

# Tax Workshop: Income Taxes and Federal Reform

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# Anatomy of a tax

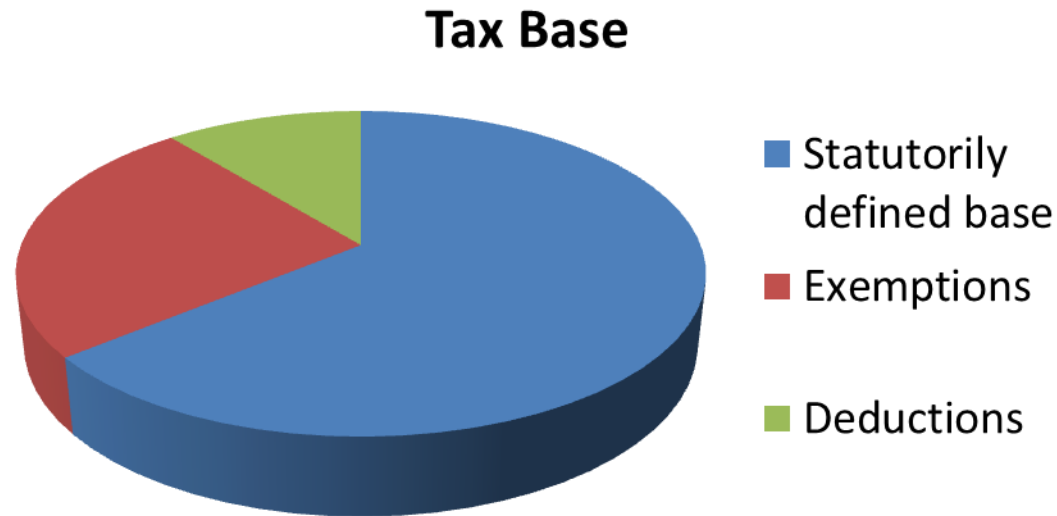
$$\text{Tax Base (x) Rate} = \text{Liability (minus credits)}$$

The bigger the base, the lower the rate

The higher the rate, the smaller the base

# Tax Base

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



# Exemptions

- An **exemption** is a systemic exclusion from the tax, and is usually limited to a particular group of taxpayers. For example, Vermont has a property tax, but most libraries are statutorily exempt from the paying the tax, even if their property would otherwise be taxable.
- An exemption can be a **full exemption** or a **partial exemption**. Full exemptions obviously cost more, while partial exemptions require more compliance work by the taxpayer and the Department of Taxes.

# Deductions

A *deduction* is an amount that an individual taxpayer is permitted to subtract from his or her tax base, which typically has the effect of reducing his or her liability.

**BASE (x) RATE = LIABILITY**

**(deduction)**



**base**

# Tax Rates

- Tax rates can be fixed or tiered.
- Vermont's 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.
  - This is accomplished by having the taxpayer pay only the assigned rate for each dollar within that bracket.

# Income tax rates: 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%
- 
- A person with \$10,000 in taxable income would pay \$500 in taxes because all of his or her income would be in the first bracket, or  $\$10,000 \times 5\% = \$500$ .

# Income tax rates – hypothetical progressive brackets

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  - \$1,000,001+                              20%
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- If the same person had \$20,000 in income, under a progressive tax structure, he or she would pay \$500 in taxes on the first \$10,000 income, but on the second \$10,000 in income, he or she would pay \$1,000 in taxes, or  $\$10,000 \times 10\%$ .
  - The total tax liability would be \$1,500, or \$500 (from the first bracket) plus \$1,000 (from the second bracket).



# Progressive brackets -- terminology

- For tiered rates, a taxpayer's "***marginal tax rate***" is the tax paid on the last dollar in the base. In the example above, a taxpayer with \$20,000 of income would have a marginal rate of 10%, because he or she would be paying 10% on his or her last earned dollar.
- However, a taxpayer's "***effective tax rate***" is the actual rate of tax for the entire liability. In the example above, the taxpayer's effective rate is 7.5%, or \$1,500 (total tax liability) divided by \$20,000 (total base).

# Liability modifications - credits

- A **credit** is an amount that reduces a taxpayer's tax liability. It does not reduce the base or the rate, but lowers the resulting liability.
- Credits can be either refundable or nonrefundable. A **refundable credit** means that the taxpayer receives a payment if the credit reduces his or her liability below zero.
  - \$100 tax liability, but a \$150 refundable credit = zero liability + \$50
- A **nonrefundable credit** can reduce a liability to zero, but not any further.
  - \$100 tax liability, but a \$150 nonrefundable credit = zero liability + a possible carryforward against future liability

# Vermont income taxes

- Federal bases
  - Personal income tax (32 VSA 5811(21)) starts with federal adjusted gross income, then subtracts the federal personal exemption, and either the federal standard deduction or some of portion of the federally itemized deductions
  - Corporate income tax (32 VSA 5811(18)) starts with federal corporate taxable income, and makes several adjustment from there.
- Decoupled rates

# Anatomy of a tax: Vermont/federal links

Tax Base (x) Rate = Liability (minus credits)

Changes to the federal bases “fall through”  
automatically to Vermont

Changes to the federal rates do NOT automatically fall  
through to Vermont

# Vermont/Federal Links: Personal Income Taxes

(based on Tax Year 2017)

**Federal Tax Return  
(Form 1040)**

**Gross Income**

Wages, salaries, dividends, capital gains,  
IRA/Pensions, business income

minus

**“Above the line” Deductions**

Examples include: teacher expenses,  
student loan interest, tuition and fees

equals

**Adjusted Gross Income**  
**(AGI)**

# Vermont/Federal Links: Personal Income Taxes

(based on Tax Year 2017)

Federal Form 1040

Adjusted Gross Income

minus

Standard Deduction

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

OR

Itemized Deductions

Examples: Medical and dental  
expenses, charitable contributions,  
state and local income and property  
taxes, home mortgage interest

minus

Personal Exemptions

\$4,050 for you, your spouse, and any dependents

equals

Federal Taxable Income (FTI)

# Vermont/Federal Links: Personal Income Taxes

(based on Tax Year 2017)

Federal Return

Adjusted Gross Income

minus

Standard Deduction

OR

Itemized Deductions

minus

Personal Exemptions

plus

Additions

Examples: State and local income taxes, itemized deductions above 2.5x the standard deduction, interest from non-Vermont obligations, bonus depreciation

minus

Subtractions

Examples include: Interest income from U.S. government bonds, a portion of capital gains

equals

**Vermont Taxable Income (VTI)**

Vermont-specific  
changes

# Vermont/Federal Links: Corporate Income Taxes

(based upon Tax Year 2017)

Federal Form 1120

**Income**

Gross receipts, dividends, interest, royalties

minus

**Deductions**

Salaries and wages, rents, repairs and maintenance,  
depreciation, advertising

equals

**Federal Corporate Taxable Income**



# Vermont/Federal Links: Corporate Income Taxes

(based upon Tax Year 2017)

## Federal Corporate Taxable Income

Plus

### Additions

Examples: Bonus depreciation, interest from non-Vermont obligations, state and local income taxes

Minus

### Subtractions

Examples: Foreign dividends, interest from U.S. Government bonds

Multiplied by

### Apportionment Percentage

Percentage of income and dividends that came from Vermont operations

Equals

## Vermont Corporate Taxable Income

Vermont-Specific  
Changes

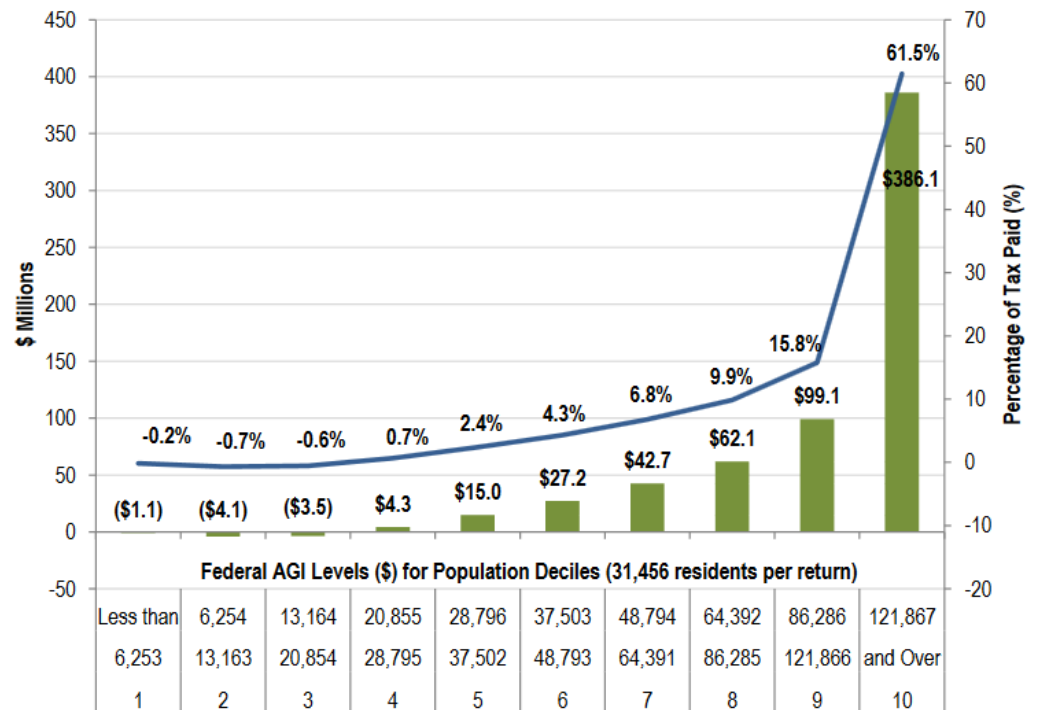


# Vermont Individual Income Taxes

## Quick Facts

- Just over 372,000 Vermont income tax returns
  - 86% (just over 320,000) were resident taxpayers
- Higher income taxpayers account for 61.5% of total income tax revenue.
- The majority of Vermont taxpayers have an effective tax rate of 2.5% or less

Figure 12. Income Tax Revenue and Percentage of Total Tax Paid by Decile of Resident Tax Filers, Tax Year 2015



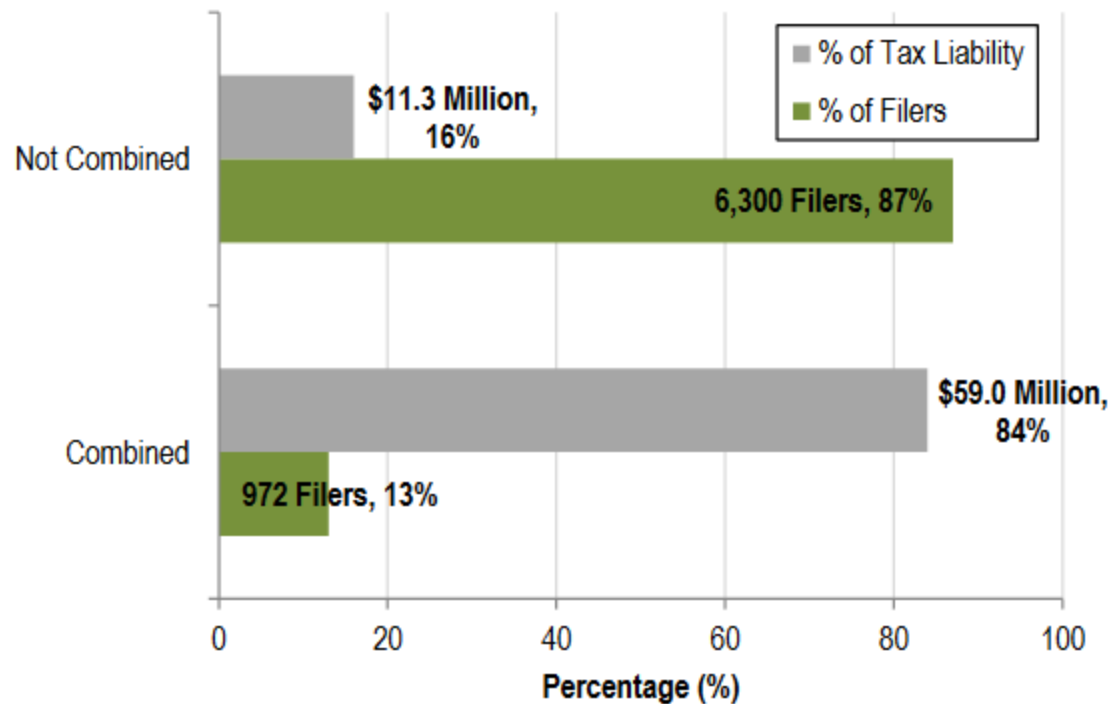
# Corporate Income Taxes

## Quick Facts

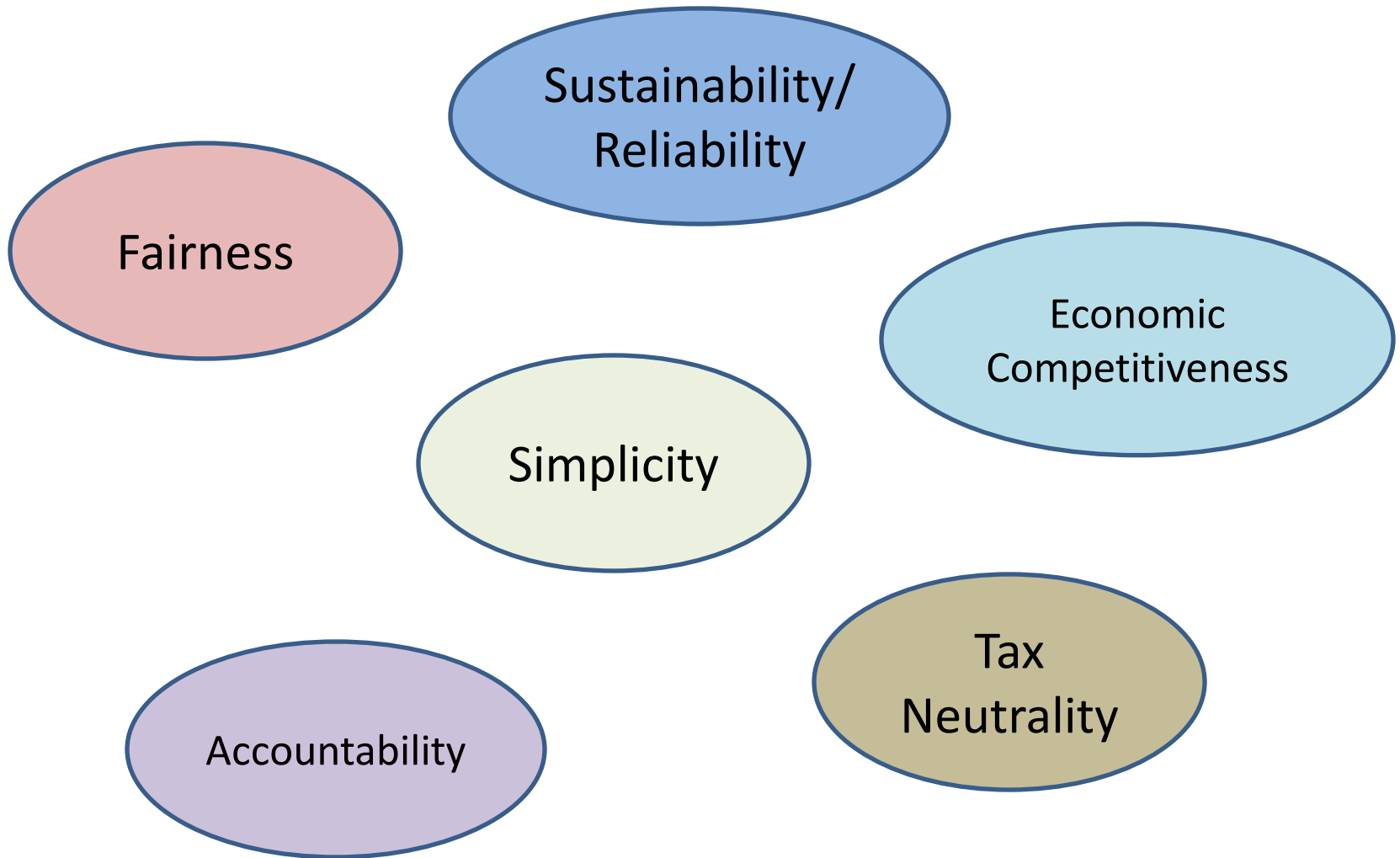
- 7,272 corporate income tax returns filed in tax year 2014.
- Two types of business:
  - 1) Unitary Combined: Those that file a VT return but are part of a larger company (13% of returns)
  - 2) Not Combined: Those businesses that are not part of a larger company (87% of returns)
- Unitary combined returns accounted for 84% of corporate income tax revenues in tax year 2014

# Corporate Income Tax Quick Facts

**Figure 22. Corporate Income Tax by Type of Return: Unitary Combined or Not Combined, Tax Year 2014**



# Income tax and the 6 pillars



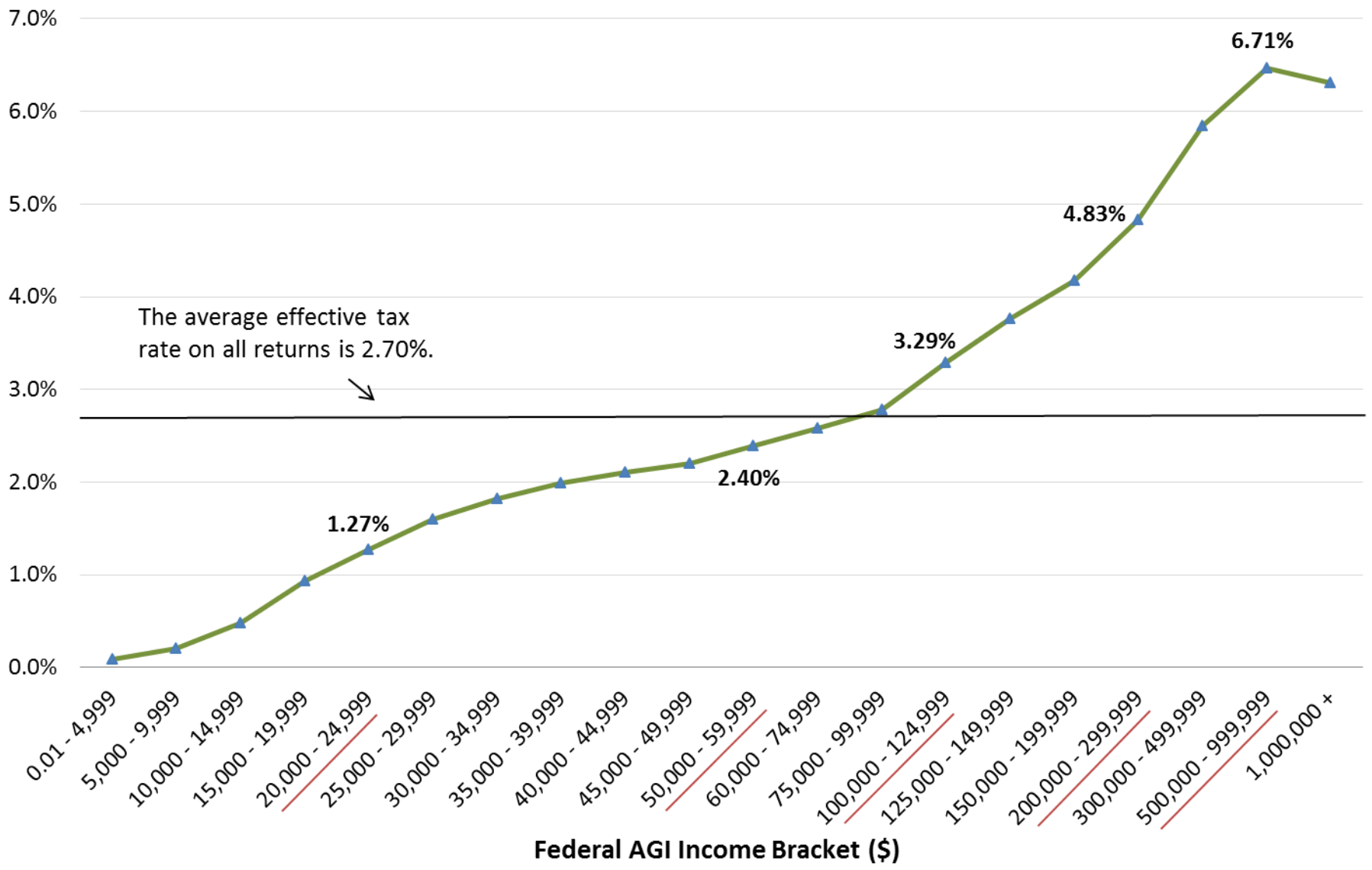
# Income Tax: The 6 Pillars

- **Sustainability: Income tax known to be more volatile**
  - Fluctuations in capital gains, one-time high income events, susceptible to economic conditions
- **Reliability: Numerous dynamics affect its reliability**
  - Aging population: working age population shrinking, retirees have lower income
  - Income distribution: greater income inequality=greater percentage of tax revenue comes from high income filers
  - Changes to the economy: automation, shared economy

# Income Tax: The 6 Pillars

- **Fairness: Vermont's progressive income tax rates promote vertical equity**
  - High income taxpayers pay a larger portion of their income
- **Simplicity: A delicate balance with fairness**
  - Simplicity and fairness can often be at odds
    - Removing deductions and tax credits from the income tax code can make it simpler, but with consequences for fairness.
  - Complexity in income taxes due to many factors
    - Definitions/calculations of income (what counts/doesn't count as income?)
    - Complexity resulting from different rates (should certain income taxed at different rates?)
    - Policy decisions: Vermont income tax requires taxpayers to add back their State income taxes to Vermont taxable income (avoids "double-dipping")

# 2015 Vermont Effective Personal Income Tax Rates, or Net Vermont Tax Divided by Federal Adjusted Gross Income (AGI)



The average effective tax rate on all returns is 2.70%.



Federal AGI Income Bracket (\$)



# Income Tax: The 6 Pillars

- **Accountability**

- Vermont publishes a report on all tax expenditures every two years
  - In 2017, VT had 20 income tax expenditures that are projected to cost \$49.8 million
  - Vermont also reviews select tax expenditures in each report and provides considerations of legislators
- Vermont limits the amount of corporation taxes that “flow through” to consumers

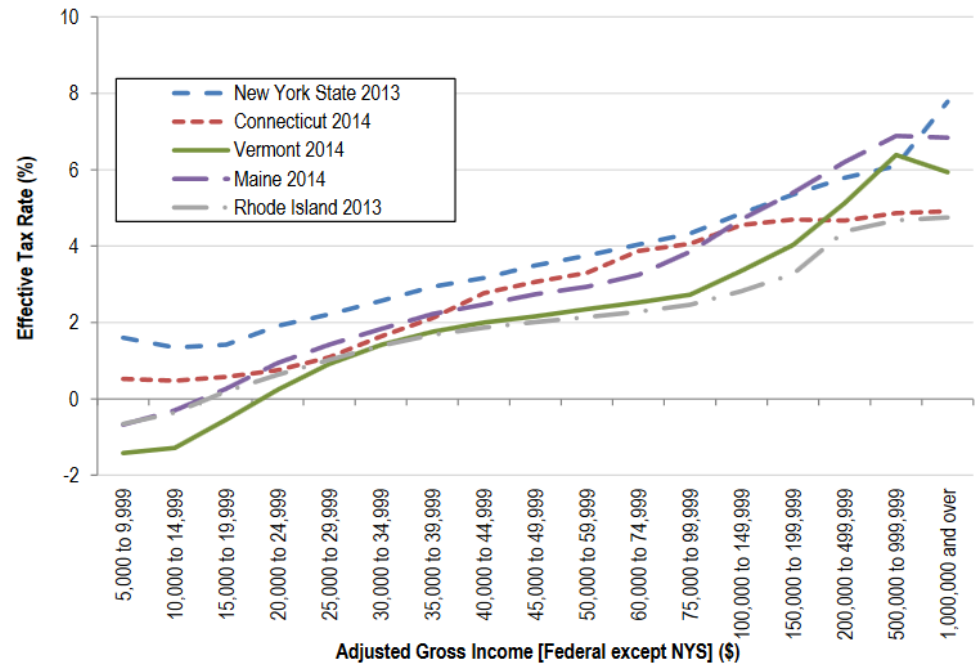
- **Tax Neutrality**

- Vermont provides some incentives through the personal and corporate income tax code to promote certain behaviors
  - Investment/savings: capital gains exclusion, investment and research and development tax credit, 529 tax credit
- Federal corporate and income tax code likely a more significant driver of behavior since tax liabilities are larger.

# Income Tax: The 6 pillars

- **Economic Competitiveness**
  - Complexity of income taxes makes it difficult to compare across states.
    - Tax rates, taxable income definitions, brackets
  - Personal Income Taxes
    - In general, lower effective rates for most income levels than New England states, but increases steeply after \$100,000

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



Note: The Effective Income Tax Rate is calculated using Federal AGI, except in New York, which uses state AGI in its calculation. New Hampshire does not tax income, and data was unavailable for Massachusetts.

# Income Tax: The 6 pillars

- Economic Competitiveness: Corporate Income Tax

**Figure 23: Corporate Income Tax\* as a Percentage of State GDP, 2013**



\*Includes taxes on corporations and unincorporated businesses including financial institutions.

Sources: U.S. Census (State and Local Government Finance) and Bureau of Economic Analysis (GDP)

# TAX CUTS AND JOB ACT OF 2017

- Enacted December 22, 2017.
- Make major changes to three federal taxes; Personal Income, Corporate Income, and Gift/Estate taxes.
- Two types of impact in Vermont:
  - Will affect how much individual taxpayers pay, given their particular situation.
  - Will affect State revenues – Vermont tied to federal bases.

# Where will changes impact Vermont revenues?

In descending order, the biggest potential for a revenue impact to the State come from changes in the federal tax bases for Personal Income, Corporate Income, and Estate taxes.

- Vermont Personal Income = \$795 million
- Vermont Corporate Income = \$87 million
- Vermont Estate Tax = \$19 million

# Example of impact:

## Keep an eye on the base

- Under old federal law, a taxpayer could subtract \$4050 from their federal adjusted gross income for each personal exemption.
- The new federal act eliminates personal exemptions, so federal taxable income will increase.
- Vermont's personal income tax base is linked on this issue – Vermont allows the subtraction of any personal exemption taken at the federal.
- If the personal exemption amount allowed at the federal level goes from \$4050 to zero, Vermont taxable income will increase as well.

# Highlights of federal changes

- The biggest personal income tax changes are elimination of personal exemptions, doubling of the standard deduction, and the alteration of numerous itemized deductions.
- The biggest corporate tax change is the move from a modified worldwide system to a territorial system, with the simultaneous repatriation of profits
- The biggest estate change is the doubling of the unified gift/estate tax credit from \$5 million/\$10 million to \$10 million/\$20 million, adjusted for inflation to 2011.