

January 5, 2023

To: Governor Maura Healey and Lieutenant Governor Kim Driscoll

From: Massachusetts Budget and Policy Center, President Marie-Frances Rivera and Policy Director Phineas Baxandall

Re: Policies to implement Ballot Question 1

---

As Massachusetts voters have amended the state constitution to include a 4 percent surtax on taxable income over \$1 million, MassBudget would like to offer policy suggestions to assist the Commonwealth in protecting this revenue and ensuring that it is directed to education and transportation, as specified in the amendment. Several other tax-and budget- related policies should be adjusted or fine-tuned to improve their interaction with this new revenue and budgeting mandate.

1. **Track spending** to demonstrate that surtax revenue is used for additional spending on education and transportation.
2. **Require consistent tax filing status (joint versus single) for both state and federal tax** to prevent revenue loss and the need for additional state audits.
3. **Clarify competing mandates on** revenues raised by the surtax and revenue that General Law would direct to other funds, especially the Stabilization Fund.
4. **Exclude surtax revenue from future 62F calculations and payments** so constitutional provisions from recent ballot questions are recognized to take precedence over long-ago statutory enactments.
5. **Enhance participatory input** on surtax spending.

This memo examines how statutory or executive action will be required to ensure the new policy works most effectively in each of these five areas.<sup>1</sup>

### **1. Track Fair Share revenue and spending to ensure that it is *additional* spending for education and transportation**

Before the ballot question vote, legislative supporters and Governor-elect Healey were clear that they intended the revenue from the surtax to *supplement* existing spending on education and transportation, as suggested by the ballot language.

To track dollars raised by the new surtax, the Legislature should create a dedicated and budgeted **Fair Share Education and Transportation Trust Fund** to hold surtax-generated

revenues. This would allow for better tracking of how these funds will be allocated within the budget through line-item appropriations or operating transfers.

The distribution of funds appropriated from the new trust fund should be explained in the Administration’s and Legislature’s budget proposals and also on a website dedicated to showing revenue from the surtax and appropriations from that revenue for education and transportation. The Legislature should mandate the creation of this website and assign its upkeep to an appropriate entity, such as the Executive Office for Administration and Finance. The website could track inflows and outflows, much like the current [website](#) for the Stabilization Fund. Moreover, the website could compare the prior fiscal year spending of accounts that receive surtax funds in order to demonstrate whether the incremental appropriations of available surtax revenue to transportation and education accounts is at least matched by increased appropriations in those accounts.

## **2. Ensure married tax filers use the same filing status for federal and state taxes**

Many states require people to be consistent in how they file their state and federal taxes. Matching the federal status of “filing singly” or “filing jointly” avoids unnecessary state tax audits, simplifies tax filing, and reduces potential “gaming” of the federal and state tax systems in ways that reduce tax revenue for the state. Massachusetts can fix these problems by requiring state income tax filers to match their federal filing status.

In Massachusetts the millionaire tax applies at the same threshold for single filers and joint filers. Under current law, couples who file jointly on their federal taxes may change their status and file separately on their Massachusetts taxes. Doing so grants each filer their own separate \$1 million

### **When Will Surtax Revenue Arrive?**

Surtax revenue will be included in the budget planning process before 2023 tax returns conclusively identify the amount of revenue which has been collected on income that will be subject to the surtax. Starting in January 2023, wage and salary earners who anticipate that they will earn more than \$1 million in tax year 2023 should start paying higher withholding taxes on their payroll earnings. Starting in April 2023, tax filers with non-payroll earnings who anticipate their 2023 taxable income will exceed \$1 million will likely begin paying higher quarterly estimated tax payments in anticipation of the surtax. As these payroll and non-payroll tax payments are received, the Department of Revenue can report (through its regular revenue updates) whether the amount of increased collections that appear due to the surtax are running above or below projections. The estimates will be based on incomplete data and will require DOR to make a variety of assumptions but can nonetheless help inform the estimates of revenue available for the budget. The degree to which taxpayers’ 2023 incomes exceed \$1 million will become clear only after 2023 taxes are filed in 2024. Income tax filings are due in mid-April, but automatic extensions are granted to mid-October, an option used by many high-income filers. Thus, it will be close to the end of 2024 before we will have a near complete picture of how much surtax revenue was collected in Tax Year 2023.

exemption on the surtax instead of a single \$1 million exemption applied against their combined income.

Moreover, married couples that choose to file separately on their Massachusetts income taxes would have additional incentive to illegally misattribute their income when one person earns more than \$1 million and the other earns less than \$1 million. By mischaracterizing a portion of the higher-income filer's income as earned by the lower-income filer, they would more fully utilize their separate \$1 million exemptions (see accompanying example box). To prevent this tax evasion, the Commonwealth might need to step up scrutiny and controls of how taxpayers attribute income from assets such as rental property.

Normally, the Commonwealth's Department of Revenue relies on the capacity of the federal Internal Revenue Service (IRS) to conduct audits and safeguard against illegal tax evasion. This takes considerable burden off state tax auditors. The IRS shares information with state revenue departments about audits and individuals' federal returns through a [partnership program](#). However, these federal audits provide little help in determining whether income has been attributed properly between joint federal filers if they file separately on their state tax returns.

A simple solution is to follow other states that require couples filing jointly on their federal taxes to also file jointly on their state taxes. The couples who might have the strongest financial incentive to file separately in Massachusetts to avoid the surtax would also tend to have a strong incentive to file jointly on their federal taxes. The structure of the federal system, where marginal tax rates are higher and climb more steeply, will determine most couples' decisions about tax-filing status. Massachusetts

**Inconsistent tax filing status is prone to manipulation for tax evasion**

Consider the example of two married individuals, Wesley and Leona, with a combined Massachusetts income of \$2.1 million. Wesley has an income of \$2 million and Leona has an income of \$100,000. On their federal taxes, this couple is likely to file jointly. For joint filers the top federal tax rate of 37 percent applies to all income above roughly \$700,000 and all income above roughly \$575,000 for single filers. Filing jointly Wesley and Leona would pay this highest federal rate on \$1.4 million of their income. Filing singly, Leona would not pay the highest rate on any of her income, but Wesley would pay the highest rate on \$1,425,000. They reduce their joint federal tax bills by filing jointly, which reduces the amount of income taxed at 37 percent. If this couple jointly files income tax to Massachusetts, they would pay a surtax of 4 percent on \$1.1 million for a total surtax of \$44,000. Filing singly, Leona would pay no surtax, and Wesley would pay surtax on \$1 million of his \$2 million income: a total surtax of \$40,000. Moreover, if the couple broke the law by misreporting the distribution of their \$2.1 million income such that \$1 million was attributed to Leona and \$1.1 million was attributed to Wesley, then Leona would still pay no surtax and Wesley would pay the surtax on only \$100,000 for a total of \$4,000. The Commonwealth would have little ability to use federal records to check whether income was accurately apportioned between the couple, and little indication of the tax evasion unless Massachusetts conducted its own audit.

can therefore address the problem without mandating that married couples file jointly or greatly increasing its volume of taxpayer audits. The Commonwealth need only require that people file their state income taxes with the same status they use on their federal taxes.

The need for a rule requiring consistent tax filing status is greater in Massachusetts than most other states. In other states tax brackets are typically set differently for couples than for singles to encourage joint filing. High-income couples have an incentive to file jointly on their state taxes because higher tax brackets apply at a lower income threshold for single filers. For instance, in California the 12.3 percent state income tax rate applies to joint filers with income above \$1 million and applies starting at \$625,000 for single filers.<sup>2</sup> Similarly, in [Oregon](#) the top rate of 9.9 percent is applied to all income over \$125,000 for single filers and over \$250,000 for joint filers. In [most other states](#) with income taxes, couples filing separately would each be subject to higher rates starting at a lower income if they filed separately.

If need be, the Administration could make specific exceptions, as some other states have. [California](#) makes an exception when a spouse has been a non-resident all year and earns zero California-based income. [New York](#) makes an exception when it can be demonstrated that the spouse's whereabouts are unknown or they are legally separated and refuse to file jointly. [New Jersey](#) makes an exception if one member of a couple earns income in the state but neither live there. [Utah](#) provides an exception only when each spouse is a full-year resident of different states.

### **3. Resolve conflicts between the Constitution and other laws regarding the treatment of surtax revenue**

The Commonwealth's constitution dictates that all revenue from the surtax on income over \$1 million – including surtax revenue derived from taxing capital gains – must be spent exclusively on public education and transportation.<sup>3</sup> This language currently conflicts with other laws that govern revenue and the state's Stabilization Fund.

Massachusetts General Law [Chapter 29, Section 5G](#) requires that all capital gains revenue over a certain statutorily determined threshold be deposited into three specified funds each year. Ninety percent of the capital gains revenue above the threshold is directed to the Stabilization Fund, and the remainder to state pension and retiree benefits funds.<sup>4</sup> Occasionally, and for a variety of reasons, the state will enact legislation to override this requirement.

Capital gains income is a relatively volatile revenue source that rises and falls with the stock market and other swings in asset prices. The existing law seeks to smooth out the impact of this volatility on the annual budget and use temporary capital gains revenue windfalls to buttress the health of important long-term accounts.

However, even when total capital gains revenue collections exceed the annual threshold, the portion generated by the new surtax cannot be diverted away from transportation and education appropriations. This should be clarified in statute.

The need for clarity is particularly acute because revenue collected from tax filers with income over \$1 million is typically disproportionately comprised of capital gains income. According to the most recent IRS data for Massachusetts, 70 percent of net capital gains income is claimed by tax filers with incomes over \$1 million.<sup>5</sup> For these ultra-high earners, capital gains represented 35 percent of their total income in 2019.

A simple solution to the conflicting directives of the Fair Share Amendment and other funds would be to clarify a two-step process, with each step independent of the other. In the first step, all income would be subject to the current 5 percent rate (12 percent for the relatively small amount of short-term capital gains), as at present. Any capital gains revenue in excess of the annual capital gains threshold that is collected during this step would be deposited to the Stabilization Fund, as is done currently. In the second step, the Fair Share surtax would be applied to the portion of each tax filer's income above \$1 million. Regardless of whether it is derived from capital gains, this revenue would *not* be deposited in the Stabilization Fund or the public pension or retiree benefits fund.

Ensuring that surtax revenue is not deposited into the Stabilization Fund also avoids another potential conflict between the constitutional provision and statutory enactments. Massachusetts [General Law Chapter 29, Section H](#), specifies that "[i]f the amount remaining in the fund at the close of a fiscal year exceeds 15 per cent of the budgeted revenues and other financial resources pertaining to the budgeted funds, as confirmed by the comptroller in the audited statutory basis financial report for the immediately preceding fiscal year, the amounts so in excess shall be transferred to the Tax Reduction Fund." But use of surtax revenues to fund tax reductions would violate the constitutional restriction on permissible uses of these funds. The constitution

#### **The Stabilization Fund**

Also known as the "Rainy Day Fund," the Stabilization Fund provides the state budget with a cushion for when the economy turns down. It is like a "savings account" for the state to turn to when there is inadequate money in the General Fund (the "checking account") to fund the state's operations. When state tax collections fall abruptly and/or expenditure needs rise sharply, money from the Stabilization Fund can bridge the gap.

In order to be available for such withdrawals during difficult times, deposits must be placed in the Stabilization Fund during good times. General Law dictates how this should occur, although the General Appropriations Act (the annual state budget) occasionally includes language overriding these requirements.

The foremost source of deposits into the Stabilization Fund is generally capital gains collections, which are directed to the fund when they exceed an annually designated threshold. For FY 2023, that threshold was \$1.4 billion.

dictates that surtax revenue be used solely for transportation and education. Clarifying that surtax revenues are not deposited into the Commonwealth's Stabilization Fund ensures that these revenues remain available for supporting education and transportation, regardless of Stabilization Fund balances.

#### **4. Surtax revenue should be excluded from Chapter 62F calculations and distributions**

The 1986 tax cap known as "Chapter 62F" is both a fundamentally flawed and poorly designed policy that is also incompatible with the constitutional dictates of the surtax. Any tax cap is an arbitrary constraint that hinders democratic decision making and fails to accommodate new public commitments. 62F can hinder the Commonwealth from retaining and investing the revenue necessary for public commitments made in recent decades, such as to expand funding for public K-12 education, provide health care coverage, and sharply reduce climate emissions. In addition to this more fundamental flaw, 62F also can be triggered somewhat [arbitrarily](#) by circumstances that have nothing to do with putative "revenue excess." This was the case for the Fiscal Year 2022 calculations for 62F, which was skewed by several pandemic-related factors and the [misaligned accounting](#) of a major new business credit. The way 62F payments are designed is also fundamentally [regressive](#), widening economic inequities.

Regardless of whether 62F is repealed or deeply reformed, new statute should clarify that revenue from the surtax should not be counted in future 62F calculations or potential 62F payments. There are at least two reasons to separate surtax dollars from 62F.

First, the provisions of the surtax are set in the state constitution and therefore take precedence over the statute creating the 62F tax cap if the two cannot be construed consistently. The constitution mandates that *all* surtax revenues fund public education and transportation, and therefore could not be returned to certain tax filers under the 62F tax cap provision.

Second, the direction of surtax funds to education and transportation supersedes 62F as the more recent statement of public intent. While voters in 1986 sought to limit public revenue, the 2022 vote for the millionaire surtax expresses the will of current day voters to make additional revenue for transportation and education available. Diverting surtax revenue to fund 62F rebate checks would prioritize the 37-year-old sentiment of voters over those of current voters.

#### **5. Enhance public participation in the allocation of Fair Share spending.**

There is growing recognition that public funds should be allocated via budget processes that are more inclusive and participatory. Passage of the new constitutional amendment presents a unique opportunity to pursue this goal at the state level for a consequential pool of new

funding. The Legislature should set up a structure for allocating a portion of new Fair Share funds to transportation and education via a more community-centered process.

Ideally, the legislature would consider a participatory budgeting process for some portion of revenue from the surtax. Participatory budgeting centers community involvement in decision-making on public finances, which can raise up the voices of marginalized communities. In [a typical participatory budgeting](#) process, community residents share and develop ideas into funding proposals, and vote for proposals that meet the community's needs. These proposals are then implemented by government. Some research suggests that participatory budgeting can also help build trust in government<sup>6</sup> and may make allocation of public resources more consistent with the needs and desires of the community.<sup>7</sup>

Participatory budgeting is active at the municipal level in Massachusetts. A participatory budgeting process for the new publicly enacted revenue source could draw from lessons of these existing initiatives. Boston is working on building out its participatory budgeting processes,<sup>8</sup> and Cambridge has run nine cycles of participatory budgeting process since 2014, steadily increasing annual funds that most recently allocated \$1 million in Fiscal Year 2024 capital funds.<sup>9</sup>

Short of directly involving residents in decision making, giving community-based organizations, especially those representing communities of color, a more meaningful seat at the table would be a step in the right direction. Lessons could be incorporated from the Equity and Accountability Panel created by the Commonwealth to track how federal American Rescue Plan Act (ARPA) funds are allocated to communities disproportionately affected by the COVID pandemic.<sup>10</sup>

---

<sup>1</sup> We are assuming that many other adjustments will happen by course, though they may require legislative authorization to the Department of Revenue. The Department of Revenue will update the [2022 Massachusetts income tax form](#). The surtax will be incorporated into the Administration and Legislature's consensus revenue forecast for Fiscal Year 2024. The Department of Revenue will calculate the inflation adjustment to raise the surtax threshold for subsequent tax years.

<sup>2</sup> This is the second highest state income tax rate applied in 2022. A 13.3 percent rate applies for income over \$1 million for single filers, and for income above \$1,250,738 for joint filers. California also has additional income taxes <https://taxfoundation.org/publications/state-individual-income-tax-rates-and-brackets/#Current> Those who work or reside in San Francisco also pay an additional 1.5 percent local income tax. <https://www.tax-rates.org/california/san-francisco-income-tax>

<sup>3</sup> The Constitution states, "To provide the resources for quality public education and affordable public colleges and universities, and for the repair and maintenance of roads, bridges and public transportation, all revenues received in accordance with this paragraph shall be expended, subject to appropriation, only for these purposes."

---

<sup>4</sup> According to MGL, [Chapter 29, Section 5G](#) capital gains revenue in excess of the threshold must be transferred in the following proportions: 90 percent to the Commonwealth Stabilization Fund; 5 percent to the State Retiree Benefits Trust Fund; and 5 percent to the Commonwealth’s Pension Liability Fund (PRIT). The threshold amount is annually adjusted by the previous five year’s average annual growth rate of the U.S. gross domestic product. The Stabilization Fund also retains earnings from invested holdings, and receives deposits from the Casino Gaming Tax (10 percent of Encore and MGM gaming tax revenue), withholding tax on certain Lottery prizes, unusually large amounts of tax judgements or settlements exceeding \$10 million, and any transfers deposited from other sources as directed by the legislature.

<sup>5</sup> Internal Revenue Service, Statistics of Income 2019, “Massachusetts” at <https://www.irs.gov/pub/irs-soi/19in22ma.xlsx> . State capital gains do not perfectly match the federal distribution but are a close approximation. Also, the volatility of capital gains revenue means that these percentages can fluctuate by year.

<sup>6</sup> Swaner, R. (2017). Trust Matters: Enhancing Government Legitimacy through Participatory Budgeting. *New Political Science*, 39 (1), 95–108. doi: 10.1080/07393148.2017.1278856

<sup>7</sup> Boulding, C., & Wampler, B. (2010). Voice, votes, and resources: Evaluating the effect of participatory democracy on well-being. *World Development*, 38(1), 125–135. doi: 10.1016/j.worlddev.2009.05.002; Gonçalves, S. (2014). The effects of participatory budgeting on municipal expenditures and infant mortality in Brazil. *World Development*, 53, 94–110. doi: 10.1016/j.worlddev.2013.01.009; Shybalkina, I., & Bifulco, R. (2019). Does participatory budgeting change the share of public funding to low-income neighborhoods? *Public Budgeting & Finance*, 39(1), 45-66. doi: 10.1111/pbaf.12212

<sup>8</sup> Center for Economic Democracy at <https://www.economicdemocracy.us/charter>

<sup>9</sup> City of Cambridge Participatory Budgeting at <https://pb.cambridgema.gov/>

<sup>10</sup> Commonwealth of Massachusetts, Federal Funds Office, “About the Federal Funds Equity and Accountability Review Panel” at <https://www.mass.gov/info-details/about-the-federal-funds-equity-and-accountability-review-panel>