PIONEER OPPORTUNITY

The Graduated Income Tax Trap:
A retirement tax on small business owners

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Introduction

In recent decades, Massachusetts policymakers have worked hard to shed the "Taxachusetts" label that plagued the Commonwealth into the 1990s. Once at 6.25 percent, the state income tax had fallen to 5 percent by 2020, while corporate tax rates have been flat.[1] Massachusetts tax policy has prioritized stability and predictability so far in the 21st century. But since 2015, a graduated income tax proposal has sought to undermine those priorities under the guise of a "fair" tax only on the super-wealthy.

Despite its purported goal of taxing only the uber-rich, the graduated income tax would fail to protect people of more modest means from overtaxation on one-time windfalls. It has the ability to push those with significant capital gains and valuable asset sales into higher tax brackets, punishing owners of retirement nest eggs and desirable real estate. In practice, these "one-time millionaires," who cash in on a lifetime of work and sacrifice in anticipation of retirement, outnumber those who consistently have seven-figure salaries or stock market windfalls.

Further, because of the tax treatment of pass-through business income, many of these "one-time millionaires" could be small business owners still reeling from the economic effects of COVID-19. Now, in the midst of the pandemic and its potentially devastating aftermath, is not the time to burden small business owners, the core of the state's economy.

What is the Graduated Income Tax?

For the past several years, Massachusetts has been considering a state constitutional amendment that would levy a four percent surtax on annual personal income over $1 million. The first attempt to do so, filed by initiative petition, failed a Massachusetts Supreme Judicial Court challenge in 2018 before re-emerging as a legislative petition and receiving initial approval at a constitutional convention in 2019. A vote on final approval by the legislature is expected in the spring of 2021. If passed, it will appear on the statewide ballot in the fall of 2022.

Proponents of the amendment, led by the Massachusetts Teachers Association and the Service Employees International Union, together with advocacy and religious groups, call it the "Fair Share Amendment," a nod to their frequent assertions that the measure would require only the very wealthy to pay what proponents believe is their "fair share" of taxes.

Opponents argue that it would endanger the long-term economic well-being of Massachusetts by prompting high-income residents and businesses to relocate to states that have lower income tax rates and discouraging high-income individuals and businesses from coming to Massachusetts in the first place. They believe that COVID-19 may exacerbate these relocation effects, as the pandemic has made telecommuting much more prevalent, at least in the short term.[2]

Who is a millionaire?

The proposed surtax may apply to hedge fund managers and technology magnates who earn salaries over $1 million annually, but would also constitute a 4 percent surtax on investors and pass-through businesses with annual incomes of over $1 million. The tax's calculation of income is not limited to salary or wages; it includes one-time income from the sale of a business or home and other forms of capital gains, interest, dividends, partnership distributions, income from pass-through entities, and all other sources of income. At the individual level, the graduated income tax casts a wide net.

Higher taxes on capital gains hamper investment, reduce productivity, and ultimately slow down wage growth

Under the terms of the proposal, capital gains, which do not affect tax brackets on federal returns, can push a taxpayer into the higher Massachusetts bracket. In the case of the sale of a home or business, the proposal would amount to a substantial tax on retirement.

Many economists agree that higher taxes on capital gains hamper investment, reduce productivity, and ultimately slow down wage growth.[3] A study by Nobel laureate Robert Lucas estimates that if the U.S. eliminated its capital gains and dividend taxes, the capital stock of American plants and equipment would be 50 percent larger.[4]

The impact on small and pass-through businesses

Capital gains from pass-through businesses far out strip those associated with the financial services industry. In 2016, the Internal Revenue Service published its most recent comprehensive analysis on the topic, entitled "Sales of Capital Assets Data Reported on Individual Tax Returns, 2007–2012."[5] The report found that net capital gains from pass-through businesses during this period were by far the largest source of capital gains reported by taxpayers on individual tax returns, totalling $1.25 trillion, which is 49.8 percent of all capital gains. In comparison, total capital gains from the sale of stocks, mutual funds, and bonds were $511.44 billion, less than half as much, representing 20.3 percent of all capital gains. In addition, capital gains from the sale of ownership interest in partnership, S corporations, and estate and trust interests totaled an additional $183.8 billion.[6]

This data demonstrates that the proposed graduated income tax, if adopted, would be a tax on businesses, including small pass-through businesses as they attempt to recover from the COVID-19 economic recession in many sectors. For owners who are depending on gains from the sale of these businesses as their principal source of retirement funding, the graduated surtax proposal represents a tax on retirement income. Pioneer Institute will delve into the surtax's impact on pass-through businesses in greater depth in a future paper.

The impact on homeowners

The proposed surtax does not include a safeguard to prevent capital gains from the sale of a home, after exclusion of $250,000 for single filers or $500,000 for joint filers, on the sale of a principal residence or long-held small business property from pushing a taxpayer into the 9 percent tax bracket. This is contrary to how taxes are treated at the federal level, where capital gains cannot force a taxpayer into a higher bracket. The graduated income tax will thus ensnare many families few would consider to be "millionaires" who have large amounts of capital gains in a single year due to the sale of a long-owned home or small business.

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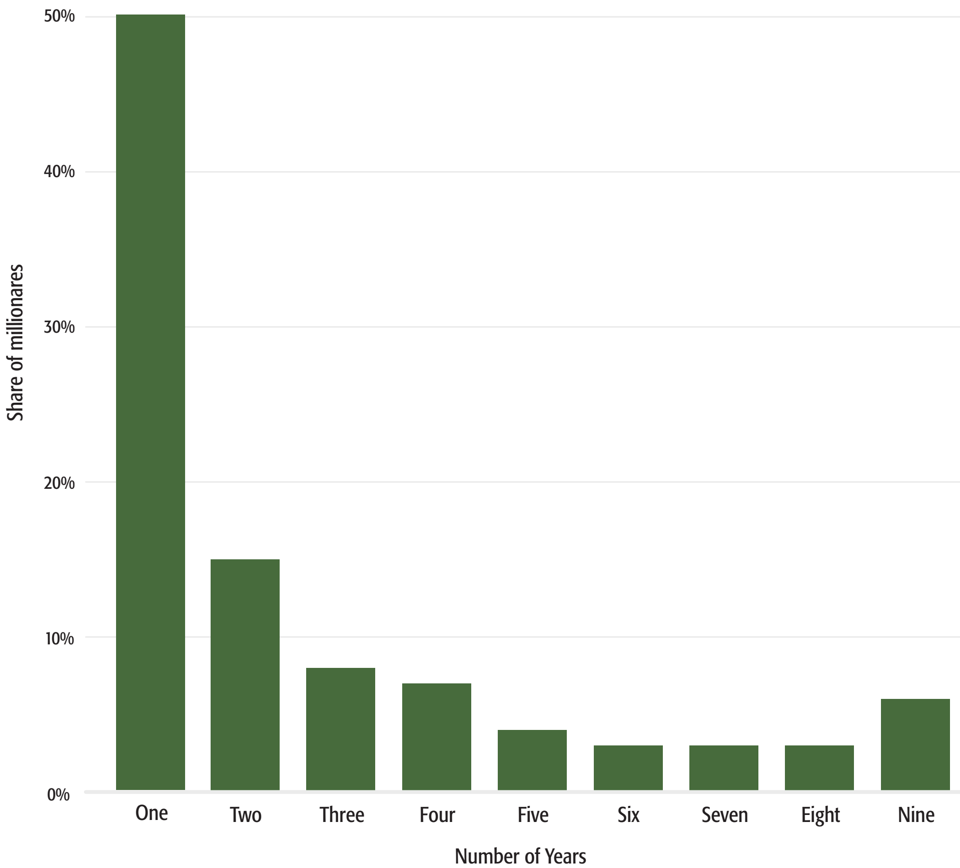
By including capital gains in the computation of annual income that exceeds the $1 million threshold, the graduated income tax effectively taxes the extraordinary escalation of Massachusetts housing prices that has occurred in recent decades. One example of such growth occurred in the city of Cambridge, where the median price of a single-family home has more than quadrupled in 24 years, from $327,000 in January 1996 to $1.47 million in January 2020, while the Consumer Price Index rose by 67 percent.[7] Seniors and small business owners who have owned their homes or business property for many years and are relying on decades of appreciation upon retirement will find themselves among those subject to the 4 percent surcharge, even if their ordinary income otherwise falls well below the million-dollar threshold.

The Retirement Tax

To understand who exactly would be affected by the so-called "Fair Share" tax proposed by the legislature at the behest of the MTA and the SEIU, it is critical to ascertain how often so-called "millionaires" earn $1 million or more in a year. Fortunately, the Tax Foundation's data on the persistence of millionaires allows us to do just that.

According to the Tax Foundation's "Income Mobility and the Persistence of Millionaires, 1999 to 2007," fully half of U.S. taxpayers who reported gross annual income of $1 million or more at least once over a nine-year period did so only once.[8] Nearly two-thirds did so two or fewer times, and almost three-quarters did so three or fewer times. Fewer than 20 percent did so in a majority of the nine years and fewer than 6 percent earned $1 million or more every year (see Figure 1).

Figure 1: Number of years from 1999-2007 in which the period's U.S. millionaires reported making over $1 million[9]



This data exposes a potential vulnerability of the proposed graduated income tax, showing it to be more of a "retirement tax," as many people rely on recouping the value from home equity or a stake in a business to pay for their retirement. In fact, Massachusetts displays the very same concentration of "one-time millionaires." In the Commonwealth, 46 percent of households with incomes over $1 million did so only once in 10 years and fully 60 percent did so twice or less in the 10-year period ended in 2017 (see Figure 2).[10]

This data alone does not prove that many "millionaires" are retirees, or whether those who are using the income to pay for retirement try to avoid taxes on that income. However, other IRS data shows that after similar graduated income tax levies passed in other states, out-migration exploded among people of retirement age. The so-called "Fair Share" tax would apply to — and dampen the retirement plans of — a significant number of people who worked a lifetime and who are not consistent millionaires.

Many people rely on recouping the value from home equity or a stake in a business to pay for their retirement

In 2012, the same year California passed a significant tax hike on people making over $250,000, it lost about $87.2 million in adjusted gross (taxable) income ("AGI") from people of retirement age moving out of state. The next year, it lost a stunning $1.26 billion on net from these migrating seniors, more than a 14-fold increase compared to the previous year (see Figure 3).[11] In this age category, California maintained 9- and 10-digit AGI losses for every subsequent year on record through 2018. Meanwhile, notable retiree destination (and income-tax-free) Florida gained nearly $1.8 billion from migrating seniors in 2012, and as much as $5.2 billion in subsequent years, in a generally increasing pattern.

Figure 2: Number of years from 2008-2017 in which the period's Massachusetts millionaires reported making over $1 million[12]

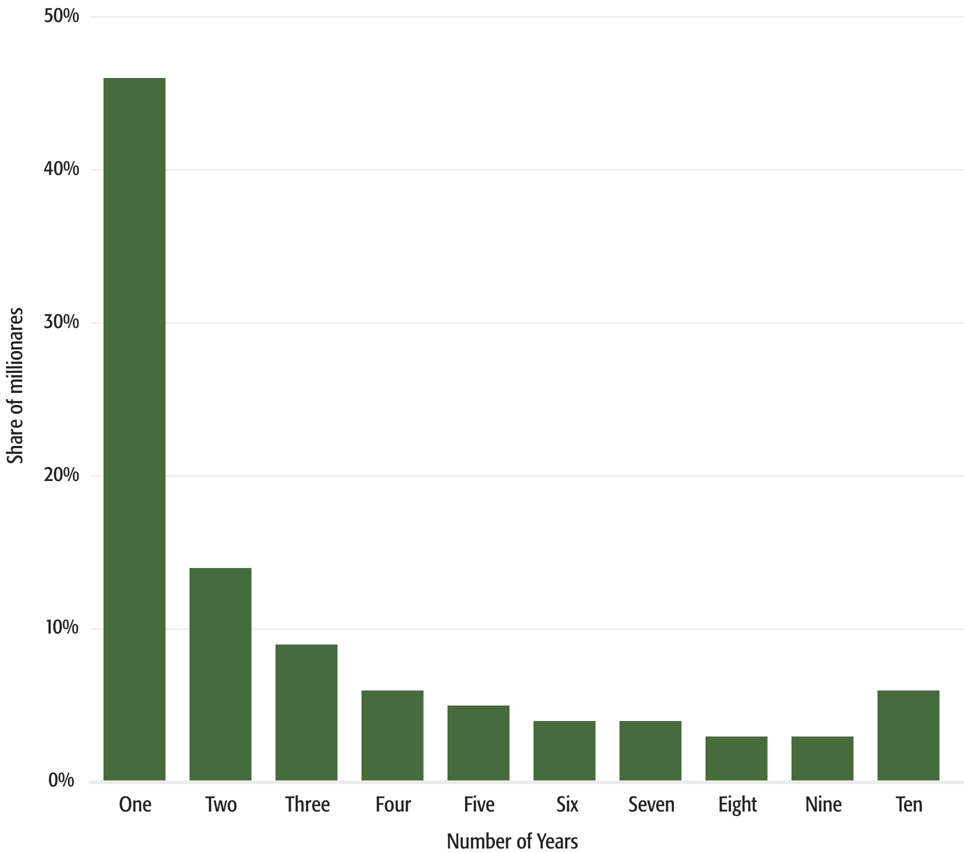
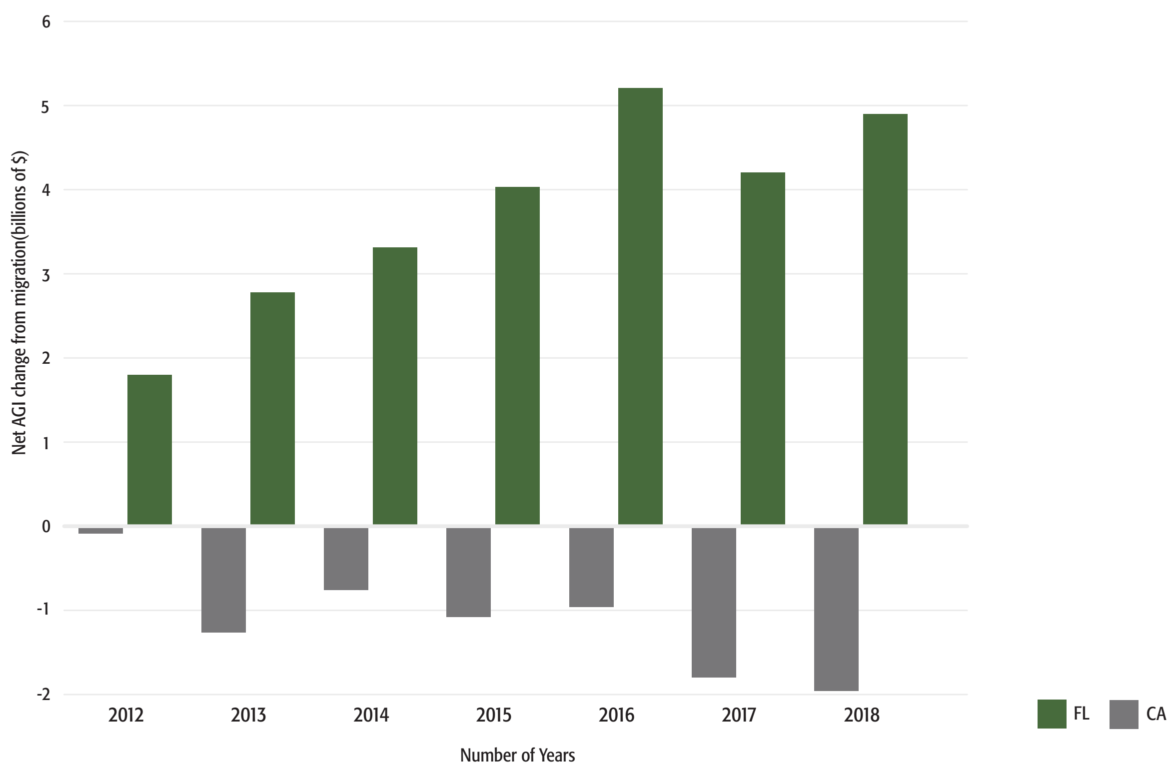


Figure 3: Net change in adjusted gross income from people ages 65 and up moving in and out of California and Florida, 2012-2018[13]



Conclusion

The bottom line is that individuals with consistent annual incomes of $1 million or more are not the only ones who will be subject to this "Fair Share" tax. Instead, included in Massachusetts' new top income tax bracket will be many middle class citizens who wisely invested in a business or real estate at the right time and merely want to remain comfortable in their old age by cashing in on those investments. Thus, the so-called "millionaires tax" is really a retirement tax for many who will be subject to it in a given year, and only in part a tax on the super-wealthy. Before the Massachusetts legislature moves this constitutional amendment forward, the following facts must be considered:

The "Fair Share" tax is anything but fair to many retirees

1. The graduated income tax proposal will take a significant bite out of the retirement nest eggs of many small business owners and longtime homeowners.
2. The surtax could hinder economic recovery efforts from COVID-19 by discouraging capital investment and making it harder for business owners to hire back workers.
3. A sizable plurality of Massachusetts million-dollar earners only have a seven-figure annual income once in a 10-year period, an indication that most people affected by the surtax will not be the uber-wealthy technology magnates and hedge fund managers usually associated with the term "millionaire."
4. When California levied a similar tax hike on high income earners in 2012, it experienced a 14-fold increase in annual net taxable income losses due to seniors leaving the state, amounting to nearly $1.3 billion in 2013 alone. In 2018, this number had still failed to return to pre-tax hike levels.

Without subjecting the graduated income tax proposal to further scrutiny, the Massachusetts legislature risks significantly damaging the economy, spurring cycles of capital disinvestment and lower productivity that reach all corners of the states, and destabilizing the budgets of both the state government and countless senior citizens.

Endnotes

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