115 STATE STREET,
MONTPELIER, VT 05633-5301

PHONE: (802) 828-2231
FAX: (802) 828-2424

STATE OF VERMONT
OFFICE OF LEGISLATIVE COUNSEL

MEMORANDUM

To: Rep. Kornheiser, Chair, Committee on Ways and Means

From: Kirby Keeton

Date: January 2, 2024

Subject: Updates to Federal Income Taxes

Overview of Link Up

Statutes often incorporate or reference other law from the same jurisdiction or from a different authority like the federal government. For example, the Internal Revenue Code (I.R.C.) in title 26 of the U.S. Code.

The question is which version of the law to use (what was in effect on what date).

- (1) refer to version of statute in effect at time of enactment, or at a particular point in time, i.e., a "snapshot" of the law, frozen in time despite later amendments.
  - This is called "static" or "fixed-date" incorporation.
- (2) refer to the most current version of the statute.
  - This is called "dynamic" or "rolling" incorporation because the incorporated law changes when the source law is amended.

Advantages & Disadvantages

- Static conformity
  - Statute will not keep up with amendments to federal statute without additional attention and approval by the Vermont Legislature. Requires an annual accounting for federal changes, otherwise conformity will remain frozen in time to a prior year's version of federal law.
  - However, this allows for more oversight by Legislature to decide which federal changes will flow through to Vermont.
- Rolling conformity
  - Automatic incorporation of federal changes without requiring review and decision-making by the Vermont Legislature.
  - Potential for constitutional challenge in Vermont.

Vermont currently uses static incorporation, pinpointing the laws of the U.S. in effect the end of the year (December 31st). 32 V.S.A. § 5824. In practice, the year is usually updated annually, which effectively results in a rolling conformity.

<u>Constitutionality of Dynamic Incorporation</u>

In conforming to federal law through static incorporation, the Legislature is presumed to know the contents of the federal law and to decide that the exact provisions contained in that law are appropriate for state law. However, in dynamic incorporation, amendments to the incorporated statute (e.g., the I.R.C.)) are automatically applied or "flow through" to the Vermont. This arguably means that a state has delegated the power to amend the state income tax code to the federal government. If Congress amends the I.R.C., then the state income tax code is also changed without any intervening act or approval by the state legislature. Essentially, Congress is given the power to write state law.

Some state high courts have held that dynamic incorporation of federal law violates state constitutions because it is an impermissible delegation of legislative power (MI).
Other states have found no constitutional problem (TN, MA, Neb.). To settle the question, several states have constitutional provisions expressly forbidding or authorizing dynamic incorporation generally or in the tax context. (HI, Ill.).

Vermont's Constitution does not specifically address incorporation of federal law.

- "The Supreme Legislative power shall be exercised by a Senate and a House of Representatives." Vt. Const. Ch. II, § 2.
- Interpreting this provision in the context of delegation to municipalities or the executive branch, the Vermont Supreme Court has said that "the functions of the Legislature which are purely and strictly legislative cannot be delegated but must be exercised by it alone."[1]
- Vermont courts have not addressed the application of this provision to incorporation of federal law, and it is not clear how they would rule.
- To be clear, this is not the current state of Vermont's conformity; Vermont conforms through static incorporation,

<u>Federal Tax Reform and the Annual Link Up</u>

This becomes a particularly salient issue whenever there is significant federal tax reform that will impact State tax law. This happened in 2018, following the TCJA, and in 2020, after the passage of retroactive tax provisions in the Families First Act, CARES Act, and the Consolidated Appropriations Act.

The choices for the Legislature are to link up to some, all, or none of the changes that occurred in 2023. To pull in all of the federal changes, the year needs to be changed. To pull in no changes, the statute would remain linked to the IRC in effect at the end of 2022. To pull in some of the changes, the Legislature would need to link up to the IRC and make individual amendments to the relevant sections of law.

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[1] *Stowe Citizens for Responsible Gov't v. State*, 730 A.2d 573, 575-76 (Vt. 1999) (emphasis original) (quoting *Village of Waterbury v. Melendy*, 199 A. 236, 239 (Vt. 1938)); see also *Heisse v. State of Vt.*, 519 F. Supp. 36, 48 (D. Vt. 1980) ("[T]here is a distinction between a delegation of power to make law and the conferring of authority for the execution of the law. The former is impermissible. The latter can be done if certain guidelines apply.").

STATE OF VERMONT

Federal Income Tax Changes and Adjustments for 2023

Vermont has already linked up to federal income tax laws that were effective on December 31, 2022. Some of those federal changes will impact tax year 2023. I am not aware of major changes from 2023 that will flow through or significantly affect Vermont. Below are some adjustments being made federally that will have the biggest impacts on taxpayers.

Some federal income tax changes do not flow through to Vermont because of how our income tax statute is structured. Ever since Act 52 of 2017, the starting point for Vermont's personal income tax is federal adjusted gross income. Accordingly, the parts of federal law that are incorporated in Vermont involve adjustments at the federal level that occur before federal AGI is computed or those provisions that are directly referenced by Vermont provisions. The EITC is an example of this.

Adjustments for 2023

Older federal laws, such as the American Rescue Plan of 2021, affect several federal rates and tax credits. Some changes relate to a reversion to old law after temporary COVID relief. The following items have been recently adjusted at the federal level:

Child Tax Credit – Reverted Back in TY 2022

- VT relies on federal law for definitions but not amounts

Child and Dependent Care Credit – Reverted Back in TY 2022 (flows through to VT)

- Credit of up to $1,050 in 2023
- VT allows 72 percent of the federal credit

Earned Income Tax Credit – Adjusted for Inflation (flows through to VT)

- Credit up $7,430 for 2023
- VT allow 38 percent of the federal credit

Federal Standard Deduction – Adjusted for Inflation

Tax Brackets and Rates – Adjusted for Inflation

SECURE 2.0 Act of 2022

Affecting Vermont Taxes

- Required minimum distribution (RMD) age increases from 72 to 73 for tax year 2023. RMDs are minimum amounts taxpayers are required to withdraw from a retirement account, 401(k) plan, and various IRAs in a year. This could slightly decrease Vermont revenue because some Vermonters may not be required to withdraw retirement as they formerly would have.
- Federal law now includes incentives to use Roth accounts and makes using them easier. Contributions to Roth accounts are taxed when a contribution is made instead of being taxed later. This means the earnings made by the account over time are not taxed (subject to rules). Employers will now be able to match contributions to a Roth account. This could result in some increased Vermont revenue in the short term but less revenue later.

Not Substantially Affecting Vermont Taxes

- Taxpayers are now able to roll 529 college savings plan funds (up to a $35,000 lifetime limit) into a Roth IRA for the 529 beneficiary penalty and tax free. The 529 account must have been open for at least 15 years. Other rules apply. This does not flow through to Vermont and the Vermont 529 plan tax credit does not have this feature.
- The federal penalty for failing to take a RMD is decreased from 50% to 25%. Vermont does not have this kind of penalty and it is unlikely to make a significant impact.
- Employers are allowed to offer employees a match to their 401(k) plan for employee payments toward student loans. This could impact Vermont employees and employers but will not directly impact taxes.
- The federal cap for qualified charitable distributions will start to be indexed for inflation and will consequently increase annually. Vermont has a credit that is linked to federal law regarding what types of contributions are allowed but Vermont's credit is capped at five percent of the first $20,000.00.
- By 2025, 401(k) plans will be automatically portable. A 401(k) plan will automatically roll over to a new employer's plan if the employee elects to do so. This will affect Vermonters but not Vermont taxes.
- A new 401(k) was created that is called a "Stater K." It involves a federal tax credit for employers that start offering a retirement plan for the first time. Vermont does not offer a comparable credit.
- RMD is no longer required for Roth employer retirement plans. Federal law will no longer require taxpayers to make RMDs from Roth accounts that are part of an employer retirement plan. Withdraws from a Roth account would not be taxed anyway.

Inflation Reduction Act of 2022

The Inflation Reduction Act created many federal income tax credits relating to investment in clean energy, with extra incentives for investing in low-income communities and following stricter labor standards. It also included incentives for property improvements, energy efficiency, and electric vehicles. None of the changes directly flowed through to Vermont.