BUDGET BRIEF **February 28, 2013**

Tax Policy Proposals in the Governor's FY 2014 Budget

Overview

In his FY 2014 budget, the Governor funds new investments in education and transportation and reduces cuts to other programs using revenues generated through a series of tax reform proposals. If enacted as part of the current FY 2014 budget process, these tax law changes would first go into effect on January 1st, 2014, halfway through the FY 2014 fiscal year. As a result, the Governor's tax package would deliver an estimated $754 million in FY 2014 (less than half the $1.95 billion the administration estimates will be generated annually thereafter).[1] The Governor's budget also relies on another $56 million that would come from a number of smaller tax initiatives not included in the Governor's overall tax package.

The Governor's Tax Package

The current state and local tax system in Massachusetts collects a greater share of household income from low and middle-income households than from upper-income households. The Governor's package would rebalance this slightly, by drawing new tax revenue predominantly from high-income households. (For a more detailed discussion of the impacts on different income groups from the major elements of the Governor's tax package, see the following MassBudget factsheet: http://www.massbudget.org/report_window.php?loc=first_look_proposals_fy14.html)

The major elements of the Governor's tax package include the following (see also the summary table, on page 3 below):

[1] These figures are MassBudget's best estimates, based on information provided by the Governor's Executive Office for Administration and Finance (ANF). ANF, however, has not yet released finalized official estimates and hence these numbers remain subject to further revision. The estimates here and throughout this budget brief are calculated assuming the Governor's proposed tax rate changes are implemented *before* his other proposed changes are made. This means that the Governor's proposed rates are used as the baseline for calculating revenue loss/gain estimates rather than using existing tax rates. This affects the value of these estimates. For example, the doubling of the personal exemption using the Governor's proposed 6.25 percent rate for the personal income tax produces a cost estimate of $1.11 billion for this change. Using the current 5.25 rate as the baseline would produce instead an estimate of about $820 million, some 16 percent lower than the estimate shown in this budget brief. These figures include the Governor's proposal to index the gas tax to inflation.

The Governor's FY 2014 budget ramps up FY 2014 investments in education and transportation more quickly than the increased FY 2014 tax collections ($810 million) alone would allow. In order to put more of the expected $1.9 billion in new annualized tax dollars to work starting in FY 2014, the Governor proposes pulling forward into FY 2014 some of the additional revenue that would be raised through his tax package in FY 2015 and FY 2016. The Governor's FY 2014 budget pulls forward a combined $400 million: $275 million from anticipated FY 2015 revenues and $125 million from anticipated FY 2016 revenues into FY 2014. (This "pull" is achieved through borrowing against the anticipated revenue that will be generated in these future years. Some additional costs would be associated with this borrowing, though these costs would be small relative to the amounts borrowed.). The result, according to the Governor's budget documents, is that the tax package would make available about $1.2 billion in additional funds in FY 2014, $1.6 billion in FY 2015, $1.8 billion in FY 2016, and the full $1.9 billion in fiscal years thereafter.

INCOME TAX CHANGES

- An increase in the tax rate on personal income from the current 5.25 percent to 6.25 percent would raise $1.16 billion in FY 2014 ($2.50 billion annually thereafter).[2] This change will increase the amount of taxes paid on the taxable income of most filers, though dollar increases will be substantially larger for upper income households than for low and moderate income households.[3]

- An increase in the amount of income automatically exempted from the personal income tax (called the "personal exemption") would reduce tax collections by about $440 million in FY 2014 ($1.11 billion annually thereafter). The current personal exemption of $4,400 for single filers would increase to $8,800, and the current $8,800 personal exemption for married filers would increase to $17,600. This change would reduce the amount of each household's income subject to state income taxes. This change would disproportionately benefit low and moderate income households, as a relatively large share of the total income of these households would become exempt from state income taxes.

- Offsetting the amount of revenue lost to the Commonwealth as a result of the personal exemption increase (above) is the revenue that would be gained by eliminating over 40 personal income tax breaks available to certain filers—though the large majority of the revenue would come from elimination of fewer than a dozen of these tax breaks (complete list here). The administration is projecting a gain of some $330 million from this change in FY 2014 ($1.26 billion annually thereafter). It is unclear exactly what the impact of this change would be on the overall regressivity of the Massachusetts tax system. Some of these tax breaks tend to be claimed more by higher income households. Others may be claimed often by low and moderate income households while also providing a larger benefit as a share of household income to these low and moderate income recipients.

SALES TAX CHANGES

- A decrease in the sales tax rate from the current 6.25 percent to 4.5 percent would reduce state tax collections by an estimated $591 million in FY 2014 ($1.43 billion annually thereafter). The Department of Revenue estimates that household consumers pay a bit less than 70 percent (68.5 percent) of the sales taxes collected in Massachusetts, with businesses paying the remaining share on the various purchases they make.[4] Households therefore will see a sales tax reduction of about $404 million in FY 2014 and $981 million annually thereafter. Businesses will see a sales tax reduction of some $187 million in FY 2014 and $452 million annually thereafter.

  This change will reduce the amount of taxes paid by residents of all income levels, but will disproportionately benefit low and moderate income households. Lower income households typically must spend most or all of their income in order to make ends meet, and thus a relatively high share of their household income is subject to the sales tax. Upper income

[2] Communication with Administration and Finance, 1-25-2013
[3] This increase includes new revenues that will be collected from businesses that choose to structure themselves and to file as S-corps, LLCs, and other types of business entities that pay the personal income tax rather than the corporate income tax. These businesses - along with businesses that are structured as C-corps (and thus pay the corporate income tax) – also will see significant reductions in the sales taxes they pay as a result of the Governor's proposed sales tax rate reduction.
[4] Email communication with DOR, 02-06-2013

households, by contrast, are able to save or invest a portion of their earnings and thus avoid paying sales tax on a larger share of their household income. (For additional discussion of the regressive effects of the sales tax, see the chapter on General Sales Taxes in the MassBudget "*Tax Primer*": http://www.massbudget.org/report_window.php?loc=Tax_Primer_83110.html)

FY 2014 REVENUE INITIATIVES	FY 2014	Annualized*
Governor's Tax Package Revenue	**Ongoing**	**Ongoing**
Income Tax:		
Increase personal income tax rate from 5.25% to 6.25%	1,163,000,000	2,503,000,000
Double the value of the personal exemption	(437,000,000)	(1,108,000,000)
Eliminate over 40 personal income tax breaks	332,000,000	1,259,000,000
Income Tax Subtotal	**1,058,000,000**	**2,654,000,000**
Sales Tax:**		
Decrease sales tax rate from 6.25% to 4.5%	(591,000,000)	(1,433,000,000)
Eliminate sales tax exemption for candy and soda	22,000,000	53,000,000
Increase cigarette tax by $1.00/pack	63,000,000	150,000,000
Harmonize tax rates for cigars & smokeless tobacco w/ cigarettes	7,000,000	16,000,000
Index motor fuels tax to inflation***	13,000,000	27,000,000
Sales Tax Subtotal	**(486,000,000)**	**(1,187,000,000)**
Business Taxes:		
Extend sales tax to certain computer services	65,000,000	259,000,000
Eliminate FAS 109 deduction	46,000,000	76,000,000
Clarify market sourcing rules for corporate excise sales factor	21,000,000	35,000,000
Reclassify utility and certain securities investment businesses	50,000,000	83,000,000
Cap film tax credit at $40 million annual cost	0	30,000,000
Business Taxes Subtotal	**182,000,000**	**483,000,000**
TOTAL	**754,000,000**	**1,950,000,000**

*Annualized estimates are for TY15 (the first full year of implementation), discounted to reflect estimated FY14 values.

** Sales tax changes to computer services are included in the Business Taxes

***Annualized estimate is for FY15, the first full year of implementation. Indexing will increase this figure in future years.

- Application of the sales tax to candy and soda purchases would raise an estimated $22 million in FY 2014 ($53 million annually thereafter). In Massachusetts, most food items are exempt from the sales tax. At present, soda and candy purchases are included in this exemption. In general, soda and candy do not fit many people's definition of food, suggesting that a tax break for these non-essential items may not be appropriate.

In addition, studies have linked consumption of these items to obesity,[5] and obesity is a substantial problem for adults and children, both nationally and here in Massachusetts. About one in three children and six out of ten adults in Massachusetts are overweight or obese.[6] Studies show that obese children are more likely to suffer from other illnesses and to miss more school; they also are at increased risk of being obese as adults.[7] Obese adults are more likely to suffer from a variety of illnesses including diabetes, heart disease and some types of cancer.[8]

This change would increase the regressivity of the overall Massachusetts tax system, disproportionately affecting low and moderate income households; purchasing an identical quantity of these products will consume more of a low-income person's income than it will for a high-income person.

- A $1 increase in the cigarette excise tax from $2.51/pack to $3.51/pack would raise an estimated $63 million in FY 2014 ($150 million annually thereafter). In addition to new revenues, increases in cigarette and tobacco taxes may have an impact on levels of tobacco consumption in Massachusetts for both adults and particularly for youth.[9] Over 16 percent of Massachusetts adults are current smokers and over 9 percent of youths ages 12-17 are current smokers.[10] In Massachusetts in 2010, smokers purchased more than 220 million packs of cigarettes.[11] The economic costs associated with smoking (including direct medical costs and lost productivity) have been estimated at over $10 per pack, suggesting that a substantial impact to the state economy results from cigarette and other tobacco use in Massachusetts.[12] Any reduction in usage due to higher user costs (resulting from the proposed tax increases) is likely to improve individual health and reduce negative impacts to the state related to tobacco use.

  Like most sales taxes, cigarette taxes are regressive, collecting a larger share of household income from low and moderate income households than from upper income households; purchasing an identical quantity of cigarettes will consume more of a low-income person's income than it will for a high-income person.

- Equalization of tax rates on other tobacco products with the tax rate on cigarettes would raise an estimated $7 million in FY 2014 ($16 million annually thereafter). This change would affect taxes on cigars and "smokeless" tobacco products. (Smokeless tobacco products include items such as chewing tobacco, snuff, and nicotine-containing breath mints and lozenges, all of which the Surgeon General is concerned are marketed toward children by the tobacco industry.[13]) As with increased cigarette taxes, higher taxes on other tobacco products will disproportionately affect low and moderate income households.

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[5] Babey, Susan H. et al., "Bubbling Over: Soda Consumption and Its Link to Obesity in California," UCLA Health Policy Research Brief

[6] Sacheck, Jennifer and Clark, Valerie, "Childhood Obesity in Massachusetts: Costs, Consequences and Opportunities for Change," Massachusetts Health Policy Forum, 2008. See also "Health of Massachusetts: Impact of Overweight and Obesity (1998-2007)," Massachusetts Department of Public Health, 2009. Kaiser Family Foundation, State Health Facts: http://www.statehealthfacts.org/comparemaptable.jsp?ind=51&cat=2&sub=14&rgnhl=23

[7] Ibid

[8] Ibid

[9] Surgeon General's 2012 Report: http://www.cdc.gov/tobacco/data_statistics/sgr/2012/
U.S. Centers for Disease Control and Prevention: http://www.cdc.gov/tobacco/data_statistics/fact_sheets/economics/econ_facts/#costs

[10] U.S. Centers for Disease Control and Prevention: http://www.cdc.gov/tobacco/data_statistics/state_data/state_highlights/2010/states/massachusetts/index.htm

[11] Massachusetts Dept. of Public Health: http://www.mass.gov/eohhs/docs/dph/tobacco-control/sales-tobacco-fy07-fy11.pdf

[12] U.S. Centers for Disease Control and Prevention: http://www.cdc.gov/tobacco/data_statistics/fact_sheets/economics/econ_facts/#costs

[13] Surgeon General's 2012 Report: http://www.surgeongeneral.gov/library/reports/preventing-youth-tobacco-use/factsheet.html

- Indexing the gas tax for inflation would reduce expected tax declines by an estimated $13 million in FY 2014 ($27 million in its first full year of implementation). Indexing the gas tax to inflation will prevent further erosion of the inflation-adjusted value of the gas tax. The gas tax was last adjusted for inflation in 1991 and has steadily lost value ever since. If the gas tax were to have the same purchasing-power value today as it had in 1991 (i.e., if we adjust for inflation), we now would be paying 36 cents per gallon rather than the 21 cents per gallon we actually do pay.

  Like other sales and excise taxes, the gas tax disproportionately affects low and moderate income households. Allowing the gas tax to continue its steady decline in value would reduce taxes as a share of household income more for lower income households than for upper income households. Arresting that decline by indexing the gas tax to inflation therefore will disproportionately impact low and moderate income households but will have other, beneficial effects, including positive impacts on the environment.

BUSINESS TAX CHANGES

- Application of the sales tax to the sale of custom modified software and other computer services would raise an estimated $65 million in FY 2014 ($259 million annually thereafter), and as businesses are the primary consumers of these services, this tax increase would fall mostly on businesses. Currently, the tax code differentiates between the sale of pre-written computer software (taxable) and the additional cost of customizing it for an end user (not taxable, as this is considered a service). The sales tax also doesn't apply to other computer services. This proposal would tax the customization of software and a number of other computer services, including computer systems planning and design and computer disaster recovery services. The Governor does not propose extending the sales tax to cover computer facilities management services, such as on-site management and operation of clients' computer systems or data processing facilities.

- Clarification of certain rules governing how corporations calculate the taxes they owe to the Commonwealth for sales made to Massachusetts customers would raise an estimated $21 million in FY 2014 ($35 million annually thereafter). At present, the rules are unclear about how a company must allocate its service sales to Massachusetts-based customers for the purpose of calculating the state taxes it owes the Commonwealth. As a result, some multistate companies headquartered outside of Massachusetts are asserting that they do not need to treat as Massachusetts sales, for tax purposes, service sales made to Massachusetts customers when the company calculates the amount of corporate income tax owed to the Commonwealth.

  The Governor proposes updating the Massachusetts tax code to make clear that service sales must be attributed to the state in which the customer is located when calculating the share of a company's total profits that will be taxed by the Commonwealth. If a company is required to pay corporate income taxes in Massachusetts (i.e., if the company has "nexus"), sales made to Massachusetts-based customers will be counted as Massachusetts sales for tax purposes, regardless of where the company is headquartered. The flip side of this tax code clarification is that companies that are headquartered in Massachusetts and are selling services to out-of-state customers would *not* have to count these service sales as Massachusetts sales in their tax calculations, thus reducing the amount of tax they owe to the Commonwealth.

- Elimination of the FAS 109 corporate tax break - primarily affecting about a dozen multi-state businesses – would raise an estimated $46 million in FY 2014 ($76 million annually thereafter). While the details of this tax law change involve technical and complex interactions among a corporation's records for tax purposes and its public financial accounting records, the FAS 109 provision in essence is an attempt to offset certain costs to publically-traded companies resulting from the 2008 combined reporting tax reform package.[14]

  As part of that package, rule changes were enacted that increased the cost of some tax liabilities of some companies operating in the Commonwealth. In some cases, these changes would have required changes to a company's existing financial statements. The FAS 109 provision allowed publically-traded companies to claim a new tax break that would offset the impact to their financial statements resulting from the effects of combined reporting on deferred tax liabilities.

  The Department of Revenue (DOR) has estimated that this provision will cost the Commonwealth $535 million during the period in which it was originally scheduled to be in effect (tax benefits were to be distributed equally across seven years, 2012-2018).[15] DOR has estimated further that 88 percent (or $472 million) of the total tax reductions associated with the FAS 109 will accrue to just fourteen corporations.[16] When this provision was enacted the cost was unknown and a process was established that would allow an evaluation of the likely cost before the tax break would be implemented.

- Elimination of special tax classifications (each with a special, low tax rate) for certain securities investment businesses and utility corporations will together generate an estimated $50 million in tax revenue in FY 2014 ($83 million annually thereafter). These special classifications are provisions that largely respond to circumstances that no longer exist. The Security Corporation structure allowed investors to hold securities in a legal entity that would not be taxed as an ordinary corporation. That function is now largely served by mutual funds and investment partnerships, such as hedge funds, venture capital funds, and other pooled investments. The special rules for security corporations now allow ordinary corporations to reduce their taxes by holding their investment assets in these entities. Similarly, when utilities were heavily regulated they received special tax treatment that reflected their special status. Today, firms in the traditional utilities sectors – like phones and energy – often operate just like other corporations. The Governor's proposal would end the special tax status of both of these types of corporations and tax them like other companies.

- Capping the state's revenue losses from the Film Tax Credit at $40 million annually would raise no new dollars in FY 2014, the Governor estimates, and would raise an estimated $40 million annually thereafter. The most recent annual assessment of the Massachusetts Film Tax Credit by the Department of Revenue finds that the credit cost the Commonwealth $40.3 million in lost revenue in 2010, while generating only an additional $0.8 million in new state revenue.[17] Broader analyses of state film tax credits in general - performed by the policy branch of the

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[14] As part of the combined reporting package, the tax rates applied to business profits were reduced significantly. This reduction in tax rates offset much of the gain in tax revenue the Commonwealth otherwise would have received through combined reporting (which closes a variety of corporate tax loopholes). For a more thorough discussion of Combined Reporting, please see MassBudget's Tax Primer (Chapter 7: Business Taxes): http://www.massbudget.org/report_window.php?loc=Tax_Primer_83110.html
[15] Department of Revenue report to Legislature: http://www.massbudget.org/reports/pdf/DOR_FAS109Report_Sept2009.pdf
[16] Ibid
[17] Department of Revenue, "*Massachusetts Film Industry Tax Incentive Report*" (see page 1): http://www.mass.gov/dor/tax-professionals/news-and-reports/other-reports/massachusetts-film-industry-tax-incentive-report/

Federal Reserve Bank of Boston and others – have found that these credits do not pay for themselves through increased employment (though some income tax revenue may be generated from newly created jobs) or increased economic activity (which could generate additional sales tax revenue).[18]

Other Tax Changes

In addition to the changes proposed in the Governor's tax package, the Governor also uses three other, smaller tax revenue sources to balance his FY 2014 budget. Each of these sources would deliver revenue in FY 2014 and ongoing revenue in the years ahead. Together, the three would provide about $56 million in FY 2014 ($83 million annually thereafter). When combined with the Governor's tax package, the Governor's FY 2014 budget proposal includes almost $850 million in new FY 2014 tax revenues.

- Increased tax collections resulting from enhanced requirements for income reporting by various businesses to the Department of Revenue (DOR). The changes would require additional reporting by liquor wholesalers and various franchisors and additional requirements for electronic reporting, and would make technical corrections to tax provisions governing pass-through business entities.

- Increased sales tax revenues resulting from the agreement made between the Administration and Amazon.com for the online retailer to begin collecting and remitting to the Commonwealth sales taxes on the online purchases made by Massachusetts residents.

- Increased tax collections resulting from the application of the "hotel tax" to various short-term accommodation rentals that currently are exempted from the tax. These include rentals of corporate executive apartments, B&B accommodations, vacation condos and time shares.

FY 2014 REVENUES	FY 2014		Annualized	
Other Tax Changes	**Temporary**	**Ongoing**	**Temporary**	**Ongoing**
Enhanced reporting requirements		27,000,000		27,000,000
Implement Amazon.com sales tax agreement		26,200,000		49,100,000
Eliminate hotel excise tax exemption for corporate executive apartment rentals,		2,600,000		6,800,000
Other Taxes Total		**55,800,000**		**82,900,000**

[18] Federal Reserve Bank of Boston, NEPPC Brief, "*Hollywood East? Film Tax Credits in New England*", October 2006: http://www.bos.frb.org/economic/neppc/briefs/2006/pb063.htm
Center on Budget and Policy Priorities, "*State Film Subsidies: Not Much Bang For Too Many Bucks*", December 2010: http://www.cbpp.org/cms/index.cfm?fa=view&id=3326