration from 1992–93 to 2014–15 for taxpayers of all incomes. Cumulatively, these states accounted for 93.4 percent of Massachusetts net AGI migration over the period while the other 30 states accounted for 6.6 percent. Of the 20 states, Massachusetts had net AGI in-migration from New York, Connecticut, New Jersey, Pennsylvania, and Illinois.

**Over just four years, Florida's net AGI attributable to migration totaled \$39 billion, of which 72 percent was attributable to taxpayers with AGI of \$200,000 of more.**

Massachusetts had the most significant net AGI out-migration with Florida and New Hampshire, followed by California, North Carolina, and Maine.

## The Florida Welcome Mat: Sun and Savings

Florida was by far the most attractive destination for migrating U.S. taxpayers from 1992–93 to 2014–15. The Sunshine State added \$133.65 billion in cumulative net AGI over this period across all income levels, according to IRS SOI data.

The IRS' addition of income categories to its income migration data reporting in 2011–12 allows researchers to calculate the percentage of AGI income migration attributable to high-income taxpayers by state. The highest income category reported in IRS migration data is an AGI of more than \$200,000. According to IRS data, Florida had a total of 56,093 migration inflow returns of taxpayers with AGIs of \$200,000 or more from 2011–12 to 2014–15. The average AGI of these inflow returns was \$820,272. Florida's inflow returns over this period totaled \$46.01 billion.

Over the same period, Florida had 25,740 outflow returns of taxpayers with AGIs of \$200,000 or more, with an average AGI of \$699,874.

Florida's net AGI attributable to migration from 2011–12 to 2014–15 totaled \$38.87 billion, of which 72 percent was attributable to taxpayers with AGI of \$200,000 of more (Figure 5).

Figure 4. Florida Cumulative Net AGI Migration, 1992–93 to 2014–15 (\$000s)

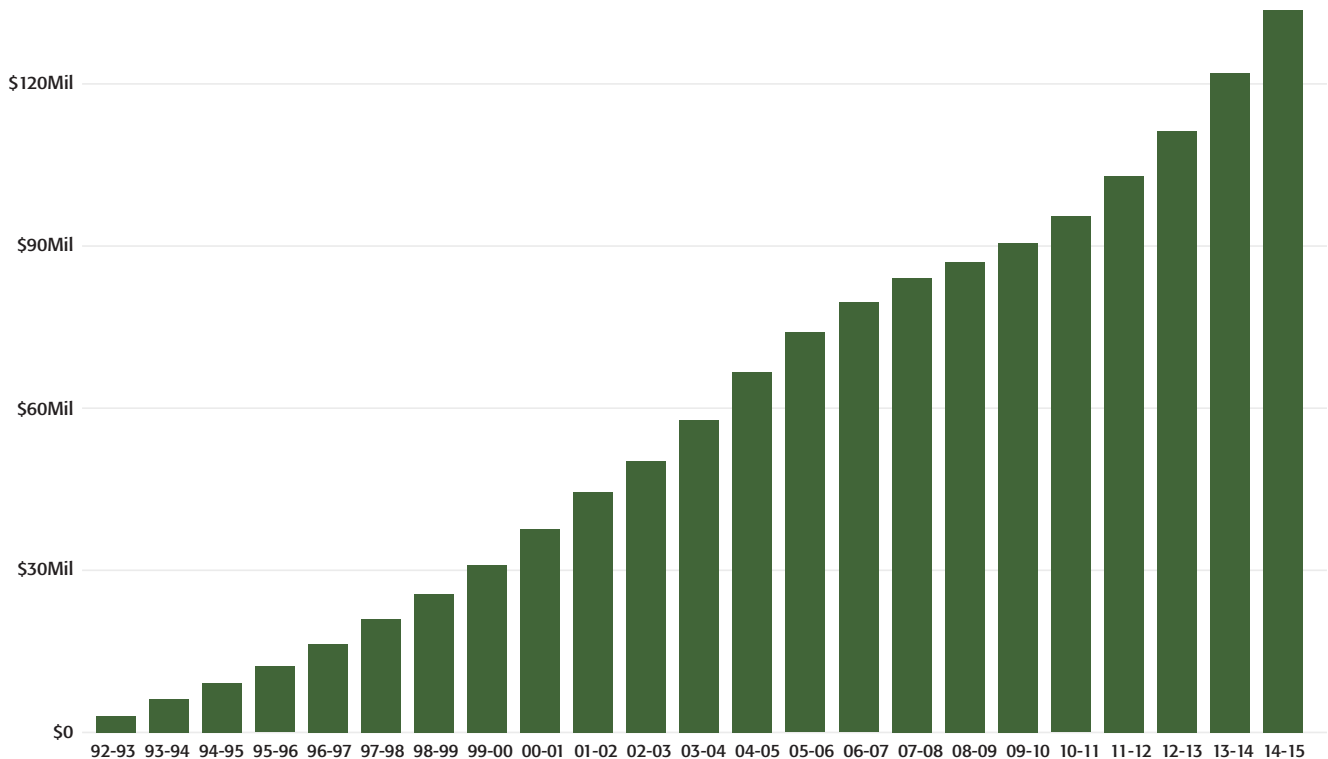


Figure 5. 72% of Florida’s net migration AGI came from high-income taxpayers (000s), 2011–12 to 2014–15

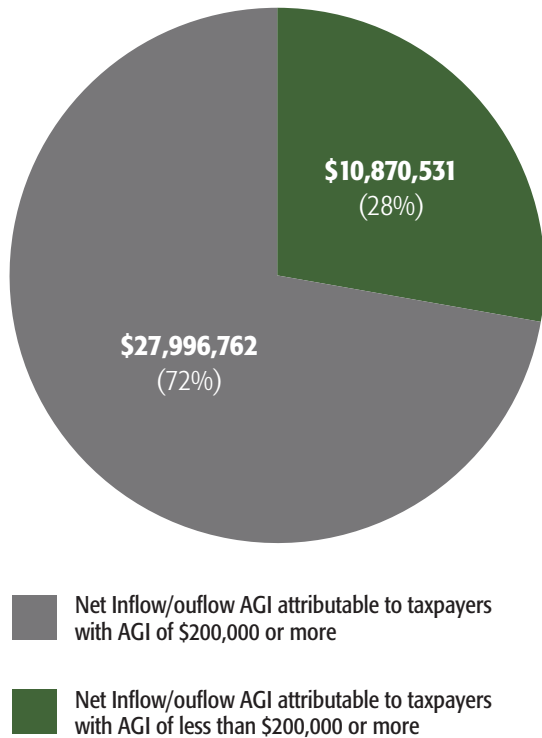
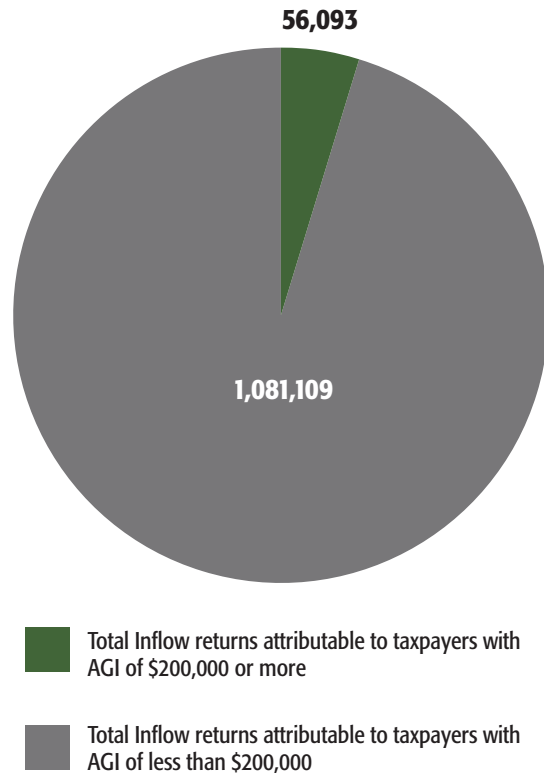


Figure 6. High-income taxpayers constituted only 5% of in-migrant returns, 2011–12 to 2014–15



This massive net AGI migration in just three years came despite the fact that they constituted only 5 percent of total inflow returns over that period (Figure 6).

### The Ripple Effect on Population Growth

**The effects of migration have been significant not only on total state AGI but also on population growth.**

Over time, migration has significantly affected not only the growth of total state AGI, but also of total state population. Since 1992, both Massachusetts and Florida have experienced growth of about 24 percent in claimed tax exemptions of their respective non-migrant populations. Figure 7 shows how much the cumulative effects of migration have dramatically changed the final outcomes. Over this period, Massachusetts lost 9.3 percent of its total exemptions through net negative migration, according to IRS data, reducing its “claimed tax exemption” growth from 24.7 percent (non-migrant taxpayers) down to 15.4 percent (all taxpayers). Florida, conversely, increased its “claimed tax exemption” growth from 23.6 percent (non-migrant taxpayers) to 46.5 percent (all taxpayers) because of net positive migration.

According to IRS SOI data, Florida had a net increase in the total exemptions reported on federal tax returns of 4.61

million over this period, from 10.14 million in 1992–93 to 14.64 million in 2014–2015.

Exemptions are considered to be a proxy for population, but understate it because IRS data is limited to “matched returns” of taxpayer filings, a smaller subset. There are two kinds of exemptions recognized by the IRS: personal exemptions for the taxpayer, including one for a single taxpayer and two for married couples filing jointly; and an additional one for each dependent. Over this period, by comparison, the U.S. Census reports that Florida’s population increased from 13.71 million in 1993 to 20.27 million in 2015.

Based on matched IRS tax returns from 1992–93 to 2014–15, Florida added 2.32 million exemptions as a result of net positive migration. This means that of Florida’s 4.61 million total increase in exemptions from 1992–93 to 2014–15, 50.3 percent, more than half, was attributable to net positive migration and 49.7 percent was attributable to an increase in non-migrant in-state residents.

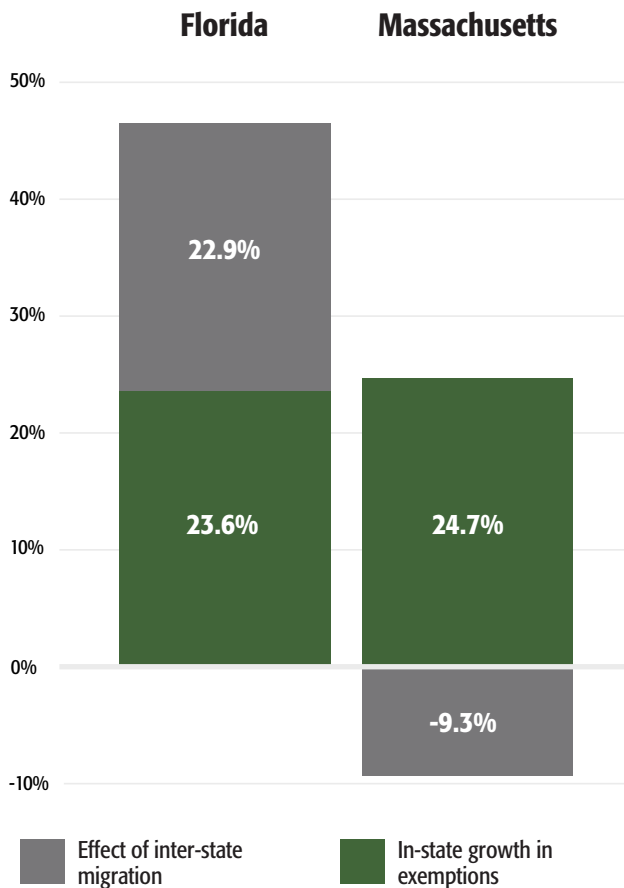
Massachusetts had a net increase in the total number of exemptions reported on federal tax returns of 702,781 over this period, growing from 4.56 million exemptions in 1992–93 to 5.26 million in 2014–2015.

Unlike Florida, Massachusetts had a net-negative flow of exemptions out of state. Between 1992–93 and 2014–15, the IRS reported net outflow from Massachusetts with 422,559

exemptions reported. Had Massachusetts not experienced a net negative migration of exemptions, its exemptions would theoretically have increased by 1.10 million rather than 702,781, but this presumes that Massachusetts could have adapted to facilitate additional inflow returns and that out-of-state taxpayers would have migrated to Massachusetts.

These statistics demonstrate the substantial effect of net migration on the total number of taxpayers and dependents over time. Had it not been for its net migration gains, Florida's exemptions would have increased by only 23.6 percent rather than 46.5 percent. Conversely, if the effects of net negative migration were not counted, Massachusetts growth in the number of exemptions would have grown by 24.7 percent instead of only 15.4 percent.

**Figure 7. Net migration has boosted Florida's and decreased Massachusetts' population**



IRS statistics also show that Florida has benefitted greatly by cumulative AGI reported on net inflow returns.

According to IRS SOI data, the total AGI of all Florida taxpayers increased from \$157.9 billion in 1992–93 to \$505.1 billion in 2014–2015, an increase of \$347.2 billion. Based on

matched IRS tax returns, a substantial percentage of this increase, 38.5 percent (\$133.7 billion), was attributable to a net increase in migration to Florida, while 61.5 percent (\$213.5 billion) was attributable to an increase of AGI from in-state residents who did not move between states. This demonstrates the significant impact of net in-migration to Florida over this period. Without the effect of in-migration, Florida's total AGI growth would have been 135.2 percent; with it, Florida's total AGI growth was 219.9 percent.

Massachusetts' AGI growth, conversely, was adversely impacted by net out-migration over this period. The total AGI of all Massachusetts taxpayers increased from \$87.8 billion in 1992–93 to \$258.3 billion in 2014–2015, an increase of \$170.6 billion.

Based on matched IRS tax returns, Massachusetts had a net decrease in AGI from migration returns of \$15.9 billion from 1992–93 to 2014–15. Had Massachusetts not experienced a net negative migration of AGI, its total AGI increase would have theoretically increased by \$186.5 billion rather than by \$170.6 billion. Because of net migration AGI outflow from 1992–92 to 2014–15, Massachusetts's total AGI growth decreased from 212.5 percent to 194.4 percent.

These statistics demonstrate the substantial effect of net migration on AGI in the two states from 1992–93 to 2014–15:

	In-state growth in AGI	Effect of in/out migration	Actual increase
Florida	135.2%	+84.6%	219.9%
Massachusetts	212.5%	- 18.1%	194.4%

### Economic Backlash: When High-Earners Hit the Road or Decide Not to Move to Massachusetts

Migration of ultra-high-income taxpayers can have significant effects on local economies. Despite all the academic research and think tank analysis about “millionaire migration” and “tax flight,” the IRS currently does not report data about this subject. To its great credit, the IRS has provided researchers and public policy analysts with a wealth of data with which to assess issues such as the ones Massachusetts now faces. Its expansion of income migration data to include AGI categories, including the category of \$200,000 or more, as well as other demographic categories, is a welcome innovation. But notwithstanding that recent data expansion, little data is publicly available with which to measure state-to-state migration of “millionaires.”

### Massachusetts had a net decrease in AGI from in-migration returns of \$15.9 billion from 1992–93 to 2014–15

A very worthwhile resource promulgated by the IRS periodically concerns tax payments of ultra-high AGI taxpayers nationally.<sup>18</sup> A review of this data should raise concerns in the debate about “millionaire migration” because it sheds light on what can happen if only a relative handful of ultra-high earners change domicile to take advantage of more favorable tax treatment. This IRS data sheds light on the potential impact of Proposition 80.

**The Top 0.001 Percent:** In tax year 2014, 1,396 taxpayers (the wealthiest 0.001 percent in the U.S.) had a total AGI of \$207.15 billion and average AGI of \$148.38 million. These taxpayers paid \$49.74 billion in total federal taxes in tax year 2014, an average of \$35.63 million at an average taxable rate of 24.01 percent. Hypothetically, if Massachusetts has 1/50<sup>th</sup> of these top 0.001 percent individuals, 28 taxpayers with an average AGI of \$148.38 million would pay \$5.90 million on average in the Proposition 80 surtax (0.04 x \$147.38M) and \$7.57 million in base (5.1 percent) tax, totaling \$13.46 million in state tax. As a group, they would pay \$164.60 million in Proposition 80 tax and \$375.89 million in total state tax.

If an ultra-high income taxpayer changed domicile from Massachusetts to a non-income tax state such as New Hampshire or Florida, he or she could save as much as \$13.46 million in state taxes on average, depending on the taxpayer’s sources of income. Recent enactment by Congress of the Tax Cut and Jobs Act has imposed a limit on itemized deductions of state income taxes on federal personal income tax returns of \$10,000, thereby enhancing the tax advantage to ultra-high income taxpayers of relocating to a state with no income tax.

**The Top 0.1 Percent:** In 2014, 139,562 taxpayers (the wealthiest 0.1 percent in the U.S.) had total AGI of \$986.08 billion and an average AGI of \$7.07 million. These 139,562 taxpayers paid \$272.83 billion in total federal taxes in tax year 2014, an average of \$1.95 million at an average taxable rate of 27.67 percent. If Massachusetts has 1/50<sup>th</sup> of these top 0.1 percent individuals, that would translate to 2,791 taxpayers with an average AGI of \$7.07 million paying \$242,621 on average in Proposition 80 surtax (0.04 x \$7.07M) and \$360,341 in base 0.051 tax, totaling \$602,962 in average state tax. As a group, they would pay \$1.01 billion in 5.1 percent state income tax and \$677.21 million in Proposition 80 tax for a total of \$1.68 billion in total state taxes.

If one such taxpayer changed domicile from Massachusetts to a non-income tax state such as New Hampshire or Florida, he or she could save as much as \$602,962 in state taxes on average, depending on the taxpayer’s source of income.

According to data promulgated by the Massachusetts Department of Revenue, more than half of estimated Proposition 80 tax revenue is expected to come from 897 of the 19,565 taxpayers who would be subject to the tax increase. These 897

taxpayers, with taxable income of \$10 million or more, would be on the hook for an additional \$1.002 billion of the estimated \$1.884 billion in total expected revenues from Proposition 80.<sup>19</sup> Although these 897 taxpayers represent only 4.6 percent of taxpayers subject to the new tax, they would be obligated to pay 53.2 percent of total Proposition 80 tax revenue. If a third of these taxpayers opted to move, i.e., 299 taxpayers constituting 1.5 percent of all taxpayer subject to the tax, Proposition 80 revenue would drop by as much as \$334.009 million annually, accompanied by a loss of as much as \$441.110 million annually in regular state income tax paid by these taxpayers.<sup>20</sup> Thus, the out-migration of just 299 of Massachusetts highest-income taxpayers would decrease the estimated net tax revenue from Proposition 80 from \$1.884 billion to \$1.1 billion. Massachusetts Department of Revenue included in its estimate of tax revenues from Proposition 80 a caveat that “a great deal of estimation uncertainty may affect revenue impact significantly” including taxpayer decisions on migration, consumption, investment, and business location, as follows:

Please note that there is a great deal of estimation uncertainty, given that many factors may affect revenue impact significantly but are unpredictable and often difficult to measure. For example, taxpayers may respond to the additional tax by changing decisions on migration, consumption, investment, business location, etc.

The number of high-income earners and amount of income reported by those earners could also fluctuate considerably from year to year. Due to these aforementioned uncertainties and the complexities involved in running simulations under various constraints/assumptions, DOR’s revenue impact estimates should be used with caution. Please also note that DOR’s role is limited to conducting revenue impact analysis of various proposals. DOR does not take any position on the desirability of such proposals.<sup>21</sup>

## Pass-through Entities: The Negative Impact

IRS records show that 70.8 percent of Massachusetts’ 16,100 taxpayers with AGI over \$1 million in 2015 received income from partnerships and sub-chapter S corporations, i.e. pass-through entities. Proposition 80 would be applicable to the portion of taxable income that exceeds \$1 million, including income from partnerships and sub-chapter S corporations.

Specifically, Proposition 80 would raise the combined federal/state tax rate on Massachusetts partnership and sub-S corporations from 26<sup>th</sup> to between the second and fifth highest in the U.S., depending on whether the taxpayer pays short-term capital gains taxes, which Proposition 80 would render the nation’s highest.

Under the Massachusetts tax code, taxation of income from

partnerships and sub-chapter S corporations is not based upon how much a taxpayer actually receives from the pass-through entity during the tax year but upon the pass-through entity's taxable net income or "paper profits." Net income that is reinvested by a growing business to purchase equipment, machinery, or building renovations, for example, are not deductible as expenses, but instead must be amortized over a longer period depending upon the asset class. Likewise, the principal portion of mortgage payments paid by a pass-through entity to

a financing institution are not deductible expenses. This creates a tax consequence whereby the taxpayer owes taxes on paper-profits that he or she did not receive, but which "profits" were instead spent on the purposes cited. This effect of this provision of the Massachusetts tax code is especially deleterious for taxpayers who own interests in growing small and medium sized businesses. Proposition 80 will exacerbate this effect.

### The following examples demonstrate potential adverse consequences of Proposition 80 on:

#### Example 1: Large Business

**Adam Portnoy, President & CEO of  
*The RMR Group Inc., Newton, MA***

The president and CEO of one of the largest alternative asset management firms in the U.S., which is based in Massachusetts, views Proposition 80 tax through a much wider lens. "In the many industries that fall within the companies that we manage — including senior care, hospitality, etc. — there are employees in all income brackets that could be at risk if Proposition 80 is enacted by the hand of voters."

Since the company is publicly traded and its managed businesses employ more than 50,000 people nationally, he has been enticed by other business-friendly states throughout the U.S., such as Texas, Florida and North Carolina, to relocate the company's corporate headquarters from Massachusetts.

In Massachusetts, we are proud to employ nearly 1,000 employees and ideally want to stay here. However, people should understand that under the current Massachusetts tax rates, relocating our headquarters to states with no income taxes, such as Florida or Texas, would mean an immediate increase in take-home pay for everyone that moved. Should Massachusetts voters enact something as short-sighted as Proposition 80, the math only gets more compelling for businesses and employees to relocate out of state. Everyone should understand that a business will live or die based on its numbers. Although it's a harsh reality that no one likes to talk about, unilateral decisions that can impact a company's profitability — no matter what the size — make sizable job losses an inevitable outcome.

#### Example 2: Medium Business

**Harvey Hurvitz, President of  
*Cape Cod Lumber, Abington, MA***

The owner of a large building supply retailer in Massachusetts, which originated as a small family business nearly 60 years ago, would not have had the capital to fund its growth if a graduated tax similar to Proposition 80 had been in place.

During economic downturns we've had to streamline operations. However, during our more profitable years, the flat tax system gave us the ability to expand our facilities, purchase equipment, hire employees, while investing in our community. With the help of this tax code, we've been able to hire more employees during years of economic growth, and our longevity has made us an even stronger business allowing us to achieve our goal of proudly becoming an employee-owned company. I can't imagine taking that opportunity away from people who have the same dream to grow a business, providing support and security for employees and their families.

#### Example 3: Small Business

**Bob Wescott, President of *Copilabs, Inc.,  
Lawrence, MA***

The president of a small family-owned business based in Lawrence, MA that has been selling and servicing office copiers and printers for more than 40 years says Proposition 80 is inequitable and poised to punish state residents who earn far less than \$1 million.

As a lifelong Massachusetts resident and business owner, I've witnessed the highs and lows of doing business here during both Democrat and Republican administrations. The bottom line is that this issue is far less about politics and more about necessary transparency for voters so they can understand that Proposition 80 will indeed impact most of them, and not just a wealthy few.

The company has been able to succeed because most of its business income comes from approximately 350 customers (small and large businesses) based in Massachusetts. He notes that these customers will feel more of Proposition 80's direct impact because many would likely qualify to pay the additional tax because their annual "paper profits" exceed \$1 million. If pass-through income from these companies is taxed at a much steeper rate, they too could decide to relocate to more tax-friendly states.

Also, since the copier company is a regional service business with additional customers in New Hampshire, even this small business could fare better by moving just across the border to New Hampshire. And if customers are forced to streamline their budgets because of the

additional tax burden, businesses will be forced to look at what to cut from their budgets, with office supplies and maintenance services being the first to go, he notes.

For a small business, every dollar saved in expenses can mean the difference of survival or failure. Proposition 80 is strong enough to kill the small or medium-sized business because we feed and fill the nook and cranny operational needs that larger Massachusetts businesses require to succeed. If they flee or reduce spending on our kinds of services, we'd have to follow or close up shop. Small businesses face higher hurdles than larger ones do when there is an artificial tax burden imposed on the marketplace.

## Why Small Businesses Matter

Small businesses, defined as entities with under 500 employees, account for just under half of total employment in Massachusetts. While their existing job base is important, a thriving small business and start-up culture also plays an essential role in the state's economy when it is coming out of a recession.

As John Friar and Megan Gay demonstrated in *Failure to Thrive*<sup>22</sup>, when coming out of recessions, it is the birth of new Massachusetts' start-ups — not expansions of existing businesses — that account for the lion's share of new jobs. Approximately 20 percent of gross job creation nationwide can be attributed to business start-ups, while firms categorized as start-ups make up under 10 percent of all firms nationwide.<sup>23</sup>

According to the Census Bureau's 2014 Annual Survey of Entrepreneurs, 8.9 percent of all U.S. firms have been in operation for less than two years, while firms that have been

around for 2–10 years and 11 or more years make up 43.9 and 47.2 percent of all companies nationwide, respectively.<sup>24</sup> The Census survey reports that the three states with the largest share of startups are Nevada, Florida, and Texas, none of which have a state income tax.<sup>25</sup>

As the author of this article and analysis notes, however, the disproportionately higher share of younger firms in these states

could be attributable to a number of factors independent of tax code, such as housing costs and other costs of living.

## Conclusion

States compete vigorously to attract and retain new business. For example, of the 238 bids submitted to Amazon for its second North American headquarters, 26 came from Massachusetts. In its HQ2 request for proposals, Amazon was explicit in underscoring that it considered "a stable and business-friendly environment and tax structure... high priority considerations for the Project."<sup>26</sup> Governments understand that economic levers available to them can be pushed and pulled in such a way as to make each state's business climate attractive to growing companies. But no matter what incentives may be offered to promote Massachusetts, a looming tax hike could only work to negate them.

As discussed in the previous section, such considerations are not limited to national and global companies. Small businesses and start-ups seek the very same features.

Massachusetts is largely reliant on investors and business innovators to maintain and grow its economy. The IRS migration of wealth data shows a marked contrast between high- and low-tax states, especially among high-income taxpayers. Massachusetts stands to lose even more AGI to the no-tax states of New Hampshire and Florida. Why then, would the public want to drive them away or give them a reason not to reside here in the first place? Proposition 80 will do just that.

Massachusetts leads the nation in K–12 education, world-class healthcare and has some of the best colleges in the world in addition to vast parklands, ski resorts and a beautiful coastline. These have long helped attract and retain innovators and investors who keep the state's economy vibrant. Yet relying on the strength of these attributes to offset misguided tax policy

**When coming out of recessions, it is the birth of new Massachusetts' start-ups — not expansions of existing business — that account for the lion's share of new jobs.**



**Voters should think long and hard before adopting a permanent change that establishes the nation's second-highest combined state-federal tax rate.**

puts the state at long-term risk and at the very least makes Massachusetts a less attractive place for entrepreneurs and the financial entities that back them. The healthiest way to

grow state revenue is to grow the economy, and that means fostering a business climate that incentivizes investors and innovators, not one that targets them.

Massachusetts voters should think long and hard before adopting a permanent constitutional change that establishes the combined the state

and federal tax rate as the second highest in the nation for those subject to the 4 percent surcharge. In the short-term,

the progressive activists and unions that are advancing Proposition 80 are very likely to be right that passage will produce net revenue notwithstanding out-migration of high-income taxpayers.

But this short-term thinking becomes highly questionable over time, as businesses of all kinds choose to contract here and expand elsewhere, and small businesses and entrepreneurs choose to make their first- or second-stage plans elsewhere. The impact of the ballot initiative on the income tax rate is only exacerbated by Massachusetts' additional disadvantage as the only state in the nation that taxes short-term capital gains including sale of stocks, businesses and property. This is important to investors as the marginal rate would be 16 percent on these short-term capital gains under Proposition 80.

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## Appendix A

What follows is the data associated with Figure 1.

### AGI migration experienced by no-tax and high-tax states, 2011–12 to 2014–15

State	State highest tax rate	Total In returns \$200K+ 2011–15	Total in-AGI \$200K+ 2011–15	AVG AGI of In-Migrating taxpayer with \$200K or more income	Total out returns 2011–15	Total out AGI 2011–15	AVG AGI of Out-Migrating taxpayer with \$200K or more income	Net migration returns \$200K and more AGI 2011–2015	Net Migration AGI (\$200+ AGI) 2011–15	Net Migration AGI (\$200K or less AGI) 2011–15	Net Migration AGI (All AGI) 2011–15
AK	0.00%	1,122	\$434,236	\$387.020	1,830	\$702,167	\$383.698	(708)	-\$267,931	-\$752,662	-\$1,020,593
FL	0.00%	56,093	\$46,011,516	\$820.272	25,740	\$18,014,754	\$699.874	30,353	\$27,996,762	\$10,870,531	\$38,867,293
NV	0.00%	7,512	\$5,927,773	\$789.107	4,795	\$2,740,918	\$571.620	2,717	\$3,186,855	\$1,256,310	\$4,443,165
NH	0.00%	3,503	\$1,887,689	\$538.878	2,838	\$1,831,740	\$645.433	665	\$55,949	\$175,032	\$230,981
SD	0.00%	1,226	\$629,860	\$513.752	917	\$575,879	\$628.003	309	\$53,981	\$234,916	\$288,897
TX	0.00%	39,336	\$22,548,121	\$573.218	30,759	\$16,013,255	\$520.604	8,577	\$6,534,866	\$10,844,401	\$17,379,267
WA	0.00%	13,897	\$7,322,972	\$526.946	11,701	\$5,366,033	\$458.596	2,196	\$1,956,939	\$2,199,886	\$4,156,825
WY	0.00%	1,263	\$11,326,755	\$8,968.135	1,223	\$729,168	\$596.213	40	\$732,488	-\$86,119	\$646,369
<b>Total</b>		<b>123,952</b>	<b>\$96,088,922</b>	<b>\$775.211</b>	<b>79,803</b>	<b>\$45,973,914</b>	<b>\$576.093</b>	<b>44,149</b>	<b>\$40,249,909</b>	<b>\$24,742,295</b>	<b>\$64,992,204</b>
CA	13.30%	44,153	\$23,949,900	\$542.430	48,809	\$32,643,472	\$668.800	(4,656)	-\$8,693,572	-\$1,867,005	\$10,560,577
OR	9.90%	6,441	\$2,617,767	\$406.422	5,008	\$2,314,570	\$462.175	1,433	\$303,197	\$1,557,803	\$1,861,000
MN	9.85%	5,531	\$2,941,642	\$531.846	7,915	\$4,674,717	\$590.615	(2,384)	-\$1,733,075	-\$981,918	-\$2,714,993
IA	8.98%	2,365	\$1,065,371	\$450.474	2,988	\$1,352,290	\$452.574	(623)	-\$286,919	-\$336,188	-\$623,107
NJ	8.97%	18,670	\$9,865,099	\$528.393	26,101	\$15,510,587	\$594.253	(7,431)	-\$5,645,488	-\$4,025,388	-\$9,670,876
DC	8.95%	4,194	\$2,078,147	\$495.505	6,114	\$3,258,983	\$533.036	(1,920)	-\$1,180,836	-\$502,536	-\$1,683,372
VT	8.95%	1,245	\$567,313	\$455.673	1,100	\$671,080	\$610.073	145	-\$103,767	-\$115,505	-\$219,272
NY	8.82%	25,805	\$19,154,767	\$742.289	46,908	\$28,379,994	\$605.014	(21,103)	-\$9,225,227	-\$10,391,340	-\$19,616,567
<b>Total</b>		<b>108,404</b>	<b>\$62,240,006</b>	<b>\$574.149</b>	<b>144,943</b>	<b>\$88,805,693</b>	<b>\$612.694</b>	<b>(36,539)</b>	<b>-\$26,565,687</b>	<b>-\$16,662,077</b>	<b>-\$43,227,764</b>

## About Pioneer

Pioneer Institute is an independent, non-partisan, privately-funded research organization that seeks to change the intellectual climate in the Commonwealth by supporting scholarship that challenges the “conventional wisdom” on Massachusetts public policy issues.

