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Will April Income Tax Returns Surprise States?

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April, when income taxes are filed in most states, often holds surprises. States expecting large increases may indeed be surprised. Our analysis suggests little or no growth this year in the typical state, and weakness or declines in oil-patch states and states with legislated revenue reductions. Caution remains the watchword: all estimates for this volatile period are highly uncertain.

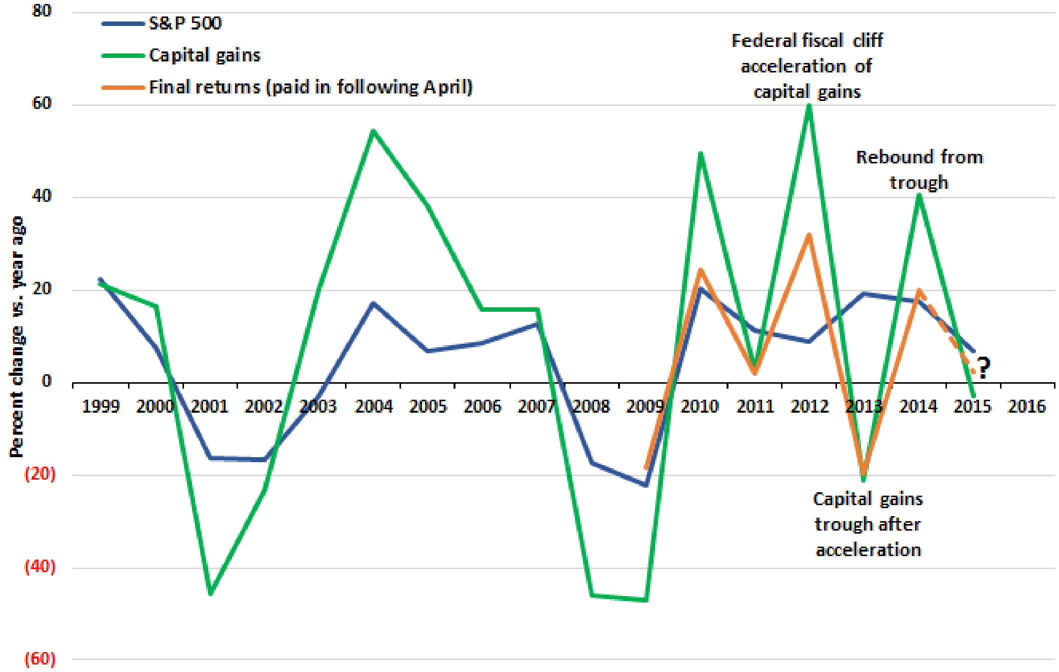
Final tax payments in April are large and can swing wildly from year to year. The typical state currently receives about a third of its income tax in the April-June quarter. The median state's payments were up 32 percent in the 2012 tax year, and down 20 percent in 2013. These payments are a residual between what taxpayers owe for the entire year and what they have paid to date: Taxpayers send a payment if they haven't paid their full liability through withholding and estimated payments, or may claim a refund if they have overpaid. Because taxes on wage income are paid largely through withholding, final payments are influenced heavily by income not subject to withholding, particularly volatile capital gains. Unanticipated swings in final returns cause pleasant surprises in some years and unpleasant surprises in others, often at the worst time, as budget negotiations for a new fiscal year are coming to an end.[1]

To help understand what may happen in April when returns are filed, forecasters can subtract withholding and estimated payments from forecasted tax liability. In practice, data shortcomings can make this difficult and rules of thumb are useful, too.

Figure 1 shows percentage changes in states' final returns (orange) and two potential indicators, the S&P 500 index (blue) and federal capital gains (green). We've labeled the graph with fiscal-cliff-related events that we have discussed in previous *State Revenue Reports*. Capital gains and final returns follow similar patterns, although capital gains often move more sharply. Capital gains and the stock market usually increase and decrease at similar times, but movements in capital gains generally are much greater.

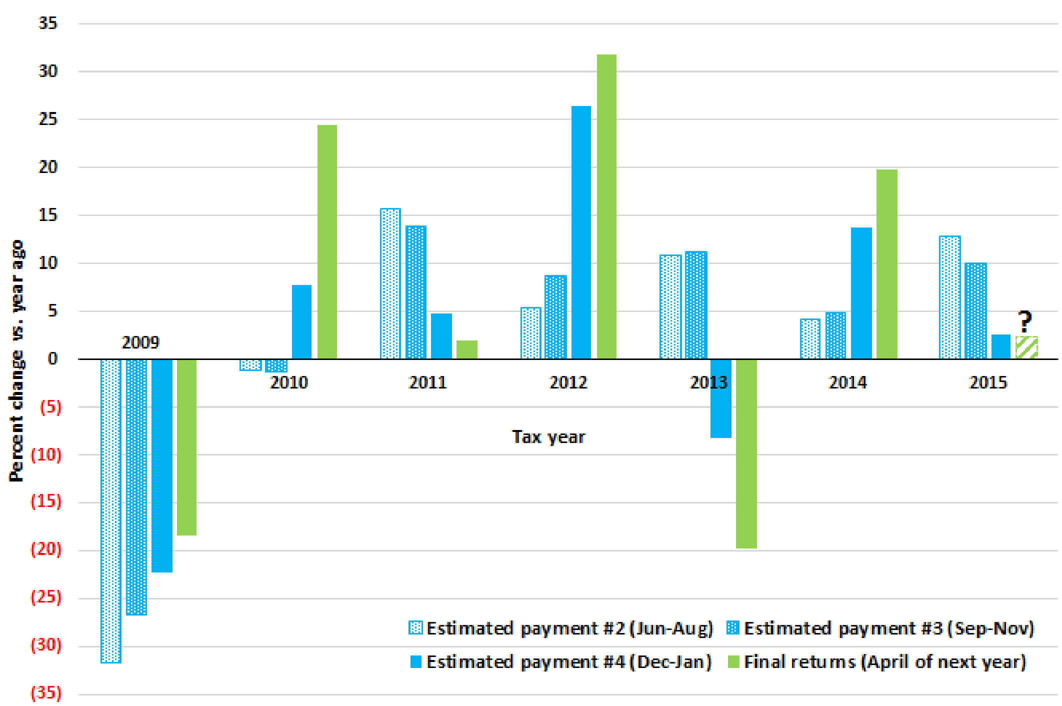
Figure 2 shows the median percentage change in the second, third, and fourth estimated payment for each tax year from 2009 through 2015, and in final returns paid the following April, including a rough guess for April 2016.[2] The graph suggests that final returns are slightly related to the fourth estimated payment, and not much related to earlier payments.

Figure 1. Percent Change in the S&P 500, Capital Gains, and April Final Returns, by Tax Year



Notes: (1) S&P 500 is calendar year average of daily adjusted closes; (2) Capital gains for 2015 are estimated by the CBO; (3) Final returns is median of state percentage changes; 2015 value (to be paid with April 2016 returns) is the authors' rough guess.
Sources: (1) S&P 500 (Yahoo); (2) Capital gains (CBO, www.cbo.gov/publication/51129); (3) Final returns (Rockefeller Institute).

Figure 2. Percent Change in Estimated and Final Payments by Tax Year, Median State



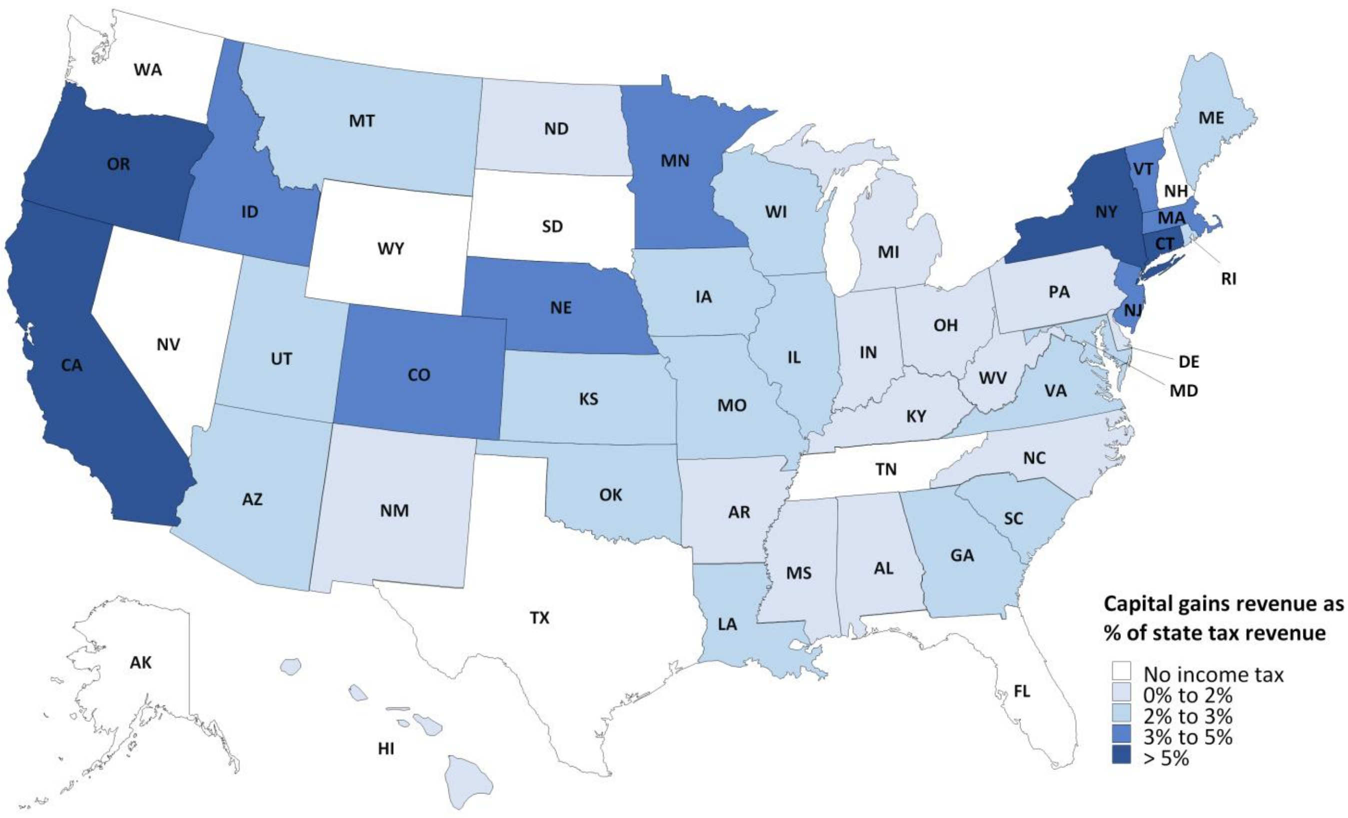
Source: Rockefeller Institute of Government. Final returns for 2015 (to be paid with April 2016 returns) is the authors' rough guess.

Our best estimate is that median-state growth in final returns in coming weeks is likely to be slightly above zero, reflecting a decline in capital gains and a significant slowdown in the fourth estimated payment, but it's a highly uncertain estimate — the historical relationships are so erratic that higher or lower growth is quite plausible. Our analysis suggests that final returns are likely to decline in some states, particularly hard-hit oil-patch states and states that had legislation reducing income tax revenue, many of which had declines in their fourth estimated payment.[3]

These conclusions depend in part on the Congressional Budget Office's estimate that capital gains declined 2.9 percent in 2015. Capital gains estimates at this point, before 2015 tax returns are tabulated, can be quite wrong because the available economic data do not have much predictive power. This uncertainty is more important for some states than others, as ***Figure 3*** shows. We estimate that income tax revenue directly attributable to capital gains was more than 5 percent of total tax revenue in the top four states (dark blue) — triple the national median in California and New York, and about double the median in Connecticut and Oregon.

Stay tuned for more information about April final returns in our next quarterly *State Revenue Report.*

Figure 3. Capital Gains Revenues as Percent of Total State Tax Revenue



Sources: Rockefeller Institute analysis of capital gains from the Internal Revenue Service, capital gains rates from the Tax Foundation with Institute adjustment, and tax revenue from U.S. Bureau of the Census.

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[1] The new fiscal year starts on July 1st in most states.

[2] We do not show the first estimated payment because it often includes payments for the prior tax year.

[3] Based on several simple models of the relationship between the percent change in final returns and percent changes in estimated payments and capital gains. Details available from the authors.