

The Far-Reaching Impact of a Massachusetts Surtax: Anecdotal Evidence and Data Analysis

By Greg Sullivan

The Proposed Graduated Surtax Applies to More Than Just Personal Income

Advocates of the proposed 4 percent surtax on personal income of \$1 million or more contend that the tax is one method to ensure that high-income individuals in Massachusetts pay their “fair share” of taxes. This graduated tax additionally applies to profits of partnerships, LLCs, S corporations, and sole proprietorships whose income is taxed as “pass-through income” on individual tax returns.

Under the proposed constitutional amendment, pass-through income from businesses plays a role in determining whether a taxpayer is subject to the proposed 80 percent tax increase, from 5 percent to 9 percent, on annual income above \$1 million.¹

Beyond affecting taxpayers in Massachusetts who meet the prescribed threshold of personal income, one of the fundamental consequences of the potential adoption of the proposed surtax is the impact on Massachusetts’ businesses.

What is the Graduated Income Tax?

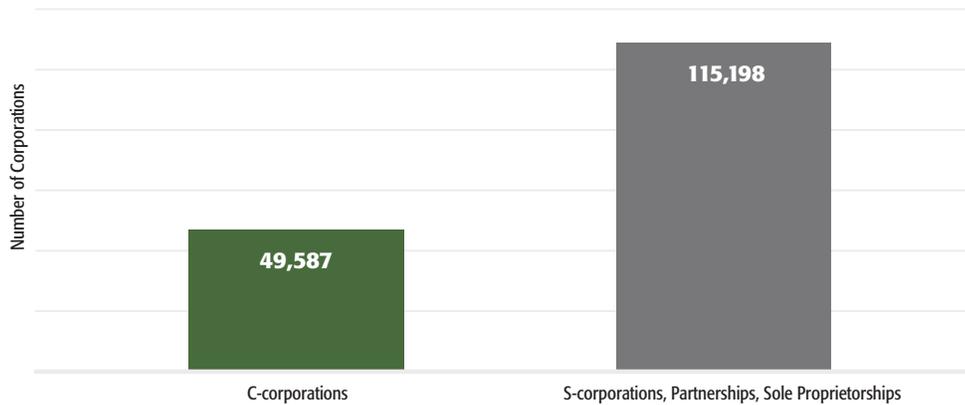
For the past several years, Massachusetts has been considering a state constitutional amendment that would levy a 4 percent surtax on annual personal income over \$1 million. The first attempt to do so, filed by initiative petition, failed a Massachusetts Supreme Judicial Court challenge in 2018 before 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 income tax rates and discouraging high-income individuals and businesses from coming to Massachusetts in the first place. They believe COVID-19 may exacerbate these relocation effects, as the pandemic has made telecommuting much more prevalent, at least in the short term.²

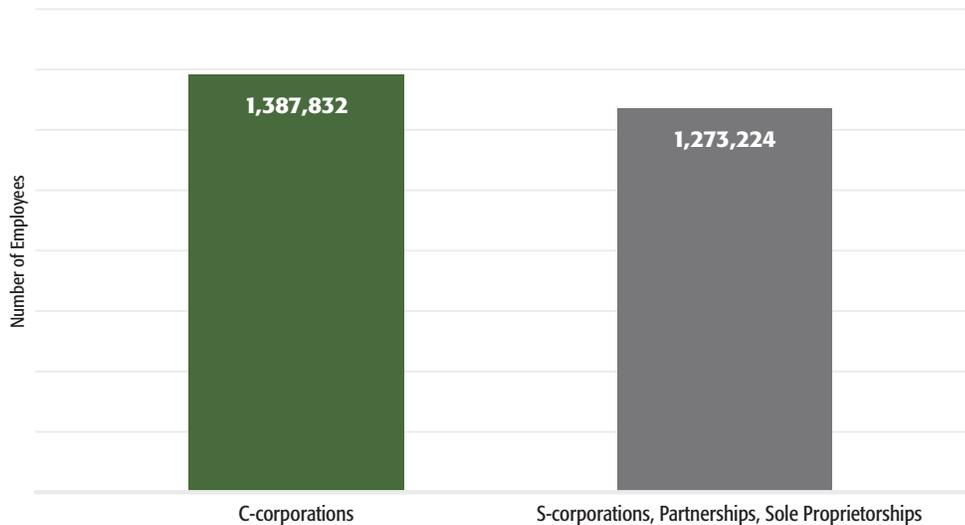
Data from the U.S. Census Bureau and the Internal Revenue Service demonstrate that the proposed surtax on the income of pass-through entities would have far-reaching effects. The Census Bureau estimated that Massachusetts had a total of 164,785 private, for-profit business establishments in 2019.³ Of these, about 70 percent were S corporations, Partnerships, or Sole Proprietorships (pass-through businesses), while about 30 percent were C-corporations.⁴

Figure One: Number of Massachusetts Private For-Profit Establishments, By Category (2019)



The Census Bureau also estimated that in 2019, 2,661,056 persons were employed by private, for-profit business establishments in Massachusetts. About half of these individuals were employed by S corporations, partnerships, or sole proprietorships, while the other half were employed by C-corporations.

Figure Two: Number of Employees Employed by Massachusetts Private For-Profit Establishments, By Category (2019)



Analysis of Internal Revenue Service data from tax year 2018 shows that 33.5 percent of the income of Massachusetts taxpayers with AGIs of \$1 million or more came from partnerships and S corporations.⁵

Under the proposed constitutional amendment, a partner or member’s proportionate share of taxable net income from a pass-through entity is counted in full in determining his or her tax liability, including the tax on income in excess of \$1 million that would be subject to the proposed surtax, whether or not the partner or member has received the income in the form of distributions.

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The proposed tax increase on the income of pass-through entities would heighten economic ramifications for owners of those Massachusetts' S corporations who are already subject to the anti-competitive Massachusetts "sting tax."⁶ S corporations are the most common form of business ownership in Massachusetts, representing 45.5 percent of all private for-profit businesses and 65.1 percent of private for-profit pass-through businesses.⁷

The Tax Foundation's Michael Lucci described the Massachusetts sting tax in an article entitled "Reforming Massachusetts Corporate Excise Tax for S Corporations":

The stinger tax is an extra income tax that is layered on top of the individual income tax and is paid only by S corporation owners. In addition, the competitiveness and economic justification for having a stinger tax should be rethought given how rare it is for a state to impose such a tax... Massachusetts' corporate code creates an extra tax liability for S corporations that is unique compared to other states. This rate structure is nonneutral between industries, uncompetitive with other states, and based on business revenue triggers with little economic justification. Furthermore, it creates tax cliffs at \$6 million and \$9 million of business revenue. Once companies hit those revenue thresholds, they have a new tax that kicks in and is imposed on all previous income...⁸

The Massachusetts Department of Revenue website explains the S corporation sting tax as follows:

- An S corporation is subject to the non-income measure of the corporate excise at a rate of \$2.60 per \$1,000 of either taxable Massachusetts tangible personal property or taxable net worth.
- An S corporation is subject to the income measure of the corporate excise at a rate of 8.0% on certain built-in gains that are taxable at the federal level under IRC § 1374 and on passive investment income taxable at the federal level under IRC § 1375.
- An S corporation with gross receipts that are \$6 million or more but less than \$9 million is subject to the income measure of the corporate excise at a rate of 2.0% on net income subject to tax.
- An S corporation with gross receipts that are \$9 million or more is subject to the income measure of the corporate excise at a rate of 3.0% on net income subject to tax.⁹

Enactment of the proposed surtax tax would mean that some S corporations would pay 12.0 percent of their taxable income above \$1 million to the state — the 5.0 percent pass-through personal income tax, the 3.0 percent sting tax,¹⁰ and the 4 percent millionaire's tax — while regular C-corporations would still pay an 8 percent excise tax.

A further adverse effect of the proposed surtax for owners of pass-through businesses is taxation of so-called "phantom income."¹¹ This is the taxable net income of a pass-through entity that is allocated but not distributed to the taxpayer. Instead, this income is reinvested by the company in business operations and expansion for hiring personnel, capital improvements, purchase of durable equipment, inventories and infrastructure. Phantom income has also been described as "income that is attributed to one's tax liability, but without receiving the cash to offset the tax liability."¹²

John Fish, CEO of Suffolk Construction Company,¹³ has argued that the "phantom income" problem associated with the proposed graduated income tax can potentially put a drain on the Massachusetts economy. Fish reasoned, "You're taking what I would argue is the economic driver of job creation in the commonwealth, and you're penalizing it."¹⁴ He reckoned, "It's going to harken back to days of 'Taxachusetts'."¹⁵

Fish explained that 25 to 35 percent of Suffolk's net income is typically reinvested rather than being distributed to owners. He noted that though he may not leave Massachusetts if the "millionaire's tax" is passed next year, he may begin to focus his business efforts elsewhere. "We're going to have to have an adult conversation... People need to understand the consequences of this, and my concern is the unintended consequences."¹⁶

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High-Stakes, Shaky Ground

As the Massachusetts economy struggles to recover from the COVID-19 pandemic, nearly 70 percent of the state's businesses face the daunting threat of a significant tax increase proposal that will appear on the ballot in November 2022.

While some voters may presume that the proposed constitutional amendment to impose a surtax on income of \$1 million or more applies only to personal income, few are aware that the surtax also applies to profits of for-profit business establishments, whose income is taxed as "pass-through income" on individual tax returns.

Imposing a steep tax increase on S corporations and pass-through entities incentivizes business owners to invest beyond the borders of Massachusetts. The surtax serves as a mechanism that makes Massachusetts a less competitive business environment; this is especially injurious as the COVID-19 pandemic continues to threaten businesses and employees.

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Endnotes

- 1 The language of the proposed amendment 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.” Source: The Commonwealth of Massachusetts, “House Docket 4019”, 19 February 2021. Italics added by author. <https://malegislature.gov/Bills/192/H86.Html>
- 2 Andrew Mikula, “New Study Finds Pandemic-Spurred Technologies Lowered Barriers to Exit in High-Cost States,” Pioneer Institute for Public Policy Research, February 10, 2021, <https://pioneerinstitute.org/covid/covid-economy/new-study-finds-pandemic-spurred-technologies-lowered-barriers-to-exit-in-high-cost-states/>
- 3 U.S. Census Bureau, “County Business Patterns, including ZIP Code Business Patterns, by Legal Form of Organization and Employment Size Class for the U.S., States, and Selected Geographies”, 2019. <https://data.census.gov/cedsci/table?q=CBP2019.CB1900CBP&g=0400000US25&d=ECNSVY%20Business%20Patterns%20County%20Business%20Patterns&tid=CBP2019.CB1900CBP&hidePreview=true>. *Note: The geographic area selected was “Massachusetts” and the selected survey observed was “ECNSVY Business Patterns, County Business Patterns”.*
- 4 Ibid.
- 5 This statistic was derived from the following source: Internal Revenue Service, “Individual Income and Tax Data, by State and Size of Adjusted Gross Income, Tax Year 2018 (Massachusetts)”. <https://www.irs.gov/statistics/soi-tax-stats-historic-table-2>. First considered was the AGI for individuals making over \$1 million a year in Massachusetts which amounted to \$70,693,909. Second, income from Partnership/S corporations net income (less loss) was reported as \$13,789,577. Third, net capital gain (less loss) was reported as \$24,416,803. According to IRS break down of capital gains for tax year 2018 — see: “Returns with Income or Loss from Sales of Capital Assets Reported on Form 1040, Schedule D: Selected Items, by Size of Adjusted Gross Income, Tax Year 2018 (Filing Year 2019).
- 6 Michael Lucci, “Reforming Massachusetts Corporate Excise Tax for S Corporations”, The Tax Foundation, 21 January 2020. <https://taxfoundation.org/massachusetts-corporate-excise-tax-s-corporations>
- 7 U.S. Census Bureau, “County Business Patterns, including ZIP Code Business Patterns, by Legal Form of Organization and Employment Size Class for the U.S., States, and Selected Geographies”, 2019. <https://data.census.gov/cedsci/table?q=CBP2019.CB1900CBP&g=0400000US25&d=ECNSVY%20Business%20Patterns%20County%20Business%20Patterns&tid=CBP2019.CB1900CBP&hidePreview=true> *Note: The geographic area selected was “Massachusetts” and the selected survey observed was “ECNSVY Business Patterns, County Business Patterns”.*
- 8 “Reforming Massachusetts Corporate Excise Tax for S Corporations”. Please note that in this quote, the “sting tax” is referred to as the “stinger tax”. These are the same tax, and colloquially the tax can be referred to as a “sting” or “stinger” tax, referring to the same tax.
- 9 S corporations. <https://www.mass.gov/service-details/s-corporations>
- 10 The Commonwealth of Massachusetts, “S Corporations”, last updated 20 March 2020. <https://www.mass.gov/service-details/s-corporations>
- 11 Jeff Brown, “Beware of Phantom Income and the Tax It Brings”, *U.S. News & World Report*, 9 July 2018. <https://money.usnews.com/investing/investing-101/articles/2018-07-09/beware-of-phantom-income-and-the-tax-it-brings>
- 12 Ibid.
- 13 Suffolk Construction Company served as general contractor for several iconic Massachusetts properties, such as: the Millennium Tower, General Electric’s headquarters, and the Encore Boston Harbor casino in Everett. Greg Ryan, “Millionaire’s Tax or Business Tax? Businesses Say Proposal May Hurt Growth in Massachusetts”, *Boston Business Journal*, 14 April 2017.
- 14 Greg Ryan, “Millionaire’s Tax or Business Tax? Businesses Say Proposal May Hurt Growth in Massachusetts”, *Boston Business Journal*, 14 April 2017.
- 15 Ibid.
- 16 Ibid.

