

Pass Through Businesses Overview

House Ways and Means

Emily Byrne, Associate Fiscal Officer

January 31, 2023



Business Taxes In Vermont

- Vermont – like the Federal Government – treats taxes on Net Income/Profit depending on how a business is structured
- Two Characterizations
 1. Pass- Through Businesses
 - Owners of the business pay taxes through the Personal Income Tax Code
 - Profits are divided amongst shareholders depending on shares of business
 2. Corporations
 - Subject to the Corporate Tax



Who Is a Pass-Through Business

- Pass-Through Business: Profits get “passed through” to owners who pay on their own personal income taxes
 - 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
 - Sole Proprietors: Profits go to a single owner as their own income.
 - File a Schedule C

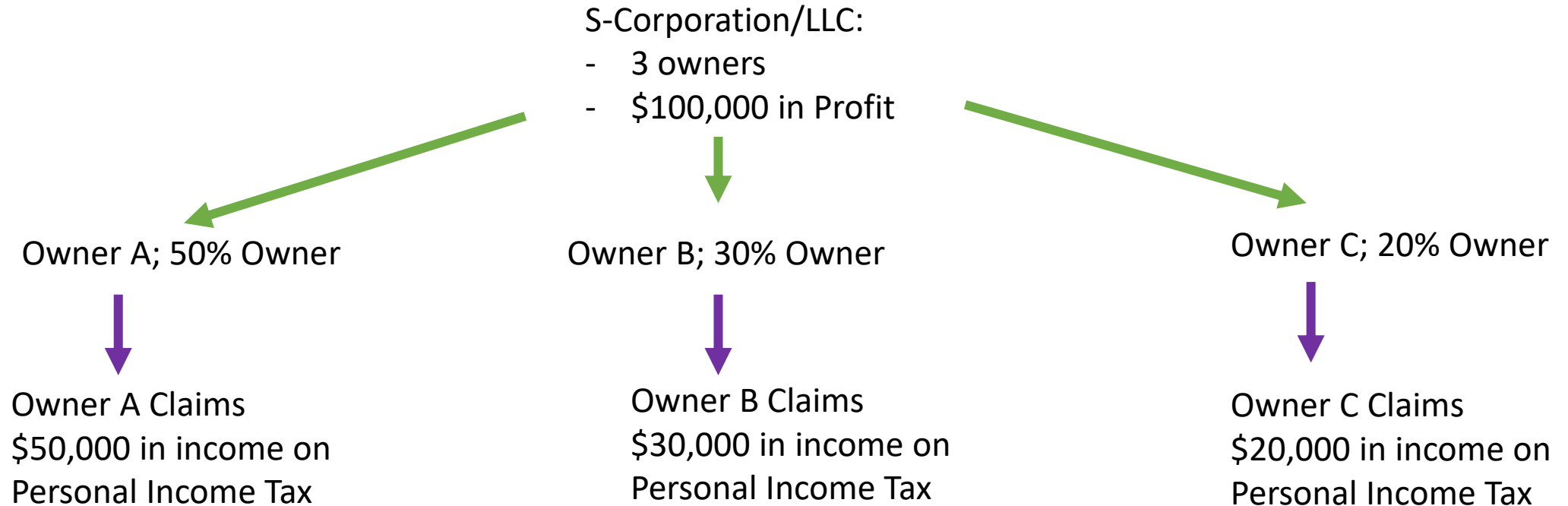


Pass-through businesses vary significantly

- Handy man who earns income as a side-business
- HVAC and plumbing business with one owner and 2 employees
- Small accounting firm with 3 partners
- Local restaurant group with 10 equity investors
- Medium sized manufacturing firm with 100 employees with a single owner.
- A large, multi-state financial firm with \$10 billion in assets and 10 partners.



How S-Corporation or LLC Taxes Flow Through



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



What is NOT a Pass- Through Business

- U.S. resident C-Corporations
 - C-Corporations: Larger businesses, profits accrue to the corporation, 100+ shareholders
- Corporate income tax is paid on the net income of a C-Corporation
 - Vermont net income is outlined in 32 V.S.A. § 5811(18)



Pass-Through Income, Schedule 1

SCHEDULE 1 (Form 1040) Department of the Treasury Internal Revenue Service	Additional Income and Adjustments to Income Attach to Form 1040, 1040-SR, or 1040-NR. Go to www.irs.gov/Form1040 for instructions and the latest information.	OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold; text-align: center;">2022</div> Attachment Sequence No. 01
---	--	--

Name(s) shown on Form 1040, 1040-SR, or 1040-NR	Your social security number
---	-----------------------------

Part I Additional Income

1 Taxable refunds, credits, or offsets of state and local income taxes		1	
2a Alimony received		2a	
b Date of original divorce or separation agreement (see instructions):			
3 Business income or (loss). Attach Schedule C		3	
4 Other gains or (losses). Attach Form 4797		4	
5 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		5	
6 Farm income or (loss). Attach Schedule F		6	
7 Unemployment compensation		7	
8 Other income:			
a Net operating loss	8a ()		
b Gambling	8b		
c Cancellation of debt	8c		
d Foreign earned income exclusion from Form 2555	8d ()		
e Income from Form 8853	8e		
f Income from Form 8889	8f		
g Alaska Permanent Fund dividends	8g		
h Jury duty pay	8h		
i Prizes and awards	8i		
j Activity not engaged in for profit income	8j		
k Stock options	8k		
l Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property	8l		
m Olympic and Paralympic medals and USOC prize money (see instructions)	8m		

Pass Through Income - Part of Federal AGI

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a Form W-2, see instructions.

Attach Sch. B if required.

Standard Deduction for—

- Single or Married filing separately, \$12,950
- Married filing jointly or Qualifying surviving spouse, \$25,900
- Head of ...

1a	Total amount from Form(s) W-2, box 1 (see instructions)		1a	
b	Household employee wages not reported on Form(s) W-2		1b	
c	Tip income not reported on line 1a (see instructions)		1c	
d	Medicaid waiver payments not reported on Form(s) W-2 (see instructions)		1d	
e	Taxable dependent care benefits from Form 2441, line 26		1e	
f	Employer-provided adoption benefits from Form 8839, line 29		1f	
g	Wages from Form 8919, line 6		1g	
h	Other earned income (see instructions)		1h	
i	Nontaxable combat pay election (see instructions)	1i		
z	Add lines 1a through 1h		1z	
2a	Tax-exempt interest	2a	b Taxable interest	2b
3a	Qualified dividends	3a	b Ordinary dividends	3b
4a	IRA distributions	4a	b Taxable amount	4b
5a	Pensions and annuities	5a	b Taxable amount	5b
6a	Social security benefits	6a	b Taxable amount	6b
c	If you elect to use the lump-sum election method, check here (see instructions)			
7	Capital gain or (loss). Attach Schedule D if required. If not required, check here		7	
8	Other income from Schedule 1, line 10		8	
9	Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your total income		9	
10	Adjustments to income from Schedule 1, line 26		10	
11	Subtract line 10 from line 9. This is your adjusted gross income		11	

Pass through Income, on Schedule 1

Federal AGI; Vermont PI Starting Point



Tax Advantage to Structuring a Business as a Pass-through

Box 1: 2018 Vermont Taxes on \$500,000 in Net Business Profits: Pass-through vs C-Corporation		
	C-Corporation	Sole-Proprietorship
Marital Status (married)		
Net Income	\$500,000	\$500,000
Taxes		
Corporate Income Tax (entity level)	\$41,800	Not Applicable
Personal Income Tax (owner/shareholder level)	\$31,919	\$35,576
of which: Business Income	\$0.00	\$35,576
of which: Dividends	\$31,919	\$0.00
Total Vermont Taxes	\$73,719	\$35,576
Effective VT Tax Rate Net Business Income	15%	7%

- If owner files as a C-corp, the entity pays corporate tax and the profits to the owner are taxed as dividends.
 - Opponents to corporate income taxes refer to this as “double taxation.”
- If the owner files as C-corp, majority of profits are taxed at 8.5% corporate rate
- If the owner files as a passthrough, a significant amount of the profits are taxed at lower income tax brackets until the highest marginal rate of 8.75%. Leads to an effective rate of 7%, lower than the corporate 8.5%
- Generally, tax advantage exists for most passthroughs when most net income does not hit the highest marginal income tax rate, both Federally, and Vermont



Tax Advantages: Federal Pass-Through Deduction

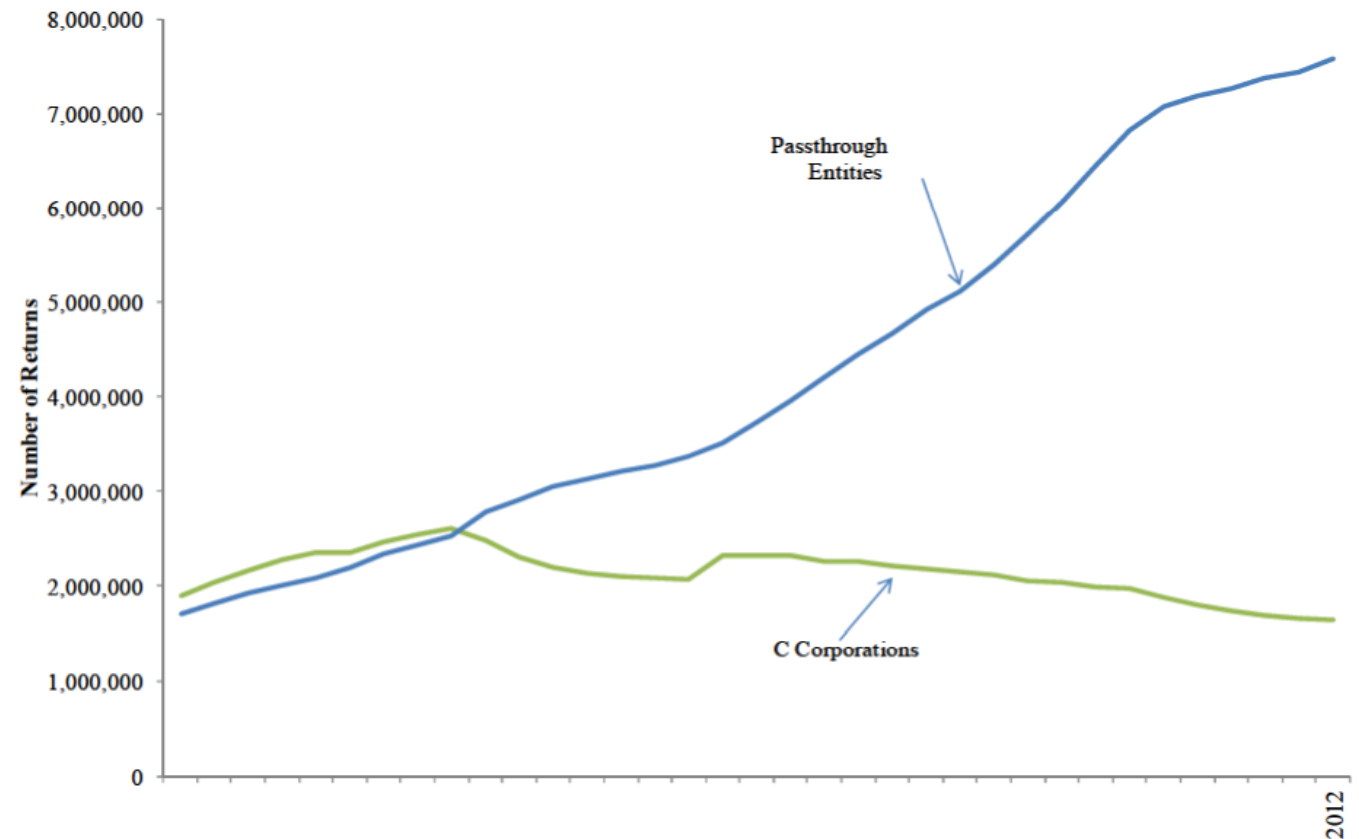
- Just like the state level, the difference between the Corporate and personal income tax rates provides Federal Tax benefits to pass-through businesses.
- Additionally, Special pass-through provision passed in Tax Cuts and Jobs Act in 2018
 - Allows most pass-through owners to deduct 20% of their pass-through income, subject to income limits
 - Estimated to be saving Vermont pass-through businesses at least \$45 million in Federal taxes each year



Pass-Throughs vs Corporate Entities

- Pass-throughs proliferated after 1986 Tax Reform by Reagan Administration, which greatly reduced personal income tax rates

Figure 2.—Number of C Corporation Returns Compared to the Sum of S Corporation and Partnership Returns, 1978-2012



Pass-Through Businesses are usually small, but not always

Distribution of S-Corps by Receipts, Nationwide, 2012

Firms Classified by Receipts	Number of Returns	Total Receipts (millions)	Returns	Total Receipts
\$0 or less	563,894	-\$3,420	13.41%	-0.05%
\$1 to \$2,500	96,155	102	15.70%	-0.05%
\$2,501 to \$5,000	54,793	199	17.00%	-0.05%
\$5,001 to \$10,000	80,031	576	18.90%	-0.04%
\$10,001 to \$25,000	202,996	3,431	23.73%	0.01%
\$25,001 to \$50,000	284,347	10,469	30.49%	0.18%
\$50,001 to \$100,000	415,507	30,363	40.37%	0.65%
\$100,001 to \$250,000	769,034	126,769	58.66%	2.61%
\$250,001 to \$500,000	569,970	205,296	72.21%	5.78%
\$500,001 to \$1,000,000	459,997	323,755	83.15%	10.79%
\$1,000,001 to \$10,000,000	616,617	1,710,611	97.81%	37.24%
\$10,000,001 to \$50,000,000	76,420	1,531,082	99.63%	60.92%
More than \$50,000,000	15,690	2,527,471	100.00%	100.00%
All Receipts	4,205,452	\$6,466,705		

Source: Background on Business Tax Reform, Joint Committee on Taxation, April 26, 2016.



Pass-Through Businesses are usually small, but not always

Distribution of Partnerships by Receipts, Nationwide, 2012

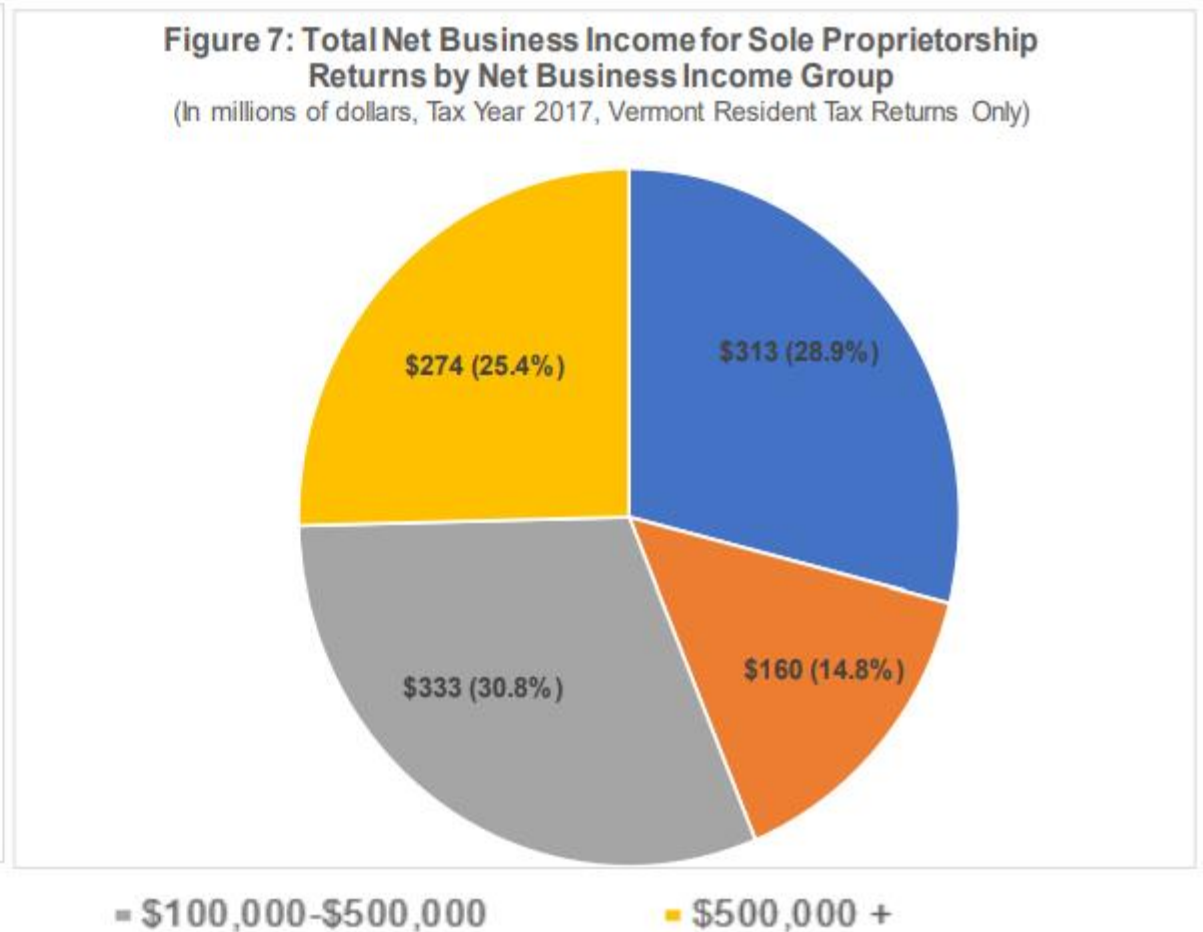
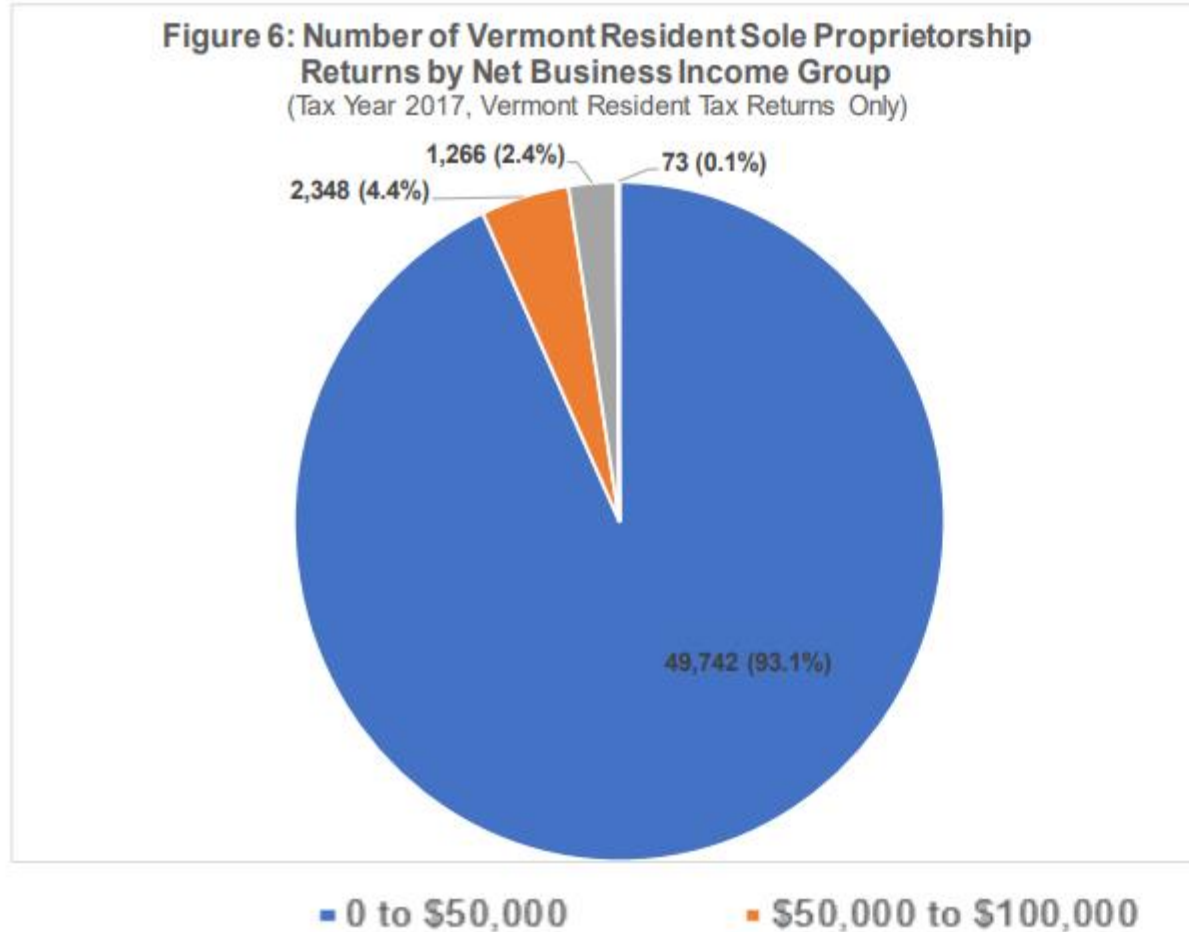
Firms Classified by Receipts	Number of Returns	Total Receipts (millions)	Returns	Total Receipts
\$0 or less	2,143,161	\$0	63.25%	0.00%
\$1 to \$2,500	63,031	65	65.11%	0.00%
\$2,501 to \$5,000	39,260	142	66.27%	0.00%
\$5,001 to \$10,000	56,283	415	67.93%	0.01%
\$10,001 to \$25,000	130,944	2,205	71.79%	0.06%
\$25,001 to \$50,000	100,183	3,665	74.75%	0.14%
\$50,001 to \$100,000	141,807	10,212	78.93%	0.35%
\$100,001 to \$250,000	210,177	34,305	85.13%	1.07%
\$250,001 to \$500,000	140,004	50,915	89.27%	2.14%
\$500,001 to \$1,000,000	126,895	90,707	93.01%	4.04%
\$1,000,001 to \$10,000,000	198,992	584,107	98.88%	16.31%
\$10,000,001 to \$50,000,000	28,789	597,322	99.73%	28.84%
More than \$50,000,000	9,036	3,389,677	100.00%	100.00%
All Receipts	3,388,561	\$4,763,737		

Source: Background on Business Tax Reform, Joint Committee on Taxation, April 26, 2016.



Pass-through Income is Highly Concentrated

Sole Proprietorships

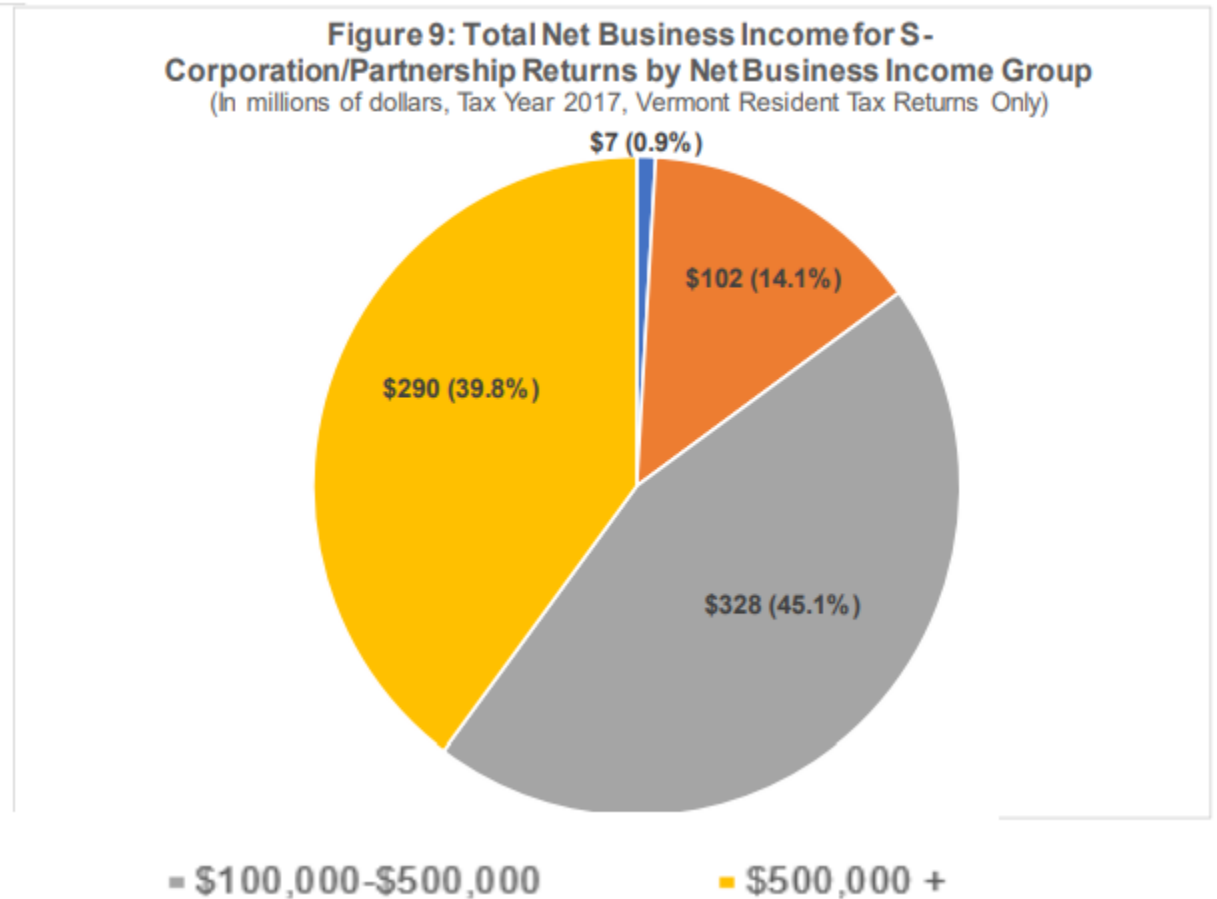
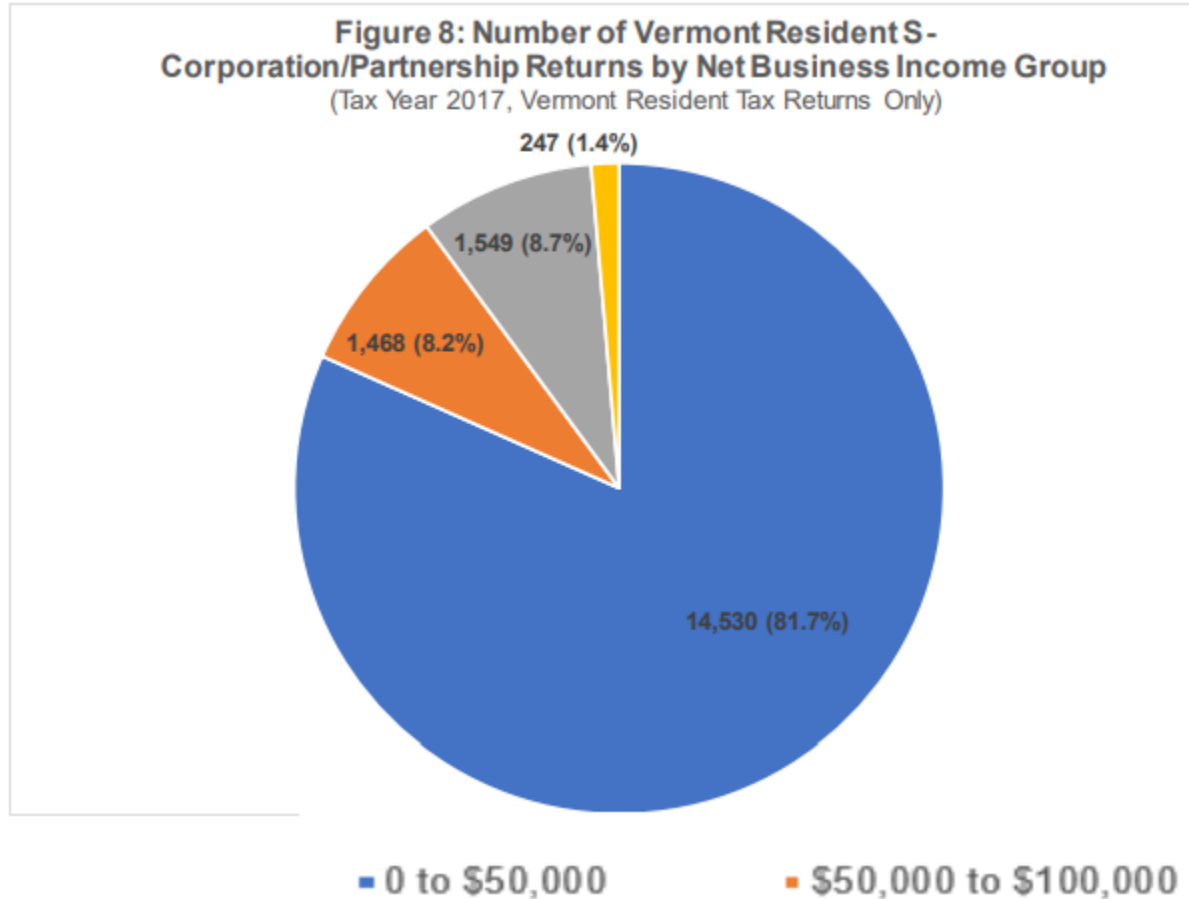


- In 2017, 93% of returns with sole-prop income reported net income of less than \$50,000.
- 73 returns had net income above \$500,000 but reported more than a quarter of total net income



Pass-through Income is Highly Concentrated

S-Corps/Partnerships



- In 2017, 82% of returns with S-corp income reported net income of less than \$50,000.
- 247 returns had net income above \$500,000 but reported almost 40% of total net income.



Who reports pass-through income?

VT Federal Sole Prop Returns, 2020			
AGI Group	Number of Returns with Sole Prop Income	Share of VT Returns with Sole Prop Income	Total Amount of Income Reported (in thousands)
Zero or Negative	2,150	20%	-\$30,203
\$0-\$10,000	5,570	12%	\$13,307
\$10,000 to \$25,000	9,200	17%	\$66,566
\$25,000 to \$50,000	11,470	13%	\$123,681
\$50,000 to \$75,000	8,540	17%	\$115,190
\$75,000 to \$100,000	6,450	20%	\$102,486
\$100,000 to \$200,000	10,840	23%	\$238,406
\$200,000 to \$500,000	3,610	28%	\$185,979
\$500,000 to \$1m	540	30%	\$52,228
\$1m or more	210	28%	\$30,595
Total	58,580	17%	\$898,235

VT Federal S-Corp and Partnership Returns, 2020			
AGI Group	Number of Returns with S-Corp/Partnership Income	Share of VT Returns with S-Corp/Partnership Income	Total Amount of Income Reported (in thousands)
Zero or Negative	1,080	10%	\$2,640
\$0-\$10,000	580	1%	\$9,750
\$10,000 to \$25,000	1,280	2%	\$18,240
\$25,000 to \$50,000	2,350	3%	\$33,170
\$50,000 to \$75,000	2,400	5%	\$26,070
\$75,000 to \$100,000	2,280	7%	\$18,300
\$100,000 to \$200,000	5,570	12%	\$32,430
\$200,000 to \$500,000	3,870	30%	\$8,860
\$500,000 to \$1m	900	51%	\$1,180
\$1m or more	520	69%	\$470
Total	20,830	6%	\$151,110

Source: IRS Historical Table 2, Data for Vermont, 2020



Questions?

- For more information:

- JFO Issue Brief from 2019:

- <https://ljfo.vermont.gov/assets/Subjects/Issue-Briefs-Relating-to-RevenueTax/3c396ed2ed/Pass-Through-Brief-Final.pdf>

