September 23, 2013

After the Tech Tax Repeal: Remembering the Big Picture

This summer the Legislature acted to address a transportation funding crisis. The legislation that was enacted also made possible important, but modest, investments in public education. This legislation represented a broad consensus that maintaining quality infrastructure is crucial to our long term economic strength – and that we were facing a substantial and ongoing gap between the costs of maintaining our roads, bridges, subways, and busses and the revenue available within our existing tax structure. The Governor, and many others, also argued that investing in education – from early education through college – could create a much stronger foundation for a vibrant Massachusetts economy that would expand access to good jobs for more of our people. The legislation raised roughly $500 million in new taxes to support priority investments in transportation and education. It also raised additional revenue primarily from increasing tolls, public transportation fares, and other non-tax revenue sources.

It now appears likely that one major element of that tax package – the "tech tax" – will be repealed without being replaced by a new permanent revenue source. This will reduce by roughly $160 million the new tax revenue annually available to address long term transportation and education needs. The revenue remaining is well below the amount needed to fund core investments in transportation and education. While addressing those needs is now likely to be more of a long term than an immediate debate, it is important to remember the big picture: the ability to maintain our transportation infrastructure and make needed investments in education and other areas is critical to the future or our economy and our quality of life.

Finding a way to pay for those investments isn't easy – but it is important.

The package that the Legislature and Governor crafted together recognized that both residents and businesses benefit tremendously from a functioning transportation infrastructure and from a strong public education system. The package spread the costs of needed investments across both residents and businesses.

With the repeal of the tech tax the major remaining elements of the tax plan are tobacco and gas taxes. These taxes are good for public health and for the environment, but they are also taxes that generally require lower income people to pay a larger share of their income than higher income people. In thinking about new revenue sources, it is important to consider how overall costs are balanced between lower income people, higher income people, and businesses.

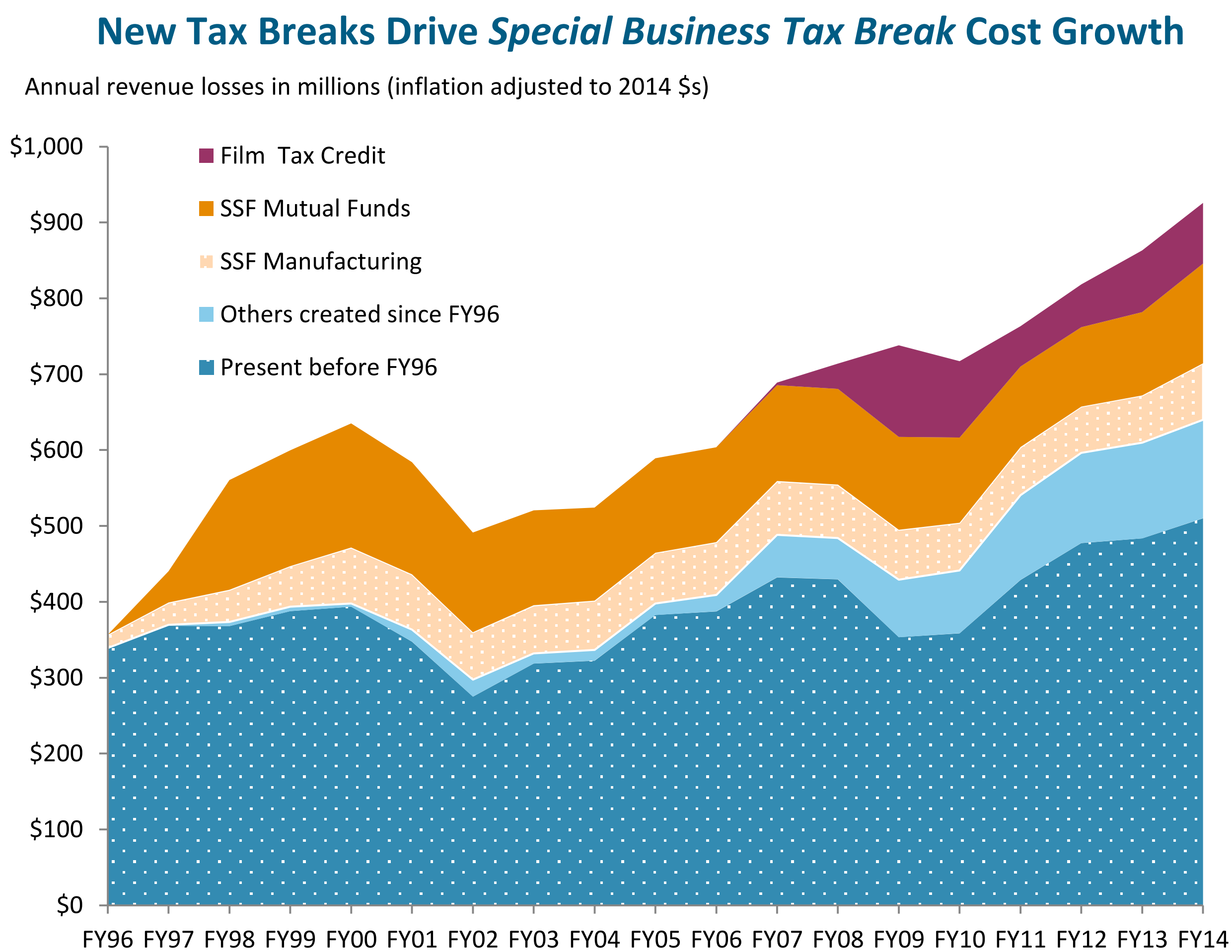
This Budget Brief examines a number of possible options for financing investments in our state's long term strength, organizing them into three broad categories:

- Reforming or eliminating special business tax breaks
- Reducing opportunities for tax avoidance
- Reexamining other major tax cuts of the past two decades

This is by no means an exhaustive list. Other researchers and participants in these debates surely have other ideas. Developing a plan to build and maintain needed transportation infrastructure, and support other investments that are important to our economy and our quality of life, will require the active participation of a broad spectrum of citizens and political and business leaders. It is likely to be a long term process. The ideas below aim to help move that debate forward. There are numerous arguments for and against each of these options – and one would want to examine a range of data carefully before making any decisions. The purpose of this Brief is not to evaluate each option in detail, but rather to identify options that should be carefully examined in the context of determining how to pay for needed investments.

REFORMING OR ELIMINATING SPECIAL BUSINESS TAX BREAKS

Over the past two decades Massachusetts has enacted a number of special business tax breaks. These are tax breaks that apply to specific industries or reward specific activities. Largely because of the enactment of new special business tax breaks, the cost of this category of tax breaks more than doubled between 1996 and 2014, rising from $357 million in FY 1996 to $926 million in 2014 (see http://www.massbudget.org/report_window.php?loc=business_tax_breaks.html).[1]



[1] The report at the link provided examines data through 2012. The numbers and chart in this briefing paper are taken from that August 2012 paper, but have been updated through 2014.

Much of this cost growth has been driven by three major industry-specific tax breaks enacted over the past 20 years: tax breaks for manufacturing companies, tax breaks for mutual fund companies and tax breaks for movie production companies. While of somewhat smaller scale than these three, in recent years the state also has been paying for a new life sciences tax break (included in category "Others created since FY96" in chart, above). These four tax breaks are briefly described below.

Single Sales Factor Apportionment for Manufacturing Companies

When multi-state companies engage in different types of activities in different states, state governments need to determine how much of a company's profits should be taxed in each state. The seemingly obvious answer might be "the profits should be taxed in the state in which they are earned." The problem is that it is not easy to answer that question. Imagine a car that is assembled in Indiana, with parts made in Ohio, overseen by management in Michigan, and sold in Massachusetts. If the sale of that car generates $2,000 in profits, in which state was that profit earned? The state where the work was done that created the value? The home state of the company? The state where the car was sold? There is no one right answer to that question.

Traditionally, state tax law across the country has worked from the premise that a multi-state company's profits can't be allocated by type of activity and rather should be apportioned by objective factors. The traditional formula uses three factors: property, payroll and sales. In that traditional formula each state averages the share of a company's national property, payroll and sales that occurred in the state and then taxes the company on that share of its national profits. In the 1990s, Massachusetts, and a number of other states, began using a one-factor apportionment formula for manufacturing companies. This one factor formula only considers sales. So, if a manufacturing company produces its goods in Massachusetts, benefitting from our infrastructure and our skilled workers, but sells those goods in other states, that company does not pay corporate income taxes in Massachusetts on those profits. In theory, the state could be able to collect more in taxes from companies that sell into Massachusetts, but in practice that has been difficult. This tax break for manufacturing companies will cost Massachusetts about $75 million in FY 2014.

Single Sales Factor Apportionment for Mutual Fund Companies

Shortly after the Single Sales Factor tax break was offered to manufacturing companies it was extended to mutual fund companies as well. For mutual fund companies, the law also defines a "sale" as occurring where the consumer is, rather than where the company is. As a result, mutual fund companies based in Massachusetts who have customers around the country are treated, for Massachusetts tax purposes, as earning much of their income in other states. This Single Sales Factor tax break for mutual fund companies will cost the state about $131 million in FY 2014.

Twenty-Five Percent Tax Credit for Movie Production in Massachusetts

For the past 8 years Massachusetts has offered very generous tax credits to movie producers. The law provides a tax credit of 25 percent of expenses for making a movie in Massachusetts. This is not simply a reduction in taxes – it is generally a tax credit much larger than any taxes paid by the producers of the movie. If a movie producer spends $40 million on a movie in Massachusetts, they are awarded a tax credit of $10 million. They are then free to sell this credit to other taxpayers who can use it to offset tax liabilities. This means that the initial cost to the Commonwealth for any movie made in Massachusetts can be 25 percent of the cost of the movie. Some of this cost is offset by other taxes paid by movie producers, but these taxes offset only a small portion of the tax credit program's total cost—for 2011, the Department of Revenue (DOR) estimates that only 16 percent of the cost of the credit was offset by new tax revenues. For FY 2014, the full cost of the Film Tax Credit is estimated to be $80 million.

Life Sciences Tax Incentive Program

Massachusetts offers tax breaks to companies engaged in life sciences research and development, commercialization and manufacturing in Massachusetts. These tax breaks are awarded by the Massachusetts Life Sciences Center through a process that also involves the state Department of Revenue and the Office of Administration and Finance. These are discretionary tax breaks and are awarded based primarily on an assessment of likely job creation in Massachusetts. The Life Sciences Tax Incentive Program will cost the state about $17 million in FY 2014.

REDUCING OPPORTUNITIES FOR TAX AVOIDANCE

Tax avoidance is the legal use of loopholes (usually unintended) in existing tax law to minimize the taxes that are owed. Revenue lost due to tax avoidance compromises our ability to make important public investments.

Use of these loopholes often relies on complex accounting strategies and/or the shifting of income among related business entities to reduce taxes owed. Massachusetts has already adopted the most important reform to address these issues: combined reporting, which generally requires companies to report the income of all of their subsidiaries together. Nevertheless, additional policy options exist for further limiting corporate tax avoidance. Specifically, Massachusetts could:

Adopt the Throwback Rule

In general, businesses are required to pay state-level income taxes only in those states where they have a substantial presence (or "nexus"), which typically means property or employees in the state. However, many companies make sales all over the nation, often into states in which the company has no property or payroll and hence is not subject to state tax. When sales are made by a company into a state in which the company will not be subject to state taxes, these sales generate what is called "nowhere income." The profit that should be allocated to the state where the sale was made will not be factored into any state's calculation of the tax the company owes and thus may go entirely untaxed.

There is a simple way to address this ongoing source of state tax loss: enact a "throwback rule." Massachusetts already has a weak, non-standard and easily-avoided version of the throwback rule. Enacting a robust and functional throwback rule requires adding a clarifying sentence to the state corporate tax. This sentence would clarify that any sale originating from Massachusetts, and that is not counted in the tax calculation of the state into which the good is sold, would be counted in the calculation of corporate taxes owed by the selling company to the Commonwealth.[2]

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[2] The Center on Budget and Policy Priorities offers the following wording as a template: "Sales of tangible personal property are [deemed to be] in this State [for apportionment purposes] if the property is shipped from an office, store, warehouse, factory, or other place of storage in this State and the taxpayer is not taxable in the State of the purchaser." (The bracketed material has been added to clarify the meaning of the throwback rule but is not part of the rule itself.) See: http://www.cbpp.org/cms/index.cfm?fa=view&id=1868

The amount of additional revenue to be generated through adoption of a throwback rule varies from state to state, but estimates range from about two percent to five percent of a state's current corporate income tax (CIT) collections.[3] In Massachusetts, where the CIT produced some $1.4 billion in FY 2013, this tax rule change therefore likely would generate between $30 million and $70 million annually.

Eliminate Off-Shore Tax Haven Loophole

Some countries provide foreign corporations with very low or non-existent tax rates.[4] Many large, multinational corporations headquartered in the U.S. take advantage of this opportunity to reduce their taxes by artificially shifting profits generated in the U.S. to subsidiaries located in these tax haven jurisdictions.[5] The result of these accounting maneuvers is a substantial loss of tax revenue for both the federal government and many state governments.[6]

States that already have adopted the "combined reporting" approach to corporate taxation (as has Massachusetts) can combat this problem by requiring that multinational corporations include in their calculations of state taxes owed, the income the corporation has booked to subsidiaries located in known tax havens.[7] Some states - including Montana, Alaska and West Virginia - already have adopted this approach.[8]

Though some administrative challenges may exist, were Massachusetts to follow the lead of these states and close the offshore tax haven loophole, the Department of Revenue offers a preliminary estimate that the Commonwealth could stand to collect between $64 million and $94 million in additional tax revenue annually.

REEXAMINING OTHER MAJOR TAX CUTS OF THE PAST TWO DECADES

Several major tax cuts enacted over the past two decades have dramatically limited the amount of ongoing revenue available to support important public investments. Personal income taxes cuts alone now cost roughly $3 billion annually (For more information, please see: Income Taxes and the Budget Deficit in Massachusetts.). Separate corporate tax cuts have further limited state tax collections. Major tax cuts enacted over the past two decades that could use careful cost/benefit analyses include the following:

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[3] Communication from M. Mazerov, Center on Budget and Policy Priorities, 9-11-2013.

[4] Jane G. Gravelle, "Tax Havens: International Tax Avoidance and Evasion," Congressional Research Service, January 23, 2013: http://www.fas.org/sgp/crs/misc/R40623.pdf

[5] Ibid

Center on Budget and Policy Priorities, *The Fiscal and Economic Risks of Territorial Taxation*, January 2013: http://www.cbpp.org/cms/?fa=view&id=3895

[6] Testimony of Dan Bucks, Montana Director of Revenue and Executive Director of Multistate Tax Commission, to the Minnesota Legislature, March 19, 20013: http://massbudget.org/reports/pdf/DanBucks_MemoToMNLegislature_%20IncludingTaxHavenSubsidiariesInCombinedGroups_March2013.pdf

U.S.PIRG, *The Hidden Cos of Offshore Tax Havens,* February 2013: http://www.uspirg.org/reports/usp/hidden-cost-offshore-tax-havens

[7] Testimony to Minnesota Legislature by Michael Mazerov, Senior Fellow at the Center on Budget and Policy Priorites, April 16, 2013: http://massbudget.org/reports/pdf/Mazerov_OffshoreTaxHavenTestimony_04-5-2013.pdf

[8] Testimony to Minnesota Legislature by Michael Mazerov, Senior Fellow at the Center on Budget and Policy Priorites, April 16, 2013: http://massbudget.org/reports/pdf/Mazerov_OffshoreTaxHavenTestimony_04-5-2013.pdf

Extension of the Net Operating Loss Carry Forward Provision

Net Operating Loss Carry Forward (NOL) provisions allow businesses, when filing their tax returns, to use prior year losses to reduce current year profits, thus reducing the taxes they otherwise would owe. The underlying, general logic of permitting a NOL carry forward deduction makes sense in terms of sound tax policy; a business's tax bill will be based on an average of its performance over a set period, taking into account both profitable years and years with net losses.[9] This helps ease tax pressures on start-up companies (which often experience losses in early years) and on established businesses as they weather economic downturns and the first several years of a downturn's aftermath.[10]

Until 2010, Massachusetts provided a 5-year carry forward period, costing the state approximately $100 million to $120 million annually in forgone tax revenue.[11] Starting in 2011, Massachusetts extended the carry forward period to 20 years, a change that the Department of Revenue has estimated will cost some $60 million annually by 2026, ten years after its first effects would be felt, and more than $90 million annually by 2031.[12]

"3-in-3" Capital Gains Tax Break

Effective January of 2011, Massachusetts tax law was changed to provide a lower tax rate on capital gains generated from investments held for three years or more in small and mid-sized startup businesses located in Massachusetts.[13] Capital gains income from these "3-in-3" investments is taxed at 3.0 percent rather than the standard 5.25 percent rate applied to other long-term capital gains.

The ability to spur investment and accelerate economic growth by providing preferential capital gains tax rates remains a debated question, though the most rigorous research suggests only very modest positive impacts at best.[14] More certain is the fact that the large majority of capital gains income flows to upper income filers, and thus the direct tax benefits of such preferential tax rates flow overwhelmingly to the state's very highest income households.[15]

The Department of Revenue estimates that this provision will cost over $11 million annually by 2020 and over $30 million annually by 2031.

Corporate Income Tax

As part of a tax reform package that also included changes aimed at substantially reducing corporate tax avoidance, the Commonwealth began cutting the corporate tax rate in 2009 (along with other cuts for S-corps). These tax cuts were phased in over several years. Ultimately, the rate on ordinary corporations has been cut from 9.5 percent to 8 percent and the rate on financial institutions has been

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9 Center on Budget and Policy Priorities, May 2009: http://www.cbpp.org/cms/?fa=view&id=2760
10 Ibid
11 Department of Revenue, Tax Expenditure Budget FY2014
12 Estimates provided by DOR upon request from MassBudget. DOR notes that these estimates were prepared in 2010.
13 MGL, Chapter 62, Sec. 4, 2c: https://malegislature.gov/Laws/GeneralLaws/PartI/TitleIX/Chapter62/Section4
14 Institute on Taxation and Economic Policy (ITEP), *A Capital Idea*, January 2011: http://www.itepnet.org/pdf/capitalidea0111.pdf
15 Ibid
Institute on Taxation and Economic Policy (ITEP), *Who Pays*, January 2013: http://www.itepnet.org/whopays.htm

cut from 10.5 percent to 9.0 percent. Overall, these tax cuts now are costing the Commonwealth as much as approximately $250 million year (pending confirmation by DOR).[16]

Dividends and Interest Tax

Until 1998 dividends and interest were taxed at 12 percent in Massachusetts.[17] The rate has been cut dramatically and today such income is taxed at 5.25 percent.[18] The original higher rate on dividends balanced more regressive elements of the state's tax code. In Massachusetts, as in most states, low and middle income people pay a larger share of their income in taxes than do higher income people (For more information, see MassBudget's brief Examining Tax Fairness.). This is primarily because lower income people pay a larger share of their income in sales taxes and property taxes than do high income people. Dividend income is a type of income that is concentrated among very high income households.[19] Taxing this income at a higher rate had allowed the Commonwealth's overall tax system to be more equitable. This dividend and interest tax cut is costing the state about $870 million today.[20]

Personal Income Tax

Beginning in 1998, a number of significant changes were made to the state tax code, including a series of phased cuts to elements of the state personal income tax. Rates on wage and salary income were reduced from 5.95 percent to 5.3 percent over a four year period. Additionally, as part of this package of changes, the state's personal exemption[21] was doubled. Further, the rate for dividend and interest income was cut from 12 percent to 5.3 percent. These cuts have contributed significantly to the repeated shortfalls in revenue the state has faced over the last decade and more, and that the state continues to grapple with today. For more information, please see: Income Taxes and the Budget Deficit in Massachusetts.

The personal income tax is the largest component of our tax system that is progressive in its effect, meaning that higher-income households pay a larger share of their household income toward the income tax than do lower-income households; for most other major taxes the reverse is true. Generating additional state revenues through the income tax, therefore, can help reduce the regressivity of the overall tax system in Massachusetts.

This is especially true if the progressivity of the current income tax structure is enhanced, for example, by increasing the value of the personal exemption. If, for any given increase in the personal income tax

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16 In Fiscal Year 2013, the Commonwealth collected $1.90 billion in combined corporate and financial institution taxes. According to DOR, somewhat less than 80 percent of total corporate collections are derived from the taxes on corporate income. Increasing the relevant tax rates by 1.5 percentage points (or by some 16 to 18 percent, on average), therefore, would produce additional tax revenue of approximately $250 million annually.

17 MassBudget, *Understanding Our Tax System,* December 2010 (See discussion in Chapter Four: Personal Income taxes): http://www.massbudget.org/report_window.php?loc=Tax_Primer_83110.html

18 MassBudget, *Income Taxes and the Budget Deficit in Massachusetts*, February 2013: http://www.massbudget.org/report_window.php?loc=tax_cuts_factsheet.html

19 Urban Brookings Tax Policy Center: http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?DocID=340&Topic2id=30&Topic3id=32

20 MassBudget, *Income Taxes and the Budget Deficit in Massachusetts*, February 2013: http://www.massbudget.org/report_window.php?loc=tax_cuts_factsheet.html

21 The personal exemption is a set amount of income upon which every tax filer is excused automatically from paying tax. The changes initiated in 1998 eventually increased the personal exemption from $2,200 per individual ($4,400 for married couples) to $4,400 per individual ($8,800 for married couples), where it stands today.

rate, half of the resulting new revenue were used to increase the value of the personal exemption, an average households in the bottom half of the income distribution would not have their taxes increased.

The rate cut on wage and salary income cost the Commonwealth some $1.6 billion in annual revenue in FY 2013 (or about $250 million for each 0.1 percentage point reduction in the personal income tax rate). Doubling the personal exemption cost the state some $550 million in FY 2013. The rate reduction for dividend and interest income cost the state an additional $870 million annually by FY 2013. Together, these three changes currently cost the Commonwealth some $3 billion annually in lost revenue.