PROPOSED MASSACHUSETTS TAX EXPENDITURES
EVALUATION SUMMARY

EVALUATION YEAR: 2021-2022

TAX EXPENDITURE TITLE	Favorable Tax Treatment of Qualified Small Business Stock (QSBS) Gain
TAX EXPENDITURE NUMBER	1.042 and 1.501
TAX EXPENDITURE CATEGORY	Exclusion from Gross Income and Preferential Rate of Taxation
TAX TYPE	Personal Income Tax
LEGAL REFERENCE	Code § 1202; M.G.L. c. 62, §§ 1,4(c)
YEAR ENACTED	Exclusion of gain effective for sales of eligible stock on or after January 1, 2005. Preferred rate effective for sales of stock in eligible corporations formed on or after January 1, 2011.
REPEAL/EXPIRATION DATE	None
ANNUAL REVENUE IMPACT	Tax loss of $32.0 - $49.8 million per year during FY19-FY23.
NUMBER OF TAXPAYERS	130 in tax year 2018
AVERAGE TAXPAYER BENEFIT	About $246,000 per taxpayer (tax year 2018).

Description of the Tax Expenditure: Gains derived from the sale of certain "qualified small business stock" ("QSBS") are eligible for a 50% income exclusion because of Massachusetts' conformity with section 1202 of the Internal Revenue Code (the "Code") as in effect in 2005. If it meets certain requirements, QSBS gain that is included in income is taxed at a rate of 3% instead of the generally applicable long-term gain rate of 5%.	**Is the purpose defined in the statute?** The statute does not explicitly state the purpose of this tax expenditure.
What are the policy goals of the expenditure?	**Are there other states with a similar Tax Expenditure?** Many states allow an exclusion for the entire amount of gain on the sale of qualified small

DOR assumes that the tax expenditure is intended to encourage investment in new small businesses.	business stock, consistent with section 1202 of the Code as currently in effect. These states include New York, Connecticut, Maine, Rhode Island, and Vermont. California is one state that does not allow an exclusion or a preferential rate on such gains. DOR is not aware of any state that applies a preferential rate on such gains.

INTRODUCTION

For federal tax purposes Internal Revenue Code (the "Code") § 1202 allows individuals an income exclusion for gains derived from the sale of qualified small business stock ("QSBS"). Because Massachusetts generally follows the Code as in effect in 2005 for personal income tax purposes, Massachusetts allows an income exclusion for 50% of such gains.

In addition, Massachusetts provides a reduced tax rate for the 50% of such gains that are included in income, if certain additional requirements are met. Specifically, gains on the sale of qualified small business stock are taxed at a reduced rate of 3%, instead of the generally applicable long-term gain rate of 5%, if the stock that is sold (i) was acquired within five years of the corporation's date of incorporation (ii) was held for three years or more prior to the sale, and (iii) was issued by a C corporation or S corporation which (a) is domiciled in Massachusetts, (b) was incorporated on or after January 1, 2011, (c) had less than $50 million in assets at the time of investment, and (d) complies with certain of the "active business" requirements of Code § 1202.

POLICY GOALS

Although the statute is silent on the intent of the expenditure, DOR infers the goal to be the encouragement of investment in new small businesses.

DIRECT COSTS

The revenue loss resulting from the favorable tax treatment of QSBS gain is estimated to be $32.0 - $49.8 million per year during FY19-FY23 (see Table 1 below). The estimates in Table 1 are for gains that are eligible for both the 50% exclusion and the reduced tax rate of 3%. For those gains that are eligible for the 50% exclusion but not the reduced tax rate, DOR does not have sufficient data to estimate the cost.

The estimates in Table 1 are based on DOR's personal income tax return data for tax years 2016 to 2019 and DOR's projection of capital gains tax for tax years 2020 to 2023, which are based on the financial and housing market projections from DOR's vendors, *Moody's Analytics* and *IHS Markit*. Given that the internal data, which is based on the actual return information, is in general much more reliable than external data, and capital gains tax is generally difficult to project, DOR is more confident in the estimates for FY19-FY20 than in the estimates for FY21-FY23.

Table 1. Tax Revenue Loss Estimates for Favorable Tax Treatment of Qualified Small Business Stock

Fiscal Year	2019	2020	2021	2022	2023
Estimated Revenue Loss ($Million)	$32.0	$33.9	$49.8	$46.5	$45.7

DIRECT BENEFITS

The primary direct beneficiaries are investors who invest in qualified small businesses. These investors benefit not only from the favorable tax treatment of gains on qualified small business stock, but also faster growth of the qualified small business due to more investment incentivized by favorable tax treatment.

Table 2 below reports the number of tax filers who took advantage of the favorable treatment for QSBS gains for the tax years 2016 through 2019, as well as the total tax savings and average tax savings to them, by the range of realized capital gains they reported.[1]

The total number of tax filers taking advantage of favorable tax treatment for QSBS gains increased over time from 42 filers in tax year 2016 to 165 filers in tax year 2019. Most of these filers have realized capital gains in the $1-$500K range, followed by those with more than $1M realized capital gains, and lastly those in the $501K-$1M range.

Table 2 also shows that total tax savings to those filers have increased over time from $2.8 million in tax year 2016 to $32.1 million in tax year 2019. Most tax savings (more than 80%) went to tax filers with more than $1 million realized capital gains (less than 40% of all filers). Average tax savings show a similar pattern with filers with more than $1 million realized capital gains saving much more tax than other tax filers.

Table 2. Massachusetts Tax Filers Who Claimed Favorable Tax Treatment of QSBS Gain During Tax Years 2016 - 2019

Range of Capital Gains Taxed at 3%	2016			2017			2018			2019**		
	Number of Filers	Total Tax Savings ($000)	Average Tax Savings ($000)	Number of Filers	Total Tax Savings ($000)	Average Tax Savings ($000)	Number of Filers	Total Tax Savings ($000)	Average Tax Savings ($000)	Number of Filers	Total Tax Savings ($000)	Average Tax Savings ($000)
$1-$500K	31	$254	$8	63	$569	$9	63	$519	$8	90	$895	$10
$501K-$1M	*	$105	*	9	$496	$55	20	$1,081	$54	17	$974	$57
Over $1M	*	$2,449	*	15	$4,314	$288	47	$30,439	$648	58	$30,231	$521
Total	42	$2,808	$67	87	$5,380	$62	130	$32,039	$246	165	$32,100	$195

Source: Massachusetts Department of Revenue.
Note: * Due to low filer count, numbers are omitted to maintain the confidentiality of filer data in accordance with DOR guidelines.
** 2019 data are preliminary and subject to change.

[1] As Table 1, Table 2 does not include the QSBS gains that are eligible for the exclusion but not the reduced tax rate due to data limitation.

EVALUATION: COMPARING COSTS AND BENEFITS

In the previous sections, we report the direct costs (to the Commonwealth, or to the residents and businesses who ultimately bear the costs when the Commonwealth cuts government spending or increases taxes to finance the favorable tax treatment of realized capital gains from selling qualified small business stock) and direct benefits (to investors of qualified small business stock) of this tax expenditure. In this instance, the direct costs to the Commonwealth, namely the capital gains tax that would have been collected from these transactions, are equal to the direct benefits afforded by the tax expenditure to investors in qualified small business stock, which is the capital gains tax they would have had to pay to the Commonwealth.

Besides the direct costs and benefits, there are indirect and induced costs and benefits associated with this tax expenditure. Generally, the indirect impact (cost or benefit) is felt by the chain of businesses that provide intermediate products and services to the first impacted businesses. The induced impact (cost or benefit) occurs when an impacted business passes on the costs or benefits to households, such as those of its employees, in the form of lower or higher income, such as wages and salaries, who then in turn reduce or increase purchases of goods and services from other businesses. The total costs or benefits to the whole economy are larger than the initial direct impacts. This phenomenon is called the "Multiplier Effect".[2]

To measure these indirect and induced costs and benefits, economists often need to utilize complicated models, such as REMI (Regional Economic Models, Inc.) or IMPLAN (Impact Analysis for Planning) models. DOR did not attempt to use such models given their complexity and the data limitations present in this instance.

DOR infers that the goal of this tax expenditure is to encourage investment in new small businesses. Although DOR is not aware of any studies assessing whether favorable state tax treatment of gains from qualified small business stock furthers this goal, studies on the impact of the corresponding federal tax expenditure arrive at different conclusions. Edwards and Todtenhaupt (2020) report that the federal capital gains tax reduction introduced by the 2010 Small Business Jobs Act (SBJA) raised the amount of investment in start-up firms per funding round by about 12%. On the other hand, Viswanathan (2020) argues that "Even if catalyzing investment in small businesses is normatively desirable, the provision [Code § 1202] does little to promote that result." Viswanathan's study also demonstrates that the loss in federal tax revenue due to Code § 1202 is far greater than previously estimated, with the provision almost exclusively benefitting the wealthy. Please note that QSBS investors can benefit from not only the favorable treatment of state capital

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[2] For an illustration of "Multiplier Effect", see Slide 4 of: https://www.ilw.com/seminars/JohnNeillCitation.pdf

gains tax, which reduces the effective state capital gains tax rate for QSBS gains from 5% to 2.5% (exclusion only) or 1.5% (exclusion plus lower rate of 3%), but also the 100% exclusion from federal capital gains tax, which reduces the effective federal capital gains tax rate from 20% to 0%. Given that the federal tax saving is much larger than the state tax saving, it is more likely that the investors' decision would mostly be determined by the federal tax policy. The increment incentive provided by the state tax policy may be small.

Similar Tax Expenditures Offered by Other States

States that follow the Code definition of taxable income will allow the federal exclusion of gain on the sale of qualified small business stock unless their statutes provide otherwise. New York, Connecticut, Maine, Rhode Island, and Vermont allow a full exclusion for such gains on this basis. California is one state that has specifically disallowed the federal exclusion and does not apply a preferential rate to such gains. See California Revenue & Tax Code Section 18152.

References

Edwards, A., & Todtenhaupt, M. (2020). Capital gains taxation and funding for start-ups. *Journal of Financial Economics, 138*, 549-571.

Viswanathan, M. (2020). The Qualified Small Business Stock Exclusion: How Startup Shareholders Get $10 Million (Or More) Tax-Free. *Columbia Law Review Forum, 120*, 29-42