

## Preventing High-Income Tax Avoidance to Protect Education and Transportation

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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 and reduces potential “gaming” of the state tax system. Such gaming could cost the Commonwealth as much as one-fifth of projected total collections annually. Using the estimate from the Executive Office of Administration and Finance for Fiscal Year 2024 surtax collections, this would amount to a loss of some \$200 million. Other estimates put the eventual revenue loss as high as \$600 million or more. **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 exemption on the surtax instead of a single \$1 million exemption applied against their combined income.

The use of inconsistent filing status to avoid taxes will cost the Commonwealth between \$200 million and \$600 million.<sup>1</sup> As a point of comparison, the [Consensus Revenue Estimate](#) projects that all other non-surtax tax revenue will increase only \$151 million in FY 2024. In other words, if not prevented by new legislation, the loss of surtax revenue from inconsistent filing status will be greater than the gain in tax revenue from all other non-surtax sources.<sup>2</sup>

These revenue losses from tax avoidance would impair the Commonwealth’s ability to make new investments. At the same time, the state budget will also face dwindling federal aid that has supported many public activities over the last several years. If the economy dips into recession,

### Key Takeaways

- The highest-income tax filers in Massachusetts can give themselves a substantial tax cut by declaring themselves single on state taxes, while simultaneously reaping the benefits of filing jointly on federal income taxes.
- Massachusetts could lose out on **one-fifth** of expected collections from the new “millionaire tax” as a result of this loophole.
- State scrutiny of federal tax audits for these taxpayers will become less useful for Massachusetts, creating pressure for more state tax audits.
- These problems can be solved by following many other states that require that taxpayers file their state income taxes with the same status they use on their federal taxes.

public revenues will face further challenges. Massachusetts residents who are counting on funds from the millionaire tax to help repair bridges and schools, support public transportation, or launch new programs for subsidized early education or community college, for instance, may find themselves disappointed.

### Inconsistent Filing Status Encourages High-Income Tax Evasion and Requires More State Audits

High-income households that file as “married filing separately” on their Massachusetts income taxes would also have incentive to illegally misreport the division of income between the two spouses 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 exploit their separate \$1 million exemptions (see example box). To prevent this type of tax evasion, the Commonwealth might need to step up scrutiny and controls of how taxpayers attribute income from their assets.

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. Requiring people to be consistent in how they file their state and federal taxes would spare Massachusetts the burden of conducting its own separate audits to determine that information.

#### **Inconsistent filing status encourages further tax evasion**

Consider Wesley and Leona, a married couple with a combined income of \$2.1 million. Wesley makes \$2 million and Leona makes \$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.

## Other States Show an Easy Fix

Inconsistent tax filing status poses a larger problem in Massachusetts than other states because, unlike the federal government and most states, our tax brackets are the same for couples and single filers. High-income couples in other states 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. But for single filers, it applies starting at \$625,000.<sup>3</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.

Even with these incentives in the structure of their state tax brackets, many states require married couples who file jointly on their federal taxes to also file jointly on their state taxes. The structure of the federal tax system, where marginal tax rates are far higher and climb more steeply than state taxes, will determine most couples' decisions about tax-filing status.

If Massachusetts taxpayers were similarly required to use a consistent status in their federal and state taxes, then most married couples would end up electing to file jointly. The federal tax advantages of filing jointly for most couples with combined income over \$1 million typically far exceed their potential state-level tax advantage from filing singly. This would reduce the opportunity for the highest-income 1 percent of tax filers to avoid the new surtax. To prevent the loss of \$200 – 600 million of revenue the Commonwealth need only require that people file their state income taxes with the same status they use on their federal taxes.

This result can be achieved by adopting the simple Massachusetts bill, “An Act Preventing High Income Tax Avoidance” ([HD.2310/ SD.1167](#)). It states that, “a married couple must file a joint return for any year in which they file a joint federal income tax return.”

## Endnotes

<sup>1</sup> Based on tax modeling conducted by the Institute on Taxation and Economic Policy (ITEP), joint federal tax filers who file separately on their Massachusetts state taxes could reduce surtax collections by as much as one-fifth of projected totals. ITEP estimates the potential revenue loss at \$615 million annually. Massachusetts' Executive Office for Administration and Finance conservatively estimates only \$1 billion in surtax revenue for Fiscal Year 2024, which would correspond to about \$200 million in possible tax avoidance from federal joint filers, or more if the revenue estimate already considers some degree of this tax avoidance. See, Executive Office for Administration and Finance, press release “Gorzkowicz, Rodrigues, Michlewitz, Announce Consensus Revenue Forecast of \$40.410 Billion for Fiscal Year 2024,” January 30, 2023 at <https://www.mass.gov/news/gorzkowicz-rodriques-michlewitz-announce-consensus-revenue-forecast-of-40410-billion-for-fiscal-year-2024>

<sup>2</sup> The loss of public revenue from high-income married filers declaring themselves “single” on their state taxes would have a relatively mild impact during the remainder of Fiscal Year 2023 because most of Tax

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Year 2023 surtaxes will not yet be collected. The full impact of the tax avoidance will not be felt until Fiscal Year 2024, which starts in July 2023.

<sup>3</sup> This is the second highest California income tax rate bracket 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. See <https://taxfoundation.org/publications/state-individual-income-tax-rates-and-brackets/#Current> California also has additional local income taxes. 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>