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Income Surtax: Fiscal Approach and Unanswered Questions

The state's 4 percent surtax on income over $1 million is now in effect. The new tax raises critical policy questions related to its effect on long-term economic growth and its impact on other areas of the tax code. At the same time, the surtax creates a number of fiscal and tax policy questions. This brief:

1. Lays out the fiscal challenges with collecting, tracking, and using surtax revenues and presents a recommended approach to address those challenges as part of the FY 2024 budget development process;
2. Identifies a number of implementation questions related to the surtax that must be clarified for taxpayers and policymakers.

Fiscal Approach

MTF's recommended approach is detailed below, but in brief, it is as follows:

- Require the Comptroller to certify surtax revenues annually to be deposited into trust funds dedicated to education (50 percent) and transportation (50 percent);
- In FY 2023, use no surtax revenue for the remaining months of the fiscal year;
- In FY 2024, cap the use of surtax revenue at $500 million;
- In subsequent years, use the most recently certified surtax amount for the budget; and
- Require that the surtax trust funds maintain a minimum balance (adjusted for inflation) to protect against future downturns.

Surtax Challenge – Collecting, Tracking & Transparency

In order to use surtax revenues in a fiscally prudent way that is consistent with constitutional requirements, the state must know exactly how much surtax revenue is collected and separate that revenue from other income tax collections. At present, there is no statutory system to monitor and separate surtax collections as all revenues will be deposited directly into the General Fund, creating transparency problems. In order to address these issues, the state must do the following:

- **Amend existing tax forms to differentiate surtax revenue from other income tax collections.** While forms are being adjusted and finalized, the Department of Revenue must not penalize filers for failing to follow withholding or estimated payment guidelines for the surtax, which have yet to be developed.

- **Publish quarterly estimates of surtax collections. Policymakers and the public need a real-time sense of surtax collection trends.** If possible, the Department of Revenue should report surtax collections separately in their monthly revenue reports, but if that is not feasible, they must provide quarterly estimates.
- **Certify annual surtax collections. It is critical that, like capital gains tax collections, the comptroller annually certify surtax revenues collected in the prior year.** This process could either occur on the same timeline as capital gains and apply to the preceding fiscal year or in time for the Consensus Revenue process and apply to the preceding tax year;
- **Deposit surtax revenues into separate trust funds.** The funds should be divided evenly between a trust fund for transportation and a trust fund for education.

Surtax Challenge – Volatility and Budget Uncertainty

More than two-thirds of surtax revenues will come in the form of capital gains and other non-withheld income. These are the most volatile tax revenues collected by the state and often vary drastically from one year to the next, making reliable predictions all but impossible. Building the budget on surtax projections would create a fiscal disaster if an unexpected economic downturn occurs. In order to mitigate volatility in the budget, the state must do the following:

- **Use already collected and certified surtax revenue in the budget.** Starting in FY 2025, the budget should use surtax revenues that have been certified by the Comptroller to support future appropriations. Doing this will eliminate the risk of inaccurate projections causing budget havoc and allow budget-makers time to respond to changing economic circumstances;
- **Maintain a minimum balance in each trust fund.** Building a reserve in surtax trust funds, will be an additional safeguard against volatility in collections. Surtax revenues will drop the most during tough economic times, just when those resources are most needed. Keeping a strong balance in the surtax trust funds is essential to offsetting this flaw in collection timing.

Surtax Challenge – Initial Collection Timing

While the surtax is already in effect, it will take more than a year for state revenue collections to provide policymakers with an accurate sense of initial revenues. Surtax revenues will come in two forms:

- About 30 percent will come in the form of withholding taxes, which are taken from weekly wages;
- About 70 percent will come through estimated payments and annual returns and will be based on capital gains, partnership, dividend, and other non-wage income.

Surtax revenue from withholding should arrive first, but will not be immediately apparent and will be difficult to identify. The surtax only applies once income exceeds $1 million, so for many impacted filers, the surtax withholding will not begin until well into 2023. In addition, the Department of Revenue is unlikely to penalize employers for withholding at 5 percent while the state creates a clear process to guide surtax withholding. These two factors will depress withholding collections in 2023 and make them challenging to track.

More than two-thirds of surtax revenue is likely to come through quarterly estimated payments and annual returns. However, estimated payments for the next year are based on 2022 tax liability, when the surtax did not exist. This means that it will not be until April of 2024 that many affected filers will pay returns based on surtax income. Those revenues will not be made public until May of 2024, less than two months before the end of FY 2024. If the FY 2024 budget uses a projection for surtax revenues, the timing of collections will leave budget-makers with essentially no time to react if actual collections differ significantly from projections. Therefore, the state must do the following:

- **Avoid using any surtax revenue in FY 2023.** The current fiscal year is already more than halfway over, and the state fiscal condition remains strong. Surtax revenues are unnecessary this year and would only add budget risk.
- **Cap the use of surtax revenue in FY 2024.** Using a set, reasonable figure for surtax revenue in FY 2024 avoids the danger of unreliable projections and enables the state to base future year budgets on already certified surtax collections. MTF recommends capping surtax revenue at $500 million in FY 2024.

Tax Implementation Questions

Without companion legislation, the income surtax will be administered by the Department of Revenue (DOR) based on four sentences now added to the state constitution. The only language that currently governs implementation of the tax is: *"there shall be an additional tax of 4% on that portion of annual taxable income in excess of $1,000,000 (one million dollars) reported on any return related to those taxes."*

To put this in perspective, the state's five percent income tax is governed by chapter 62 of the state's General Laws, which includes more than 30 distinct sections governing various aspects of the tax. The Constitutional question neither ties the tax to chapter 62, nor chapter 62C which governs how DOR administers taxes.

Below is a preliminary list of implementation questions left unresolved by the ballot question. Each of these questions has major implications for taxpayers and the state economy. MTF will augment this list as new issues arise.

- What does 'annual taxable income' include? What is meant by 'any return related to those taxes'?
- For non-residents, does the 4 percent surtax apply solely to their annual taxable income from Massachusetts or does "any return related to those taxes" capture adjusted gross income (AGI) reported on federal returns?
- How does this language affect income sources like Massachusetts tax exempt bonds that are not subject to Massachusetts income taxation but are included in returns' AGI?
- Will charitable deductions be affected by the 4 percent surtax?

- How does the surtax apply to couples that file a joint federal return, but separate state returns?
- How does the surtax affect Massachusetts residents with income over $1 million and with income from other states?
    - Currently, there is a credit on taxes paid to other states generally limited to 5 percent of the amount of income taxed by the other state and Massachusetts.
- When and how should employers add 4 percent of withholding on w-2 employees' income over $1 million?
- Will irrevocable complex trusts and estates be affected by the 4 percent surtax?
- Can the 4 percent surtax be added to the 5 percent excise tax paid by participating pass-through entities on income over $1 million?

Failure to clarify these types of questions in law will heighten taxpayers' and fiscal uncertainty, with negative results for the state economy and state finances.