

What Does the Federal Tax Law Mean for Massachusetts and How Might the Commonwealth Respond?

By Phineas Baxandall

Taxes at the state, local and federal levels are how we bring together resources to expand opportunity and ensure public well-being. Federal and state partners work together to support important programs for people of all income groups. Our contributions toward advancing public goals through taxes are based in part on our ability to pay.

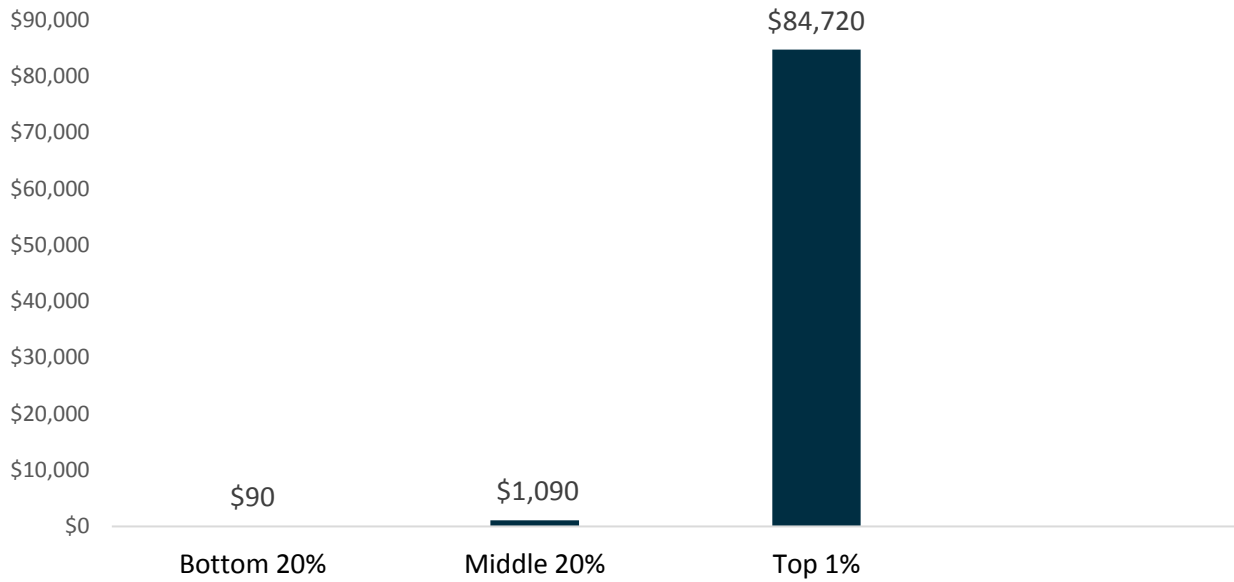
The new federal tax law reduces federal revenues by approximately \$1.5 trillion largely by cutting taxes for corporations, people receiving inheritance from very large estates, and high-income owners of pass-through entities such as partnerships. The law provides reduced tax rates and relatively smaller tax reductions to most wage and salary earners while disproportionately benefiting those with high incomes.

The federal tax cuts will reduce the taxes paid by the highest-income one percent of the Massachusetts population by over \$2.96 billion in 2019, the first year the cuts are fully in effect. If the people of Massachusetts determine that \$2.96 billion could be better spent on investments in education and transportation, which could make our economy more productive and expand opportunity for our young people, the state could adjust our tax code in ways that would effectively redirect a portion of that \$2.96 billion to those higher priority areas. That could be done by raising state income taxes for our highest-income taxpayers, who will be receiving large federal income tax cuts and benefitting from large federal corporate tax cuts.

What are the distributional effects of the federal tax law?

As is the case across the United States, the federal changes heavily favor the highest-income one percent of households in both absolute and relative terms. The average tax cut for the highest-income one percent of Massachusetts tax filers in 2019 will be \$84,720, compared to an average of \$1,090 for the middle 20 percent of filers on the income ladder and \$90 for those with the lowest 20 percent of incomes.

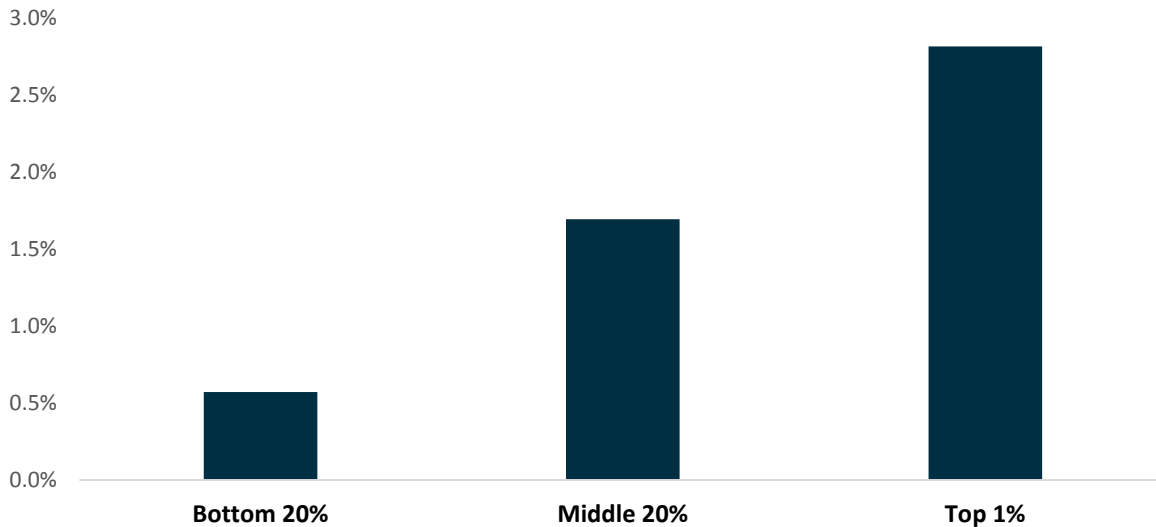
Massachusetts Federal Income Tax Cuts, by Income Group, 2019



Institute on Taxation and Economic Policy, tax year 2019

The tax cuts are also skewed toward high-income tax filers when measured as a portion of their own incomes. The top one percent of income earners in 2019 will receive a tax cut that on average is 2.8 percent of their income, while the middle-income 20 percent will receive a tax cut averaging 1.7 percent as a portion of their income; and the tax benefit for the bottom 20 percent is less than 0.6 percent of their income.¹

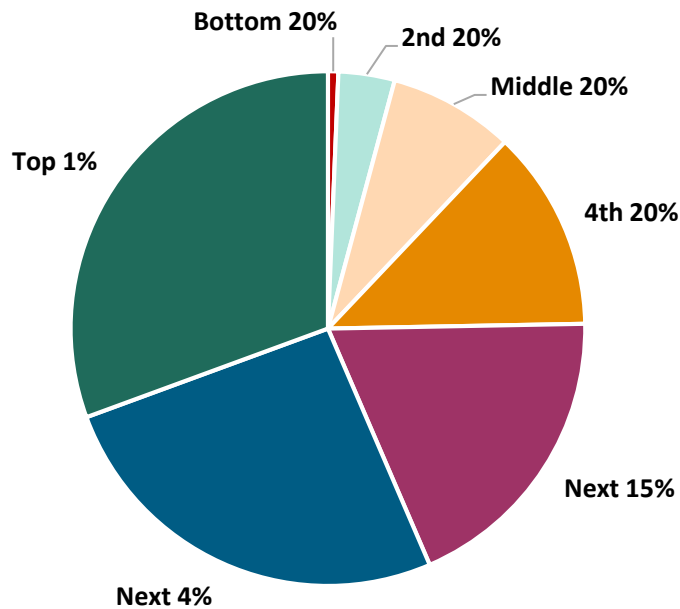
Federal Tax Cuts as a Portion of Income for Different Massachusetts Income Groups



Institute on Taxation and Economic Policy, tax year 2019

The highest income groups will receive the largest share of the tax cuts in Massachusetts. The share of the tax cut going to the highest-income one percent exceeds the share of the total tax cut going to bottom 80 percent of taxpayers combined. The highest-income five percent of income earners will receive a majority of the entire tax cut (see below).

Share of Tax Change for Each Massachusetts Income Group

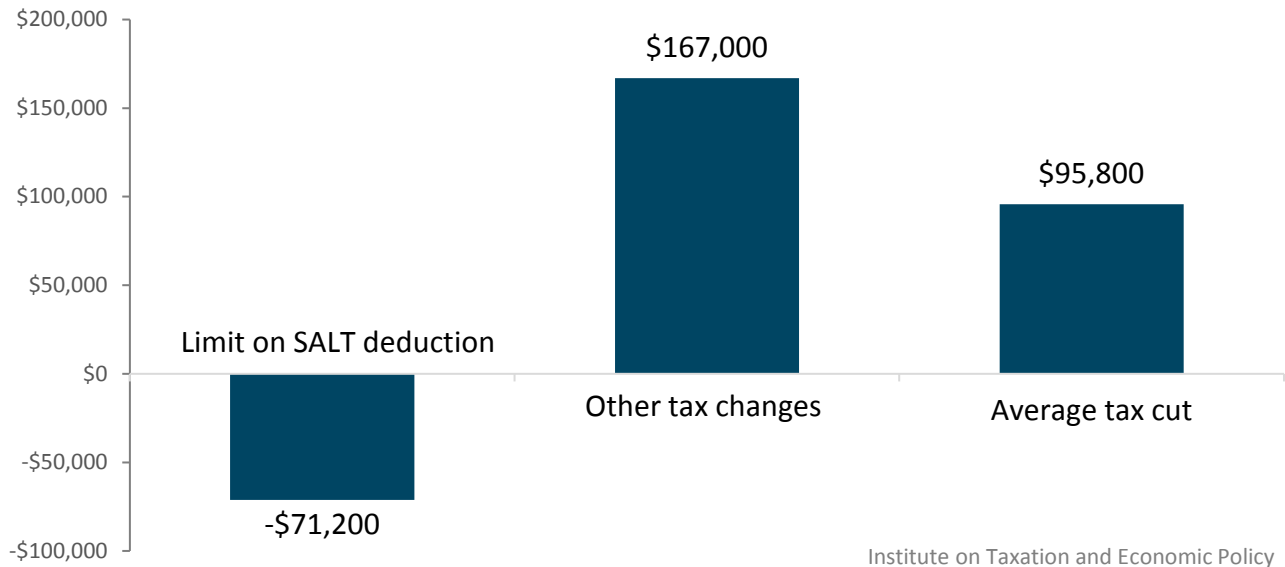


Institute on Taxation and Economic Policy, tax year 2019

In dollar terms, the top one percent in Massachusetts have incomes of at least \$808,270 and an average income of \$3.0 million per year. Almost all tax filers in the highest-income one percent will see a tax cut in 2019 (99 percent will). One of the most targeted gains for the highest-income one percent is to double the exemptions for very large estates. Previously, estates less than about \$5.5 million (or \$11 million for joint tax filers) were exempt from the estate tax. Starting in 2018, these exemption amounts are doubled. This represents a \$165.9 million tax cut for the highest-income one percent in 2019.

Households that earn over \$1 million in a single year represent the upper portion of the top one percent of the income ladder. They would pay a four percent income surtax on income over the \$1 million threshold under the Fair Share Amendment. The federal tax law will provide this group in Massachusetts with an estimated \$2.58 billion combined tax cut in 2019. The new law limits tax filers' deduction of their state and local tax (SALT) to no more than \$10,000 in annual combined state and local taxes. For those with incomes over \$1 million in a year, the cap on SALT deductions raises taxes by an amount that is less than half as large as the tax cut from other changes in the federal law. The average net effect of the SALT deduction limit and other tax changes for those with incomes over \$1 million is a tax reduction of \$95,800 in 2019. For those with incomes under \$1 million in Massachusetts, the average federal tax change from the new tax law is a reduction of about \$2,000 and would be about \$500 larger if not for the change in SALT deductibility.

Tax Filers with Massachusetts Incomes Over \$1 Million Receive Other Federal Tax Cuts over Twice the Size of Tax Changes from SALT Limits



How will federal tax cuts be paid for, and at what cost to Massachusetts?

The tax cut is not free. No serious economic analysis projects that it will pay for itself. According to Congress' Joint Committee on Taxation, the new tax law will increase the federal deficit over the ten year span by \$1.456 *trillion*.² While it is impossible to know for sure how Congress will fill the resulting budget deficits, it must ultimately be accomplished through some combination of future tax increases and spending cuts. Tax increases might affect those with higher incomes more; and spending cuts might affect low and middle-income earners more.

Current leaders in Congress and the White House have been explicit that in 2018 they intend to seek cuts in spending.³ Congress passed a budget resolution in October calling for several trillion dollars in spending cuts over the next decade. Speaker of the House Ryan, stated in November that "Congress will turn next year to spending cuts to try to lower the deficit, [and] that's the second step after cutting taxes."⁴

To the extent that federal spending cuts occur, residents of Massachusetts will experience cuts to federal programs and cuts to state programs supported with federal dollars.⁵ Federal funding paid for one quarter of the state budget in Fiscal Year 2017.⁶ Federal cuts will also make it less likely that there will be federal and state investments to improve education, infrastructure, or other programs that support the long-term health of our state's economy.

A Brookings Institution analysis has modeled the impact of the tax law based on an assumption that each household would pay the same dollar amount to cover the costs of the tax cut. It estimates "that

each household would have to pay about \$1,610 in 2018 to cover the cost of the tax cuts in that year.”⁷ They find that once these costs of paying for the tax cut are added, over 74 percent of households nationally would be worse off than under current law because the combination of subsequent program benefit cuts and new taxes will be larger than the direct effect of tax cut in the law.

The eventual extent of the lost revenues could be substantially greater than the \$1.5 trillion projection. The hastily written tax law may create extensive new tax loopholes and opportunities for tax avoidance.⁸ Moreover, in order to comply with U.S. Senate rules that would not allow a larger deficit without prolonging debate and requiring greater consensus to approve the bill, many of the tax cuts expire before the end of a ten-year period. Several members of Congress who supported the tax bill, however, have stated that they have no intention of letting those tax cuts expire. If Congress does not allow those provisions to expire, then the deficit created by the tax cut will end up being an estimated \$2.2 trillion.⁹

How does the federal tax law affect Massachusetts state policies?

The Massachusetts tax code is linked to the federal tax code in many ways. Without action by Massachusetts lawmakers, several provisions of Massachusetts tax law could change along with the new federal code. Some of those changes would reduce state revenues while others would increase them.

While it is too early for a full accounting of these impacts, several are becoming clear:

- **A gradual erosion of the value of the Earned Income Tax Credit** – The federal tax law changes the federal method for calculating inflation for the Earned Income Tax Credit (EITC). The EITC is a refundable tax break provided by the federal government and matched 23 percent by the Commonwealth to lower-income workers in order to increase the after-tax rewards to work. It is available only to tax filers with earned income and provides benefits primarily to workers with children. The new slower-growing inflation adjustment in the federal law will mean that the maximum EITC benefit will grow more slowly with inflation over time than under current law. A Center on Budget and Policy Priorities analysis based on Congressional Budget Office projections found that with the new inflation adjustment, a couple earning \$40,000 would see \$322 less in EITC benefits in 2027 than under current law.¹⁰ The Commonwealth matches 23 percent of the federal credit. Therefore, for the couple earning \$40,000, the state credit will be \$74 less than it would have been in 2027 unless the Commonwealth increases its EITC match.¹¹
- **Extension of 529 plans to private K-12 school tuition** – The federal law changes the terms of tax-favored 529 savings plans, which have in the past been limited to withdrawals to pay for college, but can now be used to pay for primary and secondary private education.¹² To the extent that this change offers additional tax sheltering for those paying private school tuition in Massachusetts, it will reduce personal income tax revenue unless the Commonwealth decouples from the federal definition of eligibility. Across the country, people with higher incomes will receive the main benefits of the federal change for 529 plans. Only 2.5 percent of households have 529 accounts, according to a Federal Reserve study of 2013 Survey of Consumer Finances data, and these holdings are heavily skewed toward wealthy households.¹³ Among the highest-income five percent of households, 16 percent hold 529 accounts. Among the lower half of the

income ladder, only 0.3 percent of households have a 529 plan. And despite limits on annual contributions, the average 529 plans held by households in the upper 10 percent of the income ladder are more than twice as large as the average size held by all households. The disparity is even greater when households are compared by wealth. For households with 529 plans in the top five percent by wealth, their plans averaged \$152,300. Meanwhile, for households in the bottom half by wealth, the average 529 plan held only \$3,800.

- **Limits on business deductions for interest payments** – The new federal law disallows deductions of net interest expenses that exceed 30 percent of a business’ adjusted taxable income. As the National Council of State Legislatures observes, “This may be intended to prevent U.S. business from borrowing substantial amounts to have deductible interest payments count against their income. This measure would raise revenues by reducing profit-shifting.”¹⁴
- **Temporary revenue increase from capital gains and “repatriated profits”** – The new federal law will likely create a one-time temporary spike in capital gains taxes as people who have seen large increases to their capital assets and have waited for capital gains taxes to decrease decide to cash in their gains by selling those assets at now-reduced federal tax rates.¹⁵ This temporary increase to revenues would depend on how quickly these selloffs occur. Similarly, the federal law provides companies that have avoided taxes through booking profits offshore with an incentive to “repatriate” these assets at a discounted tax rate. While in the long term this represents a reduction in the taxes owed by these companies on their profits, it will likely temporarily boost corporate income taxes collections.¹⁶
- **Territorial system to account for overseas profits** – Over the long term, the tax law’s switch to a “territorial” system of accounting for offshore profits may also reduce tax revenues by making it easier for multinational companies to book profits offshore and therefore report less domestic income and pay less in federal and state taxes.¹⁷
- **Dilution of state-issued federal incentives for affordable housing** – Federal tax credits granted to states to incentivize developers to create low-income housing are likely to become less productive because their value to developers has been reduced, as avoiding federal taxes has less value. A public accounting firm has projected that the reduction in the corporate tax rate will reduce the supply of affordable rental housing across the country by nearly 235,000 units, including 6,260 in Massachusetts.¹⁸

What can the Commonwealth do to compensate for the impacts of the federal tax law?

By adjusting our state tax system to offset some of the regressive federal tax cuts, Massachusetts could raise resources to invest in public priorities such as education and transportation that can strengthen our economy and expand opportunity.

One area where this could take place is the Fair Share Amendment on the upcoming November ballot. The Fair Share Amendment would make investments in education and transportation funded by a four percent addition to the income tax on income over \$1 million. Currently, the highest-income tax filers in Massachusetts on average pay a lower share of their income in state and local taxes than do the other 99 percent of income earners.¹⁹ As described above, the new federal law will widen that disparity.

Without the federal offset, a nine percent Massachusetts rate paid on income over \$1 million would still be less than what California's marginal rates have been, even with their federal offset. The most complete analysis of the relationships between taxes and migration coauthored by Stanford University professors along with economists from the U.S. Treasury was based on examination of 13 years of all actual tax returns exceeding \$1 million across the country. Confirming earlier studies found the effects of additional taxes on incomes over \$1 million found that interstate relocation motivated by tax reduction occurs "only at the margins of statistical and socioeconomic significance." Applying their analysis and the new limits on state and local tax deductibility to the impact of the Fair Share Amendment, over 99 percent of tax filers with incomes over \$1 million would continue to reside in Massachusetts if the Fair Share Amendment is approved. An anticipated \$35.4 million in state and local revenue would be lost as a result of relocation, leaving the net revenue benefit to the commonwealth at \$1.86 billion (rather than the \$1.9 billion that is the mid-point of the Department of Revenue estimate).²⁰

There are other measures the Commonwealth could choose to take. For instance, currently the state links to the federal tax code for determining eligibility of 529 plan withdrawals. By decoupling from the federal definition, Massachusetts could decide that funds from 529 plans that are used to pay private primary and secondary school tuition would be subject to the state's personal income tax. As the implications of the federal law become more apparent, the Commonwealth will have to decide how it applies state rules and where it decides to uncouple the state tax code from federal statute.

Two potential state responses to the new \$10,000 limit on deductibility of state and local taxes have been the subject of recent discussion. One idea which the Governor of New York has proposed is to convert the existing income tax into a payroll tax (which remains fully deductible).²¹ Another proposal would be to convert income taxes into a charitable donation by granting 100 percent credit for donations to the state, which would also make the tax filer eligible to receive a federal charitable deduction.²² Both proposals merit study though they face a long list of challenges for implementation.²³

Whether or not ideas for these ambitious state tax overhauls gain traction, the Commonwealth will face many decisions both large and small about how to interpret, react, and compensate for the new federal tax law and the cuts it delivers to Massachusetts.

¹ Institute on Taxation and Economic Policy, December 2017. The analysis assumes that corporate tax benefits will be passed on to shareholders and employees. Comparisons are for 2019 because the new corporate tax rates is not in full effect until 2019. The average impact for the lowest-income 20 percent is 0.57 percent.

² U.S. Joint Committee on Taxation, "[Distributional Effects of the Conference Agreement for H.R. 1, the 'Tax Cuts and Jobs Act'](#)," December 18, 2017, JCX-68-17, p. 8.

³ The budget resolution passed by Congress in October 2017 called for \$5.8 trillion in cuts over the next ten years. Center on Budget and Policy Priorities, "[GOP Budgets, Statements Make Plans Clear: Costly Tax Cuts for Wealthy Now, Program Cuts Later](#)" (December 2017).

⁴ "[Ryan Says Spending Cuts to Come Next Year, After Tax Cuts](#)," *Washington Times*, November 14, 2017.

⁵ "[Partnership in Peril: Federal Funding at Risk for State Programs Relied on by Massachusetts Residents](#)," Massachusetts Budget and Policy Center (February, 2017); and "[How Vulnerable to Federal Budget Cuts is Transportation](#)," MassBudget (April 2017).

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- ⁶ [“Partnership in Peril: Federal Funding at Risk for State Programs Relied on by Massachusetts Residents,”](#) Massachusetts Budget and Policy Center (February, 2017).
- ⁷ William Gale, [“Who Will Pay for the Tax Cuts and Jobs Act?”](#) Tax Policy Center, Tax Vox blog, January 2, 2018.
- ⁸ Avi-Yonah, Reuven S. and Batchelder, Lily L. and Fleming, J. Clifton and Gamage, David and Glogower, Ari D. and Hemel, Daniel Jacob and Kamin, David and Kane, Mitchell and Kysar, Rebecca M. and Miller, David S. and Shanske, Darien and Shaviro, Daniel and Viswanathan, Manoj, [“The Games They Will Play: An Update on the Conference Committee Tax Bill,”](#) Social Science Research Network (December 18, 2017).
- ⁹ Joel Friedman, [“Tax Bill’s Cost Could Hit \\$2.2 Trillion Over Next Decade”](#) Center on Budget and Policy Priorities, Dec. 18, 2017.
- ¹⁰ [“Instead of Boosting Working Family Tax Credit, GOP Tax Bill Erodes it Over Time,”](#) Center on Budget and Policy Priorities, Dec. 21, 2017.
- ¹¹ Calculated based on a 23 percent share of the \$322 in reduced EITC credits described in this paragraph.
- ¹² [“Yes, You Really Can Pay for Private School with 529 Plans Now,”](#) New York Times, December 21, 2017.
- ¹³ Federal Reserve, [“Saving for College and Section 529 Plans”](#) FEDS Notes, February 3, 2016.
- ¹⁴ National Conference of State Legislators, [“National Tax Reform and the States,”](#) January 11, 2018.
- ¹⁵ National Conference of State Legislators, [“National Tax Reform and the States,”](#) January 11, 2018.
- ¹⁶ Institute on Taxes and Economic Policy, [“Apple Gambled on Congressional Spinelessness on Tax Policy - and Won,”](#) January 18, 2018.
- ¹⁷ Institute on Taxation and Economic Policy, [“The Consequences of Adopting a Territorial Tax System,”](#) September 18, 2017.
- ¹⁸ [“Tax Overhaul is a Blow to Affordable Housing Efforts,”](#) *New York Times*, January 19, 2018; [“Final Tax Reform Bill Would Reduce Affordable Rental Housing Production by Nearly 235,000 Homes,”](#) Novogradac & Company, Tax Reform Resource Center, December 2017. For the Massachusetts figure, [“See How Many Jobs, Affordable Rental Homes Each State Would Lose under the Final Tax Reform Bill,”](#) (December 2017).
- ¹⁹ [“Funding Improvements for Schools, Roads, and Public Transit with Tax Reforms that Improve Fairness,”](#) Massachusetts Budget and Policy Center, December 2015, updated January 2018.
- ²⁰ [“The Evidence on Millionaire Migration and Taxes,”](#) Massachusetts Budget and Policy Center, updated January 18, 2018.
- ²¹ [“Cuomo Says Budget Will Defend New York Against Trump’s ‘Economic Missile’,”](#) *New York Times*, January 17, 2018.
- ²² On the legal basis for such a plan see, [“Federal Income Tax Treatment of Charitable Contributions Entitling Donor to a State Tax Credit”](#) at Social Science Research Network, January 8, 2018.
- ²³ Alan Essig, [“The Problems with State Workarounds to the Federal SALT Deduction,”](#) Institute on Taxation and Economic Policy (January 2018).