

Proposition 80 Will Not Raise \$2 Billion and The Money Won't Be Free

By Gregory Sullivan

Introduction

This November, Massachusetts voters are scheduled to vote on a ballot measure that would amend the state constitution by adding a 4 percent tax on annual taxable income of over \$1 million. Proponents of Proposition 80 call it a “millionaires” tax, but the economic impact of approving the initiative would have much wider impacts on the state economy than just getting the wealthy to pay their fair share. A closer look shows that it could disrupt the migration patterns of both wealthy individuals and small businesses.

Tax rates have a significant impact on where businesses and affluent individuals choose to locate, and the effect of those location decisions can be felt throughout the economy, affecting far more than just a wealthy few. If just a handful of the wealthiest taxpayers were to leave as a result of adopting the proposed amendment, Massachusetts would reap far less than the anticipated amount of revenue from the surtax and hurt countless numbers of Massachusetts residents who are far from being millionaires.

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 over the past four years while states with the high taxes have suffered. This is demonstrated by comparing net migration of adjusted gross income (AGI) in the eight states with no income tax to 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.¹ 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.



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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 \$44.23 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.

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 Internal Revenue Service does not currently report data on 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

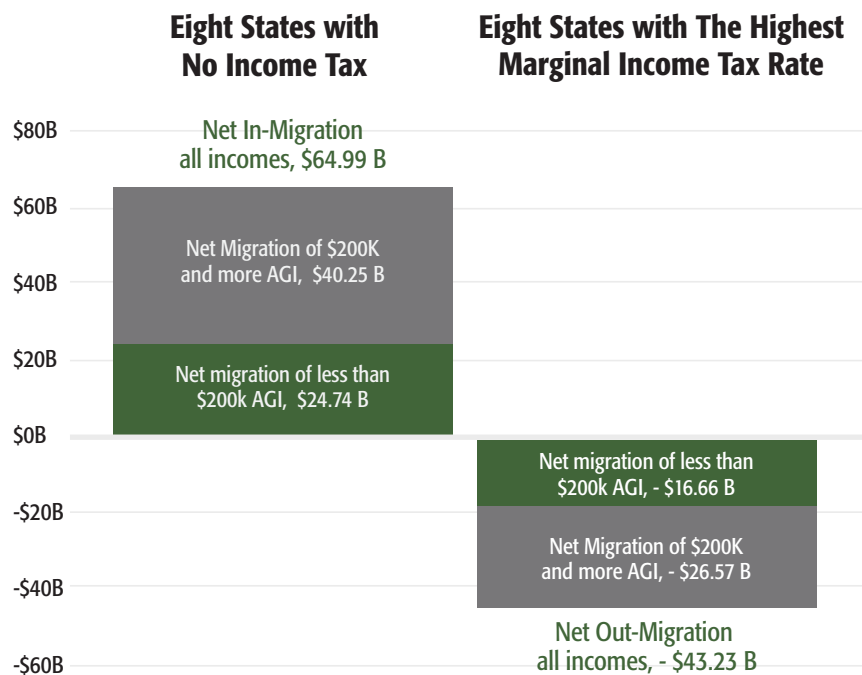
publicly available with which to measure state-to-state migration of “millionaires.”

A very worthwhile resource periodically promulgated by the IRS concerns tax payments of ultra-high AGI taxpayers nationally.² A review of this data should raise concerns in the debate about millionaire migration because it sheds light on what can happen if just 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 0.001 Percenters: In tax year 2014, 1,396 taxpayers (the wealthiest one-thousandth of 1 percent in the U.S) had a total AGI of \$207.1 billion and average AGI of \$148.4 million. These taxpayers paid \$49.7 billion in total federal taxes that year, an average of about \$35.6 million at an average taxable rate of 24.01 percent. Hypothetically, if Massachusetts has 1/50th of these 0.001 percenters, 28 taxpayers with an average AGI of \$148.4 million would pay \$5.9 million on average in millionaires’ tax and \$7.5 million in base (5.1 percent) income tax, for a total of approximately \$13.5 million in state tax. As a group, they would pay \$164.6 million in Proposition 80 tax and \$375.9 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 \$13.5 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 \$10,000 limit on itemized state income

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



tax deductions on federal personal income tax returns, thereby enhancing the tax advantage of relocating to a state with no income tax for ultra-high-income taxpayers.

The 0.1 Percenters: In 2014, 139,562 taxpayers (the wealthiest one-tenth of 1 percent in the U.S.) had total AGI of \$986.1 billion and an average AGI of \$7.1 million. These 139,562 taxpayers paid \$272.8 billion in total federal taxes in tax year 2014, an average of nearly \$2 million at an average taxable rate of 27.67 percent. If Massachusetts has 1/50th of these top 0.1 percent individuals, that would translate to 2,791 taxpayers with an average AGI of \$7.1 million paying \$242,621 on average in millionaires' tax and \$360,341 in base (5.1 percent) income tax, an average total of \$602,962 in state tax. As a group, they would pay \$1 billion in 5.1 percent state income tax and \$677.2 million in Proposition 80 tax for a total of \$1.7 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 (DOR), 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 billion of the estimated \$1.9 billion in total expected revenues from Proposition 80.³ Although they represent only 4.6 percent of those subject to the new tax, they would be obligated to provide 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 taxpayers subject to the tax, Proposition 80 revenue would drop by as much as \$334 million annually, accompanied by a loss of the as much as \$441.1 million annually in regular state income tax they pay.⁴ Thus, the out-migration of just 299 of Massachusetts highest-income taxpayers would decrease the estimated net tax revenue from Proposition 80 from \$1.9 billion to \$1.1 billion. DOR 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.⁵

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 26th to between the second and fourth 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 in building renovations, for example, is not deductible as an expense, but must instead 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 is not deductible as an expense. This creates a tax consequence whereby the taxpayer owes taxes on paper profits that he or she did not receive, but were instead spent on the purposes cited. 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 business-friendly states 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.

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.

As John Friar and Megan Gay demonstrated in *Failure to Thrive*⁶, 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.⁷⁽⁸⁾

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.⁹ 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.¹⁰ 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

State tax rates matter when it comes to where businesses choose to locate and where wealthy taxpayers choose to live. States with lower tax rates are at a distinct advantage when it comes to attracting and retaining both.

From 2011–12 to 2014–15, the eight states with no income tax saw a net positive migration of adjusted gross income of \$65 billion, more than 60 percent of which came from the small percentage of taxpayers with annual adjusted gross incomes (AGIs) of \$200,000 or more. Conversely, the eight states with the highest marginal income tax rates experienced negative AGI migration of \$44.23 billion during that period, with more than 60 percent again resulting from the relatively small number of migrants with annual incomes of \$200,000 or more.

According to Massachusetts Department of Revenue data, the majority of the tax revenue Proposition 80 is expected to generate would come from just 897 of the 19,565 taxpayers who would be subject to the tax. Over time, if even a third of those 897 chose to move, annual revenue from the measure would fall from an anticipated \$1.9 billion to \$1.1 billion.

Proposition 80 is a direct threat to business and job creation in Massachusetts. 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. Proposition 80 would make Massachusetts far less competitive by raising the combined federal/state tax rate on partnership and sub-S corporations from 26th to between the second and fourth highest in the U.S. The threat extends to large, medium and small businesses alike. The negative impact on small businesses is especially troubling as small businesses not only account for just under half of total employment in Massachusetts, but they play an essential role in the state's economy when it is coming out of a recession.

The examples of three Massachusetts businesses described above also highlight how passage of Proposition 80 would create a strong financial incentive for them to leave the Commonwealth. While proponents tout Proposition 80 as a painless way to generate additional state revenue, the negative impacts of its adoption would ripple throughout the state economy.

Endnotes

1. New Hampshire and Tennessee have a 5.0 percent state tax on interest and dividend income but not on other income.
2. <https://www.irs.gov/pub/irs-soi/soi-a-ints-id1704.pdf>
3. Massachusetts Department of Revenue estimate of revenue from proposed surtax, spreadsheet "Affected Filers 9-24-2015"; Norton, Michael P. "Proposed 'Millionaire's Tax' May Push Wealthy To Move Out Of Mass., New Analysis Finds," State House News Service, June 12, 2017. Note: Massachusetts Department of Revenue estimates that 19,565 taxpayers will be affected by the proposed surtax while Internal Revenue Service data indicates that 16,100 Massachusetts tax returns had AGI of \$1 million or more in tax year 2015.
4. Note: this presumes that all of the taxpayers' income would no longer be subject to Massachusetts income taxes.
5. Massachusetts Department of Revenue. <https://www.documentcloud.org/documents/2839106-Raise-Up-Mass-Impact-Memo-FINAL.html>
6. <http://pioneerinstitute.org/download/heading-down-the-loss-of-massachusetts-headquarters/>
7. <http://blog.indeed.com/2016/09/01/annual-survey-entrepreneurs-results/>
8. <http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.28.3.3>
9. https://www.census.gov/library/visualizations/2016/comm/cb16-148_entrepreneurs.html
10. <http://blog.indeed.com/2016/09/01/annual-survey-entrepreneurs-results/>

