Anatomy of a Tax and Income Tax Basics

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Outline

- Anatomy of a Tax
- Personal Income Tax
- Corporate Income Tax

Anatomy of a Tax

- Base
- Rate
- Liability

Anatomy of a Tax

Tax Base (x) Tax Rate = Tax Liability

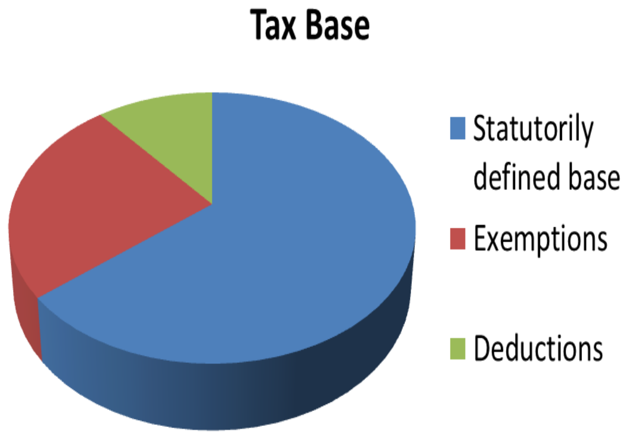
- Each part of the structure can be modified to reach different policy goals.
- The bigger the base, the lower the rate can be.
  - A smaller base requires a higher rate to generate the same amount of revenue.

Anatomy of a Tax: Tax Base

Tax Base [x] Tax Rate = Tax Liability

A **tax base** is defined by statutory language, minus any **exemptions** and **deductions**.

- An **exemption** is an exclusion from taxation and is usually limited to a particular group of taxpayers or item. **Exemptions** can be full or partial, temporary or permanent.
- A **deduction** is an amount subtracted from the **tax base**.



Anatomy of a Tax: Tax Base

- Full exemptions cost more to the State and are simpler, while partial exemptions are more complex and require more compliance work by taxpayers and to administer.
  - Example: Federally taxable Social Security income is fully exempted from Vermont personal income tax for some taxpayers but only partially, or not at all for other taxpayers, depending on their income.
- Deductions tend to cost less to the State than other modifiers, but are also less valuable to taxpayers.
  - Example: Vermont's personal income tax allows a state-level standard deduction depending on tax filing status to reduce a taxpayer's tax base.

Anatomy of a Tax: Tax Rate

Tax Base [x] **Tax Rate** = Tax Liability

- A **tax rate** can be fixed or tiered.
  - Vermont's 6% sales tax is an example of a fixed rate.
  - Vermont's income taxes are examples of tiered rates.
    - Tiered rates are typically structured as a series of brackets.
    - Most tiered rates are structured to be progressive, which means the liability increases smoothly from bracket to bracket. The taxpayer only pays the assigned rate for each dollar within that bracket.

Anatomy of a Tax: Tax Rate

Hypothetical progressive brackets

Taxable income $	Rate %
0–$10,000	5%
$10,001–100,000	10%
$100,001–$1,000,000	15%
$1,000,001+	20%

Taxpayer with $10,000 in taxable income would pay $500 in taxes because all income would be in the first bracket, or $10,000 x 5% = $500.

Anatomy of a Tax: Tax Rate

Hypothetical progressive brackets

Taxable income $	Rate %
0–$10,000	5%
$10,001–100,000	10%
$100,001–$1,000,000	15%
$1,000,001+	20%

- Taxpayer with $20,000 in taxable income would pay $500 in taxes on the first $10,000 (first bracket) and another $1,000 in taxes on the next $10,000 (second bracket), or $10,000 x 10%.
- Total taxes owed would be $1,500 or $500 (first bracket) plus $1,000 (second bracket).

Anatomy of a Tax: Tax Rate

Progressive tax rate terminology

- "**Marginal tax rate**": rate paid on the last dollar in base.
  - Example: taxpayer with $20,000 of income would have a **marginal tax rate** of 10%, because they pay 10% on the last earned dollar.
- "**Effective tax rate**": actual rate of tax for entire liability.
  - Example: taxpayer with $20,000 of income would have an **effective tax rate** of 7.5%, or $1,500 (liability) divided by $20,000 (base).

Anatomy of a Tax: Tax Liability

Tax Base [x] Tax Rate = **Tax Liability (minus credits)**

- A **credit** can reduce the initial tax liability (multiplying tax base by tax rate).
  - A **credit** is an amount that reduces a taxpayer's tax liability (tax owed). It does not reduce the base or the rate.
  - The final tax liability is the dollar amount that the taxpayer owes after subtracting the dollar amount of the ax credit.

Anatomy of a Tax: Tax Liability

Tax Credits

- Credits can be either refundable or nonrefundable.
  - A **refundable** credit means the taxpayer receives a payment if the credit reduces their liability below zero.
    - Example: $100 tax liability, but $150 refundable credit = zero liability + $50
  - A **nonrefundable** credit can reduce a liability to zero, but no further.
    - Example: $100 tax liability, but a $150 nonrefundable credit = zero liability
    - Some nonrefundable credits allow a taxpayer to "carry forward" the credit so that it may reduce a future year's tax liability.

Personal Income Tax (PIT)

- Structure
- Annual link up
- Definitions
- Recent changes

PIT: Structure

- **Tax Base**: taxable income
  - 32 V.S.A. § 5811(21)
- **Tax Rates**: progressive brackets, marginal tax rates
  - 32 V.S.A. § 5822
- **Tax Liability**: adjustments, tax credits
  - 32 V.S.A. ch. 151, subch. 2

PIT: Annual Link Up

- Statutes often incorporate other law from the same jurisdiction or from a different authority like the federal government through reference.
- Vermont income tax law incorporates federal income tax law by pinpointing the laws of the U.S. in effect at the end of a given year (Dec. 31). In practice, the year is generally updated annually.

PIT: Annual Link Up

32 V.S.A. § 5824 reads:

§ 5824. Adoption of federal income tax laws

The statutes of the United States relating to the federal income tax, as in effect on December 31, 2021, but without regard to federal income tax rates under 26 U.S.C. § 1, are hereby adopted for the purpose of computing the tax liability under this chapter and shall continue in effect as adopted until amended, repealed, or replaced by act of the General Assembly.

PIT: Annual Link Up

- The effective date of the bill amending 32 V.S.A. § 5824 applies the changes to a specific taxable year, and all following taxable years (until amended). For example, in 2022 Act 148 Sec. 9(c):
  - "Notwithstanding 1 V.S.A. § 214, Secs. 7 and 8 (annual link to federal statutes) shall take effect retroactively on January 1, 2022 and shall apply to taxable years beginning on and after January 1, 2021."

PIT Definitions: Gross Income

- Under the federal Internal Revenue Code, "gross income means all income from whatever source derived", with certain exclusions. 26 U.S.C. § 61; *Commissioner v. Glenshaw Glass*, 348 U.S. 426, 431-33 (1955) (income is any accession to wealth).
  - Examples
    - Included in gross income: wages, tips, salaries, commissions, rent, royalties, interest, dividends, IRA distributions, pensions and annuities, capital gains, and cancellation of debt
    - Excluded from gross income: certain Social Security income, interest on State or local bonds, cancellation of certain student loan debt

PIT Definitions: Adjusted Gross Income (AGI)

- Under federal law, the term "adjusted gross income" means gross income minus certain exclusions and deductions. 26 U.S.C. § 62; 32 V.S.A. § 5811(21).
  - Examples of common federal adjustments to gross income
    - Teacher expenses; IRA deductions; student loan interest; tuition and fees
  - Other adjustments
    - Certain business expenses of reservists, performing artists, and fee-basis government officials; health savings account contributions; moving expenses for Armed Forces; the deductible part of self-employment tax; self-employed SEP, SIMPLE, and qualified plans; self-employed health insurance; penalty on early withdrawal of savings; alimony paid

PIT Definitions: Taxable Income

- Federal taxable income is adjusted gross income minus itemized or standard and other miscellaneous deductions. 26 U.S.C. § 63.
- Vermont's personal income tax defines "taxable income" as "federal adjusted gross income determined without regard to 26 U.S.C. § 168(k)", relating to bonus depreciation, and adds backs certain income and subtracts other types of income. 32 V.S.A. § 5811(21).
- Vermont taxable income is different from federal taxable income. There are items of income that federal law and the U.S. Constitution prohibit states from taxing. Other than those pre-empted types of income, Vermont makes policy decisions to tax or exempt income.
    - Examples: railroad retirement income; discriminatory tax treatment of federal-source income in favor of state-source income.

Federal Income Tax Definitions …

Federal tax return (form 1040)

<u>Gross Income</u>
Wages, salaries, tips, dividends, capital gains, IRA/pensions, business income, etc.

minus

<u>"Above the Line" Deductions</u>
Examples: teacher expenses, student loan interest, self-employed plans, etc.

equals

<u>Adjusted Gross Income</u>

… Flow Through to Vermont

From federal form 1040

Adjusted gross income

plus

Additions to adjusted gross income

Bonus depreciation, interest from non-Vermont state and local bonds

minus

Subtractions from adjusted gross income

Standard deduction*

$6,350 for single filer, $12,700 for married filer

Personal exemptions*

$4,350 for taxpayer, spouse, and any dependents

Other subtractions

- Interest income from U.S. bonds
- Capital gains exclusion
- Social Security exemption
- Medical expenses

equals

Vermont taxable income

*Amounts for tax year 2021; indexed annually for inflation

PIT: Recent Changes to Tax Base

- Prior to 2002, Vermont's PIT tax base was a percentage of federal taxable income.
- In 2002, Act 140 amended the starting point for Vermont's PIT tax base to federal taxable income.
- In 2017, Act 53 changed the starting point for Vermont's PIT tax base to federal AGI.
- In 2018 (Spec. Sess.), Act 11 made further structural changes to Vermont's PIT tax base in direct response to the federal Tax Cuts and Jobs Act of 2017.

PIT: Recent Federal Changes, TCJA 2017

Federal Tax Cuts and Jobs Act, enacted Dec. 22, 2017

- Most significant federal PIT changes: elimination of personal exemptions, doubling of standard deduction, and alteration of numerous itemized and miscellaneous deductions.
  - Most were effective through TY 2025

Vermont's response

- "Decoupling" from many federal provisions, meaning Vermont tax code shifted to State-specific definitions and structure independent from federal tax code.
  - As a result, fewer federal income tax changes "flow through" to Vermont.

PIT: 2022 Vermont Legislative Session

H.738 (Act 179), an act relating to technical and administrative changes to Vermont's tax laws

- As Enacted
- Act Summary

H.510 (Act 138), an act relating to a Vermont Child Tax Credit and the Vermont Social Security income exclusion

- As Enacted
- Act Summary

PIT Recent VT Changes: Act 138 of 2022

- Refundable $1,000 VT child tax credit for qualifying children 5 and under.
  - Phases out for taxpayers with AGI over $125,000 (credit is $0 at $175,000 AGI).
- VT child and dependent care credit expanded to a refundable credit that is 72% of federal CDC credit.
- VT EITC expanded to 38% of federal EITC.
- New VT student loan interest deduction
  - Only for taxpayers with AGI $120,000 or less (single filers) or $200,00 or less (joint filers).
- Expands Social Security benefits exemption by $5,000.
- Adds new $10,000 retirement income exemptions.

Corporate Income Tax (CIT)

- Structure and definitions
- Recent changes

CIT Structure

- **Tax Base**: Vermont net income
  - 32 V.S.A. § 5811(18)
- **Tax Rates**:
  - progressive brackets, marginal tax rates
  - minimum tax based on Vermont gross receipts
  - 32 V.S.A. § 5832
- **Tax Liability**: allocation and apportionment
  - 32 V.S.A. § 5833

CIT: Who Pays?

- ONLY U.S. resident C Corporations
- Individuals and "pass-through" businesses do NOT pay corporate income tax

CIT: Who Pays?

- U.S. resident C Corporations
  - Incorporated entities (ending in names like: Inc., Corp., etc.)
  - Creation of separate legal person, which provides shareholders protection from personal liability.
  - "C" corporation" refers to the subchapter of the Internal Revenue Code.
  - Corporate income tax is imposed on the entity; not on individual shareholders.
  - Shareholders then pay personal income taxes on dividends and capital gains on the appreciation of shares.
  - Advantage: ability to raise money on public markets.

CIT: Who Does NOT pay?

Individuals and "pass-through" businesses do not pay corporate income tax.

- Business structure: partnerships, limited liability companies, S Corporations, sole proprietors.
- Income tax is generally not imposed on pass-throughs at the entity level.
  - Instead, income passes through directly to the members (or partners, owners, sole proprietor, etc.), who are then taxed under the personal income tax.

CIT Definitions: Vermont Net Income

- Vermont taxes C corporations' "net income"
- "Net income" starts with federal taxable income, plus and minus certain items of income.
  - No deductions allowed for bonus depreciation, non-VT bond interest, or federal operating losses.
  - Deductions allowed for certain income added at the federal level related to foreign credits and job-creating credits. Cannabis establishments may now deduct business expenses in Vermont.

CIT Definitions: Federal Taxable Income

- Federal taxable income is a corporation's receipts minus allowable deductions, including:
  - cost of goods sold, wages and other employee compensation expenses, interest, nonfederal taxes, depreciation, and advertising.

CIT Rates

- Vermont's corporate tax rate is tiered.
- The top marginal rate is 8.5%.

VT Net Income Allocated and Apportioned to VT	Base tax	Plus	of Amount Over:
$0-$10,000		6%	$0
$10,001-$25,000	$600	7%	$10,000
$25,001 and over	$1,650	8.5%	$25,000

CIT Minimum Tax

- A minimum tax applies to all active corporations (including LLCs electing to be taxed as C corporation).
- The minimum tax is based on the amount of the corporation's Vermont gross receipts.

Vermont gross receipts	Min. tax amount
$0-100,000	$250
$100,001-$1 million	$500
Over $1 million to $5 million	$2,000
Over $5 million to $300 million	$6,000
Over $300 million	$100,000

CIT Allocation and Apportionment

- Multistate corporations typically have complex organizational structures composed of a "parent" corporation and a number of "subsidiary" corporations owned by the parent. The different entities often operate in and receive income from different taxing jurisdictions.
  - When a C Corp's income is derived entirely from within Vermont, all the C Corp's Vermont net income is allocated to Vermont.
  - When a C Corp's income is derived from both within and outside Vermont, Vermont law "apportions" a corporation's income that is allocated to the State based on a statutory formula.

CIT Allocation and Apportionment

- Historically, apportionment formulas looked at property, payroll, and sales, but the recent trend has been to increase the importance of the sales factor.
  - Many states counted the sales factor twice or more (double or triple weighting).
  - More recently, many states, including Vermont as of 2023, have moved to a "single sales factor," where sales is the only factor used in apportioning net income to the state.

CIT: Recent Federal Changes, TCJA 2017

Federal Tax Cuts and Jobs Act, enacted Dec. 22, 2017

- Move from a modified worldwide system to a territorial system, with simultaneous repatriation of profits, and decrease in corporate income tax rates.
  - Federal corporate tax rate is a flat 21%, lowered by TCJA from top rate of 35%.
  - TCJA eliminated tiered corporate income tax rates and 20% corporate alternative minimum tax.

Vermont's response

- *Rates*: No response, because Vermont's income tax rates are already decoupled from the federal rates.
- *Income*: Vermont's existing definition of corporate income was sufficient to capture one-time federal revenue changes such as the repatriation of certain deferred foreign profits.

CIT: Recent Federal Changes, IRA 2022

Federal Inflation Reduction Act, enacted August 16, 2022

- 15% corporate alternative minimum tax, or "book tax"
  - Applies to adjusted financial statement income for corporations with profits of more than $1 billion. Effective starting tax year 2023.
- 1% excise tax on fair market value of corporate stock buybacks

Impact on Vermont

- None. Vermont's corporate income tax law does not impose either of these corporate taxes at the State level, and these taxes do not impact federal taxable income, which Vermont law uses to define its own corporate tax base.

CIT Recent VT Changes: Act 148 of 2022

S.53 (Act 148), an act relating to changes to Vermont corporate income tax and conformity to federal tax laws

- As Enacted
- Act Summary

CIT Recent VT Changes: Act 148 of 2022

Beginning Jan. 1, 2023:

- Only apportionment factor is sales ("single sales factor")
- VT jurisdiction changed from *Joyce* to *Finnigan* method
- 80/20 rule re: overseas corps repealed
- "Throwback" rule repealed
- New minimum tax brackets and amounts