Child Care Financing

House Ways and Means
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Overview

Goal

- As passed by the Senate the expected annual cost of S.56 will be approximately $100 million per year.
- Considerations:
  - A broad base for ensure stable funding
  - Simplicity
  - Ensure that beneficiaries are paying into the system
  - Vertical equity/ability to pay

How did the Senate finance S.56?

- Repeal the child tax credit which eliminates it as a tax expenditure to the State.
  - $31.8 million starting in FY 2024.
- Levy a 0.42% payroll tax on wages and self-employment income up to the Social Security taxable maximum which is $160,200 in 2023.
  - $82.8 million starting in FY 2025.
- Combined the two proposals would generate approximately $31.8 million in FY 2024 and $114.6 million in revenue in FY 2025.

Option for financing child care

1. Increase the top corporate income tax bracket rate to 10%.
   - Benefit principle: Testimony indicated that companies will benefit from their workers having access to child care and help ensure that they don’t have to miss work to care for their children.
2. Increase all personal income tax brackets by 0.5%.
   - Simplicity: Would be a simple change to understand and implement.
   - Reliability and sustainability: Would provide a broad base to ensure stability.
   - Benefit principle: Would ensure that all benefit recipients are paying in.
3. Increase the EITC to 59% to offset tax increase on low income Vermonters.
   - Vertical equity: Would help ensure vertical equity and expand a program that has been shown to be very effective in alleviating child poverty.

Business taxation:
Increasing the top corporate tax rate to 10%

How does Vermont tax businesses?

- Vermont – like the Federal Government – treats taxes on net income/profit depending on how a business is structured
- Two Characterizations
  1. Corporations
     - Subject to the Corporate Tax.
  2. Pass-Through Businesses
     - Profits are divided amongst shareholders depending on shares of business.
     - Owners of the business pay taxes through the Personal Income Tax Code.
     - Increasing the corporate tax rate would not affect business income owners receive from pass-throughs.

Corporate Income Taxes

- Vermont currently applies an 8.5% marginal tax rate on net corporate income above $25,000.
- Corporate income of a unitary group includes, the total net income of a parent corporation and all subsidiaries.
- Income is determined by an apportionment formula:
  - Pre-2023: a three factor formula used share of payroll, property and sales in Vermont relative to national payroll, property and sales.
  - Beginning January 2023: single factor sales apportionment
  - Tax rates apply to the net income apportioned to Vermont
- Firms with zero taxable income (roughly 70% of returns) pay the minimum tax, which ranges from $100 to $100,000

Corporate Income Taxes

Marginal Tax Rates		
Income Allocable to Vermont		Tax Rate
$0	$10,000	6.0%
$10,000	$25,000	7.0%
$25,000	and up	8.5%

Minimum Annual Tax		
Vermont Gross Receipts		Minimum Tax
$0	$500,000	$100
$500,000	$1,000,000	$500
$1,000,000	$5,000,000	$2,000
$5,000,000	$300,000,000	$6,000
$300,000,000	and up	$100,000

Corporate income tax in other states

- 44 states have a corporate income tax.
- 15 of these states (including Vermont) have different rates that apply to different income brackets.
- The remainder levy a single tax rate on all levels of corporate income.
- Note that apportionment factors and determination of net income across states differs so looking at the rate is only part of the story.
- Vermont's current 8.5% top corporate income tax rate starts at $25,000 of net income.
  - At $25,000 California (8.84%), Delaware (8.7%), Illinois (9.5%), Minnesota (9.8%), and Pennsylvania (8.9%) have higher tax rates at that level.
- A corporate tax rate of 10% would be highest in the country applied to $25,000 of net income.
- Only New Jersey would have a higher top marginal rate at 11.5%, but that applies to net income above $1.0 million.

Estimated corporate income revenue impact from top rate changing to 10%

Corporate Income Tax Projection

Net Income Group		Filers	Change in Taxes
-	10,000	11,442	-
10,001	15,000	335	-
15,001	25,000	399	-
25,001	50,000	516	85,137
50,001	75,000	281	154,420
75,001	100,000	180	166,127
100,001	250,000	417	825,959
250,001	500,000	213	1,040,115
500,001	1,000,000	156	1,597,532
1,000,001	infinity	208	15,474,592
Grand Total		**14,146**	**19,343,883**

Summary: Corporations

- C-Corporation businesses pay corporate income tax on their net income.
- Of the roughly 14,000 CI taxpayers in Vermont, about 12,000 of them had annual net income less than $25,000 and would be unaffected by the increase in the top marginal rate.
- Of the remaining 2,000 c-corps that would be affected by the increase, roughly 200 of them would account for approximately $15.5 million of the estimated $19.3 million in revenues.
- Currently, C- Corporation with net income greater than $25,000 account for 14% of total filers and pay approximately 99% of total corporate taxes.
- Currently, C-Corporations with net income greater than $1 million pay approximately 77% of all corporate income taxes.

Not all businesses pay corporate income taxes

- As mentioned, pass-through businesses pay taxes through the personal income tax code.
- These businesses often also have employees that would have access to childcare and would receive benefits from a State funded child care system (i.e. employees would be less likely to need to miss work because of lack of child care).
- In order to raise revenue from pass-through businesses a change to the personal income tax code would need to be made.

Who Is a Pass-Through Business

- Pass-Through Business: Profits get “passed through” to owners who pay on their own personal income taxes
  - Sole Proprietors: Profits go to a single owner as their own income.
    - File a Schedule C.
  - S-Corporations: Can have one or not more than 100 share holders.
    - Prohibited by law from being owned by another corporate entity.
    - “S” stands for small business corporation.
    - File Schedule E.
  - Partnerships: two or more individuals own and operate a business. All partners have equal ownership rights.
    - File Schedule E.

How Sole Proprietor Taxes Flow Through

Sole Proprietor
- 1 Owner
- $100,000 in Profit

Owner 1 = 100%

Owner 1 Claims $100,000 of income on Personal Income Tax

How S-Corporation or LLC Taxes Flow Through

S-Corporation/LLC:

- 3 owners
- $100,000 in Profit

Owner A; 50% Owner

Owner A Claims $50,000 in income on Personal Income Tax

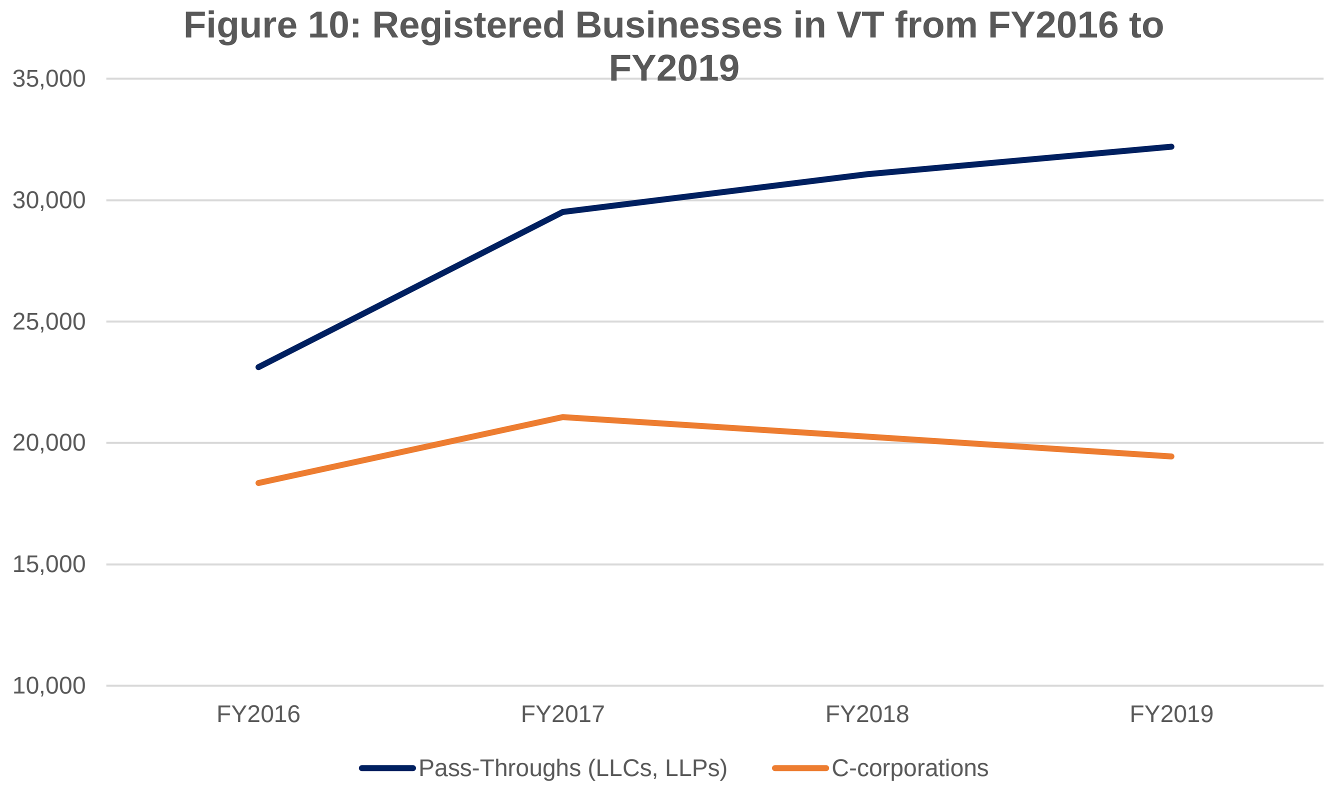
Owner B; 30% Owner

Owner B Claims $30,000 in income on Personal Income Tax

Owner C; 20% Owner

Owner C Claims $20,000 in income on Personal Income Tax

The number of pass-through entities in Vermont has been growing



Note: Includes foreign and domestic pass-throughs and corporations. Does not include non-profit businesses
Source: Vermont Secretary of State

Pass-Through Summary

- In 2019, 58,580 VT resident returns reported $895 million in sole-proprietorship business income
  - Represents 4% of total Vermont AGI on income tax forms
- In 2019, 20,500 VT resident returns reported $1.0 billion in s-corporation/partnership income
  - Represents 4.6% of total Vermont AGI on income tax forms
- JFO Pass-through Issue Brief estimated that in FY 2020, pass-through returns generated at least $110 million in Vermont personal income tax revenue
  - Represents about 12% of personal income tax revenues
  - An estimated 6.7% of available General Fund revenues in FY 2020

Summary: Pass-Through Businesses

- Most pass-throughs are small and most pay modest amounts of tax on their profits, if any.
  - Most pass throughs are small and benefit from the lower rates in the personal income tax code.
  - Many pass throughs (estimated about a third) report no taxable income.
- The tax base, however, is driven by a very small number of very large and/or profitable pass-throughs
- The number of pass-through businesses and amount of income generated by these businesses has increased sharply in the past 30 years
- Passthrough income returns, with the exception of the most profitable pass-throughs, benefit from the discrepancy between personal income tax rates and corporate income tax rates.
- Because pass-through income in subject to personal income taxes, a simple way to raise revenue from these businesses is to raise personal income tax rates.
  - Targeting only pass-through income would require complex changes to Vermont’s tax code.

Increasing Personal Income Tax Rates 0.5%

What are the new brackets?

Filing Status: Single			
AGI		Existing Marginal Tax Rate	Proposed Marginal Tax Rate
$0	$42,150	3.35%	3.85%
$42,150	$102,200	6.60%	7.10%
$102,200	$213,150	7.60%	8.10%
$213,150	and up	8.75%	9.25%

Filing Status: Married Filing Jointly			
AGI		Existing Marginal Tax Rate	Proposed Marginal Tax Rate
$0	$70,450	3.35%	3.85%
$70,450	$173,300	6.60%	7.10%
$173,300	$259,500	7.60%	8.10%
$259,500	and up	8.75%	9.25%

Filing Status: Head of Household			
AGI		Existing Marginal Tax Rate	Proposed Marginal Tax Rate
$0	$56,500	3.35%	3.85%
$56,500	$145,950	6.60%	7.10%
$145,950	$236,350	7.60%	8.10%
$236,350	and up	8.75%	9.25%

Filing Status: Married Filing Separately			
AGI		Existing Marginal Tax Rate	Proposed Marginal Tax Rate
$0	$35,225	3.35%	3.85%
$35,225	$85,150	6.60%	7.10%
$85,150	$129,750	7.60%	8.10%
$129,750	and up	8.75%	9.25%

Refresher on marginal tax rates

- For MFJ filers the first $70,450 is taxed at a rate of 3.85%
  - AGI from $70,450 to $173,300 is taxed at 7.1%
  - AGI from $173,300 to $259,500 would be taxed at 8.1%
  - All income above $259,500 would be taxed at 9.25%
- Suppose you were to only change the tax rate to the top two brackets.
  - That would only affect taxes collected on AGI above $173,300 and leave all income below that level untouched.
  - Only increasing the rate on the top two brackets would greatly reduce the base and require a much higher rate increase to raise the same amount of revenue.

Filing Status: Married Filing Jointly			
AGI		Existing Marginal Tax Rate	Proposed Marginal Tax Rate
$0	$70,450	3.35%	3.85%
$70,450	$173,300	6.60%	7.10%
$173,300	$259,500	7.60%	8.10%
$259,500	and up	8.75%	9.25%

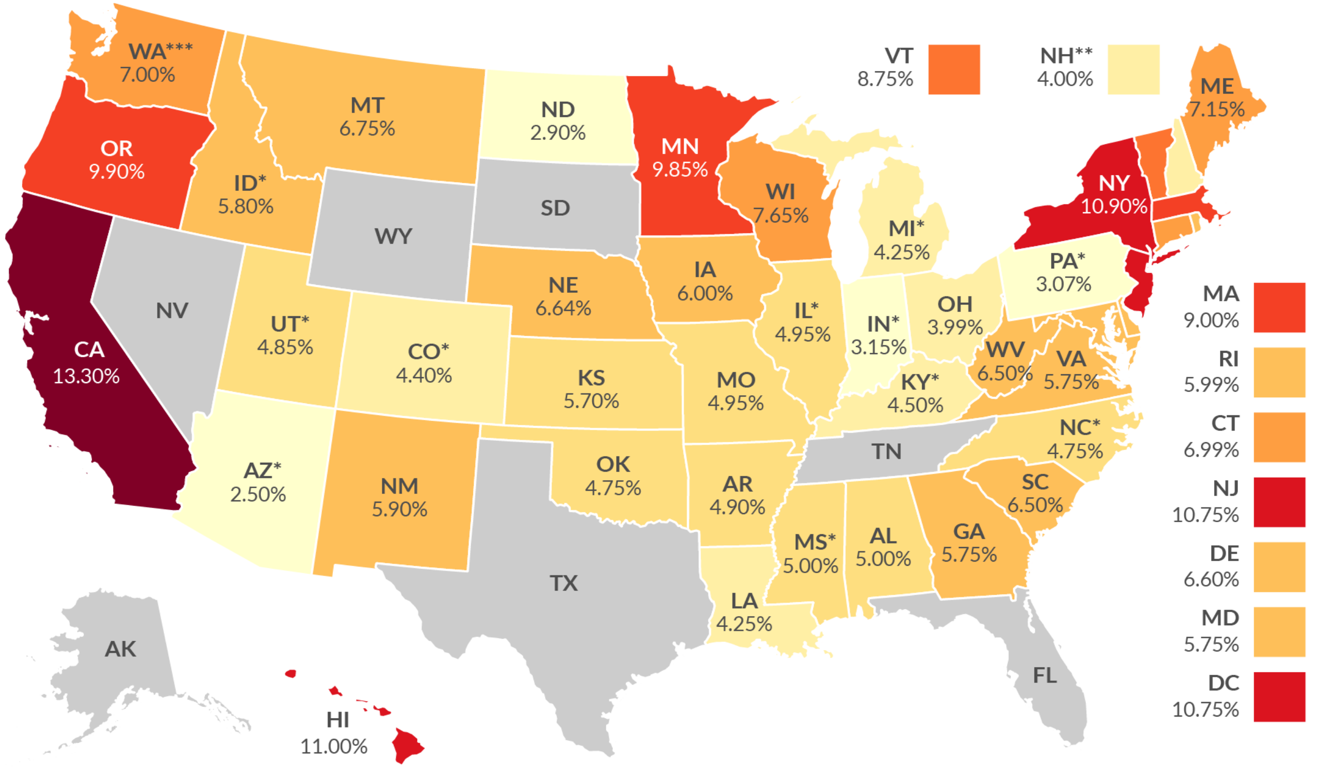
- **High income tax payers pass through all four tax brackets.**
- **Increasing the tax rates on the lowest brackets also affects high income taxpayers**.

Income tax rates in other states

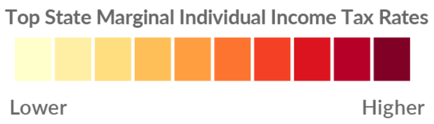
- 43 states and D.C. have income taxes
- 30 of those states and D.C. levy-graduated income taxes with the number of brackets varying by state. The remaining 13 states that tax income have flat tax structures.
- New Hampshire exclusively taxes dividend and interest income but a recently enacted bill would phase these taxes out by 2027.
  - New Hampshire also does not have a personal income tax on wages.
  - https://www.revenue.nh.gov/assistance/tax-overview.htm

Top marginal tax rates in other states

Top Marginal State Individual Income Tax Rates (as of January 3, 2023)



Note: Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal tax rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included.
(*) State has a flat income tax.
(**) State only taxes interest and dividends income.
(***)State only taxes capital gains income.
Sources: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg Tax.



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Top marginal tax rates in other states

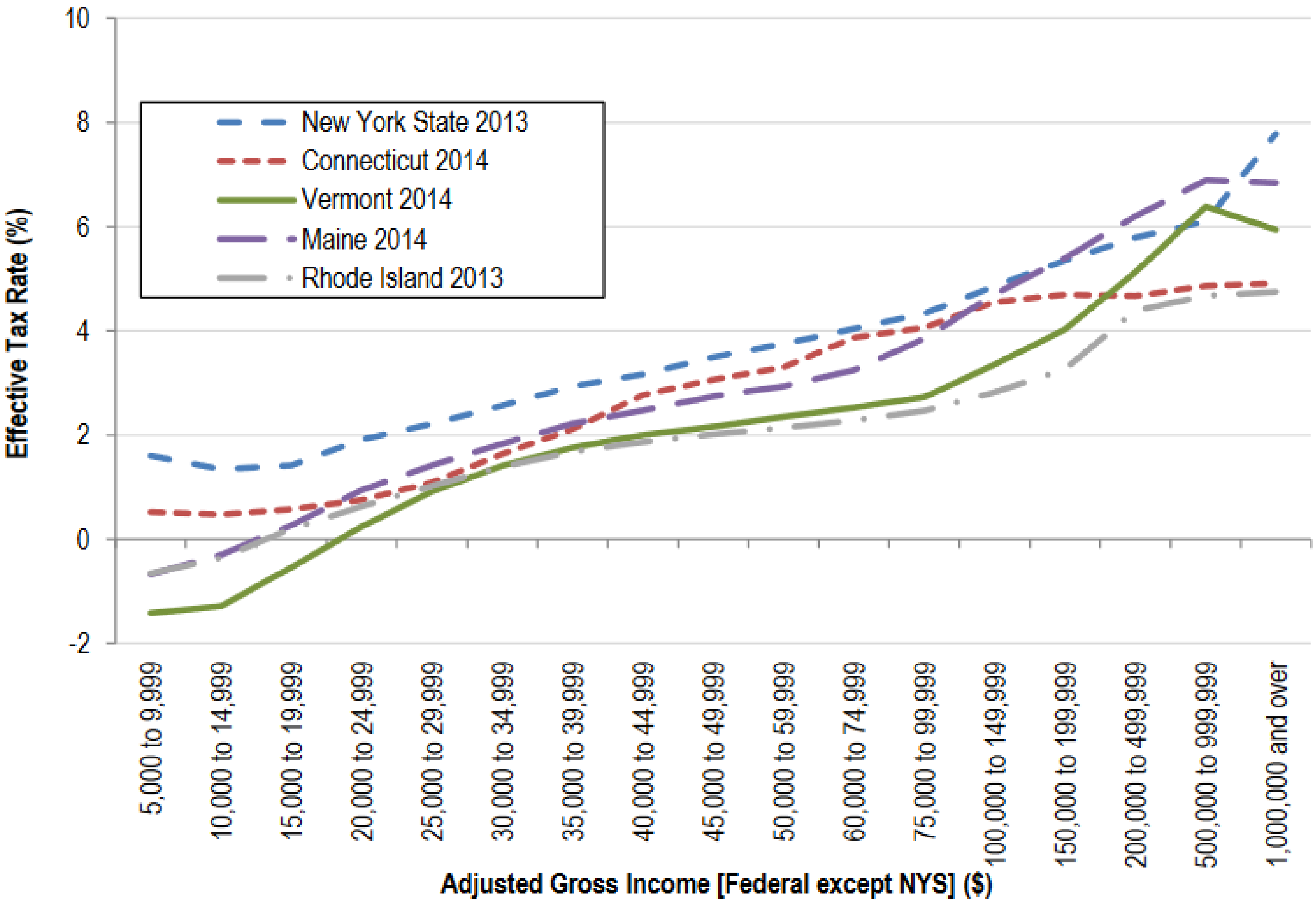
- Under this proposal the Vermont top marginal rate would increase to 9.25% which would be among the highest in the country but not the highest.
  - Oregon (9.9%), California (13.3%), Minnesota (9.85%), New York (10.9%), D.C. (10.75%) and New Jersey (10.75%) would all still have higher top marginal rates.
  - California, D.C. and New Jersey levy their top marginal rate on income above $1 million and New York levies their top marginal rate on income above $25 million.
  - Oregon and Minnesota would be the new closest state equivalents with top marginal rate applying to income above similar thresholds to Vermont.
    - *https://taxfoundation.org/state-income-tax-rates-2023/*

Top marginal rates don’t tell the whole story

- Top marginal rates do not tell the full story. More important is effective rates by AGI, which take into account different income brackets, credits and exemptions across states.
- For example, Maine has a lower top marginal rate, but the effective rate in Vermont is lower at all AGI levels. Maine’s lowest marginal rate is 5.8%.
- Vermont also has income tax credits which offset tax liability for many low-income taxpayers.

Income tax rates in other states

Figure 20. Effective Rate Comparison by AGI Level for the New England States and New York, Tax Liability as a Percentage of Federal AGI, 2013 and 2014



- The top marginal rate does not tell you the full story.
- Overall Vermont has lower effective tax rates for most income levels but does start increasing steeply at $100,000 AGI.
- The decrease in effective tax rates for filers with AGI above $1 million was due to the Capital Gains Exclusion. The Capital Gains Exclusion has since been changed to remove that dip.
- This chart does not factor in the Child Tax Credit or recent expansions to the EITC in Vermont.

Increasing PI Tax Rates by 0.5%

Increasing Income Tax Rates 0.5%				
AGI Group		**Returns with Tax Increase**	**Avg. Tax Increase**	**Total Revenue Raised (millions)**
Negative	$25,000	37,037	$31	$1.1
$25,001	$50,000	67,482	$100	$6.7
$50,001	$75,000	57,136	$199	$11.4
$75,001	$100,000	37,931	$307	$11.7
$100,001	$125,000	26,863	$405	$10.9
$125,001	$150,000	19,695	$508	$10.0
$150,001	$175,000	13,544	$608	$8.2
$175,001	$200,000	8,918	$708	$6.3
$200,001	$250,000	10,563	$844	$8.9
$250,001	$500,000	13,861	$1,214	$16.8
$500,001	$1,000,000	3,856	$2,098	$8.1
$1,000,001	and up	2,689	$5,448	$14.7
Total		**299,575**	**$1,283**	**$114.8**

- Increasing all personal income rates by 0.5% would raise an estimated $114.8 million in FY 2025.
- Approximately 73% of the revenue raised would come from tax filers with AGI of $100,000 and above.
- Those with AGI of $100,000 or above account for roughly 33% of affected filers.

Increasing the EITC from 38% to 59%

Quick EITC reminders

- If a Vermont taxpayer is eligible and receives a federal EITC they are entitled to a refundable credit worth 38% of that amount when they file their state return.
- The EITC was last increased in 2022 from 36% to 38%.
- The annual value of EITC received by Vermont taxpayers is estimated to be $28.0 million in FY2024.
- EITC is especially helpful for taxpayers with children, particularly head of household filers.
- EITC is designed to also offset the impact of regressive taxes on Vermont.
- For greater detail on the Vermont EITC see the 2023 Vermont Tax Expenditure Reviews Report https://ljfo.vermont.gov/assets/Subjects/Tax-Expenditure-Reports/11b4d43c7d/2023-Tax-Expenditure-Reviews-Report.pdf

The EITC in other states- at 59% Vermont would be among the highest in the county

- Currently, 31 states and D.C. have a state EITC
- Compared to other states that structure their EITC like Vermont, at the current 38% we trail only D.C. (70% to 100%) and New Jersey (40%).
- Other states like California and Minnesota base their EITC based on income and are not linked to the federal EITC, but their effective percentage of the federal EITC is about 45% in each.
- South Carolina provides an EITC equal to 125% of the federal EITC but is *nonrefundable.*
- At 59% Vermont would trail only D.C among states with a *refundable* EITC.
- For more information: https://www.taxpolicycenter.org/statistics/state-eitc-percentage-federal-eitc

Combined increase in tax rates and EITC expansion

Increasing Income Tax Rates 0.5% and expanding the EITC to 59%				
AGI Group		**Returns with Tax Increase**	**Avg. Tax Increase**	**Total Revenue Raised (millions)**
Negative	$25,000	56,409	-$128	-$7.2
$25,001	$50,000	68,764	$13	$0.9
$50,001	$75,000	55,633	$201	$11.2
$75,001	$100,000	37,927	$307	$11.7
$100,001	$125,000	26,862	$405	$10.9
$125,001	$150,000	19,695	$508	$10.0
$150,001	$175,000	13,544	$608	$8.2
$175,001	$200,000	8,918	$708	$6.3
$200,001	$250,000	10,563	$844	$8.9
$250,001	$500,000	13,861	$1,214	$16.8
$500,001	$1,000,000	3,856	$2,098	$8.1
$1,000,001	and up	2,689	$5,448	$14.7
Total		**318,721**	**$315**	**$100.5**

- Vermont's lowest income households would end up with a decrease in aggregate tax liability due to the EITC expansion.
- Expanding the EITC helps alleviate vertical equity issues with raising income tax rates in a targeted way
  - Not changing the lowest brackets' rates limits tax increases paid by lower income households, but also does for every other taxpayer in the higher brackets.
- Increasing the EITC flat percentage to 59% would increase the value of the EITC by approximately $14.3 million in FY 2025.

Net change if all three options were implemented

Net change in revenue if all three options were implemented

Options	Change in Revenue (million)
Increase Top CI Rate to 10%	$19.3
Increase all income brackets by 0.5%	$114.8
Increase the EITC to 59%	($14.3)
Total Net Change	**$119.8**

Some considerations

Some considerations - Pros

1. Increasing all income tax brackets creates a broad base which allows for relatively low rate increases.
2. A broad base helps ensure that funding for the program will be relatively stable.
3. Increasing all rates by the same amount is simple to understand and easily implemented.
4. Increasing income tax rates ensures that all beneficiaries and all income types are paying into the system:
   - Lower- and middle-income taxpayers with children are paying some amount for the benefit that they are *directly receiving*
   - Pass-through owners/businesses who are *indirectly* benefitting also pay.
   - Captures all income (ie. not just wage income)
5. Vertical equity is better targeted using a backend credit like the EITC rather than not increasing the lowest personal income tax brackets.
   - High-income taxpayers' income also passes through the lowest brackets.

Some considerations - Cons

1. Even with a back-end credit, many lower- and middle-income taxpayers will experience a tax increase and receive no direct benefit from the program.
   - This would include those who do not have children and do not qualify for the EITC.
2. A top corporate tax rate of 10% would be a high marginal rate nationally and would apply to a relatively low level of net income ($25,000).
3. The legislature recently made major changes to the corporate tax system.
   - There may be advantages to waiting to see how changes made last year impact overall revenues.
   - Shifting corporate income tax base and rates multiple times in a short period could make it more difficult for businesses to plan.
   - Raising corporate rates may clash with stated policy objectives from last years changes. For example, switching to a single sales factor lowers taxes for more Vermont-based corporations, but the benefit may been wiped out by higher corporate tax rates.

Thank you!