

# Tax Workshop: Income Taxes and Federal Reform

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# Anatomy of a tax

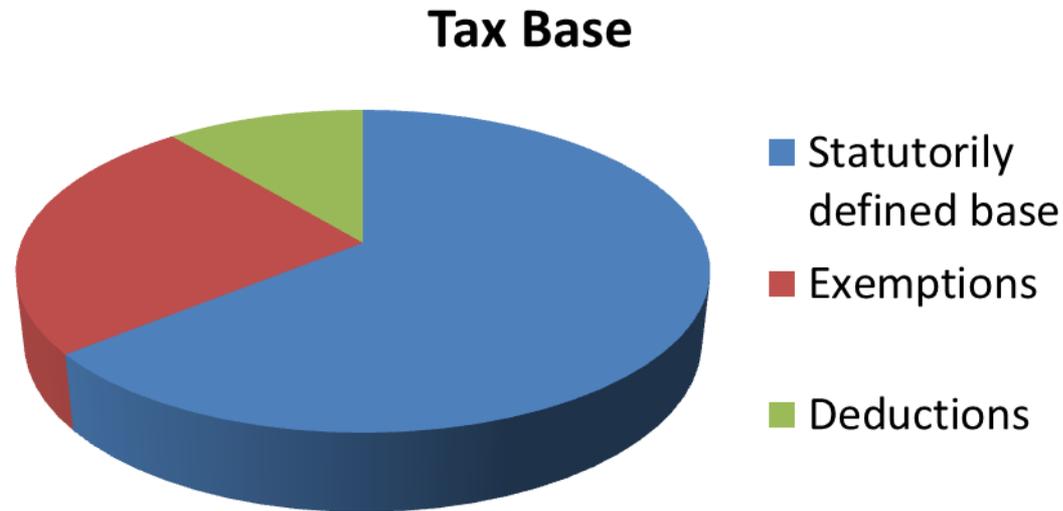
$$\text{Tax Base (x) Rate} = \text{Liability (minus credits)}$$

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  $\$10,000 \times 5\% = \$500$ .



# 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

# 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.

# Highlights of federal changes

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

# How did Vermont react?

## PERSONAL INCOME TAXES

- Because Vermont had been more directly linked to the federal definitions, the changes to the federal personal income tax base would have resulted in Vermonters paying approximately \$30 million more in state taxes they would have normally expected to pay.
  - Vast majority of Vermonters are likely to receive a Federal tax cut in 2018 (over \$500 million in total tax cuts)
- Vermont decided to essentially “decouple”, meaning we moved to a system where we have independent state level definitions and structure.
- Moving forward, many fewer federal changes will “fall through” to Vermont.

# How did Vermont react?

## CORPORATE INCOME TAXES

- There were numerous business related tax changes, but because the largest federal corporate tax changes related to the federal corporate tax rates, no state changes were required – Vermont already has a decoupled rate structure.
- In addition, 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.

# Vermont/Federal Links: Personal Income Taxes

(based on Tax Year 2018)

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)**

# Personal Income Tax- What is it?

(based on Tax Year 2018)

Federal Form

1040

Adjusted Gross Income

minus

Subtractions from Adjusted Gross Income

Standard Deduction

\$6,000 for single filer,  
\$12,000 for married filer

Personal Exemptions

\$4,150 for you, your  
spouse, and any  
dependents

Other Subtractions

- Capital Gains Exclusion
- Social Security Exemption
- Interest income from U.S. bonds

plus

Additions to Adjusted Gross Income

Examples included: interest from non-Vermont state and local bonds, bonus depreciation

equals

Vermont Taxable Income

# How to calculate tax liability

**Vermont Taxable Income (VTI)**

Multiplied by

Income tax rates at various brackets  
of income

## Married Filing Jointly

Taxable Income				
over	But not over	Pay	+ % on Excess	of amt over
0	64,600	0.00	3.35%	0
64,600	156,150	2,164.00	6.60%	64,600
156,150	237,950	8,206.00	7.60%	156,150
237,950	-	14,423.00	8.75%	237,950

## Single Individuals

Taxable Income				
over	But not over	Pay	+ % on Excess	of amt over
0	38,700	0.00	3.35%	0
38,700	93,700	1,296.00	6.60%	38,700
93,700	195,450	4,926.00	7.60%	93,700
195,450	-	12,659.00	8.75%	195,450

Equals

**Initial Vermont Tax Liability (Before Credits)**

# How to calculate final tax liability

**Initial Vermont Tax Liability (Before Credits)**

minus

**Non-Refundable Credits**

Credit for child and dependent care expenses, credit for elderly and disabled, investment tax credit, [Charitable Tax Credit](#)

minus

**Refundable Credits**

[Earned Income Tax Credit](#)

Multiplied by

**Vermont Apportionment Percentage**

The percentage of income based in Vermont

Equals

**Final Vermont Tax Liability (or Refund)**

# Vermont/Federal Links: Corporate Income Taxes

(based upon Tax Year 2018)

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 2018)

## 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

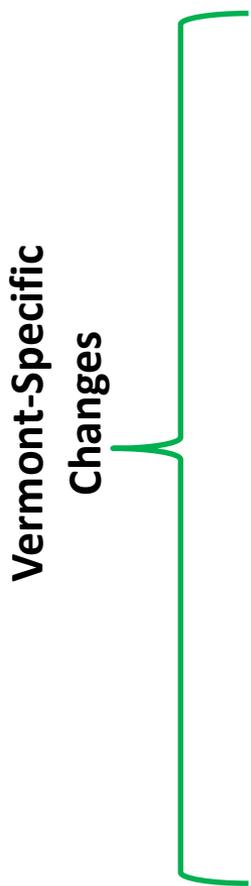
### Apportionment Percentage

Percentage of income and dividends that came from Vermont operations

Equals

## Vermont Corporate Taxable Income

Vermont-Specific  
Changes

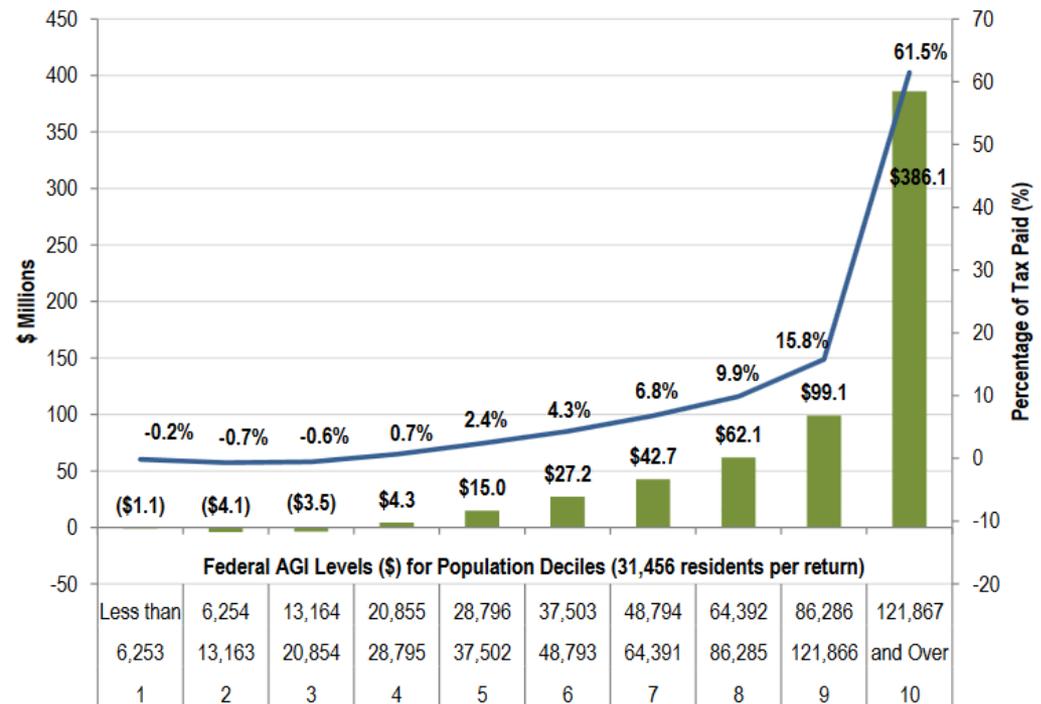


# Vermont Individual Income Taxes

## Quick Facts

- Just over 383,000 Vermont income tax returns
  - 85% (just over 326,000) were resident taxpayers
- Higher income taxpayers account for ~60% 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



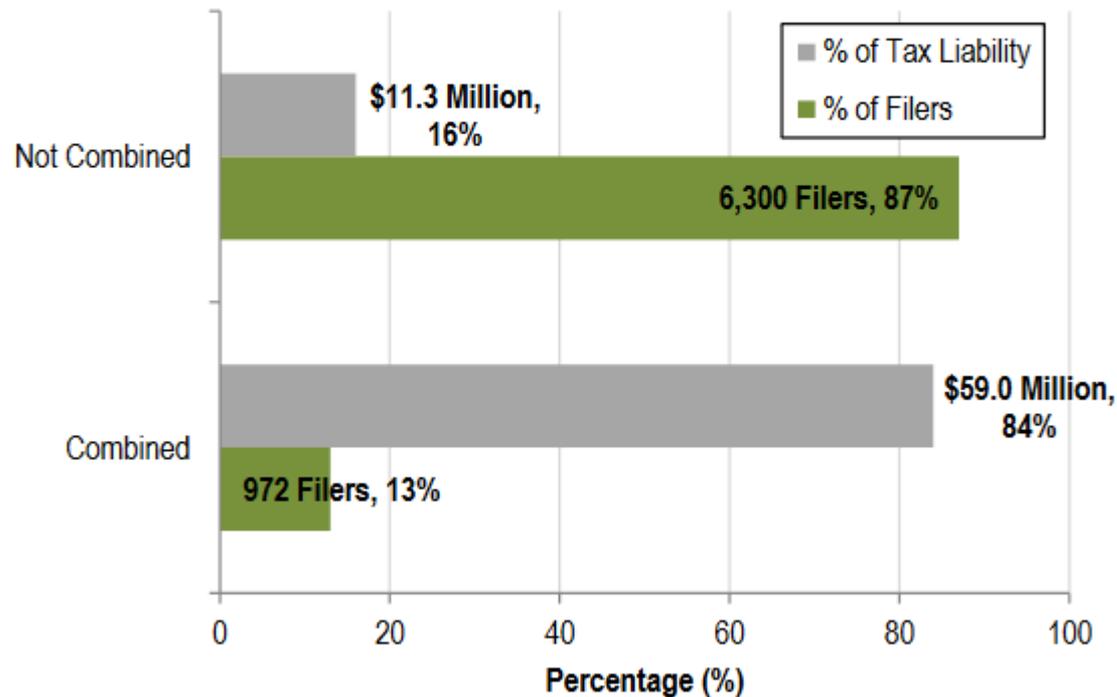
# Corporate Income Taxes

## Quick Facts

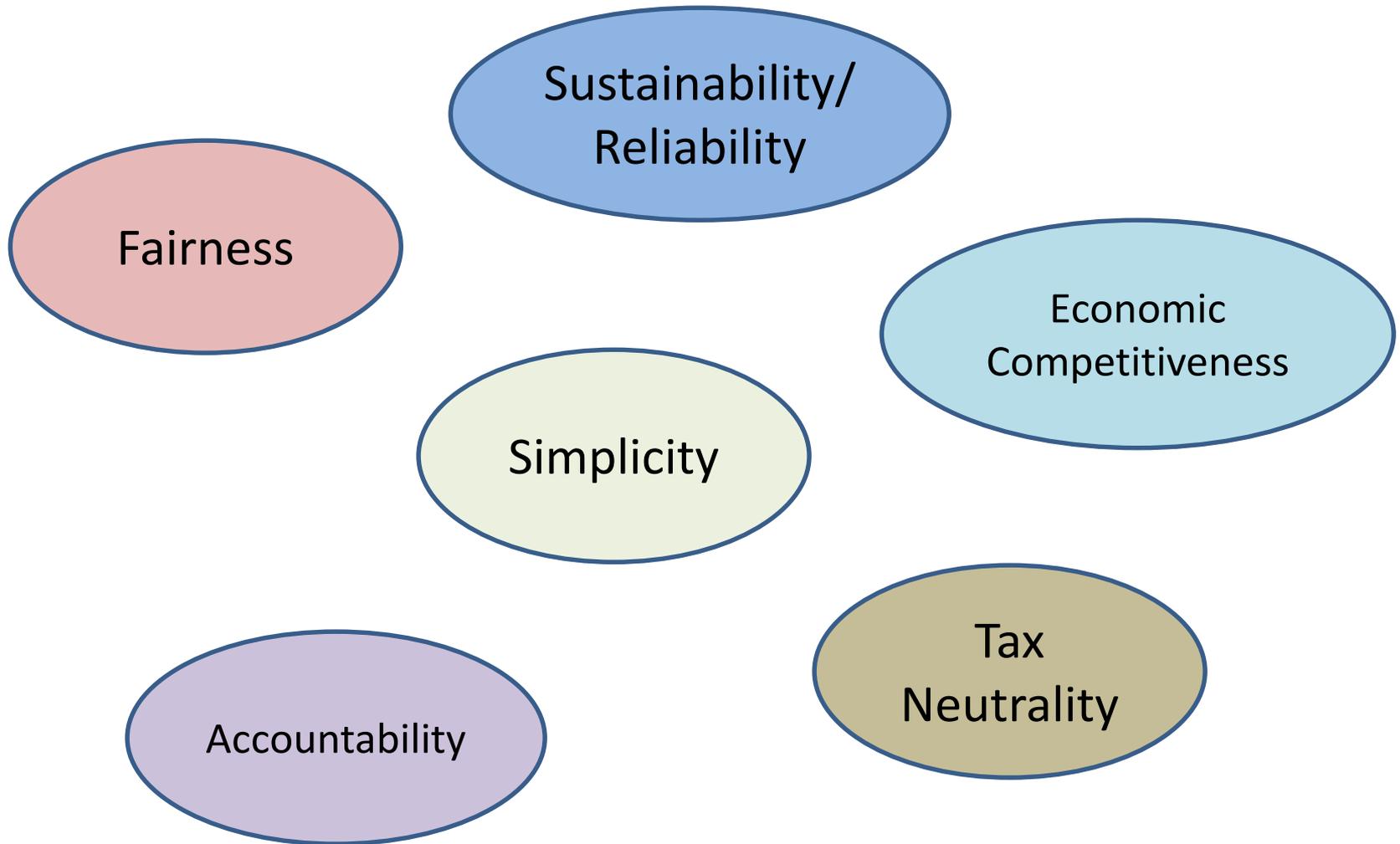
- 7,272 corporate income tax returns filed in tax year 2014.
- Two types of business:
  - 1) Unitary Combined: Those that file a VT return but are part of a larger company (13% of returns)
  - 2) Not Combined: Those businesses that are not part of a larger company (87% of returns)
- Unitary combined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



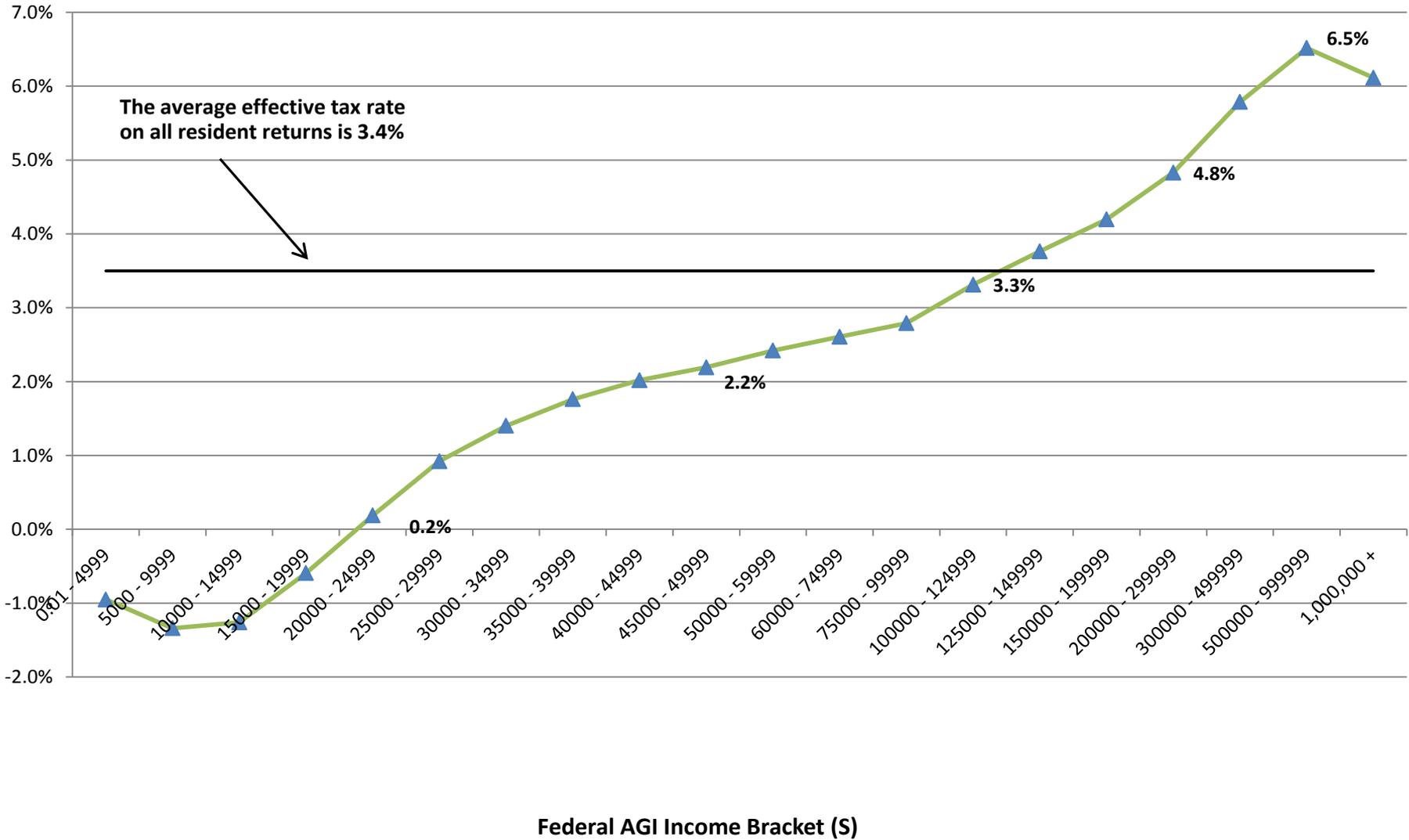
# Income Tax: The 6 Pillars

- **Sustainability: Income tax known to be more volatile**
  - Fluctuations in capital gains, one-time high income events, susceptible to economic conditions, tax policy changes
- **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: Tax deductions and credits

# 2016 Vermont Effective Personal Income Tax Rates, or Net Vermont Tax Divided by Federal Adjusted Gross Income (AGI)- Residents Only



# Income Tax: The 6 Pillars

- **Accountability**

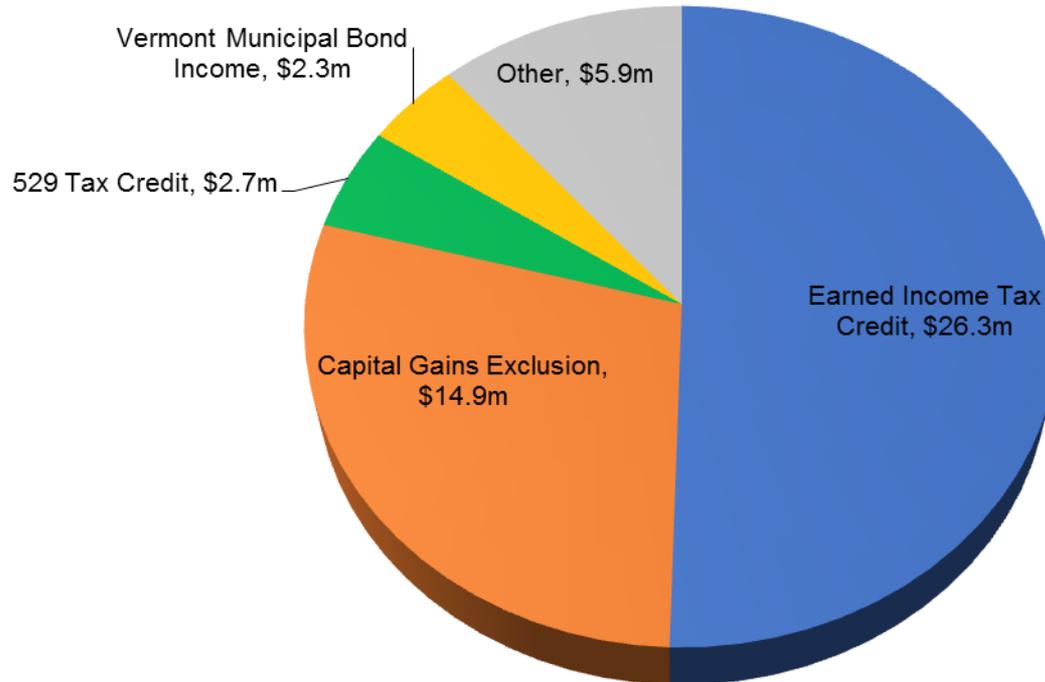
- Vermont publishes a report on all tax expenditures every two years
  - In 2018, VT had 20 income tax expenditures that cost \$52.1 million
  - Vermont also reviews select tax expenditures in each report and provides considerations of legislators
- Vermont limits the amount of corporation taxes that “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.

# Accountability: Tax Expenditures

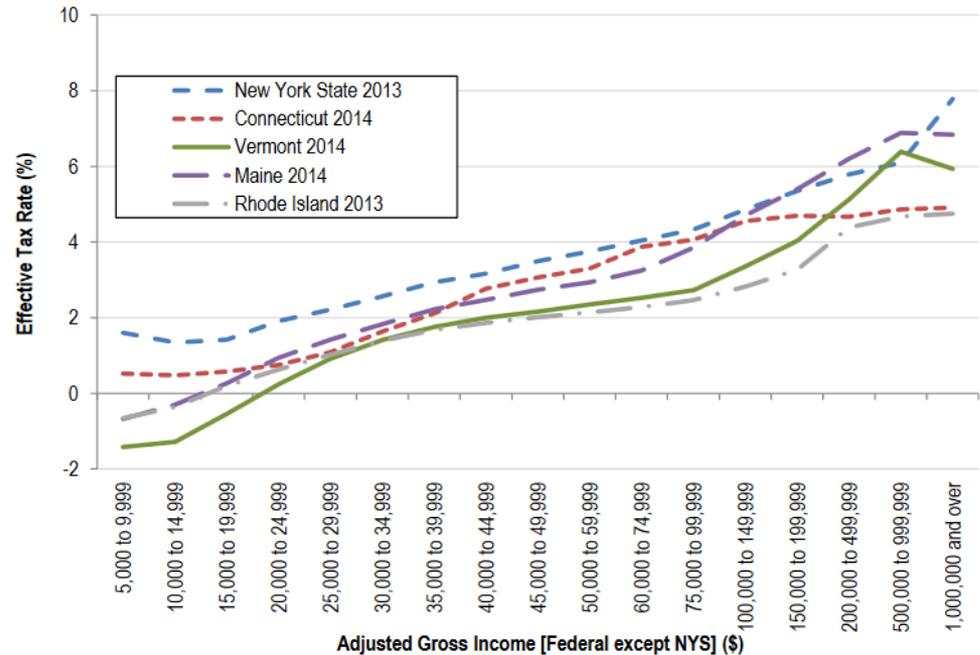
**FY2017 Vermont-Specific Personal Income Tax Expenditures:  
\$52.09 million**



# 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

