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| PROPOSED MASSACHUSETTS TAX EXPENDITURES EVALUATION SUMMARY  |
| EVALUATION YEAR: 2020 |

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| **TAX EXPENDITURE TITLE** | Small Business Corporations  |
| **TAX EXPENDITURE NUMBER** | 2.001 |
| **TAX EXPENDITURE CATEGORY** | Favorable tax treatment for S corporations *(corporate and business tax)* |
| **TAX TYPE** | Corporate and business excise tax |
| **LEGAL REFERENCE** | IRC, §§ 1361-1363; M.G.L. c. 62, § 17A; M.G.L. c. 63, §32D  |
| **YEAR ENACTED** | 1986 |
| **REPEAL/EXPIRATION DATE** | None |
| **ANNUAL REVENUE IMPACT** | Tax loss of $134.7 - $161.3 million per year during FY18-FY22 |
| **NUMBER OF TAXPAYERS**  | 112,509 (2018) |
| **AVERAGE TAXPAYER BENEFIT** | About $1,300 per impacted filer (2018) |

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| **Description of the Tax Expenditure:**Upon enactment of the S corporation statute in 1985, S corporation taxation was reduced from the full C corporation rate plus the full personal income tax rate on distributions, to a modified system under which S corporation income is taxed at three different levels depending on the receipts of the corporation, with the lowest being the personal income tax rate, and the highest the full C corporation rate, as described below. | **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?** While not defined in the statute, we assume the purpose of the rate structure is to bring the total tax burden on S corporations into parity with that of C corporations, by imposing on shareholders the personal income tax rate for S corporation income, with a reduced corporate rate so that the two figures combined more closely replicate the C corporation rate. | **Are there other states with a similar Tax Expenditure?**New York, Rhode Island and Vermont have a modified two-level taxation structure, described below. |

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| Conclusion/Recommendations: [To be Entered by TERC] |

**INTRODUCTION**

In general, corporations organized under, or subject to, Chapters 156, 156A, 156B, 156C, 156D or 180 of Massachusetts General Laws (M.G.L.) or that have privileges, powers, rights or immunities not possessed by individuals or partnerships are subject to the corporate excise. Most corporations have an income tax component of their excise. For those corporations, income is taxed at a rate of between 8 and 9%. Dividends distributed to Massachusetts residents are also subject to the personal income tax rate of 5%.

Certain corporations with no more than 100 shareholders may elect to be taxed, for both federal and state tax purposes, as “S corporations.” Under federal law, most S corporation income is passed through and taxed only as personal income to shareholders, and is not taxable at the entity level. Only limited categories of income are subject to an entity-level tax for federal tax purposes.

For Massachusetts purposes generally, S corporation income is not subject to an entity-level tax, except as follows: 1) those limited categories of income that are subject to an entity-level tax for federal tax purposes are also taxable in Massachusetts at the full corporate rate; and 2) the income of an S corporation with receipts of $6 million or more is subject to tax at reduced corporate rates.

As of 2020, S corporations with total receipts of at least $6 million but less than $9 million are subject to a corporate excise of 2.00% of net income for non-financial institutions and 2.67% for financial institutions. An S corporation with total receipts of $9 million or more is subject to an excise of 3.00% of net income for non-financial institutions and 4.00% for financial institutions.

The favorable manner in which income is taxed to an S corporation and its shareholders as compared to an ordinary business corporation (including its shareholders) constitutes a tax expenditure. Massachusetts first adopted this treatment of S corporations in 1986.

**POLICY GOALS**

Congress adopted federal S corporation treatment in 1958 to promote the competitiveness of small businesses. Operating in corporate form provides benefits to businesses, including limited liability. However, corporations were subject to two levels of tax, which made the corporate form less attractive to smaller businesses. Thus, many smaller businesses operated as partnerships, which did not enjoy limited liability. Congress enacted the S corporation regime to allow eligible small businesses in corporate form to elect to be S corporations, allowing them to claim the same liability protection as large businesses in corporate form (hereafter referred to as C corporations) but without the double tax.

The Massachusetts statute does not explicitly state the purpose of this tax expenditure. Presumably, the purpose parallels the purpose of the federal S corporation rules, notwithstanding the fact that Massachusetts adopted its S corporation regime nearly twenty years after the enactment of the federal rules. The purpose of the rate structure is to bring the total tax burden on S corporations into parity with that of C corporations, by imposing on shareholders the personal income tax rate for S corporation income, with a reduced corporate rate so that the two figures combined more closely replicate the C corporation rate.

**DIRECT COSTS**

The revenue loss resulting from this tax expenditure is estimated to be $134.7 - $161.3 million per year during FY18-FY22. See Table 1. The estimates are based on several factors, including historical claims, economic forecasts, and related law changes.

Although S corporations pay less corporate excise because of reduced tax rates, they are pass-through entities and their owners pay personal income tax on their taxable income. Still, the overall tax burden of S corporations is lighter than that of C corporations. Such favorable tax treatment for S corporations results in lost tax revenues to the Commonwealth.

**Table 1. Tax Revenue Loss Estimates for Favorable Tax Treatment**

 **for S Corporations**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Fiscal Year  | 2018 | 2019 | 2020 | 2021 | 2022 |
|  Estimated Revenue Loss ($Million)  | $134.7 | $149.4 | $152.6 | $156.6 | $161.3 |

**DIRECT BENEFITS**

Direct beneficiaries of this tax incentive are S corporations that conduct business in Massachusetts. In 2018, as shown in Table 2, there were 112,509 S corporations. About 86.7% of them had gross receipts of less than $6 million, representing about 16.7% of total tax liability of all S corporations and 0.8% of total taxable income; about 2.8% of all S corporations had gross receipts of at least $6 million but less than $9 million, representing about 5.8% of total tax liability of all S corporations and 8.9% of total taxable income; and about 10.5% of all S corporations had gross receipts of at least $9 million, representing about 77.5% of total tax liability of all S corporations and 90.2% of total taxable income. The term “tax liability” for S corporations includes both the income and non-income measure of the corporate excise, when applicable.

**Table 2. Tax Liability, Taxable Income of S Corporations by Range of Gross Receipts**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Gross Receipts  | Tax Liability ($000)  |  *Percent of Total S Corporation Tax Liability* |  Taxable Income ($000)  |  *Percent of Total S Corporation Taxable Income* |  Taxable Income Per Impacted Corporation ($000) |  Number of S corporations |  *Percent of Total Number of S Corporations* |
|  Less than $6Million  | $54,303 | *16.7%* | $71,361 | *0.8%* | $1 | 97,537 | *86.7%* |
|  At least $6Million but less than $9Million  | $18,910 | *5.8%* | $753,794 | *8.9%* | $237 | 3,183 | *2.8%* |
|  At least $9Million  | $251,996 | *77.5%* | $7,606,752 | *90.2%* | $645 | 11,789 | *10.5%* |
|  Total or average  | $325,209 | *100.0%* | $8,431,906 | *100.0%* | $75 | 112,509 | *100.0%* |

Source: Department of Revenue (2018 corporate excise returns).

Notes: 1. The data is preliminary and subject to change.

 2. Tax liability is all from non-income measure for S Corporations with less than $6 million gross receipts. Some taxable income for this group was reported but actually not taxed.

By range of taxable income, as shown in Table 3, more than 90% of the S corporations had taxable income between $0 and $9,999, representing 18.0% of the total tax liability of all S corporations and 0.1% of total taxable income. Only 0.1% of the S corporations had taxable income of $10 million or more, but those corporations represented 28.4% of the total tax liability of all S corporations and 40.3% of total taxable income.

By number of employees, as shown in Table 4, almost all S corporations were businesses with fewer than 100 employees, representing about 65.4% of total tax liability of all S corporations and 57.7% of total taxable income. About 63.0% of total S corporations had fewer than 5 employees, representing about 26.5% of total tax liability and 18.1% of total taxable income. Only 0.6% of S corporations had more than 500 employees, representing about 10.7% of total tax liability and 14.5% of total taxable income.

By industry, as shown in Table 5, about 17.8% of S corporations were in the industry of “Professional, Scientific, and Technical Services”; those S corporations represented 14.2% of total tax liability of all S corporations and 18.0% of total taxable income. The industry with the smallest number of S corporations is “Mining, Quarrying, and Oil and Gas Extract”, with only 0.1% of all S corporations, representing 0.19% of total tax liability and 0.22% of total taxable income.

The average taxable income of all S corporations in 2018 was about $75,000, and the average tax liability was $2,891 ($325,209,000 total tax liability divided by 112,509 total S corporations).

**Table 3. Tax Liability, Taxable Income of S Corporations by Taxable Income Level**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Taxable Income Range | Tax Liability ($000) | *Percent of Total S Corporation Tax Liability* | Taxable Income ($000) | *Percent of Total S Corporation Taxable Income* | Taxable Income Per Impacted Corporation ($000) | Number of S corporations | *Percent of Total Number of S Corporations* |
| Less than $0 | $4,658 | *1.4%* | -$502,521 | *-6.0%* | -$219 |  2,292  | *2.0%* |
| 0 to $9,999 | $58,519 | *18.0%* | $8,818 | *0.1%* | $ |  101,325  | *90.1%* |
| $10,000 to $99,999 | $5,904 | *1.8%* | $141,521 | *1.7%* | $41 |  3,452  | *3.1%* |
| $100,000 to $999,999 | $46,141 | *14.2%* | $1,434,444 | *17.0%* | $375 |  3,830  | *3.4%* |
| $1,000,000 to $9,999,99 | $117,728 | *36.2%* | $3,952,268 | *46.9%* | $2,658 |  1,487  | *1.3%* |
| $10,000,000 or more | $92,258 | *28.4%* | $3,397,267 | *40.3%* | $28,077 |  121  | *0.1%* |
| Unmatched\* | $1 | *0.0%* | $110 | *0.0%* | $55 |  2  | *0.0%* |
| Total or average | $325,209 | *100.0%* | $8,431,906 | *100.0%* | $75 |  112,509  | *100.0%* |

Source: Department of Revenue (2018 corporate excise returns)

Notes: 1. \*Unmatched means that we could not find some taxpayers in one or more of data sets to match.

 2. The data is preliminary and subject to change.

**Table 4. Tax Liability, Taxable Income of S Corporations by Number of Employees**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Employees Range\* | Tax Liability ($000) | *Percent of Total S Corporation Tax Liability* | Taxable Income ($000) | *Percent of Total S Corporation Taxable Income* | Taxable Income Per Impacted Corporation ($000) | Number of S corporations | *Percent of Total Number of S Corporations* |
| Less than 5 | $86,308 | *26.5%* | $1,525,794 | *18.1%* | $22 |  70,829  | *63.0%* |
| 5 to 49 | $85,336 | *26.2%* | $2,167,299 | *25.7%* | $63 |  34,334  | *30.5%* |
| 50 to 99 | $41,353 | *12.7%* | $1,169,942 | *13.9%* | $315 |  3,713  | *3.3%* |
| 100 to 199 | $36,590 | *11.3%* | $1,067,669 | *12.7%* | $569 |  1,878  | *1.7%* |
| 200 to 499 | $40,809 | *12.5%* | $1,274,967 | *15.1%* | $1,198 |  1,064  | *0.9%* |
| 500 or more | $34,813 | *10.7%* | $1,226,235 | *14.5%* | $1,775 |  691  | *0.6%* |
| Total or average | $325,209 | *100.0%* | $8,431,906 | *100.0%* | $75 |  112,509  | *100.0%* |

Source: Department of Revenue (2018 corporate excise returns)

Notes: 1. Information is based on number of employees as reported by taxpayers.

 2. The data is preliminary and subject to change.

**Table 5. Tax Liability, Taxable Income of S Corporations by Industry**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Industry  |  Tax Liability ($000)  |  *Percent of Total S Corporation Tax Liability*  |  Taxable Income ($000)  |  *Percent of Total S Corporation Taxable Income*  |  Taxable Income Per Impacted Corporation ($000)  |  Number of S corporations  |  *Percent of Total Number of S Corporations*  |
|  11 Agriculture, Forestry, Fishing and Hunting  | $1,954 | *0.6%* | $43,892 | *0.5%* | $43 |  1,016  | *0.9%* |
|  21 Mining, Quarrying, and Oil and Gas Extract  | $631 | *0.2%* | $18,759 | *0.2%* | $179 |  105  | *0.1%* |
|  22 Utilities  | $248 | *0.1%* | $821 | *0.0%* | $6 |  134  | *0.1%* |
|  23 Construction  | $52,190 | *16.0%* | $1,355,112 | *16.1%* | $77 |  17,623  | *15.7%* |
|  31-33 Manufacturing  | $35,473 | *10.9%* | $1,110,555 | *13.2%* | $216 |  5,147  | *4.6%* |
|  42 Wholesale Trade  | $41,057 | *12.6%* | $1,132,782 | *13.4%* | $258 |  4,398  | *3.9%* |
|  44-45 Retail Trade  | $46,724 | *14.4%* | $970,203 | *11.5%* | $82 |  11,810  | *10.5%* |
|  48-49 Transportation and Warehousing  | $6,798 | *2.1%* | $132,457 | *1.6%* | $33 |  4,018  | *3.6%* |
|  51 Information  | $4,643 | *1.4%* | $108,829 | *1.3%* | $59 |  1,840  | *1.6%* |
|  52 Finance and Insurance | $20,071 | *6.2%* | $553,345 | *6.6%* | $150 |  3,691  | *3.3%* |
|  53 Real Estate and Rental and Leasing  | $16,195 | *5.0%* | $305,238 | *3.6%* | $28 |  10,779  | *9.6%* |
|  54 Professional, Scientific, and Technical Services | $46,336 | *14.2%* | $1,517,716 | *18.0%* | $76 |  20,034  | *17.8%* |
|  55 Management of Companies and Enterprises  | $11,897 | *3.7%* | $306,697 | *3.6%* | $382 |  802  | *0.7%* |
|  56 Administrative and Support and Waste Management  | $9,271 | *2.9%* | $217,410 | *2.6%* | $40 |  5,394  | *4.8%* |
|  61 Educational Services  | $1,346 | *0.4%* | $33,918 | *0.4%* | $38 |  903  | *0.8%* |
|  62 Health Care and Social Assistance | $9,276 | *2.9%* | $242,458 | *2.9%* | $38 |  6,450  | *5.7%* |
|  71 Arts, Entertainment, and Recreation  | $5,287 | *1.6%* | $115,842 | *1.4%* | $37 |  3,119  | *2.8%* |
|  72 Accommodation and Food Services  | $7,840 | *2.4%* | $142,208 | *1.7%* | $20 |  6,983  | *6.2%* |
|  81 Other Services (except Public Administration)  | $7,517 | *2.3%* | $118,356 | *1.4%* | $15 |  7,697  | *6.8%* |
|  Others or unmatched\* | $455 | *0.1%* | $5,309 | *0.1%* | $9 |  566  | *0.5%* |
|  Total or average  | $325,209 | *100.0%* | $8,431,906 | *100.0%* | $75 |  112,509  | *100.0%* |

Source: Department of Revenue (2018 corporate excise returns)

Notes: 1. \*Unmatched means that we could not find some taxpayers in one or more of data sets to match.

 2. The data is preliminary and subject to change.

**EVALUATION: COMPARING COSTS AND BENEFITS**

In the previous sections, we reported 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) and direct benefits (to taxpayers who claim the benefits) of this tax expenditure. Since the direct costs to the Commonwealth are the direct benefits to taxpayers, they are equal.

However, when looking at the broader economy, there are, in addition to direct impacts, indirect and induced impacts on other residents and businesses in Massachusetts. See the appendix for more discussion.

To determine the net impact of the tax expenditure, i.e., the total benefits (including direct, indirect and induced benefits) offset by the total costs (including direct, indirect and induced costs), we employed the model of “Tax-PI” developed by Regional Economic Models Incorporated (“REMI”).[[1]](#footnote-1) See the appendix for details.

The estimated net impact of the tax expenditure for fiscal years 2018 through 2022 are shown in Tables 6 and 7. As shown, the favorable tax treatment for S corporations combined with a cut in state government spending results in less economic activity, with real state GDP decreasing by $21 million-$91 million. The net impact on total employment is negative, decreasing by 499 – 1,130 jobs annually. The net additional impact on state revenues[[2]](#footnote-2) is also negative, decreasing by $0.6 million to $2.5 million annually.

Because the tax expenditure has a specific purpose (see the section “POLICY GOALS”), the net negative impacts do not necessarily imply that the tax expenditure is not desirable.

**Table 6. Net Additional Revenue Impact of Favorable Tax Treatment**

**for S Corporations\***

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Fiscal Year | 2018 | 2019 | 2020 | 2021 | 2022 |
| Net additional revenue impact ($000) | -$1,416 | -$2,490 | -$1,652 | -$1,007 | -$605 |

\* assuming state government spending is cut by the same amount as the revenue loss due to the favorable tax treatment for S corporations to balance budget.

**Table 7. Net Economic Impacts of Favorable Tax Treatment for S Corporations**

**by Selected Economic Measure\***

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Calendar Year | 2018 | 2019 | 2020 | 2021 | 2022 |
| Impact on total employment | -1,130 | -867 | -665 | -555 | -499 |
| Impact on private non-farm employment | 461 | 777 | 946 | 1,028 | 1,041 |
| Impact on GDP ($000), real dollars (2012) | -$91,000 | -$64,000 | -$43,000 | -$29,000 | -$21,000 |
| Impact on personal income ($000) | -$88,000 | -$76,000 | -$64,000 | -$56,000 | -$53,000 |

\* assuming state government spending is cut by the same amount as the revenue loss due to the favorable tax treatment for S corporations to balance budget.

**Similar Tax Expenditures Offered by Other States**

Looking at neighboring states, some tax the pass-through income to shareholders (copying the federal model, as Massachusetts does), and also impose some corporate-level tax: New York taxes both shareholder distributive share income, and also has an entity-level component with some modifications to C corporation taxation, including slightly lower corporate tax rates. In Rhode Island and Vermont, S corporations pay a minimum corporate franchise tax, but not a corporate income tax. Connecticut historically conformed to this model, but changed its law in response to the 2017 federal Code amendment that imposed a $10,000 cap on personal income tax deductions for state and local taxes paid. Starting in 2018, Connecticut has a system for pass-through entities, including S corporations, to pay an income tax at the personal income tax rates, with a credit for these taxes allowed to individual shareholders. Maine generally follows the federal model, with most S corporation income taxable only at the individual level, but with any income taxable federally at the entity level also taxable at the entity level.

New Hampshire, which has limited personal income taxes, taxes S corporations in the same manner as C corporations, offering no reduced rate.

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# References

Felix, R. A. (2009, Second Quarter). *Do State Corporate Income Taxes Reduce Wages?,* Economic Review, FEDERAL RESERVE BANK OF KANSAS CITY.

Keith R. Ihlanfeldt, David L. Sjoquist. (2001, August). Conducting an Analysis of Georgia’s Economic Development Tax Incentive Program. *ECONOMIC DEVELOPMENT QUARTERLY, 15*(3), 217-228.

*MODELS: TAX-PI*. (n.d.). Retrieved from Regional Economic Models, Inc.: https://www.remi.com/model/tax-pi/

**Appendix: Further Discussion on Costs and Benefits**

The text of the report discusses the direct costs (to the Commonwealth, or more specifically, to the Massachusetts residents or businesses who benefit from state expenditures[[3]](#footnote-3)) and direct benefits (to taxpayers who claim the benefits) of this tax expenditure. It also summarizes indirect and induced costs and benefits associated with this tax expenditure. This appendix will discuss the indirect and induced, as well as other costs and benefits in more detail.

**Other costs and benefits: Indirect and Induced**

*Indirect and Induced Costs*

Regardless of its size, the existence of a specific tax incentive means less revenue for other spending given the Commonwealth’s balanced budget requirement, assuming no increase in state revenues. Reduced spending on other expenditure items means forgone benefits from those items. This is an **“opportunity cost”** to the Commonwealth. The opportunity cost to the state includes not only the impact on the businesses and their employees that directly benefit from those expenditure items (this is called “direct impact”), but also the indirect impact on the chain of businesses that provide intermediate products and services to the directly impacted businesses (this is called “indirect impact”). In addition, there is the cost to the chain of businesses that benefit when the employees working for the directly impacted businesses spend their wages and salaries to buy goods and services (this is called “induced impact”). The total forgone benefits to the whole economy are larger than the initial forgone benefits. This phenomenon is called the “Multiplier Effect”.[[4]](#footnote-4)

To estimate the total forgone benefits of the reduced spending, we employed Tax-PI, an economic analysis tool for evaluating the total fiscal and economic effects of tax policy changes. Tax-PI is built on over 30 years of experience in modeling the economic effects of tax policy changes, according to MODELS: TAX-PI in the reference. The popularity of the model has grown substantially since it was introduced. Note that while the tax incentive has a specific purpose, the reduced spending that results from the expenditure is assumed to be proportionally distributed across the Commonwealth’s current expenditures.

*Quantifying total costs (direct, indirect and induced)*

The period of study is limited to the five years from 2018 through 2022, for which we prepared input data to run the model. Tables A1 and A2 report the model results. The figures for 2018 and 2019 are estimates of forgone benefits (opportunity costs) that the Massachusetts economy experienced due to having the expenditure, and those for 2020, 2021 and 2022 are projections of forgone benefits that the Massachusetts economy will experience going forward. The effects are displayed as negative numbers as reduced spending has a negative impact on the state economy.

Tables A1 and A2 show that the reduction in state government spending results in lost economic activities, with real state GDP declining by $324 million-$366 million and total employment declining by 3,754 -4,156 jobs annually. Lost economic activities result in further loss of state revenues, ranging from $6.9 million to $19.7 million annually. Note that the revenue impact reported in Table A1 does not include the estimated direct impact of the tax expenditure from Table 1, but only the additional indirect/induced impact.

**Table A1. Additional Revenue Impact due to Decreased Government Spending\***

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Fiscal Year | 2018 | 2019 | 2020 | 2021 | 2022 |
| Additional revenue impact ($000) | -$6,918 | -$15,450 | -$17,678 | -$19,131 | -$19,704 |

\* This table reports the lost revenues from the foregone economic activities as the state reduced government spending to finance the favorable tax treatment for S corporations.

**Table A2. Economic Impacts due to Decreased Government Spending by Selected Economic Measure\***

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Calendar Year | 2018 | 2019 | 2020 | 2021 | 2022 |
| Impact on total employment | -3,754 | -4,015 | -4,156 | -4,028 | -3,804 |
| Impact on private non-farm employment | -2,070 | -2,213 | -2,300 | -2,195 | -2,024 |
| Impact on GDP ($000), real dollars (2012) | -$324,000 | -$350,000 | -$366,000 | -$359,000 | -$344,000 |
| Impact on personal income ($000) | -$271,000 | -$320,000 | -$360,000 | -$377,000 | -$383,000 |

\*This table reports the lost economic activities as the state reduced government spending to finance the favorable tax treatment for S corporations.

*Indirect and Induced Benefits*

The cost savings due to the favorable tax treatment for S corporations encourages the directly affected businesses to invest, expand, hire additional workers, etc. Such decisions would increase demand for goods and services provided by other individuals and businesses in the economy, or put another way, generate a “Multiplier Effect” (see discussion in the previous section) from the initial or direct benefits described in the text of the report. As a result, the total benefits of the favorable tax treatment for S corporations would be larger than the initial or direct benefits.

*Quantifying total benefits (direct, indirect and induced)*

To quantify the total benefits, including indirect/induced benefits, we again employed Tax-PI. A summary of the revenue impact of the favorable tax treatment for S corporations is reported in Table A3, and the economic benefit from the favorable tax treatment for S corporations is reflected in Table A4 below. The figures for 2018 and 2019 are estimates of benefits that the Massachusetts economy experienced and those for 2020, 2021 and 2022 are projections of the benefits that the Massachusetts economy will experience going forward.

Tables A3 and A4 show that, the favorable tax treatment for S corporations results in more economic activities, with real state GDP increasing by $233 million - $330 million and total employment increasing by 2,624-3,491 jobs annually. More economic activities result in more state revenues, ranging from $5.5 million to $19.1million annually, which partially offsets the cost of this tax incentive.

**Table A3. Additional Revenue Impact of Favorable Tax Treatment for S Corporations**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Fiscal Year | 2018 | 2019 | 2020 | 2021 | 2022 |
| Additional revenue impact ($000) | $5,502 | $12,960 | $16,026 | $18,124 | $19,099 |

**Table A4. Economic Impacts of Favorable Tax Treatment for S Corporations**

**by Selected Economic Measure**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Calendar Year | 2018 | 2019 | 2020 | 2021 | 2022 |
| Impact on total employment | 2,624 | 3,148 | 3,491 | 3,473 | 3,305 |
| Impact on private non-farm employment | 2,531 | 2,990 | 3,246 | 3,223 | 3,065 |
| Impact on GDP ($000), real dollars (2012) | $233,000 | $286,000 | $323,000 | $330,000 | $323,000 |
| Impact on personal income ($000) | $183,000 | $244,000 | $296,000 | $321,000 | $330,000 |

**Comparison of costs and benefits**

Without taking into account the opportunity cost of the tax incentive, total benefits are greater than costs. Considering the opportunity cost means asking what benefits would be generated if the Commonwealth used the dollars expended on this tax incentive for other purposes. Those dollars could be spent in many other ways, and examining them is beyond the scope of the current evaluation report. Nonetheless, we reported net impacts of the tax incentive in Tables A5 and A6 below under the balanced budget requirement, which are the combined effects in Tables A1-A4.

Tables A5 and A6 show that the favorable tax treatment for S corporations combined with a cut in state government spending results in less economic activity, with real state GDP decreasing by $21 million-$91 million. The net impact on total employment is negative with total employment decreasing by 499 – 1,130 jobs annually. The impact on state revenues is also negative, decreasing by $0.6 million to $2.5 million annually.

Because the tax expenditure has its own specific purpose, the net negative impacts do not necessarily imply that the tax expenditure is not desirable.

**Table A5. Net Additional Revenue Impact of Favorable Tax Treatment**

**for S Corporations\***

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Fiscal Year | 2018 | 2019 | 2020 | 2021 | 2022 |
| Net additional revenue impact ($000) | -$1,416 | -$2,490 | -$1,652 | -$1,007 | -$605 |

\* assuming state government spending is cut by the same amount as the revenue loss due to the favorable tax treatment for S corporations to balance budget.

**Table A6. Net Economic Impacts of Favorable Tax Treatment for S Corporations**

**by Selected Economic Measure\***

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Calendar Year | 2018 | 2019 | 2020 | 2021 | 2022 |
| Impact on total employment | -1,130 | -867 | -665 | -555 | -499 |
| Impact on private non-farm employment | 461 | 777 | 946 | 1,028 | 1,041 |
| Impact on GDP ($000), real dollars (2012) | -$91,000 | -$64,000 | -$43,000 | -$29,000 | -$21,000 |
| Impact on personal income ($000) | -$88,000 | -$76,000 | -$64,000 | -$56,000 | -$53,000 |

\* assuming state government spending is cut by the same amount as the revenue loss due to the favorable tax treatment for S corporations to balance budget.

**Other unquantified costs and benefits:**

Besides the additional costs and benefits quantified in the previous sections, there are other costs and benefits that are hard to quantify due to lack of data or other challenges. In this section we will enumerate some of these costs and benefits.

Ihlanfeldt and Sjoquist (2001), a published study for the state of Georgia, summarizes some of other costs and benefits as follows:

*Loss of competitiveness.* Providing tax incentive such as credits to selected firms may diminish the competitiveness for existing similar firms.

*Compliance costs.* They think that the costs to the firm may be substantial.

*Improved business climate.* Tax incentive improves the perception of the business climate in the state and is used by site location specialists in screening alternative sites.

*Synergistic or clustering effects.* Tax incentive may attract a firm in an industry new to the state, which then serves as a magnet for attracting additional firms in the industry.

Another hard to quantify cost is the administrative cost. The administrative cost attributable to this incentive should be relatively small because the Department of Revenue administers this incentive with existing staff as part of its overall mission.

**Other issues related to costs and benefits**

The burden of a tax does not necessarily fall on those responsible for remitting the tax. It is known through economic theories that corporate taxes change the allocation of capital between corporations and noncorporate businesses and among states because capital would flee from states of higher corporate taxes if all other considerable factors are not significantly different.

Felix (2009) finds that labor bears a significant burden from the state corporate tax in the form of lower wages. Her study further suggests that a one-percentage-point increase in the marginal state corporate tax rate reduces wages by 0.14% to 0.36%, that labor’s burden from the state corporate tax has trended upward over time due to increased global competition and increased competition among states to attract businesses, and that state corporate taxes reduce the wages of highly educated workers more than that of less-educated workers.

This incentive is significant to the direct beneficiaries by reducing the effective tax rate greatly. Hence, the findings imply that the incentive may have benefited workers who were employed by the corporations in the form of higher wages. The incentive may have further benefited the shareholders and clients due to the growth of businesses.

1. Regional Economic Models Inc. is a recognized leader in economic analysis at the state level. See their website for background information and further details <https://www.remi.com/> [↑](#footnote-ref-1)
2. Including both tax and non-tax revenues but excluding the revenue loss reported in Table 1. [↑](#footnote-ref-2)
3. Spending on a specific tax incentive means less spending on other expenditure items for the Commonwealth under balanced budget requirement if there is no increase in state revenues. Reduced spending on other expenditure items means forgone benefits from those items. This is an opportunity cost to the Commonwealth, which, more specifically, is borne by the Massachusetts residents or businesses who benefit from those expenditure items. [↑](#footnote-ref-3)
4. For an illustration of “Multiplier Effect”, see Slide 4 of: <https://www.ilw.com/seminars/JohnNeillCitation.pdf> [↑](#footnote-ref-4)