

The SALT Cap: An Accelerator for Tax Flight from Massachusetts

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Introduction

When Congress enacted the Tax Cuts and Jobs Act of 2017 (TCJA), it altered the economic landscape surrounding the surtax petition that Massachusetts voters will consider in November 2022. The TCJA placed a \$10,000 limit on deductions of state income and local property taxes (SALT) on federal individual tax returns, effective for tax years 2018 to 2025. By limiting the deductibility of state and local taxes on federal tax returns, the TCJA effectively raised taxes on many high-income filers who itemize deductions.

Notably, much of the existing literature that claims the wealthy do not move in response to tax changes predates the TCJA, which, by capping the SALT deduction, has given those who itemize deductions a stronger incentive to leave high-tax jurisdictions. When proponents advanced the surtax in 2015, they did so before adoption of the federal SALT limitation. Despite this momentous change to the federal tax code and its potential to exacerbate the impacts of a tax hike in Massachusetts, the surtax amendment language remained unchanged between the original 2015 version submitted by Raise Up Massachusetts and the 2018 version filed by members of the Massachusetts Legislature.

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What is the Graduated Income Tax?

For the past several years, Massachusetts has been considering a state constitutional amendment that would levy a 4 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. The state legislature granted final approval in June 2021, and the proposal 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 personal income tax rates and discouraging high-income individuals and businesses from coming to Massachusetts in the first place. Opponents also believe that COVID-19 may exacerbate these relocation incentives, as the pandemic has made telecommuting much more prevalent, at least in the short term.¹

A Whole New Tax Form

The SALT limitation came into effect in tax year 2018 in the form of two new lines, 5(d) and 5(e), on I.R.S. Schedule A (Form 1040). In line 5(d), taxpayers enter the total taxes paid, including state and local income taxes, sales taxes, real estate taxes, and personal property taxes. In line 5(e), taxpayers enter the smaller of line 5(d) or \$10,000, as shown in Figure 1. Taxpayers with adjusted gross incomes (AGI) in excess of \$1 million paid an average of \$284,050 in state and local taxes in 2018. The SALT limitation reduces their deductions to \$10,000 (see Figure 1).

IRS data demonstrate the financial impact of the SALT limitation. Prior to passage of the TCJA, U.S. taxpayers took \$624.1 billion in SALT deductions on federal returns, an average of \$13,395 per return. In tax year 2018, taxpayers took \$147 billion in SALT deductions, a drop of 76.4 percent in total deductions, with an average deduction of \$8,432 per return (see Figure 2). The number of U.S. taxpayers claiming itemized SALT deductions dropped from 46.6 million in tax year 2017 to 17.4 million in tax year 2018, with a corresponding increase in taxpayers claiming the increased standardized deduction authorized by the TCJA.²

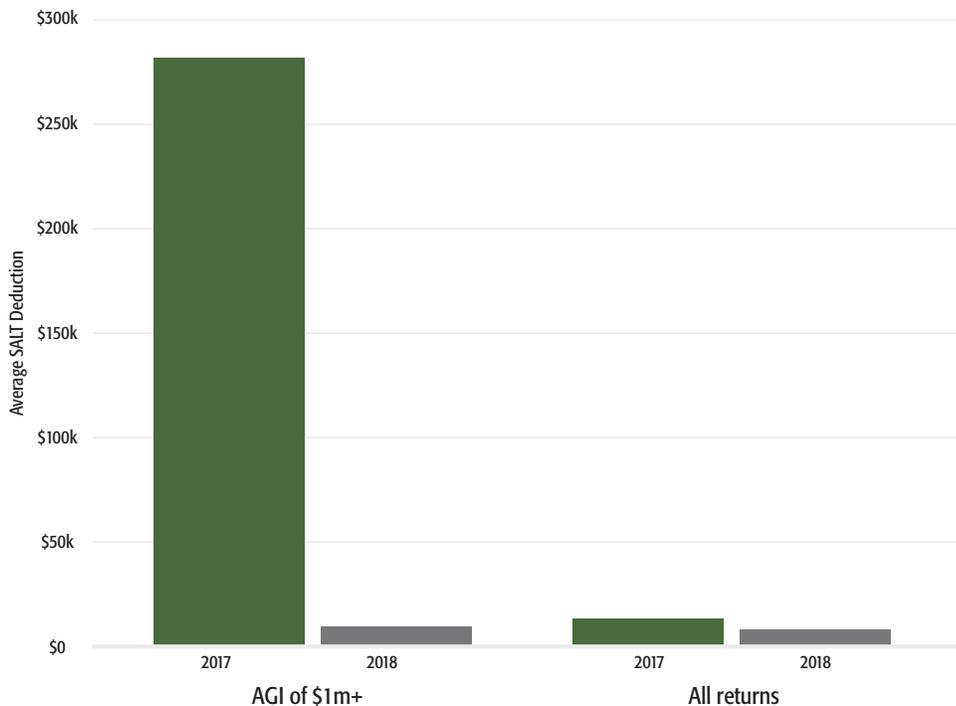
Figure 1: Example of revised Schedule A including \$10,000 SALT limitation, introduced in tax year 2018³

SCHEDULE A (Form 1040) Itemized Deductions		2018	
Medical and Dental Expenses 1 Medical and dental expenses (see instructions) 1 2 Enter amount from Form 1040, line 7 2 3 Multiply line 2 by 7.5% (0.075) 3 4 Subtract line 3 from line 1. If line 3 is more than line 1, enter 0 4		Your social security number 555-55-5555	
Taxes You Paid 5 State and local taxes: a State and local income taxes or general sales taxes. You may include either income taxes or general sales taxes on line 5a, but not both. If you elect to include general sales taxes instead of income taxes, check this box. <input type="checkbox"/> 5a 256,454 b State and local real estate taxes (see instructions) 5b 26,505 c State and local personal property taxes 5c 1,091 d Add lines 5a through 5c 5d 284,050 e Enter the smaller of line 5d or \$10,000 (\$5,000 if married filing separately) 5e 10,000 6 Other taxes. List type and amount: 6 0 7 Add lines 5a and 6 7 30,000		NEW LINES	

While the SALT limitation reduced the average deduction of all taxpayers who itemized SALT deductions by 37.1 percent from \$13,395 to \$8,432, it had a much greater impact on high-income taxpayers. Prior to passage of TCJA, U.S. taxpayers with adjusted gross incomes (AGIs) of \$1 million or more took SALT deductions totaling \$128.3 billion on federal returns, an average of \$281,916 per return. After the SALT limitation took effect in tax year 2018, these taxpayers’ total SALT deductions dropped by 96.9 percent to \$4 billion, an average of \$9,856 per return. The number of U.S. taxpayers with AGI over \$1 million claiming itemized SALT deductions dropped from 455,310 in tax year 2017 to 406,120 in tax year 2018, with a corresponding rise in taxpayers claiming the increased standardized deduction authorized by the TCJA.⁴

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Figure 2: Average SALT deduction taken before and after enactment of TCJA by income category



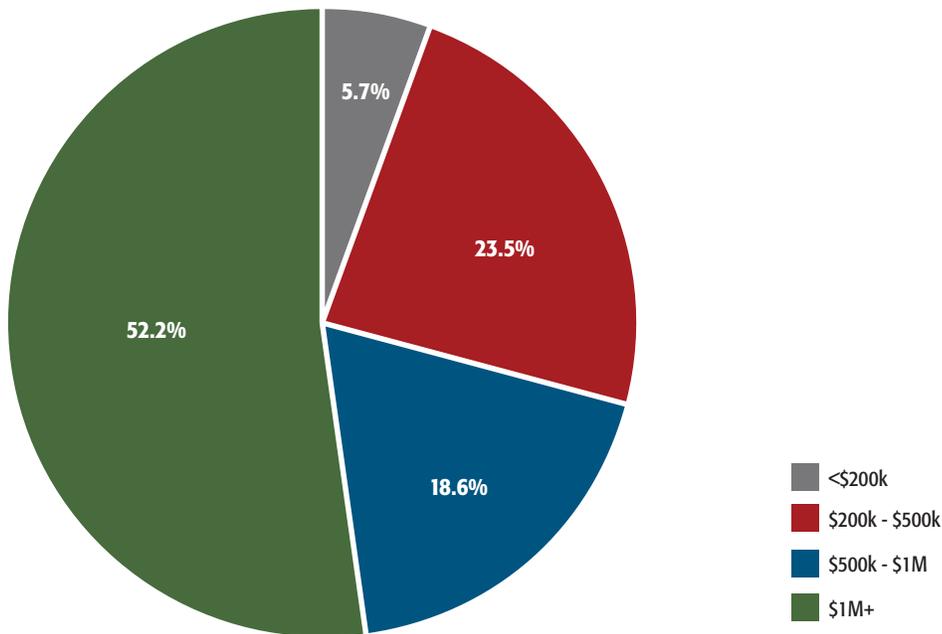
Source: IRS, Individual Income Tax Returns Complete Report, Tax Years 2017 and 2018. Table 2.1. <https://www.irs.gov/pub/irs-pdf/p1304.pdf>. Pioneer Institute analysis

Figure 2 compares the average SALT deduction taken by U.S. taxpayers who itemized deductions in tax years 2017 and 2018 with the average SALT deduction taken by taxpayers with AGIs of \$1 million or more in tax years 2017 and 2018.⁵

In 2017, before the TCJA became effective, 97.6 percent of 18,090 Massachusetts taxpayers with AGIs of \$1 million or more took deductions for state and local taxes totaling \$4.02 billion, an average of \$227,471 per return. Once the TCJA became effective in tax year 2018, 75.9 percent of 20,040 Massachusetts taxpayers with AGIs of \$1 million or more took deductions for state and local taxes, while the others opted to take the standardized deduction. Of the high-income taxpayers who itemized deductions, total SALT deductions dropped from \$4.02 billion in tax year 2017 to \$152 million in tax year 2018, a reduction of 96.2 percent. The average SALT deduction dropped from \$227,471 to \$9,984.

In June 2019, the Joint Committee on Taxation of the U.S. Congress estimated that 52.2 percent of the negative tax impact of the SALT limitation is borne by taxpayers with AGIs of \$1 million or more, \$40.4 billion of the total of \$77.4 billion (see Figure 3).⁶

Figure 3: Share of tax burden from SALT limitation by income category, Tax Year 2019



Source: Joint Committee on Taxation of the U.S. Congress. Analysis by Pioneer Institute.

The Political Fallout

A large contingent of congressional Democrats, predominantly from states most adversely impacted by the SALT limitation, has been working to repeal it, but it won't happen without a fight, according to Jonathan Traub, tax policy leader of the national tax practice at Deloitte Tax LLP. "Progressives say that full SALT deductibility is a giveaway to the wealthiest of the wealthy, while governors cry about wealthy residents leaving their states and losing their tax base."⁷ In April 2021, seven governors of high-tax states signed an open letter urging President Biden to remove the Tax Cuts and Jobs Act's cap on the SALT deduction.⁸

Larry Summers, former U.S. Treasury Secretary and former president of Harvard University, warned on April 9, 2021 that New York's proposed millionaire's tax will send the state into a downward spiral without congressional repeal of the SALT limitation.⁹ This likely alludes to the economic and fiscal impact of the tax base erosion, revenue volatility, and disinvestment associated with such tax increases.

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Massachusetts is already acknowledged as being one of the states most affected by the SALT limitation. According to a study published by the Rockefeller Institute of Government, Massachusetts had the fourth worst “SALT burden” among the 50 states and D.C. in tax year 2019.¹⁰ A UMass Donahue Center study concluded that the \$10,000 cap on deductibility under the TCJA “will make it more difficult for Massachusetts to maintain their prior tax structures. Massachusetts will face greater tax competition from lower-tax neighboring states, particularly New Hampshire. The most productive areas ... are particularly hard hit. The result will be a decline in national competitiveness.”¹¹

Other states, however, may have something to gain from the SALT deduction cap. According to Florida real estate developer Nitin Motwani, “SALT has been the number one theme when we speak with finance companies about relocating or opening branch offices in Miami.”¹² In January 2020, a Bank of America analysis found that lower-tax states gained \$32 billion more in adjusted gross income than higher-tax states in 2018, nearly twice the average amount since 2005.¹³ *Financial Advisor Magazine* later called the Bank of America report the “hardest evidence yet” that the 2017 tax cuts, and specifically the SALT deduction cap, are disproportionately hurting states like Massachusetts and New York.¹⁴

Bloomberg News reported on July 28, 2021 that New York City Democratic mayoral nominee Eric Adams has grave concerns over the SALT limitation. Adams “told a group of House lawmakers that the limit on the state and local tax deduction enacted in 2017 is a top issue harming the city, according to two congressional aides familiar with the conversation.”¹⁵

According to Roll Call, many Democrats support a compromise with partial SALT cap relief being included in the fall 2021 budget reconciliation bill.¹⁶

CNBC reported in June 2021 that two compromise proposals appear to be gaining momentum. One establishes an income threshold to allow taxpayers with incomes of less than \$400,000 to take an unlimited SALT deduction and those making more than \$400,000 to take no more than \$10,000 in SALT deductions. The other raises the \$10,000 limit on SALT deductions to \$20,000 or \$25,000.¹⁷ If either of these compromises prevails, it would do little to change the impact of the SALT cap on the proposed Massachusetts surtax.

The SALT limitation has met both friend and foe across the aisle. When President Biden entered office, some presumed the administration would attempt to repeal the SALT limitation.¹⁸ However, it is uncertain whether this will happen, as SALT cap relief comes with a heavy price tag, especially as the Biden administration is aiming to bolster environmental and social-welfare programs.¹⁹ Experts hypothesize that a partial repeal is the most likely course of action for the immediate future.²⁰ As of this writing, Congress has not passed legislation repealing or amending the SALT limitation.

While efforts to address the impact of the SALT cap at the federal level are uncertain, Massachusetts, along with other states, is establishing a workaround to the SALT limitation for pass-through entities. On July 16, 2021, Governor Baker signed the FY 2022 Massachusetts budget, which included outside Section 39 — entitled “Taxation of Pass-Through Entities” (PTEs), which he returned to the legislature unsigned.²¹

Section 39 is intended to lessen the impact of the \$10,000 SALT cap on federal taxes paid by Massachusetts taxpayers who report income from PTEs. These entities can include S corporations, partnerships, and LLCs. Under Section 39, an eligible PTE may elect to pay an excise on its income taxable in Massachusetts at a rate of 5 percent, qualifying members to be eligible for a tax credit on Massachusetts tax returns equal to 90 percent of their share of excise paid by the PTE. Qualified members of PTEs include natural persons, trusts, and estates. Under Governor Baker’s proposal, the credit would be 100 percent of the excise paid.

Under the legislature’s version, if a PTE elects to use the Section 39 workaround, the Massachusetts Department of Revenue (DOR) will receive more in total revenue from the PTE and its members than it otherwise would have received. This is due to the PTE paying the excise, and members paying a 5 percent tax on the 10 percent of pass-through income that is not offset by the 90 percent tax credit. Therefore, DOR will receive a total of 5.5 percent of entity taxable income

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from PTEs electing to use the SALT cap workaround, 5 percent excise from the entity and 0.5 percent income tax from the member. That is, unless DOR determines that the entity-level tax payment reduces the owner's distributive share of income for MA tax purposes.

The Governor's proposed amendment was filed in the House of Representatives on August 5, 2021. As of this writing, the matter has not been taken up for further action.

In November 2020, the IRS issued an advisory greenlighting this SALT cap workaround. It announced that future IRS guidance would provide that taxes paid by a partnership or S corporation to a state, a political subdivision of a state, or the District of Columbia would be recognized as legitimate deductible expenses on PTE federal tax returns. This is applicable without regard to whether liability for the income tax is the result of an election by the entity, or whether shareholders receive a deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability.

The federal government does not require PTEs to pay federal taxes on net income; instead PTE members pay taxes on their proportionate share of income passed through by the PTE entity. By allowing a deductible expense at the entity level of a 5 percent excise paid to the Massachusetts DOR, the IRS effectively lifts the SALT cap on PTE income on federal tax returns. Analysis of Internal Revenue Service data from tax year 2018 show that 33.5 percent of the income of Massachusetts taxpayers with AGIs of \$1 million or more came from partnerships and S corporations.²²

The tax law changes that may be made by Section 39 of the FY2022 Massachusetts state budget do not diminish the amount of surtax payments Massachusetts taxpayers will owe DOR if state voters approve the graduated income tax. This is due to the language of the proposed amendment that states: "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."²³ Section 39 does not change the amount of taxable income that a pass-through entity is responsible to report to its members as their proportionate share of taxable income. It appears that neither the Section 39 tax credit nor the taxpayer's state tax liability are relevant to the proposed constitutional amendment because the additional 4 percent surtax is charged by calculating the total amount of annual taxable income, not the amount of taxes due on that income.

Two Tax Hikes Join Forces

While the proposed surtax would make Massachusetts' top nominal income tax rate the sixth highest in the nation, its effective tax rate could actually rank higher because of its high "SALT burden."²⁴

The previously unlimited SALT deduction essentially reduced aggregated tax paid by allowing taxpayers to deduct state taxes against federal income. According to the estimate made by the Massachusetts Department of Revenue prior to adoption of the federal SALT limitation, the average Massachusetts taxpayer who would become subject to the proposed surtax was expected to pay \$160,786 in state income taxes in 2019.²⁵ At the top federal tax rate of 37 percent, that taxpayer would have received an after-tax benefit of \$59,491 on his or her federal taxes as a result of the unlimited SALT deduction of \$160,786 of state income taxes paid by him or her (i.e. $37\% \times \$160,786 = \$59,491$).²⁶ This \$59,491 benefit had the effect of reducing the average state income tax paid by taxpayers in this income category, when aggregated with the federal SALT deduction, from \$160,786 to \$101,295. After the SALT limitation was capped at \$10,000, the average tax savings from the SALT deduction among those who itemize deductions dropped from \$59,491 to \$3,700, or 37 percent of \$10,000. Thus, the SALT limitation increased the average aggregate income tax paid by Massachusetts taxpayers with incomes of more than \$1 million from \$101,295 to \$157,086, after taking the SALT deduction into account. This represents the effect of the SALT limitation prior to consideration of the proposed surtax.

According to tax revenue estimates prepared by the Massachusetts DOR in 2015, the average state income tax paid by a taxpayer earning at least \$1 million in tax year 2019 was expected to increase from \$160,786 to \$254,355 if the surtax were enacted, an increase of 58.2 percent, not

Thus, the SALT limitation increased the average aggregate income tax paid by Massachusetts taxpayers with incomes of more than \$1 million from \$101,295 to \$157,086.

counting the deductibility of SALT payments on federal taxes.²⁷ But enactment of the SALT limitation has made the relative increase much larger, — 147.5 percent — when the TCJA’s cap on SALT deductions is included (see Figure 4).

Figure 4: Average net Massachusetts income tax among millionaires after federal tax savings due to the SALT deduction, 2019

	Pre-Surtax/ Pre-SALT Cap	Pre-Surtax/ Post-SALT Cap	Post-Surtax/ Pre-SALT CAP	Post-Surtax/ Post-SALT Cap
Average AGI of MA taxpayer with AGI of \$1M or more	\$3,407,240	\$3,407,240	\$3,407,240	\$3,407,240
Average MA income tax owed	\$160,786	\$160,786	\$254,355	\$254,355
Percentage increase in MA income tax on all income from amount due pre-surtax, pre-SALT cap	N/A	0.0%	58.2%	58.2%
Average tax savings due to SALT deduction (at 37% tax rate)	\$59,491	\$3,700	\$94,111	\$3,700
Average MA income tax less benefit of federal SALT deduction	\$101,295	\$157,086	\$160,244	\$250,655
Percentage increase in MA income tax on all income less benefit of federal SALT deduction from pre-surtax, pre-SALT cap	N/A	55.1%	58.2%	147.5%
Average MA income tax after SALT deduction as share of average AGI	3.0%	4.6%	4.7%	7.4%

DOR estimated that a total of \$47.1 billion of income would become subject to the surtax in tax year 2019 if the proposal were enacted.²⁸ This represented an average of \$2,407,240 of income per affected taxpayer who would owe, on average, \$96,290 in surtax payments. After enactment of the SALT limitation, these taxpayers were limited to a total of \$10,000 of itemized deductions for all state and local taxes, including state income taxes, real estate taxes, and personal property taxes.

The limitation of deductibility of SALT expenses may 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, amendments to the alternative minimum tax (AMT), and the repeal of the Pease limitation on itemized deductions.²⁹ However, unlike the SALT deduction cap, there’s not much evidence that these changes have disproportionately affected Massachusetts taxpayers, as opposed to those in other states. Thus, while the TCJA reduced federal tax obligations for most Americans, it also made Massachusetts a relatively less attractive place to live, work, and do business compared to other states.

As further evidence of how the SALT cap disadvantages Massachusetts, consider that in 2017, the value of the SALT deduction for Massachusetts taxpayers was equivalent to 6.5 percent of the state’s adjusted gross income, but to U.S. taxpayers it was just 5.6 percent of national AGI. By 2018, the Tax Cuts and Jobs Act had reduced these figures to 1.2 percent and 1.1 percent, respectively, much closer to parity.³⁰ Thus, what used to be a tax code provision that gave Massachusetts residents much more of a tax break than many other Americans now confers similar benefits to all. While this may be more fair, it could also make Massachusetts taxpayers more likely to leave under the graduated income tax, as the federal tax code now does little to mitigate the burden on residents of high-tax states.

Thus, while the TCJA reduced federal tax obligations for most Americans, it also made Massachusetts a relatively less attractive place to live, work, and do business compared to other states.

While the proposed tax increase would make Massachusetts' top nominal tax rate the sixth highest in the country at 9 percent, its effective tax rate could rank even higher because Massachusetts does not allow taxpayers to take many itemized deductions offered by the five states with higher nominal tax rates, i.e. California (13.3 percent), Hawaii (11 percent), New Jersey (10.75 percent), Oregon (9.9 percent), and Minnesota (9.85 percent).³¹ All the states with top income tax rates nominally higher than that of Massachusetts, except for New Jersey, allow taxpayers to itemize deductions. California, Hawaii, Oregon and Minnesota allow their taxpayers to deduct home mortgage interest and local property taxes, while Massachusetts does not.³² Oregon allows taxpayers a deduction of up to \$6,950 for federal income taxes paid in prior years, while Massachusetts does not.³³

Conclusion

After the authors of the proposed graduated tax in Massachusetts submitted their proposal for legislative approval in 2017, the federal government placed a \$10,000 limitation of deductibility of state and local taxes on federal tax returns. This unforeseen change in the federal tax code had the effect of turning what would have been a 58 percent increase in average state income tax payments among Massachusetts millionaires, from \$160,786 to \$254,355, into what is essentially a 147 percent increase when the federal SALT limitation is included in the calculation. This substantial change should be taken into consideration by voters when they contemplate approving the surtax proposal. As noted by prominent economist Larry Summers, a so-called millionaire's tax has the real potential to send a state into a downward spiral when exacerbated by the SALT limitation. Massachusetts has already been identified as the fourth hardest hit state by the SALT deduction. Doubling the average net income tax in Massachusetts, after taking into account the SALT deduction, risks following in the footsteps of states like Connecticut and Illinois, whose tax policies have contributed to perennial budget gaps and prolonged economic stagnation.

Acknowledgements

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This unforeseen change in the federal tax code had the effect of turning what would have been a 58 percent increase in average state income tax payments among Massachusetts millionaires, from \$160,786 to \$254,355, into what is essentially a 147 percent increase.

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Pioneer Institute develops and communicates dynamic ideas that advance prosperity and a vibrant civic life in Massachusetts and beyond.

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Success for Pioneer is when the citizens of our state and nation prosper and our society thrives because we enjoy world-class options in education, healthcare, transportation and economic opportunity, and when our government is limited, accountable and transparent.

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