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333 Washington Street | Suite 853 | Boston, MA 02108 | 617.720.1000  
[www.masstaxpayers.com](http://www.masstaxpayers.com)

## *MTF Bulletin*

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### **Fiscal Year 2027 Budget: A Closer Look**

#### *Understanding Governor Healey's OB3 Federal Tax Conformity Proposal*

On January 28<sup>th</sup>, the Healey-Driscoll administration filed its budget proposal for Fiscal Year (FY) 2027. The \$63.36 billion plan increases spending over the FY 2026 General Appropriations Act (GAA) by \$2.3 billion (3.8 percent) and over the administration's estimated spending level for FY 2026 by \$668 million (1.1 percent). The Governor's proposal relies on \$404 million in revenues tied to the passage of legislation she filed two weeks prior related to recent federal corporate tax changes.

That tax bill, filed on January 15<sup>th</sup>, addresses Massachusetts' conformity with certain tax provisions included in the One Big Beautiful Bill Act (OB3). OB3 contains a myriad of tax changes, some of which extend tax cuts made in the 2017 Tax Cuts and Jobs Act (TCJA), while others restore tax policies that predated the TCJA or address other issues.

On the corporate tax side, the OB3 changes established tax provisions or reinstated several policies intended to spur economic development by incentivizing business investment in infrastructure and other assets. As a result of these changes, there is a fiscal impact for states like Massachusetts that conform to the federal corporate code and those impacts are more pronounced in the initial years of implementation with varying estimated impacts in later years.

As MTF's earlier [analysis](#) summarized, Massachusetts automatically conforms to most federal changes to definitions of corporate income. This means that when the federal government makes changes to how corporate income is defined, it automatically changes the calculation of corporate taxes at the state level as well. Those revenue losses are projected to be significant in FY 2026 and FY 2027.

This Brief summarizes the Governor's proposal to address the Commonwealth's conformity with tax changes included in OB3.

#### **Governor Healey's Plan**

Governor Healey framed her proposal around four primary goals: (i) mitigating revenue loss in fiscal years (FY) 2026 and 2027 related to changes in the federal tax code; (ii) adjusting the state's state and local tax deduction workaround to account for the income surtax; (iii) safeguarding against future revenue loss associated with changes to the federal tax code; and (iv) making necessary, minor tax changes to comply with federal reforms.

The Governor's FY 2027 budget proposal assumes \$404 million in additional tax revenue related to passage of this bill. That assumption, based on an earlier Department of Revenue analysis of the revenue impacts of Massachusetts' rolling conformity with the corporate tax code, assumes \$108 million in revenue from delaying conformity in several instances and \$296 million in revenue from expanding the state's Pass Through

Entity (PTE) tax to apply to income surtax revenue. What follows is an analysis of the provisions of the Governor’s plan related to conformity with changes to the federal corporate tax code included in OB3.

### Phased-In Conformity

The DOR revenue analysis cited above identified five policy changes they estimated to reduce FY 2026 revenue by \$442 million; that lessens to \$235 million in FY 2027 and \$203 million in FY 2028:

- Research and Experimental Expenditures;
- Manufacturing Facilities and other Qualified Production Property;
- Modification on Business Interest Deductions;
- Increased Depreciation of Certain Business Expenses; and
- Enhanced Opportunity Zones.

To mitigate the estimated revenue impact for FY 2026, the Governor proposes a phased in approach of these policy changes through two separate tranches: (i) changes effective for tax years beginning on or after January 1, 2026; and (ii) changes effective for tax years beginning on or after January 1, 2027.

### Effective Tax Year 2026 (Delayed one year)

#### Research & Experimental (R&E) Expense Deduction

DOR Estimated Revenue Impact of OB3

	FY2026	FY2027	FY2028	FY2029	FY2030
Research and Experimental Expenditures	-\$288	-\$87	-\$56	-\$33	-\$16

*\$ in millions*

**Background** – Prior to the TCJA, businesses could fully deduct all eligible research and experimentation (R&E) expenses in the year they were incurred. However, starting in 2022, the TCJA required businesses to capitalize and amortize domestic R&E expenditures over five years, resulting in a lower upfront credit on businesses’ returns.

**OB3 Changes** – OB3 restores the full deductibility of domestic R&E expenses that occurred on or after January 1, 2025 for large firms and retroactively back to 2022 for businesses with average gross receipts of \$31 million or less over the last three years. OB3 also allows businesses to deduct any remaining unamortized domestic R&E expenditures incurred between January 1, 2022 and December 31, 2024 either entirely in 2025 or proportionally in 2025 and 2026.

**Governor’s Proposal** – The Governor’s bill conforms with the full deductibility of domestic R&E expenses with two changes in relation to the deduction. First, unlike OB3, the Governor’s proposal does not allow businesses to retroactively claim the deduction or to deduct any remaining unamortized R&E expenditures in 2025 or across 2025 and 2026. Second, the Governor proposes delaying the full deductibility of domestic R&E expenses until tax year 2026. This approach results in a \$288 million revenue savings for the state in FY 2026 and a \$21 million revenue savings assumption for FY 2027 (compared to full conformity with the changes included in OB3 assumed by the consensus revenue estimate).<sup>1</sup>

<sup>1</sup> Each fiscal impact of the conformity delays described below similarly provides the revenue savings in FY 2026 and FY 2027 compared to full conformity, as assumed in the Consensus Revenue agreement

## Effective Tax Year 2027 (Delayed two years)

The Governor proposes phasing in the four remaining changes to the federal tax code beginning in 2027:

DOR Estimated Revenue Impact of OB3

	FY2026	FY2027	FY2028	FY2029	FY2030
Manufacturing Facilities & Qualified Production Property	-\$98	-\$131	-\$134	-\$118	-\$82
Modification of Business Interest Deductions	-\$52	-\$25	-\$23	-\$21	-\$21
Increased Depreciation on Certain Business Assets	-\$25	-\$17	-\$14	-\$12	-\$10
Enhanced Opportunity Zones	\$0	-\$18	-\$33	-\$32	-\$20

\$ in millions

### *Manufacturing Facilities and other Qualified Production Property*

**Background** – Historically, businesses have been required to deduct qualified business expenses associated with depreciation over a time horizon of years, reflecting the potential useful life of the property. Generally, manufacturing facilities and other qualified production properties have depreciated over a period of 39 years. Spreading deductions across several years rather than allowing the full costs to be deducted in the year they are incurred, results in businesses recovering only a portion of the facility’s cost.

**OB3 Changes** – OB3 establishes an elective 100 percent depreciation allowance, through 2030, for businesses to fully depreciate newly constructed manufacturing facilities and other qualified production property involved in manufacturing, production or refining of products in the year that the property was placed into service.

**Governor’s Proposal** – The Governor’s bill establishes the elective 100 percent depreciation allowance through 2030, much like OB3. However, the proposal delays conformity with the temporary depreciation allowance until tax year 2027. This would reduce the FY 2026 revenue loss by \$98 million and reduce the FY 2027 revenue loss by \$65 million .

### *Modification on Business Interest Deductions*

**Background** – Prior to 2017, businesses were generally allowed to fully deduct their interest expenses from taxable income – the TCJA limited the ability of businesses to deduct interest expenses. Under the TCJA, small businesses were exempt from limitations on interest deductions while larger businesses were subject to a cap based on the business’ earnings before interest, taxes, depreciation, and amortization (EBITDA) through 2021. Starting in 2022, the limitation on business interest deductions was tightened further by rewriting the basis for the cap from EBITDA to earnings before interest and taxes (EBIT), shrinking the bucket of allowable costs businesses could fill with interest deductions.

**OB3 Changes** – For tax years starting on or after January 1, 2025, OB3 restores the business interest deduction based on EBITDA, adding depreciation and amortization expenses back to a business’ income and effectively increasing the size of the bucket businesses can fill with interest deductions.

**Governor’s Proposal** – In line with the changes made by OB3, the Governor’s bill proposes restoring business interest deduction based on EBITDA, but delays conformity with the change until tax year 2027. This would reduce the FY 2026 revenue loss by \$52 million and reduce the FY 2027 revenue loss by \$13 million.

### *Increased Depreciation of Certain Business Expenses*

Background – Generally, businesses are not allowed to immediately write off the full cost of investment in certain property, such as office furniture, computers, machinery and equipment, and instead are required to recover the cost through depreciation schedules spread over multiple years. However, since 1958, businesses have been able to elect to deduct a portion of their investments, up to a specified cap. The TCJA raised the cap on these expensing deductions to allow businesses to immediately deduct up to \$1 million of purchases.

OB3 Changes – OB3 increases, from \$1 million to \$2.5 million, the cap on the total amount businesses may deduct for the cost of certain business property in a given year, allowing businesses to receive a larger deduction than under the TCJA.

Governor’s Proposal – Similar to other changes to the federal tax code included in OB3, the Governor proposes increasing the deduction cap on certain business expenses from \$1 million to \$2.5 million beginning in tax year 2027. This would reduce the FY 2026 revenue loss by \$25 million and reduce the FY 2027 revenue loss by \$9 million.

### *Enhanced Opportunity Zones*

Background – In 2017, the TCJA established opportunity zones to offer temporary tax incentives for investors to spur economic growth in low-income communities. In Massachusetts, 138 census tracts in 79 communities have been designated as opportunity zones. While the policy offers tax incentives for investments ranging from housing, infrastructure, and business growth, nationally approximately 75 percent of all investments have been made in the real estate industry.

OB3 Changes – OB3 establishes permanent incentives for opportunity zones that were scheduled to sunset in 2028 under the TCJA but creates a narrower set of zones beginning in 2027. OB3 restricts eligibility for low-income communities to be designated as opportunity zones by decreasing the threshold for eligibility from 80 percent to 70 percent of statewide or metropolitan median income. OB3 also establishes new incentives related to opportunity zones for investments in rural communities, offering a 30 percent reduction in capital gains tax if an investment is made for at least 5 years.

Governor’s Proposal – The Governor’s bill conforms with OB3, authorizing permanent incentives for investment in opportunity zones, with one distinction. Unlike OB3, the Governor’s proposal limits eligibility for tax benefits to only investments in opportunity zones located in Massachusetts. Changes related to opportunity zones are not expected to result in a revenue impact for the state in FY 2026 or FY 2027.

### **PTE Excise Expansion**

In addition to conforming with tax changes included in OB3, Governor Healey’s proposal includes an expansion of the state’s existing state and local tax deduction workaround to account for the income surtax.

Background - Prior to the TCJA, itemizing taxpayers were able to deduct all state and local taxes from their federal income. This policy meant that taxpayers in states with relatively high levels of tax, like Massachusetts, received a major federal tax benefit. In 2017, the TCJA imposed a \$10K cap on SALT deductions which led Massachusetts lawmakers to enact legislation establishing a pass-through entity (PTE) excise serving as a workaround to the SALT cap. The workaround reduced the federal taxable income of a PTE’s members without triggering the SALT cap and allowed the members to receive a credit against their Massachusetts taxable income that offset most of the excise paid by the PTE. Because the state credit was not equal to the entire PTE excise, this change also generates revenue for the state.

Governor’s Proposal – The Governor’s bill includes an expansion of Massachusetts’ state and local tax deduction workaround to account for the income surtax by authorizing PTEs to elect to pay an excise of 4 percent on each qualified member’s Massachusetts taxable income that exceeds the surtax threshold. Each member then receives a credit, much like the existing workaround, for their portion of the of the income surtax paid by the PTE. The Governor estimates this expansion will generate \$296 million in revenue in FY 2027.

### **Prospective Conformity Delay**

To provide budget writers additional time to consider revenue implications related to future changes in the federal tax code, the Governor proposes establishing a requirement, based on a model used in Maryland, delaying conformity of any amendment to the IRC related to personal income and corporate excise that DOR determines has an estimated revenue impact of at least \$20 million.

### **Other Provisions**

#### *DFML Leave Contributions*

The Governor proposes adjusting the application of paid family leave and paid medical leave contribution rates between employers and employees. The change is being proposed in light of recent IRS guidance under which family leave benefits are taxable while medical leave benefits depend on whether the benefits are attributable to the employer or the employee. The change will provide a tax benefit for employees and employers.

#### *Slot Machine Winnings*

The Governor’s proposal aligns Massachusetts with federal reporting requirements included in OB3 related to slot machine winnings by increasing the reporting threshold from \$1,200 to \$2,000 for tax years beginning on or after January 1, 2026.

### **Next Steps**

Governor Healey filed her tax conformity bill as standalone legislation that was referred to the Joint Committee on Revenue and heard on February 12<sup>th</sup>. The Committee has until April 13, 2026 to act on the bill. If given a favorable report, the bill would move to the House Committee on Ways and Means.

Given the FY 2027 fiscal impact assigned to the bill in Governor Healey’s budget, the House could choose to incorporate these, or other, tax provisions in their budget, but in recent sessions the House and Senate decided to address major tax changes in separate legislation. Timely action on the Governor’s bill would provide clarity for tax filers and provide budget writers an estimated \$404 million in revenue, however if lawmakers choose to delay action on the bill, evidence of plans to consider the legislation as a standalone bill prior to the start of FY 2027 will be made apparent in their respective budget proposals.

### **Key Questions for the House and Senate**

- ***How important is the Governor’s conformity proposal to balancing the FY 2027 budget?***  
*MTF’s analysis of the Governor’s budget proposal identifies a combination of revenue and spending-side solutions to close a budget gap in FY 2027 estimated to exceed \$3.5 billion, including \$404 million in tax revenue tied directly to the passage of this bill.*



Fiscal Impact of Governor Healey’s Bill

	FY 2026	FY 2027
Delayed Conformity		
<i>R&amp;E Expense Deduction (1 year delay)</i>	\$288	\$21
<i>Manufacturing Facilities and other Qualified Production Property (2 year delay)</i>	\$98	\$65
<i>Modification on Business Interest Deductions (2 year delay)</i>	\$52	\$13
<i>Increased Depreciation of Certain Business Expenses (2 year delay)</i>	\$25	\$9
<i>Enhanced Opportunity Zones (2 year delay)</i>	\$0	\$0
PTE Excise Expansion	\$161	\$296
<b>Total Revenue</b>	<b>\$624</b>	<b>\$404</b>
Net Impact	\$182	\$127

\$ in millions

*This \$404 million in additional tax revenue that the Governor applies to close a portion of the budget gap is divided between two key components of the bill: delayed conformity with the federal corporate tax code and the expansion of the PTE tax to apply to income surtax revenue. Specifically, delaying conformity with the five provisions in OB3 estimated by the Department of Revenue to have the largest state revenue impact is expected to generate \$108 million in tax revenue in FY 2027, while the expansion of the PTE tax is estimated to generate \$296 million in tax revenue in FY 2027.*

*These revenue solutions work in conjunction with several other revenue and spending-side solutions to close the budget gap for the upcoming fiscal year and represent a sensible approach to smooth revenue impacts associated with federal tax changes in OB3 without substantially sacrificing tax competitiveness in Massachusetts.*

- How will the timing of legislative action on Governor Healey’s proposal impact Massachusetts?**  
*As the legislature considers Governor Healey’s bill, timely legislative action is essential to preserve simplicity in tax administration and mitigate impacts in FY 2026 and FY 2027.*

*Because of Massachusetts’ rolling conformity with the corporate tax code, delayed action on the Governor’s proposal is likely to create challenges for taxpayers as tax law affecting 2025 could be made after returns are submitted. This timing challenge could require amending, improperly calculated estimated payments, or the need to file late returns. As the first deadline for corporate tax filing on March 16<sup>th</sup> quickly approaches, if the legislature does act on these changes, it will create challenges for at least some corporate filers.*

*Also of note is the impact of timely legislative action on the FY 2027 budget. As highlighted above, the Governor’s FY 2027 budget proposal assumes \$404 million in additional tax revenue tied to the passage of this bill. Given that the House and Senate will likely need to rely on these revenues to balance their own budget proposals for FY 2027, action on tax conformity legislation may take place in conjunction with the budget development process.*

- Could the House and Senate take a different approach to mitigating OB3 tax revenue impacts?**  
*As the House and Senate consider Governor Healey’s conformity proposal alongside the FY 2027 budget, lawmakers may consider policies related to decoupling along with other tax policy reforms to mitigate revenue impacts.*



*MTF's earlier analysis on [tax conformity](#) discussed that there are generally two options when it comes to decoupling: permanently eliminating state conformity with a specific federal change or, as the Governor proposes, delaying adoption of a federal change at the state level.*

*Any action to fully decouple from the changes to the federal tax code in OB3 would represent a significant misstep – introducing unnecessary complexity and eroding the Commonwealth's competitiveness. Adhering to federal corporate changes, especially related to the expensing and treatment of business interest, builds on the passage of single sales factor apportionment and maintains Massachusetts' progress on business taxes. Eliminating conformity with tax policies designed to incentivize business investment would create an immediate disadvantage with more than two dozen other states with rolling conformity with the corporate tax code.*

*In recent legislative sessions, lawmakers have filed several bills aimed at raising revenue in Massachusetts by increasing the corporate tax rate, including proposals related to Global Intangible Low-Taxed Income (GILTI). As MTF has testified, these proposals should be advanced. Making one off corporate changes proposed prior to OB3 in an effort to simply raise revenue will create bad policy that runs counter to the goals of a predictable, reliable, and fair tax code that helps the state maintain its competitive edge. Any legislative action on the Governor's bill should remain targeted at addressing short term revenue impacts, while maintaining ongoing corporate conformity.*