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Connecticut Tax Receipts from Estimates & Finals and Pass Through Entity Tax Likely to Decline $2.1 Billion in Fiscal Year 2023

The Projected 32% Decline is Double
The Official Projection of a 16% Decline

by

The Townsend Group Intl, LLC

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The Townsend Group

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Executive Summary

This paper assesses the outlook for Connecticut tax receipts in fiscal 2023 (July 2022 to June 2023) from Individual Income Taxes paid via Estimates & Finals (E&F) and the Pass Through Entity tax (PET), which depend heavily upon stock market income.

- ***Conclusion:*** Tax receipts will fall significantly in fiscal year 2023 ending June 30, 2023.
  - ***Tax receipts will fall $2.1 billion***, or 32% from fiscal 2022 ended June 30, 2022.
  - ***Decline will far surpass the official estimate*** of a $1.0 billion, or 16%, decline.
- ***Historical Perspective***: In recent history, the stock market declined in only one year, 2018, when it declined 6.2%. E&F and PET receipts declined 10.3% in the associated fiscal year of 2019. Accordingly, receipts in fiscal 2023 can be expected to decline by a greater amount than the 17.8% decline in the stock market in 2022.
- ***Three Factors Will Depress E&F and PET Tax Receipts in Fiscal 2023:***
  - ***1. Capital Gains:*** With the stock market down 17.8% in calendar 2022, on average, there were minimal capital gains and, thus, little tax revenue from gains.
  - ***2. Safe Harbor Rule for Underpayment of Estimated Taxes***:
    - ***Under federal and state rules***, taxpayers do not have to pay a penalty for underpayment of estimated taxes, if they pay 100% of their prior year's taxes (110% for high-income federal taxpayers). This rule inflated estimated tax payments for 2022; refunds will be claimed in April 2023.
    - ***In Connecticut***, lower final payments and refund claims in April 2023 for overpaid estimated payments April, June and September of calendar 2022 and January 2023 will depress receipts in April through June 2023.
  - ***3. Depressed Estimated Tax Payments in April and June of 2023***: The 100%-of-prior-year safe harbor rule will operate as a ceiling on estimated tax payments in April and June for calendar 2023, just as it operated as a floor during 2022.
  - ***Net Effect of Three Factors:*** The net effect of the three factors is projected to be a $2.1 billion, or 32% decline in E&F and PET tax receipts in fiscal 2023.
- ***E&F and PET Tax Receipts in July 2022 through February 2023:*** In July through November, E&F and PET tax receipts were buoyed by the lingering effects of the 2021 stock market boom. In December through February, receipts plummeted 23%, reflecting the stock market downturn in 2022, but not yet the depressive impact of tax refunds.
- ***Projected E&F and PET Tax Receipts for April through June of 2023:*** This paper projects a 47% decline in tax receipts in the final four months of fiscal 2023, producing a $2.1 billion, or 32%, decline in receipts for the full fiscal year.
- ***Significant Impact on Pension Funds:*** The decline in E&F and PET tax revenue will reduce by two-thirds the Volatility Cap Deposit into the BRF, which, in turn, will reduce the excess of BRF over its legal maximum. The excess is required to be deposited into Connecticut's two big public pension funds, so these two severely underfunded pension funds will absorb the impact of the decline in E&F and PET income.

Introduction

Connecticut's official budget for fiscal 2023 (July 2022 to June 2023) adopted in April 2022 projected a decline of only $1 billion, or 16%, in tax revenue from Estimates and Finals (E&F) and the Pass-Through Entity tax (PET), both of which rely heavily upon investment income. Despite an 18% decline in the stock market in 2022 as measured by the S&P Index, this remains the official projection in March 2023.

The actual decline is more likely to be closer to twice the official projection: $2.1 billion.

These taxes surged almost $2 billion in fiscal 2022 to $6.6 billion, compared to $4.7 billion in the prior fiscal year of 2021. In fiscal 2023, these taxes are likely to total just $4.4 billion.

The April 2022 projection for fiscal 2023 was confirmed in the Consensus Revenue Forecast released in mid-January, 2023 and, then, again in Office of Policy and Management's Monthly Letter to the Comptroller in mid-March 2023. Revenue of $5.5 billion is still budgeted, representing a decline of only about $1.0 billion versus the likely $2.1 billion decline projected herein.

Historical Precedent

In recent history the only year-over-year stock market decline occurred in 2018, when the S&P index closed a modest 6.2% below the prior year's close. In the following year, fiscal 2019, E&F and PET income in Connecticut fell 10.3% (and fell an additional 7.7% in fiscal 2020, despite a stock market rebound that year). This would suggest that E&F and PET revenue in fiscal 2023 will fall more than the deep 17.8% decline in the S&P in 2023, and, perhaps, fall further in fiscal 2024.

Using the same extra margin of decline would suggest a year-over-year decline of 22% to 23%. Yet, 2022's stock market decline was about three times more severe than the stock market decline in 2018, and it followed an advance in 2021 that was significantly more robust than 2017's increase. This might suggest a decline in fiscal 2023 E&F and PET revenue of greater than 23%.

Three Factors Contributing to Significant Decline in FY2023 E&F and PET Revenue

Three significant factors suggest a significant decline in FY 2023 E&F and PET revenue.

First Factor - Minimal Capital Gains in Calendar/Tax Year 2022: First, the core of this tax revenue derives from the sale of investment securities. In fiscal 2022, gains on such sales during the dramatic stock market advance in calendar 2021 drove a surge in capital gains tax revenue (which is taxed as ordinary income in Connecticut). The S&P index advanced 27% in 2021.

In calendar 2022, the S&P dropped 18%. On average, there were minimal gains to tax, and, thus, virtually no such taxes for 2022 will be due in fiscal 2023. Many investors follow traditional stock market advice, not to panic in face of a stock market decline. They do not sell at all; they realize neither gains nor losses.

Second Factor - Safe Harbor Rules With Respect to Underpayment of Taxes: Safe Harbor rules applicable to estimated quarterly payments of taxes due for calendar / tax year 2022 inflated those payments. The safe harbor rules applicable to both federal and Connecticut income taxes say that no penalty for underpayment of taxes will be charged if taxpayers pay the lesser of (i) 100% of the taxes they paid the prior year (110% for federal taxes for high-income taxpayers) or (ii) 90% of the actual taxes ultimately due for the tax year in question.

Naturally, taxpayers do not know the actual amount of taxes they will ultimately owe for the full year eight, six and three months before the year's end. Therefore, in April, June and September, many use the first safe harbor option, i.e. pay at a rate of 100% of what they paid the prior year.

The same is true to some extent for the January 15th payments, since, by that time, the tax year has only been closed for two weeks, leaving taxpayers little time to compute their actual taxes due.

If taxpayers experienced a 16% decline in taxable E&F and PET income in 2022 and many taxpayers followed the first safe harbor option, then tax receipts would reflect a combination of overpayments prior to filing of final returns, which would trigger refunds and/or reduced final payments with the filing of final returns.

The combination of refunds of inflated estimated payments and lower final payments should show a net 16% decline in taxes reflecting the 16% decline in taxable such income. Yet, in Connecticut, the first two quarterly payments for calendar / tax year 2022 were made in Connecticut's prior fiscal year 2022. Accordingly, fiscal 2023 will have to absorb refunds for overpayments made in fiscal 2022, without fiscal 2023 benefiting from those overpayments. Given the magnitude of the year-over-year decline in taxable E&F and PET income, this factor will have significant impact.

The following table illustrates the impact of the 100%-of-prior-year Safe Harbor rule, if half of E&F and PET taxpayers followed it in making their first two estimated quarterly payments in fiscal 2022. As illustrated, the interplay between this Safe Harbor rule and actual decline in taxable E&F and PET income is such that the official projection of a 16% decline in E&F and PET income tax revenue is produced by only about an 13% decline in such taxable income.

	Fiscal 2022	Fiscal 2023		FY22 v FY23
Implied Taxable E&F and PET Income @ 6.5% Tax Rate	$ 100.77	$ 87.67		$ (13.10)
	100.0%	87.0%		**-13.0%**
Taxes: FY2022 Actual; Projection for FY2023	$ 6.55	$ 5.70		$ (0.85)
	100.0%	87.0%		
Estimated Quarterly Tax Payments: April & June 2022				
At Safe Harbor Level: 100% of Prior Year **Used by 50% of Taxpayers**			$ 1.64	
Actually Due			$ 1.42	
Refund of FY22 Overpayments				$ (0.21)
Implied E&F and PET Income Tax Revenue in FY2023		$ 5.49		$ (1.06)
As % of FY 2022 Actual		83.8%		**-16.3%**

In turn, a 16% decline in taxable E&F and PET income would produce a 20% decline in E&F and PET tax revenue, as illustrated below.

	Fiscal 2022	Fiscal 2023		FY22 v FY23
Implied Taxable E&F and PET Income @ 6.5% Tax Rate	$ 100.77	$ 84.34		$ (16.43)
	100.0%	83.7%		**16.3%**
Taxes: FY2022 Actual; Projection for FY2023	$ 6.55	$ 5.48		$ (1.07)
	100.0%	83.7%		
Estimated Quarterly Tax Payments: April & June 2022				
At Safe Harbor Level: 100% of Prior Year **Used by 50% of Taxpayers**			$ 1.64	
Actually Due			$ 1.37	
Refund of FY22 Overpayments				$ (0.27)
Implied E&F and PET Income Tax Revenue in FY2023		$ 5.22		$ (1.33)
As % of FY 2022 Actual		79.6%		**-20.4%**

Accordingly, in April, Connecticut is likely to receive refund claims from many taxpayers rather than large tax payments. While not all E&F and PET taxable income derives from capital gains, a significant proportion does. While not all taxpayers will have followed the 100%-of-prior-year Safe Harbor rule, many will, at least with respect to the first two quarterly estimates due in mid-April and mid-June when income prospects for most of the tax year were an unknown.

The decline in taxable E&F and PET income is unlikely to be less than the decline in the stock market as measured by the S&P. Indeed, the decline in taxable such income is likely to significantly exceed the percentage decline in the S&P. The table below shows a 25% year-over-year decline in taxable E&F and PET income, resulting in a 31.4% decline in fiscal 2023 E&F and PET revenue.

	Fiscal 2022	Fiscal 2023		FY22 v FY23
Implied Taxable E&F and PET Income @ 6.5% Tax Rate	$ 100.77	$ 75.58		$ (25.19)
	100.0%	75.0%		**-25.0%**
Taxes: FY2022 Actual; Projection for FY2023	$ 6.55	$ 4.91		$ (1.64)
	100.0%	75.0%		
Estimated Quarterly Tax Payments: April & June 2022				
At Safe Harbor Level: 100% of Prior Year **Used by 50% of Taxpayers**			$ 1.64	
Actually Due			$ 1.23	
Refund of FY22 Overpayments				$ (0.41)
Implied E&F and PET Income Tax Revenue in FY2023		$ 4.50		$ (2.05)
As % of FY 2022 Actual		68.8%		**-31.3%**

Third Factor - Depressed Estimated Tax Payments for Calendar/Tax Year 2023: Fiscal 2023 includes the first two estimated quarterly payments for tax year 2023, which are due April 15th and June 15th of 2023. These payments will be depressed. Even if the stock market advances in 2023, safe harbor rules will bias estimated payments to the downside, for the April and June quarterly estimated tax filings (and thereafter), just as they biased them upward for calendar/tax year 2022. The 100%-of-prior-year Safe Harbor option will operate as a ceiling on estimated quarterly tax payments.

Net Effect of Three Factors: It is almost certain that E&F and PET income tax revenue in fiscal 2023 will fall short of the $5.48 billion projected in the fiscal 2023 budget adopted in April 2022 and reconfirmed in the Consensus Revenue Forecast in January 2023 and OPM's Letter to the Comptroller in the mid-March 2023.

It is highly likely that E&F and PET taxable income will fall 25% after the stock market plummeted 18% in 2022. A 25% decline would take this tax revenue down to $4.9 billion. It is also quite likely that overpayment of estimated taxes in April and June of calendar 2022 (fiscal 2022) due to the 100%-of-prior-year safe harbor rule will result in about $400 million in refunds (either paid in cash or credited against taxes due in 2023). The combination would result in E&F and PET income falling roughly 30% to $4.5 billion in fiscal 2023, as shown in the scenario above.

This projection does not give any specific effect to the expectation of depressed estimated tax payments in April and June of 2023 (fiscal 2023). It should also be noted that this projection would return E&F and PET revenue to only to a level roughly equivalent to the level in fiscal 2021, thus, a 30% decline is well within the bounds of reasonable expectations.

Review of E&F and PET Tax Receipts for the First Eight Months of Fiscal 2023

In the early months of fiscal 2023, E&F and PET tax receipts were buoyed by the lingering effects of the 2021 stock market boom. In the subsequent months, actual payments reflected the downturn in the market in 2022.

Fiscal 2023 Year to Date E&F and PET Revenue

Month	Calendar Year	Fiscal Year	Income Tax: Estimates & Finals	Pass-Through Entity Tax	E&F & PET	E&F & PET: Change from Prior FY		E&F & PET	Total Tax Revenue
			Current Fiscal Year 2023 Actual					Current FY 2023 Actual	
				($000)		(%)	($000)	($000)	
July	2022	FY 2022-23							35,862
August	2022	FY 2022-23	41,284	29,939	71,223		7,451	71,223	1,084,886
September	2022	FY 2022-23	363,772	361,709	725,481	6.3%	43,098	725,481	2,160,771
October	2022	FY 2022-23	193,832	32,168	226,000	39.6%	64,087	226,000	1,859,440
November	2022	FY 2022-23	45,392	38,497	83,889	15.7%	11,363	83,889	1,461,801
December	2022	FY 2022-23	71,208	290,559	361,767	-22.5%	(105,095)	361,767	1,966,094
January	2023	FY 2022-23	474,982	292,100	767,082	-23.3%	(232,770)	767,082	2,750,869
February	2023	FY 2022-23	44,110	26,850	70,960	-20.4%	(18,203)	70,960	1,471,965
			1,234,580	1,071,823	2,306,403	-10.0%	(230,069)	2,306,403	12,791,688
								18%	100%

E&F and PET tax payments in September 2022 exceeded such payments in September 2021 by $43 million, or 6.3%, likely reflecting quarterly estimated payments at the 100%-of-prior-year safe harbor rule.

October 2022 payments surged $64 million, or 39.6%, above October 2021 levels, likely due to the filing of final 2021 returns at the final extension date. The October 2022 payments reflected the robust results in calendar / tax year 2021 (26.9% gain in the S&P), while the October 2021 payments reflected the more modest results in calendar / tax year 2020 (16.3% gain in the S&P) and also the fact that better stock market results in 2019

(28.9% gain in the S&P) than 2020 generated inflated previous quarterly estimated payments under the 100%-of-prior-year safe harbor, refunds of which reduced net payments with final filings in October 2021.

E&F and PET tax receipts declined precipitously in December, January and February, reflecting taxes due for calendar / tax year 2022, declining in line with, but exceeding, the 2022 decline in the stock market as measured by the S&P. The three-month 23% decline is a harbinger of further declines in the remainder of fiscal 2023.

It is likely that the rate of decline will exceed 23% by a significant margin in the last four months of fiscal 2023, as refunds are claimed for prior overpayment of estimated taxes by those taxpayers following the 100%-of-prior-year Safe Harbor rule concerning the penalty for underpayment of taxes.

Projected E&F and PET Tax Receipts for the Final Months of Fiscal 2013

While the 23% pace of decline is highly likely to increase in the final four months of fiscal 2023, it would have to *moderate* for the consensus revenue forecast of E&F and PET revenue to be accurate, as the following table illustrates.

Consensus Revenue Forecast

Remainder of FY2023; Full Year Totals			Prior Fiscal Year 2022 Actual			Projected YOY Change		Projected FY 2023 Revenue	
Month	Calendar Yea	Fiscal Year	E&F	PET	(E&F and PET)	(%)	($)	(E&F andPET)	Total
March	2023	FY 2022-23	$ 109,444	$ 598,679	$ 708,123	-21.0%	(148,706)	$ 559,417	
April	2023	FY 2022-23	2,197,460	198,487	2,395,947	-21.0%	(503,149)	1,892,798	
May	2023	FY 2022-23	150,762	26,131	176,893	-21.0%	(37,148)	139,745	
June Final	2023	FY 2022-23	$ 412,622	$ 322,503	735,125	-21.0%	(154,376)	580,749	
			$ 2,870,288	$ 1,145,800	$ 4,016,088	-21.0%	(843,378)	$ 3,172,710	$ 12,486,312
(Dollars in thousands)								25%	100%
			Full Fiscal Year:		6,552,559	-16.4%	(1,073,447)	$ 5,479,113	$ 25,278,000
								22%	100%

A more likely scenario is shown in the table below, reflecting the impact of (1) refunds of inflated estimated quarterly payments in fiscal 2022 and fiscal 2023, and (2) depressed payments in the first two quarterly estimated payments for calendar / tax year 2023.

Likely Scenario

Remainder of FY2023; Full Year Totals			Prior Fiscal Year 2022 Actual			Projected YOY Change		Projected FY 2023 Revenue	
Month	Calendar Yea	Fiscal Year	E&F	PET	(E&F and PET)	(%)	($)	(E&F andPET)	Total
March	2023	FY 2022-23	$ 109,444	$ 598,679	$ 708,123	-47.0%	(332,818)	$ 375,305	
April	2023	FY 2022-23	2,197,460	198,487	2,395,947	-47.0%	(1,126,095)	1,269,852	
May	2023	FY 2022-23	150,762	26,131	176,893	-47.0%	(83,140)	93,753	
June Final	2023	FY 2022-23	412,622	322,503	$ 735,125	-47.0%	(345,509)	389,616	
			$ 2,870,288	$ 1,145,800	$ 4,016,088	-47.0%	(1,887,561)	$ 2,128,527	$ 11,442,129
(Dollars in thousands)								19%	100%
			Full Fiscal Year:		6,552,559	-32.3%	(2,117,630)	$ 4,434,930	$ 24,233,817
								18%	100%

Conclusion

Multiple indicators point to a substantial decline in E&F and PET tax revenue in fiscal 2023. The decline from fiscal 2022 is likely to be $2.1 billion, or 32%. Total E&F and PET revenue in fiscal 2023 is likely to be closer to $4.4 billion than the official forecast of $5.5 billion.

The likely $2.1 billion decline ($1.1 billion greater than the official projection) would reduce the Volatility Cap Deposit in fiscal 2024 from the official $1.8 billion projection to $700 million. This would be a precipitous decline compared to the $3.0 Volatility Cap Deposit in fiscal 2024.

In recent years, the Volatility Cap Deposit, together with budget surpluses, which together are deposited into the Budget Reserve Fund, have pushed the BRF over its legal maximum amount, resulting in large deposits of the excess into the State's two big pension funds.

These deposits into the pension funds have been critical contributions. Nevertheless, these pension funds remain severely underfunded. On December 31, 2022, the State employee pension fund held assets of $18.8 billion, while pension liabilities were $40.7 billion according to the pension valuation report as of June 30, 2022.