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Issue Brief

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Passthrough Entity Taxes and SALT Cap Workarounds

Executive Summary

In late 2017, Congress passed, and President Trump signed the Tax Cuts and Jobs Act, one of the more significant overhauls in the federal tax code in decades. The bill made several changes to personal income taxes but among the most publicized was the $10,000 limit on state and local tax (SALT) deductions taxpayers were eligible to itemize on their federal tax return, colloquially called the SALT cap. While the bill overall led to a large aggregative reduction in federal tax liability, individuals and policy makers living in states with high state and local property taxes felt the provision unfairly targeted them. In response, states set about ways to allow their taxpayers to circumvent the $10,000 SALT cap. The result was the creation of passthrough entity (PTE) taxes at the state level.

Federally, and under current Vermont law, a passthrough entity is a business whose profits are distributed (or "passed through") to the owners who then pay personal income tax associated with those profits. Under PTE taxes (and all entity level taxes like the corporate income tax), on the other hand, the business pays taxes on their profits as a business, not by the individual shareholders as personal income tax. When a business is calculating its taxable profits for the year (also known as net income), it can deduct the expenses for state taxes paid as an entity. If the business owners report their profits as personal income, personal income taxes are not deductible as a business expense. Instead, they can deduct personal income taxes as an itemized deduction, but those taxes are subject to the SALT cap. State taxes paid as a business entity are subject to no such cap as a business expense.

The creation of state PTE taxes allows business owners and shareholders to deduct state taxes paid not through the traditional itemized deduction route, but rather, as a business expense that reduces overall taxable income for the shareholder. In this way, it allows for these business owners to get around the $10,000 SALT cap. Connecticut first adopted a PTE tax in 2019 and as of June 2022, 27 more states have followed suit. Vermont is not one of them.

This Issue Brief aims to inform on the mechanics of a PTE tax and the potential federal tax benefits for individuals who might elect to pay it. Overall, it makes the following findings:

- The creation of a PTE tax could save Vermont taxpayers between $10 and $20 million a year in federal taxes, depending upon the number and composition of taxpayers who elect to pay it.
- These federal tax savings are almost certain to accrue to a very modest number of taxpayers with high incomes.
    - JFO modeling suggests that a full repeal of the SALT cap for only passthrough business owners would result in over 70% of the federal tax benefit accruing to returns with Adjusted Gross Income (AGI) above $500,000, or 0.23% of total Vermont returns.
- Depending upon the structure of a PTE tax, the impact on State revenues is likely to be modestly positive or revenue neutral.

JFO presents the following considerations for legislators if they decide to explore a PTE tax:

- A PTE tax treats classes of income differently, with individuals with passthrough income benefitting from lower federal income taxes and individuals without that type of income being excluded.
- Legislators should balance the goals of creating vertical equity (ie. progressivity) in the personal income tax code while potentially reducing taxes for some business owners.
- A PTE tax introduces a third tax option for resident businesses in the tax code with complexities for administrators and taxpayers.[1]
- Legislators should weigh the consequences of creating tax policy solely in response to changes in federal tax policy.
- The details for a PTE tax are complex and important. These include the rate, the associated credits, and the election criteria for businesses. Each is worthy of Legislative discussion.

Background and Context

Background

To first understand passthrough entity taxes, it is necessary to understand how businesses pay taxes in the United States.

At a very fundamental level, to determine how much income is subject to tax, a business must take the revenues it earns and subtract from it expenses and other losses. Revenues could include revenues from sales of goods/services, leases, royalties, and many other sources. Expenses include employee compensation, maintenance of machinery and equipment, advertising, and taxes paid. The result of this calculation is the business' profit.[2] The IRS and state tax codes require businesses to count certain items as revenue (sales and interest revenue, for example) and also require or allow them to subtract certain expenses (wages paid, investment spending, vehicle expenses, for example). When a business does this calculation using the definitions from the IRS or state tax codes, the result is taxable **net income**. This net income is what is subject to tax.

Businesses at both the federal and Vermont level pay taxes on this net income based upon how they are structured. Depending on that structure, a business' net income will be subject to either the corporate income tax or will be passed through to the shareholders who will then pay the personal income tax associated with their share of that net income. There are two relevant structures – C-corporations and passthrough entities

C-corporations pay Vermont's (and the federal) corporate income tax. Net income of a C-corporation accrues at the business level and is taxed using a bracket structure with increasing rates from 6% to 8.5%. Most C-corporation businesses pay the 8.5% rate (Table 1). Because this net income is taxed first at the business level, it is considered an **entity-level tax.** That is, the owners themselves are not paying the tax on the profits, the business is.

[1] In Vermont, nonresident passthrough owners already pay at the entity level (Business Income Tax), but most resident passthroughs pay through the personal income tax.

[2] There are many different definitions of profit that are used for different purposes, such as measuring performance or calculating tax liability.

Table 1: Vermont corporate income tax Table

Taxable Income Bracket	Tax rate
$3,751 up to $10,000	6%
$10,000 up to $25,000	7%
$25,000 and over	8.5%

After paying the corporate income tax as a business, any remaining net income (after reinvestment in the business) may be distributed to the shareholders of the business as dividends. Those shareholders are required to pay personal income tax rates on those dividends.

There are numerous reasons why a business might structure itself as a C-corporation. C-corporations generally are better suited for businesses looking to raise money in public markets because the structure allows for over 100 shareholders. C-corporations also have access to some deductions, particularly for employee benefits, that non-C corporations do not.

Passthrough entities, on the other hand, do not pay the corporate income tax. Instead, a business' net income is "passed through" to the owner's or shareholder's personal income tax returns. That net income is taxed at federal and Vermont personal income tax rates along with other earned and unearned income such as wages, capital gains, pensions, and Social Security income. The following are examples of passthrough entities:

- **Partnerships**: two or more individuals own and operate a business. All partners have equal ownership rights, and profits accrue to the partners.
- **S-corporations:** Similar to partnerships but S-corporations are not allowed to have more than 100 shareholders. S-corporations are also prohibited by law from being owned by another corporate entity. These corporations, along with partnerships, file Schedule E when completing their income taxes each year. An S-corporation can have a single owner or up to 100 shareholders.
- **Sole Proprietorships:** the business is owned by a single owner to whom all profits accrue. The owner files a Schedule C when completing his or her income taxes each year.

Partnerships and S-corporations often will further structure themselves as Limited Liability Corporations (LLCs). This allows the owners of these businesses to have liability protections that are afforded to C-corporations in the event of bankruptcy or legal concerns.

To summarize, if a business structures itself as a passthrough for taxation purposes, the business itself does not remit taxes on its net income to the IRS and Vermont. Instead, the shareholders divide the net income amongst themselves and pay personal income tax on their individual shares. For this reason, passthrough businesses do not currently pay entity-level taxes federally or in Vermont.[3]

The Tax Cuts and Jobs Act and the SALT Deduction

On December 22, 2017, President Donald Trump signed into law the "Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018", more commonly known as the Tax Cuts and Jobs Act (TCJA). The bill made several changes to the federal Internal Revenue Code, including but not limited to, the federal personal and corporate income tax systems. The bill was made effective for tax year[4] 2018.

On the personal income tax, the bill made several changes. One of the central themes of the bill was a desire to make the tax filing process more straightforward for taxpayers. To achieve the goal of simplicity the

[3] The exception to this is nonresident passthroughs which are required to pay the Business Income Tax in Vermont, an entity level tax.

[4] The tax year runs from January through December of a given year.

TCJA made changes to various deductions to make more taxpayers' tax situations straightforward.

When completing their federal taxes, a taxpayer has the option of taking what is known as the standard deduction or itemizing their deductions. The standard deduction is a flat amount depending upon filing status, while itemized deductions include certain types of deductions, the most relevant to this Issue Brief, **the state and local tax deduction (SALT)**.[5]

The **SALT deduction** allows a taxpayer to deduct certain taxes paid to state and local governments. These include state income taxes or sales taxes and local property taxes. The deduction is only available to a taxpayer who chooses to itemize their deductions on their federal tax return (rather than take the standard deduction). The SALT deduction, and other deductions generally, reduce a taxpayer's taxable income, which in turn, reduces their tax liability.

In addition to changing other deductions, the bill limited the SALT deduction to $10,000 per tax return. In other words, a taxpayer would be unable to deduct more than $10,000 in state and local taxes from their taxable income if they itemized their deductions. This limitation is colloquially known as the **SALT cap.** The SALT cap was controversial. Many states with higher state and local taxes argued that the provision targeted, almost in a punitive way, taxpayers in their state since they would be most affected by the change.[6] Another argument was that capping the deduction limited the capacity for state and local governments to levy taxes.

Several states challenged the bill in court, saying the provision interfered with states' ability to levy taxes. The Supreme Court ultimately decided not to take up the case.[7] Attempts have been made to repeal the SALT cap. In 2021, the House of Representatives passed a version of the Build Back Better legislation that would have expanded the cap to $80,000. However, the bill did not receive approval in the Senate.

Early State Actions and Entity Level Taxes

Almost immediately after the passage of the TCJA, states with high state and local taxes faced pressure from their taxpayers to find ways to circumvent the SALT cap because this would greatly lessen their federal taxes.

The earliest version of these attempts concerned using the existing charitable itemized deduction, which was not limited by the TCJA. At a high level, these schemes worked in the following steps:

- A state would set up a charitable organization of sorts operated by the state government. The charitable organization's main purpose would be to remit money to the state coffer or perform an existing state service.
- State taxpayers would make contributions to the charity.
- Then, those who contributed to the charity would receive a state tax credit on their state personal income tax, fully offsetting what they paid on their actual state taxes.

On their federal taxes, the individual would be able to fully deduct their "charitable" contributions, thereby evading the $10,000 SALT cap. Connecticut, New Jersey, and New York all created workarounds similar to this.

[5] Other itemized deductions include the home mortgage interest deduction, the charitable contributions deduction, and the deduction for casualty losses in a Federally declared disaster.

[6] https://vtdigger.org/2022/05/20/a-tax-proposal-could-have-saved-vermont-business-owners-millions-legislators-let-it-die/

[7] https://www.reuters.com/legal/government/us-supreme-court-snubs-challenge-state-local-tax-cap-2022-04-18/

In 2019, the Internal Revenue Service (IRS) issued guidance that effectively stopped this type of workaround, by requiring that the individual's charitable contribution to state charitable organizations be offset by the size of the corresponding state tax credit.

While this attempt to get around the SALT cap failed, states continued to look for ways to allow taxpayers to fully deduct state and local taxes federally. In general, the goal was to find a way for individuals to pay their state taxes in a different way. To make sure they would not be double taxed, the state would have them pay their state personal income taxes (thus, having them pay twice), and then offer them a credit on their personal income taxes close to or equal to the amount they paid under the "new" tax. The solution came in the form of entity level taxes for passthroughs which will be explained in more detail below.

State Entity Level Taxes for Passthroughs

Connecticut was the first state to introduce **passthrough entity (PTE) taxes** to get around the SALT cap in 2019.

PTE taxes are designed to allow passthrough business owners and shareholders to pay state taxes on their net income at the entity level, like the corporate income tax, rather than paying taxes on their profits on the personal income tax. Most state PTE taxes are only available to S-corporation and partnership passthrough businesses, not sole proprietorships.

On the state level, PTE taxes generally follow this structure:

- At the business (entity) level, the business pays the PTE tax on its net income.
- The shareholders each divide up the net income made as a business depending upon their shares, and each pay personal income tax on the distributions.
- Each individual shareholder receives a tax credit on their personal income tax for their share of PTE entity paid. This credit is designed to offset the personal income tax paid and avoid double taxing the same net income.

Federally, the state PTE tax has the following impacts for the shareholders of the business:

- The PTE tax is deductible as an expense from their net income. When the profits of the business are divided amongst the shareholders, their share of the total net income is reduced by their share of the PTE tax paid.
- The deduction of the PTE tax paid lowers taxable income on their federal tax return, and therefore reduces their tax liability.

In effect, what the PTE tax allows a taxpayer to do is to deduct state taxes paid not through the traditional itemized deduction route, but rather, as a business expense that reduces overall net income. Expenses for taxes paid as a business are not limited by the SALT cap. The full deduction of state taxes paid on business income can significantly reduce a taxpayers' federal taxable income and therefore, tax liability. Herein lies the main argument for creating a PTE tax: states can save their taxpayers significant sums federally with little to no impact on state revenues.

A more detailed example of how a PTE works and hypothetical savings to a taxpayer is included in the Appendix.

In 2020, the IRS gave its blessing to full deduction of PTE taxes. As of June 2022, 28 states have created a PTE tax as a way to circumvent the SALT cap. In Vermont, though not included in the final as passed version, S.11 of the 2022 session included the creation of a PTE tax. The main parameters were a 7.6% PTE tax on business net income with a corresponding tax credit on the personal income tax equal to 90% of the

PTE tax paid. The PTE tax in S.11 passed the Senate but was not included in the final Committee of Conference agreement.

Analysis of Potential Beneficiaries

Estimates of the potential tax benefits of a PTE tax for Vermonters are only approximate. Many state PTE taxes are elective on the part of the taxpayer. As such, it is impossible to say with certainty the exact beneficiaries. Looking at the data for those who report passthrough income and those who are impacted most by the SALT cap gives a universe of potential beneficiaries, rather than a definitive conclusion.

To briefly summarize the results of JFO's analysis:

- **The creation of a PTE tax could save Vermont taxpayers between $10 to $20 million in federal taxes depending upon take-up rates.**
- **These savings are expected to be heavily skewed towards high-income taxpayers: preliminary JFO estimates find that 70% of the federal tax savings of a full SALT cap repeal for business owners would accrue to taxpayers with AGI above $500,000, or 0.23% of total Vermont returns.**
- **Depending on how it is structured, a PTE tax is expected to have a modest positive State revenue impact.**

In order to understand who might benefit from a potential PTE tax as a SALT cap workaround, it is important to first highlight two pieces of information:

- The option to pay PTE taxes is only available to owners or investors of passthrough businesses. Beneficiaries of a PTE tax, by definition, will accrue to this group of taxpayers.
- The main tax benefit to individuals who elect to pay the PTE tax is the ability to circumvent the $10,000 SALT cap federally, so the main beneficiaries are those who have state and local taxes that exceed $10,000.

Overall, the income of S-corporations and partnerships is very concentrated among a small number of profitable and high-income tax returns.

When looking at the structure of businesses in the United States and Vermont, the data show that most small businesses are passthroughs, not C-corporations. In 2019, JFO released an Issue Brief examining passthrough businesses.[8] Using data from JFO's Chainbridge Tax Model, in 2017, 17,794 resident tax returns reported S-corporation or partnership income. Another 53,429 tax returns reported income from a single-owner business. This compares to approximately 12,000 to 15,000 tax returns filed each year under the corporate income tax, meaning businesses that are C-corporations and not passthroughs.

However, while most small businesses are passthroughs, not all passthroughs are small. Because S.11 would have made the PTE tax available only to those with S-corporation or partnership income, this analysis will look primarily at those taxpayers. Amongst those with this income, most of them report very small or negative amounts of net income and the distribution of income is highly concentrated amongst a small number of returns:

- Of the 17,794 tax returns in tax year 2017 with this type of income, 14,530 of them reported net income (not revenues) of $50,000 or less (81.7%). The total amount of net income reported by these returns was $7 million (1.4% of the total).
- 1,796 tax returns (10.1%) reported net income of greater than $100,000. However, they accounted for over $618 million worth of net income, almost 85% of the total net income earned.

[8] https://ljfo.vermont.gov/assets/Subjects/Issue-Briefs-Relating-to-RevenueTax/3c396ed2ed/Passthrough-Brief-Final.pdf

Looking at net income is important because the beneficiaries of a PTE tax are only those who are able to report net income. The PTE tax would not apply, or would be very small, if a tax return reported a small amount or negative net income, and therefore, would not allow an individual to deduct anything federally. As such, based upon the data, it is likely that a small number of very profitable S-corporations or partnerships would benefit from the entity level tax. The roughly 80% of S-corporations and partnership tax returns with small or negative net income would benefit very little at the federal level from a PTE tax.

Looking next at the income distribution, JFO finds that taxpayers across the income distribution have S-corporation and partnership income, although they represent a small share of the overall population. According to the latest available IRS data from 2019, just over 6% of tax returns reported having some passthrough income. As Table 8 shows, higher income returns are significantly more likely to report S-corporation or partnership income, as are those with negative income.

- 15.59% of returns with negative income had S-corporation or partnership income, likely reflecting businesses with deductible expenses that exceeded revenue and/or those with losses.
- Almost 75% of returns with AGI above $1 million reported having some amount of this type of income.

Table 8: 2019 Vermont Federal Tax Returns with Pass Through Income

	Share of Returns with S-Corp or Partnership Income	Total Tax Returns Overall
Less than Zero	15.59%	5,900
$1-$10,000	1.38%	44,900
$10,000 to $25,000	2.29%	55,060
$25,000 to $50,000	2.70%	84,720
$50,000 to $75,000	4.79%	49,220
$75,000 to $100,000	7.34%	31,470
$100,000 to $200,000	12.22%	46,150
$200,000 to $500,000	31.09%	11,900
$500,000 to $1m	55.49%	1,640
$1m+	74.24%	660
Total	**6.18%**	**331,620**

Source: Internal Revenue Service, SOI Historic Table 2

Looking more closely at these returns, the top-heavy nature of this type of income reflects what JFO found in its Issue Brief from 2019. As Table 9 shows, 34.5% of the total net income earned by Vermont returns with S-corporation or partnership income came from 490 returns with AGI above $1 million. Alternatively, returns with S-corporation or partnership net income and AGI below $100,000 accounted for 47.6% of all returns with that type of income but accounted for only 5% of the business income.

Table 9: 2019: S-Corp and Partnership Income by Income Group			
	Number of Returns	Average	Share of Total Income
Less than Zero	920	-$77,101	-0.3%
$1-$10,000	620	-$3,282	0.7%
$10,000 to $25,000	1,260	$2,895	1.6%
$25,000 to $50,000	2,290	$5,638	1.3%
$50,000 to $75,000	2,360	$9,621	0.7%
$75,000 to $100,000	2,310	$14,169	1.1%
$100,000 to $200,000	5,640	$25,954	5.3%
$200,000 to $500,000	3,700	$77,305	4.5%
$500,000 to $1m	910	$231,390	6.1%
$1m+	490	$781,265	34.5%
Total	**20,500**	**$49,991**	**4.5%**

Source: Internal Revenue Service, SOI Historic Table 2

The federal tax benefits of full SALT repeal would be highly concentrated among very high-income tax returns.

The TCJA limited SALT deductions to $10,000 and nearly doubled the standard deduction. As a result, a significant number of Vermont tax filers no longer itemized their deductions and instead took the standard deduction. In 2017, prior to the TCJA, almost 30% of Vermont filers itemized their deductions. In 2019, after the law was passed, only about 7% did.

The fact that so many taxpayers began taking the standard deduction after the law was passed makes it difficult to estimate the exact number of taxpayers impacted by the SALT cap. People impacted by the SALT cap can be broken down into two groups:

- Those who were itemizing their deductions prior to the law passing, had greater than $10,000 in SALT deductions, but ceased itemizing after the law was passed because their total itemized deductions were less than the new standard deduction amounts ($24,000 married and $12,000 single).
- Those who had greater than $10,000 in SALT deductions and continued to itemize their deductions even after the law was passed.

Estimating the exact impact of the SALT cap is difficult because of the first group. Beginning in 2018, after TCJA was effective, this group was not likely to complete IRS form Schedule A reporting their state and local taxes because they knew the standard deduction was going to exceed all their itemized deductions. As a result, it is impossible to know with certainty what their state and local taxes were.

In order to get a best-guess estimate of what the SALT cap's impact would be on Vermont taxpayers, JFO used the Chainbridge Income Tax Model. JFO estimated what the tax year 2019 impact of uncapping the deduction would be on a database of 2017 taxpayers. 2017 was prior to the law becoming effective, so the group was fully reporting their state and local taxes. The results are below in Table 10:

Table 10: Estimated Impact of SALT Cap on Vermont Resident Returns (Tax Year 2017 Returns)

Income Group		Number of Returns Impacted	Share of VT Resident Returns Impacted	Total Federal Tax Impact (in millions)	Average Tax Impact
Negative	$100,000	2,425	1%	$1.62	$668
$100,000	$125,000	2,250	11%	$1.92	$853
$125,000	$150,000	2,449	22%	$2.68	$1,094
$150,000	$200,000	4,739	44%	$6.78	$1,431
$200,000	$300,000	4,909	72%	$12.97	$2,642
$300,000	$500,000	2,614	82%	$14.87	$5,689
$500,000	$1,000,000	1,165	87%	$17.50	$15,021
$1,000,000	Infinity	466	76%	$24.15	$51,824
Total		**21,017**	**6%**	**$82.49**	**$3,925**

Source: Chainbridge Income Tax Model

Based upon this analysis, at least 21,000 Vermont tax returns are impacted by the SALT cap (about 6% of total returns).

- If the SALT cap were fully repealed, these returns would see an approximately $82.49 million reduction in their federal tax liability. The true number is likely higher because income and taxes were higher in nominal terms in 2022 versus 2017, the database used for this analysis.
- Full repeal of the SALT cap would be highly regressive at the federal level: more than 50% of the tax savings would accrue to tax returns with AGI of $500,000 or more or 0.6% of total tax returns. This analysis is in line with analyses completed by national organizations.[9],[10],[11]

Before continuing, the impacts of the SALT cap on Vermonters should not be viewed in isolation. The TCJA included numerous changes that resulted in an overall significant federal tax cut for a large majority of taxpayers nationally and in Vermont.

- According to IRS data, in 2017, prior to the TCJA, the total federal tax liability for Vermonters was $2.68 billion. In tax year 2018, the year after the law passed, total liability dropped by over $170 million to $2.51 million, despite total income growing by over $1 billion.
- The average federal tax bill for income groups most affected by the SALT cap ($100,000 in AGI and above) declined from $35,019 in 2017 to $31,855 in 2018 (Figure 1).

[9] https://taxfoundation.org/salt-deduction-cap-repeal/

[10] https://www.crfb.org/blogs/salt-cap-repeal-does-not-belong-build-back-better

[11] https://www.taxpolicycenter.org/taxvox/salt-cap-repeal-would-overwhelmingly-benefit-high-income-households

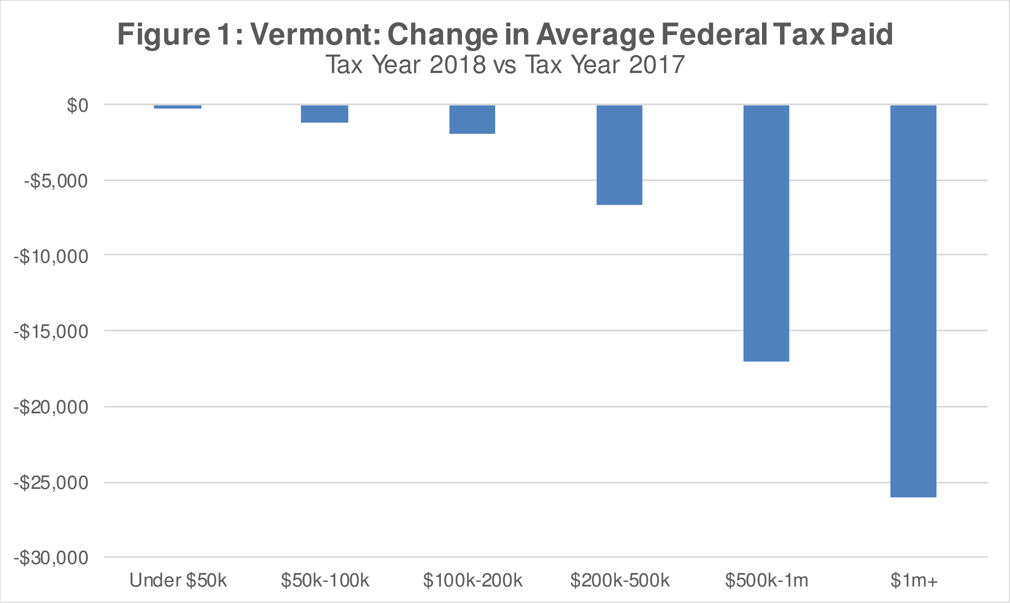
Figure 1: Vermont: Change in Average Federal Tax Paid
Tax Year 2018 vs Tax Year 2017

The reduction in federal tax liabilities was even more pronounced for taxpayers with passthrough income. The TCJA created a new 20% deduction of business income from taxable income, subject to certain professions and income limits. JFO's 2019 Issue Brief on passthrough businesses estimated that the overall federal tax benefit of the passthrough deduction in 2019 was almost $50 million, the benefits of which were highly concentrated (Table 11):

- The passthrough owners most impacted by the SALT cap, those with AGI $100,000 or greater, received an estimated federal tax cut of more than $40 million from the 20% deduction alone.
- The reduction in federal effective tax rate due to the deduction, that is, the change in tax paid as a share of income, grew as incomes rose.

Table 11: Federal Tax Benefits of Pass-Through Deduction: VT Resident Pass-Through Returns (based upon tax year 2017 data)

Adjusted Gross Income		Number of Returns	Total Federal Tax Change (in millions of dollars)	Average Tax Benefit	Change in Effective Tax Rate
Less than $0		0	$0.00	…	0.00%
$0	$10,000	37	$0.00	-$29	0.00%
$10,000	$20,000	1,953	-$0.11	-$57	-0.11%
$20,000	$50,000	8,241	-$1.66	-$201	-0.32%
$50,000	$100,000	11,215	-$5.36	-$478	-0.42%
$100,000	$150,000	6,082	-$6.58	-$1,082	-0.62%
$150,000	$200,000	2,596	-$4.80	-$1,850	-0.76%
$200,000	$300,000	2,071	-$6.37	-$3,074	-0.88%
$300,000	$500,000	1,129	-$4.64	-$4,109	-0.72%
$500,000	$1,000,000	315	-$2.43	-$7,708	-0.43%
Greater than $1,000,000		178	-$15.57	-$87,491	-1.07%
Total		**33,817**	**-$47.52**	**-$1,405**	**-0.69%**

The federal tax benefits resulting from a PTE tax, which JFO estimates could be between $10 and $20 million, are almost certain to be highly concentrated among very high-income taxpayers.

To narrow down the population to the group of taxpayers eligible for the PTE tax, JFO performed the same analysis of a full SALT cap repeal but restricted the dataset to only those with positive net partnership or S-corporation income. The results are below in Table 12:

Table 12: Estimated Impact of SALT Cap Repeal, S-Corp and Partnership Returns
(Tax Year 2017 Returns)

Income Group		Number of Returns Impacted	Share of VT Resident Returns Impacted	Total Federal Tax Impact (in millions)	Average Tax Impact
Negative	$100,000	298	0%	$0.23	$772
$100,000	$125,000	321	2%	$0.30	$935
$125,000	$150,000	335	3%	$0.48	$1,433
$150,000	$200,000	809	8%	$1.38	$1,706
$200,000	$300,000	1,145	17%	$3.13	$2,734
$300,000	$500,000	785	24%	$4.44	$5,656
$500,000	$1,000,000	520	39%	$8.27	$15,904
$1,000,000	Infinity	276	45%	$15.61	$56,558
Total		**4,489**	**1.3%**	**$33.84**	**$7,538**

Source: Chainbridge Income Tax Model

The number of potential beneficiaries from an entity level tax cap is modest. Less than 4,500 returns or 1.3% of total Vermont tax returns have positive S-corporation or partnership income and are impacted by the SALT cap. Repealing the SALT cap for only this group is even highly concentrated than overall repeal: over 70% of the federal tax benefit would accrue to returns with AGI above $500,000, or 0.23% of total Vermont returns. This is because, as the previous section noted, tax returns with positive net income are much more likely to be in the highest income groups.

It is important to point out that the PTE tax is elective: not every S-corporation or partnership tax return will choose to pay it. These numbers represent the absolute upper bound of federal tax benefit; that is, if every single S-corporation and partnership return elected to pay the entity level tax.

Depending upon take-up rates, JFO estimates the federal tax benefits for those who use a PTE tax are likely in the $10 to $20 million range with a great majority of the tax benefit going to taxpayers with AGI above $500,000. There is good reason to believe that the take-up rate is likely to rise with income for two reasons. First, those with the highest incomes rely the most on S-corporation and partnership income. Second, they also pay the most in state and local taxes. The combination of these factors leads JFO to conclude that the federal tax benefit would be even more concentrated towards the higher end of the income distribution than Table 11 shows.

The impact of a PTE tax on Vermont revenues is likely to be positive.

JFO estimates that the impact of a PTE tax on State revenues is positive, depending upon the design. The size of this positive impact depends upon the parameters of the tax and corresponding credit, as well as the take-up rate.

For determining whether State revenues will rise or fall as a result of a PTE tax, the only relationship that matters is that between the personal income tax credit for PTE taxes paid and the highest marginal tax rate. To explain this further, it is useful to think of the 90% PTE tax credit instead as a 10% tax. For every dollar the taxpayer has, if they pay the personal income tax, the maximum amount that they will ever pay is 8.75 cents (the highest marginal rate in Vermont). If they pay taxes using the PTE tax, even though the state is remitting a credit back to them on their personal income tax, it is only 90%, or rather, 10% is withheld. Because this 10% is always greater than the maximum 8.75% paid under the income tax, the State ends up generating a small amount of revenue. Therefore, if the State does not want to lose revenue from creating a PTE tax, it should set the corresponding tax credit to no higher than 91.25%.

Considerations for Legislators

On the surface, creating a state PTE tax is an easy way for states to provide federal tax relief without any impact on state revenues. That is largely the justification for the 28 states who have already enacted them. There are additional policy considerations at play, however, and this section puts forth some areas legislators may discuss before enacting a PTE tax.

A PTE tax treats classes of income differently

PTE taxes were primarily designed to allow shareholders to circumvent the SALT cap and provide them with a tax benefit. Because PTE taxes are not available to individuals who do not report S-corporation or partnership income, they cannot benefit from any federal tax savings. As previous sections noted, only 6% of Vermont tax returns report S-corporation or partnership income. Most taxpayers earn their income through wages or other forms of income like Social Security and retirement savings. They would be unable to access the benefits of the PTE tax.

Vermont has given preferential treatment to certain classes of income. The Vermont capital gains exclusion provides a sizeable tax benefit for capital gains as a way of encouraging savings and investment, and to mitigate the tax consequences of one-time realizations.

In this case, legislators could consider whether there is anything about S-corporation and partnership income that justifies a specific tax benefit even if it has no impact on state revenues. S-corporation and partnership income is, by definition, the income of a businesses, so tax relief for businesses could be the goal. That being said, if business tax relief is the goal, it is important to note that PTE taxes only benefit one type of business owner. C-corporation shareholders, sole proprietorships, landlords and rental property owners not organized as a limited liability company would not benefit from a PTE tax.

Moreover, if the goal of a PTE tax is to provide tax relief for busines owners, legislators should clearly define the objectives of that tax relief. Is it so that businesses with resources to make investments or pay higher wages? Is it to increase the after-tax income of owners? To date, there have been no studies or evaluations of PTE taxes and their link to enhanced business investment or wage increases.

It should also be noted that the Legislature has traditionally focused personal income tax policy around ability to pay, rather than the source of income. For instance, on the capital gains exclusion, the Legislature has acted over the years to scale back the exclusion because of its emphasis on a single income type.

Do the Legislature's goals of vertical equity in income taxes (ie, progressivity) extend beyond the Vermont personal code to the Federal code?

Vertical equity in a tax code states that those with a greater ability to pay should pay a larger percentage of the tax burden. Over the years, in Vermont's personal income tax policy, legislators have generally sought to achieve the goal of maintaining as much progressivity in the income tax code as possible: tax brackets are progressive, and most deductions and exemptions are either progressive in nature or limited by income.

While a PTE tax would not sit within Vermont's personal income tax system and the tax savings would be at the federal level, the tax benefits of the proposal appear inconsistent with Vermont's historic progressive goals. The federal tax benefits of a PTE tax, and any sort of SALT cap repeal and workaround for that matter, are almost certain to be highly regressive at the Federal level: most of the tax benefit is expected to accrue to a very small number of tax filers.

This raises the question about whether the Vermont Legislature has a policy interest in making the overall (Federal and Vermont) tax code as progressive as possible, or whether it should focus more narrowly on Vermont's tax code.

The PTE tax introduces a third business tax option into the tax code.

According to the National Conference of State Legislature's Tax Policy Handbook, one of the principles for evaluating state tax codes is simplicity.[12] Revenue systems should be easy to understand, minimize compliance costs, and be as simple as possible to administer. The tax system should also be easy to understand by all taxpayers.

This goal is easy to state in theory but difficult to carry out in practice. Business taxation is complex. The many different legal structures of businesses, the types of income and expenses, and the location of subsidiaries and partners all create complexities in trying to design a fair and efficient tax code. In the United States, business taxation usually occurs at either the entity level (for C-corporations, the corporate income tax) or at the shareholder level (for passthroughs, the personal income tax). Whether to solely tax businesses at the entity level or at the shareholder level is an ongoing policy debate. For instance, in the United Kingdom, almost all businesses pay corporation tax at the entity level. Profits to shareholders are taxed as dividends on the personal income tax.

If the Legislature seeks to move its tax system towards simplicity, it should consider whether the extent to which a PTE tax creates additional complexity for the tax code, and whether that complexity is justified or if that complexity can be effectively mitigated.

On its surface, the idea is relatively straightforward: a tax paid at the entity level that is split amongst shareholders, who then receive a back-end credit on their personal income tax. However, the tax will require additional administrative work at the Department of Taxes to ensure that the proper taxes are being paid by business owners and will need to ensure proper compliance, similar to the current system for nonresidents and the Business Income Tax and nonresident withholding.

Legislators should also consider whether the concept of a PTE tax and its federal tax benefits are going to be easily understood by all taxpayers, and not just those who are savvy or can afford strategic tax advice. In its analysis, JFO believes take-up rates for a PTE tax will be higher as income rises, partly because these taxpayers have access to this level of tax planning and strategy.

Legislators should consider the consequences of creating tax policy solely in response to changes in federal tax policy.

In the states that have adopted them, the primary reason for creating a PTE tax is to allow business owners to fully deduct state and local taxes on their federal tax returns. This policy was created in the wake of the TCJA and the new $10,000 SALT cap.

Over the years, the Legislature has generally tried to make Vermont's personal income tax code as independent of the federal income tax code as possible. For instance, from its creation in 1980 to 2022, a Vermonter's personal income tax was simply a percentage of their federal tax liability. In 2002, the Legislature created a separate system with Vermont-specific rates applied to federal taxable income. In 2018, the Legislature almost completely decoupled from the federal personal income tax code by using AGI as the starting point for the Vermont personal income tax, creating new Vermont standard deductions and personal exemptions, and repealing all itemized deductions.

An entity level tax to circumvent the SALT cap would represent a linkage of Vermont's revenue system to actions determined federally. Vermont would be creating a new tax whose sole purpose would be to allow taxpayers who utilized it to get around a federal limitation. That limitation is set to sunset in 2025 and in 2021, the House of Representative passed a $80,000 SALT cap that would render the PTE tax obsolete for many taxpayers. For any change to the SALT cap federally, the Legislature would need to consider whether it is worth the administrative costs if its federal tax benefit no longer exists.

[12] https://www.ncsl.org/documents/fiscal/TaxPolicyHandbook3rdEdition.pdf

Finally, legislators should consider the pros and cons of designing a tax system based on a taxpayer's overall tax liability at *both* the State and federal level or solely based upon the revenue needs of the State. Traditionally, the State has not designed its tax policy in a way that considers a taxpayer's overall State and federal tax liability. For instance, in the wake of the TCJA, despite the fact that it was estimated that taxpayers were going to be paying significantly less in federal taxes, the State did not respond in kind by increasing State taxes, even if it meant the overall tax burden would remain the same.

The details for a PTE tax are important and each is worthy of Legislative discussion.

This Issue Brief has assumed the parameters for a PTE tax as they were designed in S.11 of 2022. However, not all PTE taxes across the U.S. are the same. While the parameters in S.11 passed the Senate, the entire General Assembly may decide upon different parameters on the following issues:

- Should the credit be 90%?
    - S.11's credit was 90%. Other state credits vary. Connecticut's, for example, is 87.5%.
- Should the PTE tax be mandatory for all passthrough businesses?
    - S.11's tax was voluntary, and an election was made each year by the business. Some states, like Connecticut, make the PTE tax mandatory
- Should the PTE tax be for all passthrough types?
    - S.11 stated that the PTE tax was only for partnerships, limited liability corporations, and S-corporations. Sole proprietorships and others who are not limited liability corporations would be ineligible.
- Do all shareholders of the business have to agree to take the election?
    - S.11 stated that all shareholders must agree and cannot opt out of paying the PTE tax. California, for instance, allows individual shareholders to elect to pay their PTE tax
- How are PTE taxes paid to other states treated?
    - S.11 allows a credit against PTE taxes paid to other states, but it is not refundable, meaning that if a taxpayer has a credit larger than their tax liability, it results in a payment from the State.

Appendix

Passthrough Entity (PTE) Tax Example

Suppose two business partners own a business with equal shares. The business in 2022 had net income (profits) of $2 million, meaning each shareholder had net income of $1 million. The partners have no other income besides the income from their business.

Under current Vermont law, each shareholder's situation would look like Table A1. Their Adjusted Gross Income (AGI), assuming no other deductions would be $1 million. Assuming a married filer with no children, this taxpayer would owe $78,668 in state income tax in 2022. They would not owe any taxes at the entity level because Vermont does not have an entity level tax.

Table A1: Current Law: Individual Level- Vermont	
Adjusted Gross Income	$1,000,000
Pass Through Income	$1,000,000
Filing Status	Married
Children	0
Exemptions	2
State Income Tax	**$78,668**

Knowing each shareholder would pay $78,668, we can move to Table A2 which shows how that interacts on their federal tax return.

Table A2: Individual Level- Federal	
Adjusted Gross Income	$1,000,000
Pass Through Income	$1,000,000
Filing Status	Married
Children	0
State Income Taxes	$78,668
State Property Taxes	$15,000
Total State and Local Taxes	$93,668
Limited by SALTCap	**$10,000**
Total Other Itemized Deductions	$20,000
Total Itemized Deductions	**$30,000**
Federal Taxable Income (after 20% Federal pass-through deduction)	**$770,000**
Total Federal Tax Liability	**$219,449**

Each shareholder would have AGI of $1 million. This taxpayer would itemize their deductions. Their state income taxes are $78,668. Assuming their property taxes are $15,000, their total state and local taxes would be $93,668. However, the SALT cap limits the amount they can deduct to $10,000 (highlighted). Assuming this taxpayer has $20,000 in other itemized deductions, the total amount they can deduct through itemization is $10,000 in SALT plus $20,000 in other deductions, so $30,000. After accounting for the existing 20% passthrough deduction available to this type of income federally and applying 2022 federal tax rates to taxable income of $770,000, Their total federal tax liability would be $219,449.

Under a PTE tax, as conceived by S.11 of the 2022 session, the calculation for the taxpayer would be the following. For a business with two equal partners with $2 million in net income from their business, a 7.6% PTE tax would be $152,000 paid by the business. Split equally, each shareholder would be responsible for paying $76,000 in PTE tax. See Table 4:

Table A3: Entity Tax, Vermont	
Business Net Income	**$2,000,000**
Partners	2
Split	50%
Entity Tax Paid	**$152,000**
Shareholder PTE Tax	**$76,000**

Because the PTE tax paid by the business is split by the shareholders, the individual shareholders can deduct the PTE tax paid from the net business income on their federal tax return. This means that their net business income is no longer $1 million each, but $924,000 ($1 million minus $76,000 in PTE tax paid). They will each report $924,000 on their federal Schedule E, which in turn, is used to calculate AGI.

Tables A4 and A5 show how this works at the federal and Vermont level. The net income before the PTE tax paid is $1 million per shareholder. After deducting it as a business expense, the final net income of the shareholder is $924,000. This is the number that is used to calculate Adjusted Gross Income.

Table A4: Individual Level- Federal after Entity Tax	
Net Income Before PTE Tax Deducted	$1,000,000
Net Income After PTE Tax Deducted	$924,000
Net Pass Through Income	$924,000
Adjusted Gross Income	$924,000
Filing Status	Married
Children	0
State Income Taxes	$3,618
State Property Taxes	$15,000
Total State and Local Taxes	$18,618
Limited by SALT Cap	**$10,000**
Total Other Deductions	$20,000
Total Itemized Deductions	**$30,000**
Federal Taxable Income (after 20% Federal pass-through deduction)	$709,200
Total Federal Tax Liability	**$196,953**

Table A5: Vermont Personal Income Tax after Entity Tax	
Net Income Before PTE Tax Deducted	$1,000,000
Net Income After PTE Tax Deducted	$924,000
Net Pass-Through Income	$924,000
Adjusted Gross Income	**$924,000**
Filing Status	Married
Children	0
Exemptions	2
State Income Tax Before Entity Credit	$72,018
State PTE tax Credit (90% of PTE tax paid)	$68,400
Total State Income Tax **(Tax minus PTE tax credit)**	**$3,618**

In Table A4, the taxpayer's net income after paying the PTE tax is $924,000 and their AGI is $924,000, instead of the $1 million it was before. For their itemized deductions, their total state and local taxes are $3,618 (which is what they paid in Vermont personal income tax) plus $15,000 in property taxes, so $18,618. However, they are limited by the $10,000 cap. Assuming $20,000 in other itemized deductions, this taxpayer would have $30,000 in itemized deductions which they would then deduct from their taxable income. After accounting for the federal 20% passthrough deduction and applying 2022 federal tax rates to taxable income of $709,200, their total tax liability is $196,953.

In Vermont, federal AGI is the starting place for Vermont income taxes. Table A5 shows that an individual with $924,000 in AGI, an exemption for them and their spouse and no children, would pay $72,018 based upon 2022 Vermont personal income tax rates. However, because this individual has already paid PTE taxes on their business income, the $82,018 would be reduced by a PTE tax credit credit equal to 90% of the PTE tax paid (90% of $76,000). Their total State personal income tax due is $3,618.

As Table A6 shows, while this causes the taxpayer to pay slightly more to the state, the work around the SALT cap creates a significant federal tax benefit that swamps the increased state taxes.

Table A6: Difference Between Total Taxes Paid by Scenario

	Current Law	With PTE Tax	Difference
Total State Taxes	$78,668	$79,618	**$950**
of which: State Income Tax	$78,668	$3,618	
of which: State Entity Tax Tax	0	$76,000	
Federal Income Tax	$219,449	$196,953	**-$22,496**

In effect, what the PTE tax allows a taxpayer to do is to deduct state taxes paid not through the traditional itemized deduction route, but rather, as a business expense that reduces overall net income. Herein lies the main argument for creating a PTE tax: states can save their taxpayers significant sums federally with little to no impact on state revenues.