

Fundamentally Flawed: 62F Formula Overstates "Excess" by \$1.4 Billion

By Kurt Wise, Senior Policy Analyst

The \$2.9 billion estimate of 62F "excess tax collections" [recently certified](#) by the State Auditor overstates these net Fiscal Year (FY) 2022 collections by \$1.4 billion. The problem is not that the Auditor miscalculated but that the calculation as stipulated in the 62F statute fails to account for situations where taxes are received by the Commonwealth in one fiscal year, but corresponding, offsetting tax credits are not applied until the following fiscal year. This is one of the [many fundamental flaws](#) in the 1986 tax cap law (referred to as "62F").

Based on data provided by the Executive Office of Administration and Finance (ANF), this problem arises in the FY 2022 calculation due to a mismatch in timing between business tax *payments* made through the recently enacted [pass-through entity \(PTE\) excise tax](#) and the use by individual filers of the corresponding PTE tax *credits* to which they are entitled. (See Appendix A for an overview of how the PTE tax and credit program works.)

Businesses' initial PTE tax *payments* for all of tax year 2021 and the first part of tax year 2022 were made during FY 2022. These payments are counted as part of the FY 2022 tax collection total. However, for every dollar paid in PTE excise taxes in FY 2022, pass-through business owners are entitled to 90 cents of credits against their personal income tax. Due to the statutory timing of PTE payments and credits, only a small portion of the credits were actually taken against FY 2022 personal income tax payments. Many eligible filers have yet to claim and apply these PTE credits on their income taxes. These guaranteed credits, once claimed, are expected to reduce tax collections by [90 percent of the value of the PTE tax excise](#).

The flawed 62F structure does not subtract these as-yet-unclaimed credits from the FY 2022 tax collection total. The result is that the 62F net revenue calculation for FY 2022 includes as much as 18 months' worth of PTE tax payments, but only a fraction of a single year's worth of the corresponding PTE tax credits. (Several other flaws in the 62F structure likewise have artificially

Key Takeaways

- Fundamental flaws in the 62F formula have resulted in an overstatement of FY22 excess tax collections by about \$1.4 billion.
- The artificially high calculation of excess tax collections in FY22 is due to a timing mismatch between when tax filers paid their pass-through entity (PTE) excise taxes and the lag in claiming their corresponding personal income tax credits.
- This calculation mismatch almost doubles the total amount of money designated for 62F tax refunds.
- The 62F refund formula heavily favors very high-income households, so most of this \$1.4 billion overstatement will flow to the state's highest income households.

driven up FY 2022 net revenues, including how 62F fails to account for unemployment benefits, federal supports to businesses and households, and surges in inflation.)

According to ANF data, [pass-through businesses](#) eligible for participation in the new PTE program (which includes most S-corps, LLCs, and partnerships, as well as certain trusts) paid a total of \$2.258 billion in PTE excise tax in FY 2022. With PTE credits set equal to 90 percent of payments, *net* total PTE collections will be reduced by something very close to \$2.032 billion once the full value of PTE credits is claimed and applied by filers. This issue [was flagged](#) by the Auditor in the press release accompanying her FY 2022 certification and is tracked regularly by the Department of Revenue, including in [their summary](#) of FY 2022 collections.

Filers, however, to date have claimed only \$196 million in FY 2022 PTE credits for use in FY 2022. ANF provides a further estimate of a \$442 million reduction in FY 2022 estimated personal income tax payments that are attributable to filers’ anticipated use of as-yet-unclaimed PTE credits.

The officially certified FY 2022 PTE collection total was reduced by only \$638 million (\$196 million + \$442 million = \$638 million) rather than by the full \$2.032 billion in anticipated FY 2022 PTE credits. This means that approximately \$1.394 billion of PTE excise credits remain unclaimed (\$2.032 billion - \$638 million = \$1.394 billion). The vast majority of these credits, however, *will* be claimed, and when applied, *will* reduce future tax collections accordingly. Phrased another way, the \$2.9 billion “excess” certified by the State Auditor overstates the long-term net FY 2022 tax collection total by about \$1.4 billion. (Another \$28 million in FY 2022 PTE credits have been claimed for use in future years. However, because they will be applied by filers to future year tax liabilities, these credits do not reduce FY 2022 actual collections. Thus, they were not deducted from the state’s official estimate of total FY 2022 collections.)

Accounting of FY 2022 PTE Credits Yet to Be Claimed	\$ (Millions)
Total anticipated FY 2022 PTE credits (90% of PTE excise collections)	2,032
Claimed FY 2022 PTE personal income tax credits	(196)
Estimated reduction in FY 2022 personal income tax payments	(442)
FY 2022 PTE personal income tax credits yet to be claimed	1,394

What will the impact be of this very large overstatement of the net FY 2022 62F excess? Governor Baker [has announced](#) that his administration will begin providing refunds to taxpayers starting in November. The total amount refunded is set by the Auditor’s certification (\$2.9 billion) and the amount refunded to individual taxpayers will be calculated using the formula outlined in the 62F statute. As structured, this formula will deliver the vast majority of 62F refund dollars to high-income households. This imbalance is equally true of the portion of refunded dollars that will come from the \$1.4 billion overstatement of the FY22 62F excess.

For households with incomes below \$25,000 that will receive a 62F refund, on average they'll get about \$75 each. Together, they will receive less than 1.5 percent of all FY 2022 62F refund dollars. Moreover, about half of households with incomes below \$25,000 (roughly the bottom fifth of households) will receive no refund at all. Households with annual incomes above \$1 million, by contrast, will receive, on average, refunds of approximately \$28,850 each. These households (well less than 1 percent of Massachusetts tax filers) will collect over one quarter of all FY 2022 62F refund dollars, while the top 10 percent of households will collect over half of the total \$2.9 billion to be refunded. For households with incomes of \$1 million and higher, roughly \$13,700 of their average 62F refund will result from the failure of the 62F formula to account for the \$1.4 billion in as-yet-unclaimed FY22 PTE credits.

Due to 62F's failure to account properly for PTE tax credits, the Commonwealth will refund an additional \$13,700, on average, to each household with million-plus-incomes.

The Governor's plan to refund this illusory \$1.4 billion of "excess" FY 2022 revenue through the 62F process does not change the fact that future fiscal year personal income tax collections will be reduced by some \$1.4 billion, as filers claim and apply their outstanding FY 2022 PTE tax credits. This means there will be \$1.4 billion less that is available to address critical needs.

Unless policymakers act to clarify and correct the workings of 62F, this fundamentally flawed statute is poised to make after-tax income inequality in Massachusetts worse than it now is, while also reducing the resources available to support important priorities throughout the Commonwealth.

APPENDIX A

What is the pass-through entity (PTE) excise tax? In 2017, the federal Tax Cuts and Jobs Act (TCJA) placed a cap of \$10,000 on the amount of state and local taxes (SALT) that personal income tax filers could deduct from their federal taxable income. Businesses, however, remain able to deduct all their state and local taxes from their profits. For high-income households, the SALT cap resulted in a substantial increase in their federal tax liability. Roughly half the states, including Massachusetts, have responded by creating workarounds that deliver much of the federal tax benefit of SALT deductibility to a subset of state income tax filers.

How do the workarounds work? The difference between how the SALT cap applies to individuals versus businesses creates the opportunity for a workaround. Businesses can deduct the full amount of their state (and local) tax from their profits. The workarounds take advantage of this by allowing many individuals with pass-through business income to, in effect, pay their state personal income taxes through their business rather than at the individual level, thus avoiding the federal cap. This outcome is achieved by having the business pay a tax – in Massachusetts, this is the PTE excise tax - equivalent to the amount that otherwise would be paid by individual owners at the individual level. This tax, paid by the business, in turn reduces the amount of profit (i.e., income) distributed to owners. With less income, these owners owe less federal and state personal income tax – an outcome very similar to how things stood prior to implementation of the federal TCJA SALT cap.

What do the PTE personal income tax credits do? PTE taxes paid at the business level reduce a pass-through business owner's taxable personal income, but this reduced amount of personal income is still subject to state income taxes. To avoid "double taxation", a corresponding state income tax credit is issued to the filer in an amount equal to 90 percent of the amount of PTE excise tax that has been paid on this income at the business level. (The Commonwealth generates a modest gain by retaining the remaining 10 percent.) While the federal government loses out on a significant amount of tax due to the workaround, this arrangement provides the Commonwealth with a modest amount of additional personal income tax revenue and provides pass-through owners with much of the federal SALT reductions they used to receive, prior to TCJA.