# S.45 Fiscal Considerations

Senate Committee on Finance

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# Outline

1. Legislation review
2. Distribution of pass-through income
3. State revenue impact
4. Considerations for Legislators

# 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.

# Key features of proposed legislation

1. Creates an entity-level tax of 7.6%, the second highest marginal personal income tax rate
2. Creates a refundable 90% personal income credit for PTE taxes paid
3. Credit also includes amount of PTE taxes paid to other states
4. Tax is elective and must be elected by all members of a pass-through entity
5. Effective January 1, 2023

# Who reports pass-through income?

| 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*

- Small number of returns in Vermont report pass-through income
- High income individuals are much more likely to report pass-through income

# Pass-through income is highly concentrated

## S-Corps/Partnerships

**Figure 8: Number of Vermont Resident S-Corporation/Partnership Returns by Net Business Income Group**
(Tax Year 2017, Vermont Resident Tax Returns Only)

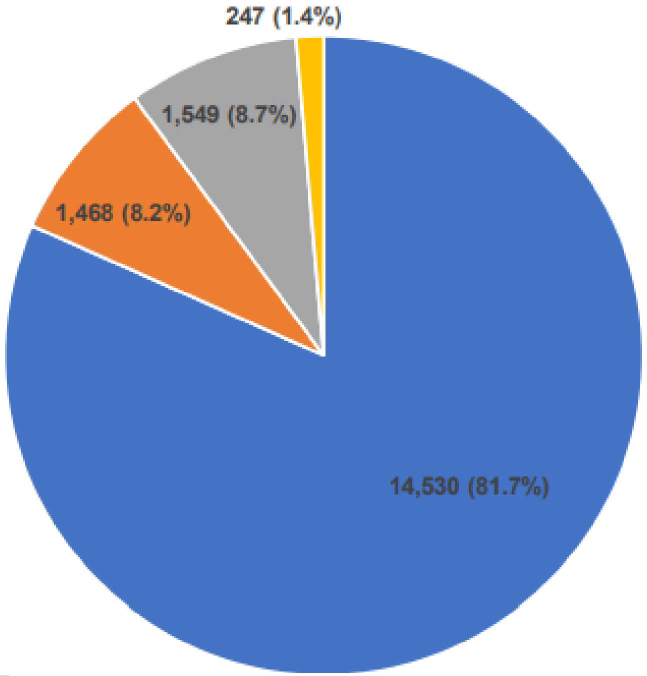
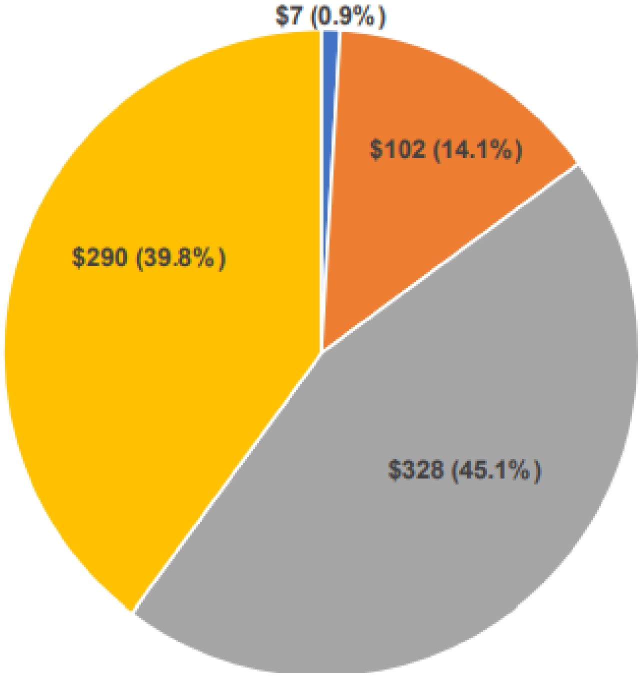



**Figure 9: Total Net Business Income for S-Corporation/Partnership Returns by Net Business Income Group**
(In millions of dollars, Tax Year 2017, Vermont Resident Tax Returns Only)




0 to $50,000 | $50,000 to $100,000 | $100,000-$500,000 | $500,000 +

- 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 is impacted by the SALT Cap?

- The SALT Cap impacts those who pay more than $10,000 in state and local taxes AND choose to itemize
- But with the standard deduction increase to $24,000 in Tax Cuts and Jobs Act (TCJA), fewer filers itemize
- 21,000 or 6% of VT resident returns impacted by the SALT Cap
- Impact of SALT Cap kicks in above $200,000 of AGI
  - Only 44% of resident returns reporting $150,000 to $200,000 in income impacted
  - Increases to 72% of returns with $200,000 to $300,000 in income

# Who is impacted by the SALT cap?

| Table 1: 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 VT Resident Returns |
| Negative | $100,000 | 2,425 | 1% | 296,765 |
| $100,000 | $125,000 | 2,250 | 11% | 19,634 |
| $125,000 | $150,000 | 2,449 | 22% | 11,006 |
| $150,000 | $200,000 | 4,739 | 44% | 10,735 |
| $200,000 | $300,000 | 4,909 | 72% | 6,778 |
| $300,000 | $500,000 | 2,614 | 82% | 3,207 |
| $500,000 | $1,000,000 | 1,165 | 87% | 1,341 |
| $1,000,000 | Infinity | 466 | 76% | 614 |
| **Total** | | **21,017** | **6%** | **350,080** |

Source: JFO Analysis of Chainbridge Income Tax Model

- Changes in the Tax Cuts and Jobs Act mean that most filers take the standard deduction
- Majority above an AGI of $200,000 would deduct state and local Taxes if they were able to

# Federal tax benefits

- If the SALT Cap was repealed for S-corps and partnership returns, Vermont tax filers in that group would experience an estimated $33.84 million reduction in federal tax liability
- More than 70% of these tax savings would accrue to tax filers with an AGI of $500,000 or more, or only .23% of total returns
- **JFO estimates $10-$20 million federal tax benefit for Vermont resident filers**
  - Take-up matters: since the PTE tax is elective, the overall impact depends on who chooses to participate

# Federal tax benefits to S-corps and partnerships impacted by the SALT cap

| Table 11: 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 VT Resident Returns | Total Federal Tax Impact (in millions) | Average Tax Impact |
| Negative | $100,000 | 298 | 0% | 296,765 | $0.23 | $772 |
| $100,000 | $125,000 | 321 | 2% | 19,634 | $0.30 | $935 |
| $125,000 | $150,000 | 335 | 3% | 11,006 | $0.48 | $1,433 |
| $150,000 | $200,000 | 809 | 8% | 10,735 | $1.38 | $1,706 |
| $200,000 | $300,000 | 1,145 | 17% | 6,778 | $3.13 | $2,734 |
| $300,000 | $500,000 | 785 | 24% | 3,207 | $4.44 | $5,656 |
| $500,000 | $1,000,000 | 520 | 39% | 1,341 | $8.27 | $15,904 |
| $1,000,000 | Infinity | 276 | 45% | 614 | $15.61 | $56,558 |
| **Total** | | **4,489** | **1.3%** | **350,080** | **$33.84** | **$7,538** |

Source: JFO Analysis of Chainbridge Income Tax Model

- Even smaller group of filers have positive S-corporation or partnership income
- Majority of benefits accrue to filers with more than $500,000 in AGI

# State revenue impact

- State revenue depends on the design of PTE tax and credit
- Impact is going to be positive because of the difference between credit and the highest marginal tax rate
  - Since the 10% difference is more than the highest marginal personal tax rate of 8.75%, a 90% credit will generate positive revenue for the State
- No formal JFO estimate of State revenue at this time, but it is not likely to be significant
  - Limited data are available, and estimates would depend on take-up rates
  - Other states with SALT Cap workarounds either do not have revenue estimates or forecast minimal changes as a result of their workaround

# State revenue impact – 90% credit

| Entity Level | |
|---|---|
| **Business Net Income** | **$2,000,000** |
| Partners | 2 |
| Split | 50% |
| | |
| **Pass-through Income** | **$1,000,000** |

| Table 6: Difference Between Total Taxes Paid with 90% Credit | | | |
|---|---|---|---|
| | **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** |

Relatively small positive revenue impact for the State

# Considerations

- A PTE tax treats classes of income differently
- Do the Legislature's goals of vertical equity in income taxes extend beyond the Vermont tax code to the Federal Code, or the overall income distribution?
- Legislators should consider the consequences of creating tax policy solely in response to changes in federal tax policy
- The PTE tax introduces a third business tax option into the tax code

# A PTE tax treats classes of income differently

- PTE tax only available to S-Corporation or partnership income
  - Only 6% of returns
  - Taxpayers who earn income exclusively through wages or social security would not be able to access the tax
  - Sole proprietors are a type of pass-through entity but also cannot access the tax
- Preferential treatment of a certain type of income should come with a goal
  - Is the goal of the tax to promote economic activity through businesses?
    - Research has found no effect of state-level preferential PTE rates on economic activity proxies such as gross receipts, capital investment, or employment (DeBacker et al 2018, Goodman et al 2021)
    - Other policies can promote economic activity
  - Is the goal to provide tax relief to this group of taxpayers?

# State and federal tax policy interactions

- How important is the progressivity of the overall tax code? And the income distribution of all Vermonters?
  - Federal
  - ONLY State
- Traditionally, Legislators have generally sought to maintain as much progressivity in the income tax code as possible
  - Remember, 50% of the federal tax benefits would accrue to a small number of filers with an AGI of more than $200,000
  - However, it would not change the distribution effects of the tax code at the state level

# State and federal tax policy interactions

- PTE tax is explicitly designed in response to federal changes in the Tax Cuts and Jobs Act
- However, in 2018, the Legislature decoupled from federal income tax code by using AGI as a starting point, and created new Vermont standard deductions and personal exemptions
- Policy is set to expire in 2025 -- what happens to new PTE tax if federal legislation sunsets?

# The PTE tax introduces a third business tax option

- One of the six pillars of a good tax system is simplicity
  - Simplicity maintains that revenue systems should be easy to understand, minimize compliance costs and be as simple as possible to administer
  - Nonresident pass-throughs pay at entity level *to reduce complexity for them and the tax department*
- Businesses can pay corporate income taxes or personal income taxes depending on structure -- the PTE tax would add another tax option
- The new tax will require some additional compliance costs
  - Compliance costs could be unequally distributed: is this workaround accessible or easy to any individual/business who does their own taxes?
- Could introduce distortionary incentives around business structure decisions

# Questions?

For further information, please see JFO Issue Brief "Passthrough Entity Taxes and SALT Cap Workarounds"