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Generations Fall 2023 - Massachusetts Releases Millionaires Tax Guidance

Last month, the Massachusetts Department of Revenue published guidance on its website related to the recently enacted "millionaires tax." The guidance, which is presented in a FAQs format, addresses several critical questions that taxpayers and advisers have been asking since the new surtax became law. While the guidance is not very taxpayer-friendly, it at least helps taxpayers understand the rules, which is a critical condition for any type of effective tax planning. For tax years beginning on or after January 1, 2023, Massachusetts taxpayers will be required to pay an additional 4 percent surtax on net income in excess of $1 million. This new surtax, which many refer to as the "millionaires tax," was passed by voters last November in the form of a ballot initiative. We previously discussed here the passage and anticipated impact of the millionaires tax. Between then and now, many questions have arisen as to how the new surtax would work. For example, it was unclear whether the tax applied to trusts or whether certain credits or elections to alleviate the impact of the tax would be made available. These types of issues have made it difficult for taxpayers who are subject to the millionaires tax to plan, and until recently, the Department of Revenue had not issued any material guidance on it. The Department of Revenue's FAQs page addresses many of these open issues. Here are some of the key takeaways from the FAQs page:

1. **The millionaires tax applies to trusts and estates.**

This was surprisingly unclear when the surtax became law. The millionaires tax was portrayed in the media as a tax that would apply only to the wealthiest individuals, but the actual amendment to the Massachusetts Constitution was written so broadly that it could also apply to trusts and estates. The FAQs now make clear that individuals, trusts and estates with taxable income exceeding $1 million in any tax year are subject to the surtax.

2. **Gain from the sale of a primary residence could be subject to the millionaires tax.**

To the extent that income from the sale of a personal residence is otherwise subject to income tax, that income also goes into the calculation of annual taxable income for the purpose of assessing the millionaires tax. If a Massachusetts taxpayer excludes $250,000 of gain from the sale of their personal residence under the primary residence exclusion, that $250,000 is not subject to the millionaires tax, but gain from the sale that is not otherwise excluded is taken into account for purposes of the tax.

3. **Taxpayers cannot rely on the pass-through entity tax program to achieve the economic benefit of a deduction for millionaires taxes paid.**

Massachusetts is one of many states that passed some form of a pass-through entity (PTE) tax regime to help provide relief to taxpayers who can no longer deduct state income taxes on their federal tax returns because of the state and local tax (SALT) cap limitation imposed by the Tax Cuts and Jobs Act (TCJA) passed in late 2017. Massachusetts taxpayers who pay a significant amount of state taxes personally can no longer deduct those taxes on their federal returns, but if they are shareholders in an S corporation or partners in a partnership, they could elect into the state's PTE tax program and pay 5 percent state tax at the entity level. This moves the payment of the state income tax "above the line," where the deduction is not subject to the limitations enacted by the TCJA. The PTE statute hardwired a 5 percent rate into the language, since that's the regular tax rate for nearly all types of income in Massachusetts, and therefore does not account for the fact that taxpayers subject to the millionaires tax will be paying tax on some of their income at a 9 percent rate. The FAQs make clear that the current PTE tax program does not accommodate the millionaires tax, which means that high-income Massachusetts taxpayers subject to the new 4 percent surtax will not be able to get a benefit on their federal tax returns for paying the

surtax. It's worth noting that Gov. Maura Healey recently passed a large tax reform bill (which we previously discussed here) and that the legislation mentions that this issue remains under further review. This suggests that legislators are at least aware of the issue. It's also worth noting that the SALT cap limitation is set to sunset at the end of 2025 unless otherwise extended by Congress, so relief might be on the way without the need for any changes to the PTE tax regime.

4. **Taxpayers who pay taxes in other high-tax states (e.g., New York, California) cannot take the millionaires tax into account when calculating their nonresident tax credit.**

This represents another negative development for taxpayers. Suppose a Massachusetts resident works part time in New York and pays income taxes on that New York-sourced income at a 9 percent rate. Massachusetts taxes its residents on their worldwide income at a 5 percent rate, so the income that this taxpayer earns in New York is subject to tax in both states. To avoid double taxation in a situation like this, Massachusetts offers an "other jurisdiction" tax credit that the taxpayer can apply so that they only pay 9 percent to New York on their New York-sourced income and do not need to pay additional Massachusetts tax on that income. Now suppose that the taxpayer in our example is subject to the millionaires tax. They are paying 9 percent income tax in both jurisdictions, which one might expect would result in a 0 percent tax in Massachusetts after applying the credit, but the FAQs state that taxpayers cannot take the 4 percent surtax into account as Massachusetts tax paid on an item of income that is taxed to another jurisdiction when calculating the credit for taxes paid to the other jurisdiction. Thus, in our example, the taxpayer could use the other jurisdiction credit to offset their 5 percent Massachusetts income tax but not the 4 percent millionaires tax that might also apply to that income. The reasoning set forth in the FAQs is that taxpayers cannot assume that all the income that was taxed by another jurisdiction was included in the taxable income over the $1 million threshold. While this makes some logical sense, it does not solve for the fact that this will be perceived by taxpayers affected by the new surtax as double taxation on the same income. In turn, this could have an impact on whether wealthy taxpayers will choose to remain in Massachusetts or instead consider moving to other states, like Florida, that do not have any income, estate or millionaires taxes.

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