PASS-THROUGH BUSINESSES IN VERMONT: A SNAPSHOT

January 9, 2020

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Overview of Business Taxation

- For tax purposes, there are two types of businesses: C-corporations and pass-through entities
- C-corporations: pay the corporate income tax at the entity level
- Generally better-suited for businesses looking to raise money in public markets.
- Some tax advantages not available to pass-throughs
  - *More flexibility with fiscal years and easier to do carry-forwards/backwards*
  - *Full deductibility of certain employee compensation (medical premiums, fringe benefits). Also deductibility of charitable expenses*
- Any after-tax profits are distributed to shareholders either as dividends or capital gains when realized, at least in theory

Table 1: Vermont Corporate Income Tax Table	
Taxable Income Bracket	**Tax rate**
$3,751 up to $10,000	6%
$10,000 up to $25,000	7%
$25,000 and over	8.5%

Overview of Business Taxation

- What is a pass-through?
  - Businesses that do not pay taxes at the entity-level, and instead, profits are “passed-through” to the owners/shareholder’s individual income tax return.
  - Do not pay the corporate income tax
  - Examples include:
    - <u>Sole-proprietorships</u>: Business is owned by a single owner to whom all profits accrue. The owner files a Schedule C when completing his or her income taxes each year.
    - <u>Partnerships</u>: two or more individuals own and operate a business. All partners have equal ownership rights, and profits accrue to the partners.
    - <u>S-corporations:</u> Similar to partnerships but S-corporations are not allowed to have more than 100 shareholders. They enjoy the benefits of limited liability. S-corporations are also prohibited by law from being owned by another corporate entity.
  - Pass-through income is listed as either Schedule C or E income as a part of the total income calculation before AGI

Pass-Through Income

1	Wages, salaries, tips, etc. Attach Form(s) W-2				1	
2a	Tax-exempt interest	2a		b Taxable interest. Attach Sch. B if required	2b	
3a	Qualified dividends	3a		b Ordinary dividends. Attach Sch. B if required	3b	
4a	IRA distributions	4a		b Taxable amount	4b	
c	Pensions and annuities	4c		d Taxable amount	4d	
5a	Social security benefits	5a		b Taxable amount	5b	
6	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐				6	
7a	Other income from Schedule 1, line 9				7a	
b	Add lines 1, 2b, 3b, 4b, 4d, 5b, 6, and 7a. This is your **total income** ▶				7b	
8a	Adjustments to income from Schedule 1, line 22				8a	
b	Subtract line 8a from line 7b. This is your **adjusted gross income** ▶				8b	
9	**Standard deduction or itemized deductions** (from Schedule A)			9		
10	Qualified business income deduction. Attach Form 8995 or Form 8995-A			10		
11a	Add lines 9 and 10				11a	
b	**Taxable income.** Subtract line 11a from line 8b. If zero or less, enter -0-				11b	

Standard Deduction for—
- Single or Married filing separately, $12,200
- Married filing jointly or Qualifying widow(er), $24,400
- Head of household, $18,350
- If you checked any box under *Standard Deduction*, see instructions.

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2019)

Pass-Through Income

SCHEDULE 1
(Form 1040 or 1040-SR)
Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

▶ Attach to Form 1040 or 1040-SR.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2019
Attachment Sequence No. **01**

Name(s) shown on Form 1040 or 1040-SR | **Your social security number**

At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency? . . . . ☐ **Yes** ☐ **No**

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. List type and amount ▶	**8**	
9	Combine lines 1 through 8. Enter here and on Form 1040 or 1040-SR, line 7a	**9**	

Hypothetical Example

- A single-owner business with $500,000 in profits (married)

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%**

- Note: in practice, C-corporation profits are often either distributed to tax deferred accounts (IRAs), or tax-deferred as capital gains or estate tax

Quick note on data sources

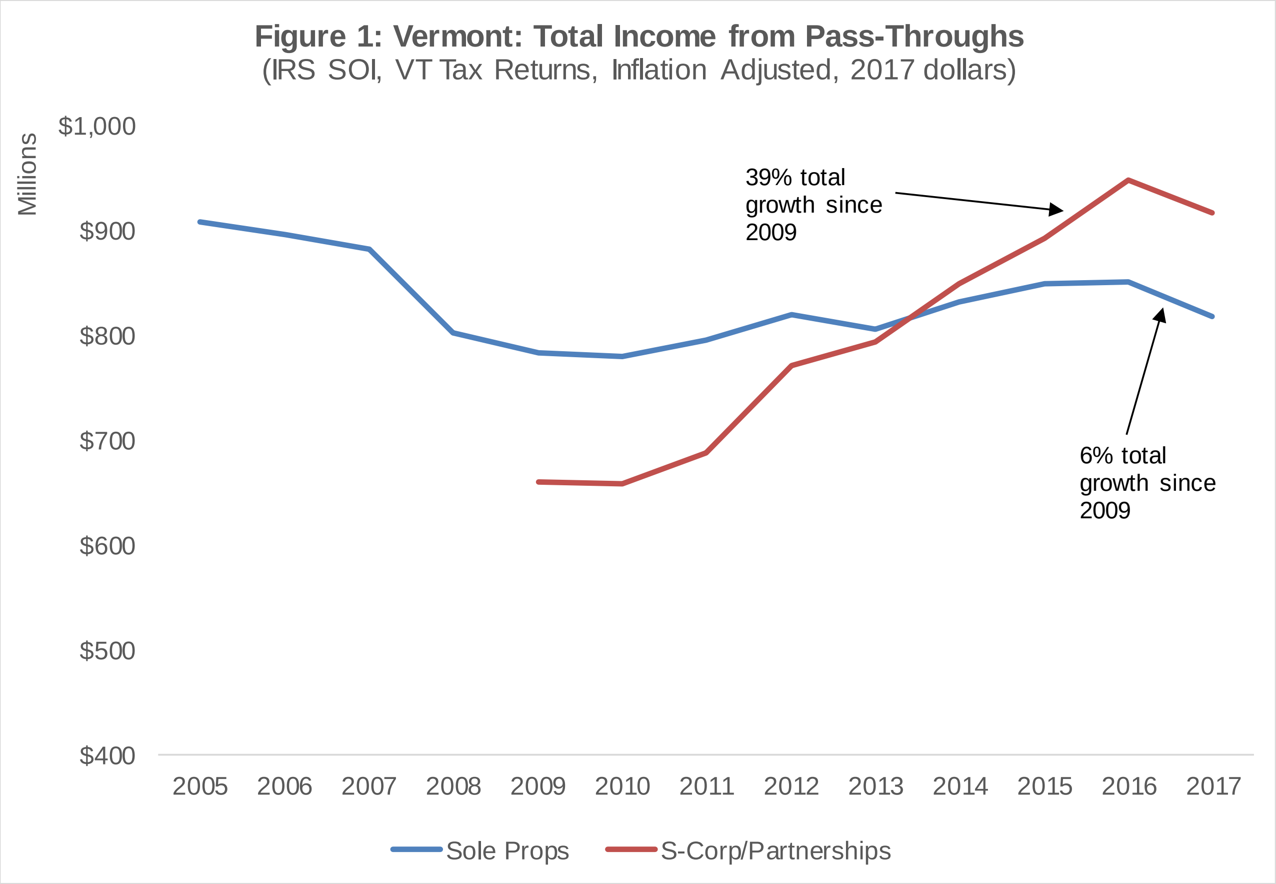
- Analysis relies on two sources of data:
  - *JFO's Chainbridge Tax Model:* contains 2017 tax year data for personal income tax returns.
    - **Only includes resident tax filers**, largely due to the difficulties in interpreting business income information from nonresident tax returns.
  - *Internal Revenue Service's state Statistics of Income:* contains information on income sources from federal personal income tax returns with a Vermont filing address.
    - This dataset is advantageous because it contains multiple years of data.
- The datasets have different figures for the number of pass-through returns, but they are largely similar.

Major Finding #1

- <u>Pass-throughs are an important source of personal income tax revenues</u>
- In 2017:
  - 53,429 resident tax returns reported sole proprietorship income (20% of total returns), generating about $1.07 billion in net income (5% of total income)
  - 17,794 resident tax returns reported partnership/S-corp income (5% of returns), generating about $727 million worth of net income (3.5% of total income)
- It is estimated that these pass-through returns will generate $109 million in personal income tax revenue in FY2020 (about 12% of the total)
  - $61.2 million from sole props
  - $48.2 million from partnerships/S-corps

Major Finding #2

- **<u>Between 2009 and 2017, sole proprietor income stagnated while S-corporation/partnership income rose significantly.</u>**
- The number of pass-through returns was remarkably flat over the 2009-2017 period.
  - *Sole props: decreased by 776 returns over the period*
  - *Partnerships/S-corps: increased by 385 returns*
- Real total partnership/S-corp income grew by 39% over the period while sole prop income only grew by 6%
  - *For reference, wages grew by 6%, capital gains grew by 148% while dividends and interest grew by 40%.*



Major Finding #3

- **The vast majority of pass-throughs report modest amounts of income. However, to a much greater extent than income taxes as whole, a very small number of large pass-throughs account for most of the total profits.**
- How do we define “large or small” pass-through returns?
  - Gross income: income before deductions and expenses. Can be thought of as a proxy for sales/revenue
  - Net income: income after deductions and expenses. This is what gets taxed. A proxy for pre-tax profits

Sole Props by Gross Income

- Of the 53,429 returns, 43,156 reported gross income of less than $50,000, accounting for 18.7% of total gross income
- 553 returns (1% of the total) had gross income above $500,000. These 553 returns accounted for 40% of total gross income

Figure 2: Number of Vermont Resident Sole Proprietorship Returns by Gross Business Income Group
(Tax Year 2017, Vermont Resident Tax Returns Only)

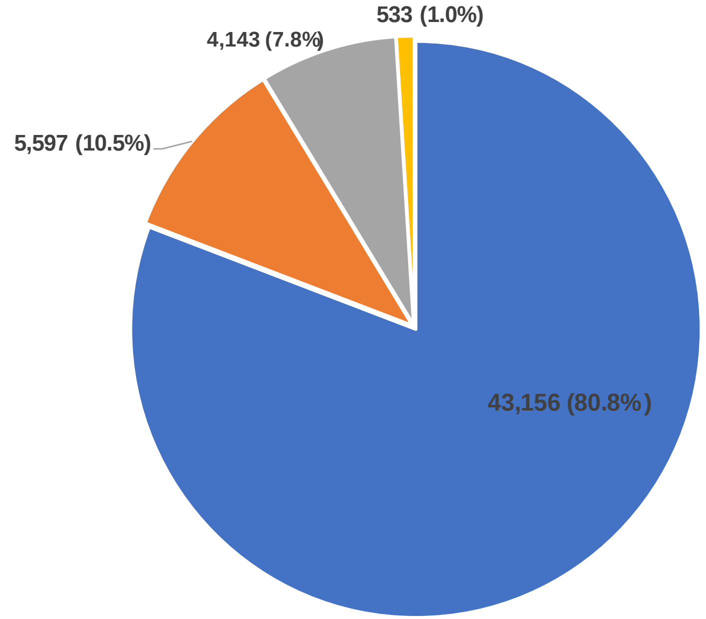
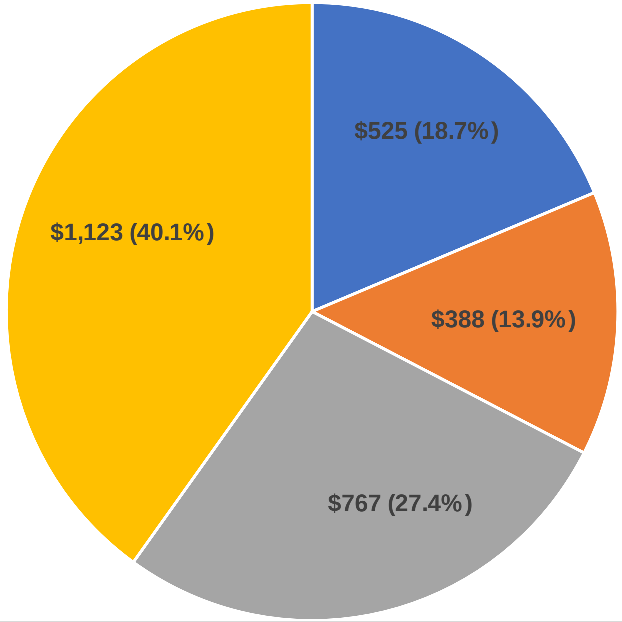


Figure 3: Total Gross Business Income for Sole Proprietorship Returns by Gross Business Income Group
(In millions of dollars, Tax Year 2017, Vermont Resident Tax Returns Only)



Partnerships/S-Corps by Gross Income

- Of the 17,794 returns, 13,886 reported gross income of less than $50,000, accounting for 12.7% of total gross income
- 320 returns (1.8% of the total) had gross income above $500,000. These 320 returns accounted for 35% of total gross income

Figure 4: Number of Vermont Resident S-Corporation/Partnership Returns by Gross Business Income Group
(Tax Year 2017, Vermont Resident Tax Returns Only)

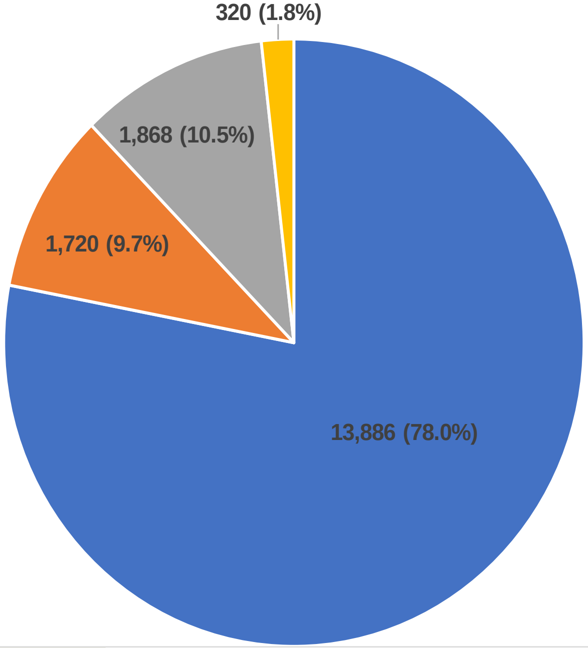
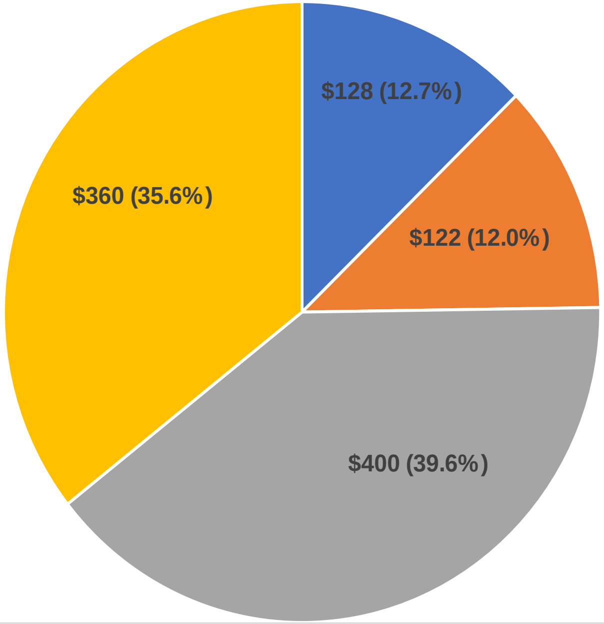


Figure 5: Total Gross Business Income for S-Corporation/Partnership Returns by Gross Business Income Group
(In millions of dollars, Tax Year 2017, Vermont Resident Tax Returns Only)



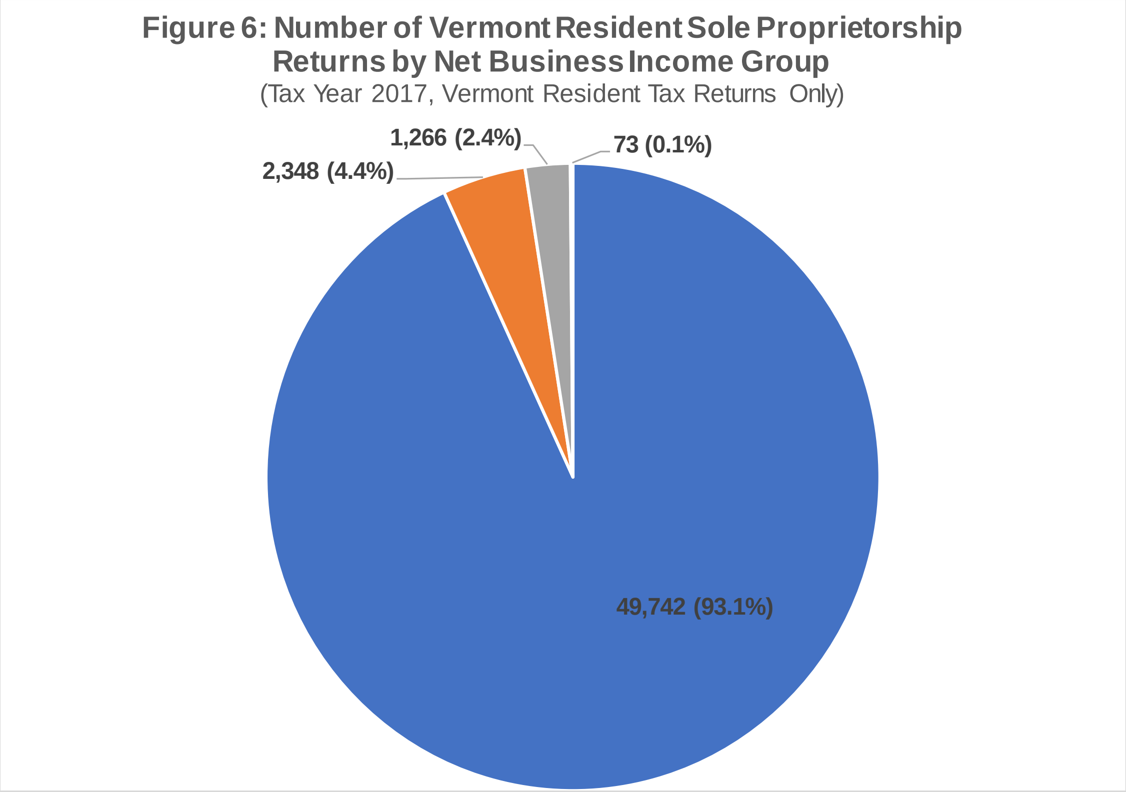
0 to $50,000 | $50,000 to $100,000 | $100,000-$500,000 | $500,000 +

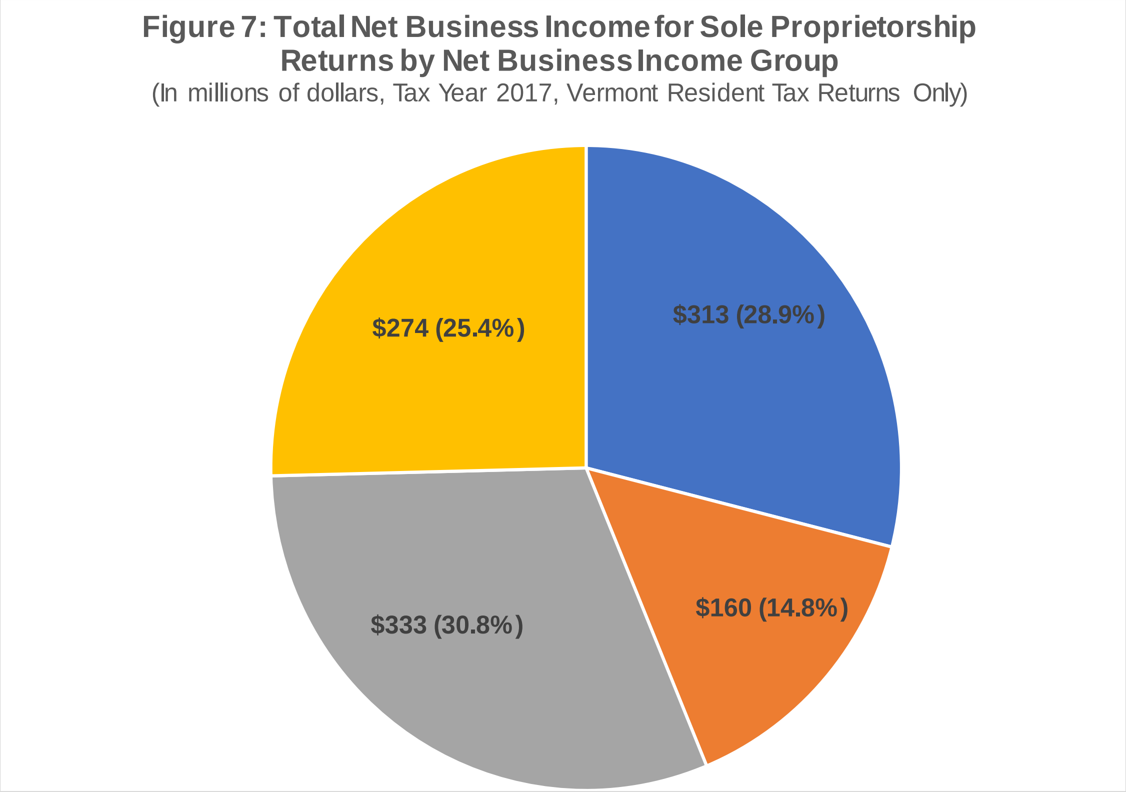
Gross Income to Net Income

- **Sole proprietor** gross income was $2.8 billion, but net (taxable) income was $1.08 billion
  - Largest deductions/expenses in order: wages, depreciation, vehicle expenses
  - In any given year, 1 in 5 sole proprietor returns report zero or negative taxable income
- **Partnership/S-corp** gross income was $1.01 billion but net income was $727 million.
  - In any given year, 1 in 3 partnership/S-corp returns report zero or negative taxable income.

Sole Props by Net (Taxable) Income

- 49,742 returns (93%) had net income of $50,000 or less. These returns accounted for $313 million in net income or 27% of the total net income
- 73 returns (0.14% of the total) had net income above $500,000. These 73 returns accounted for 25% of net income ($274 million).

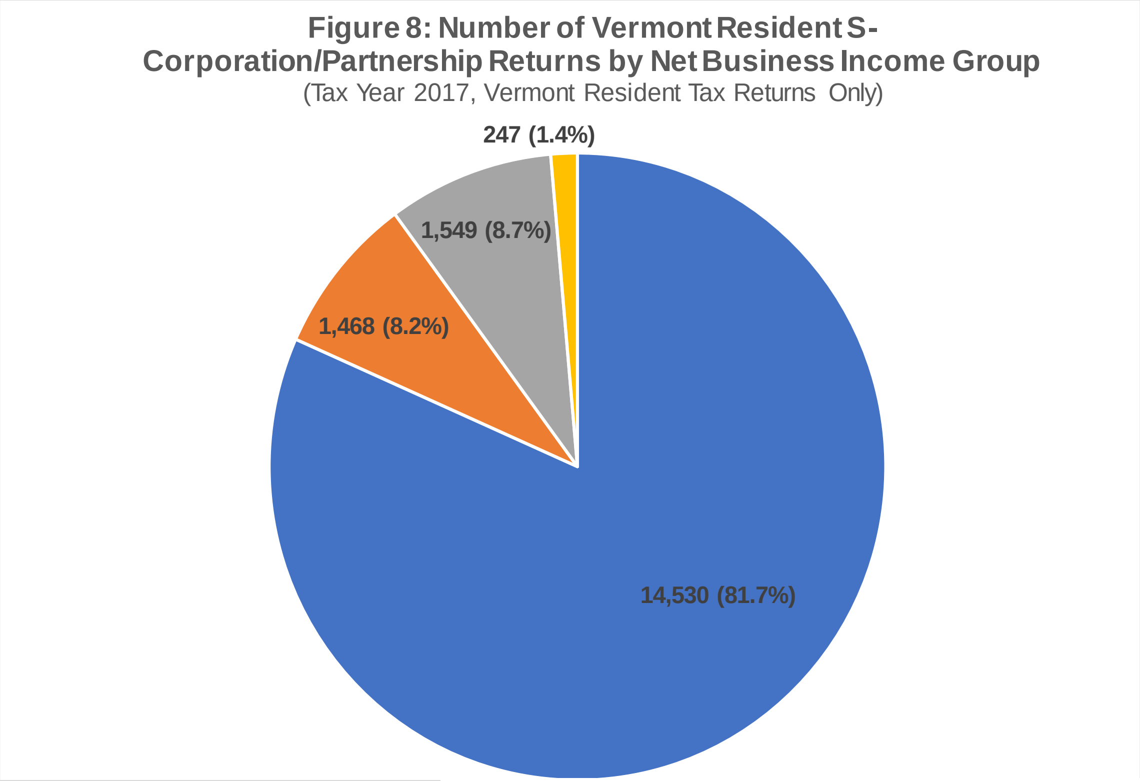


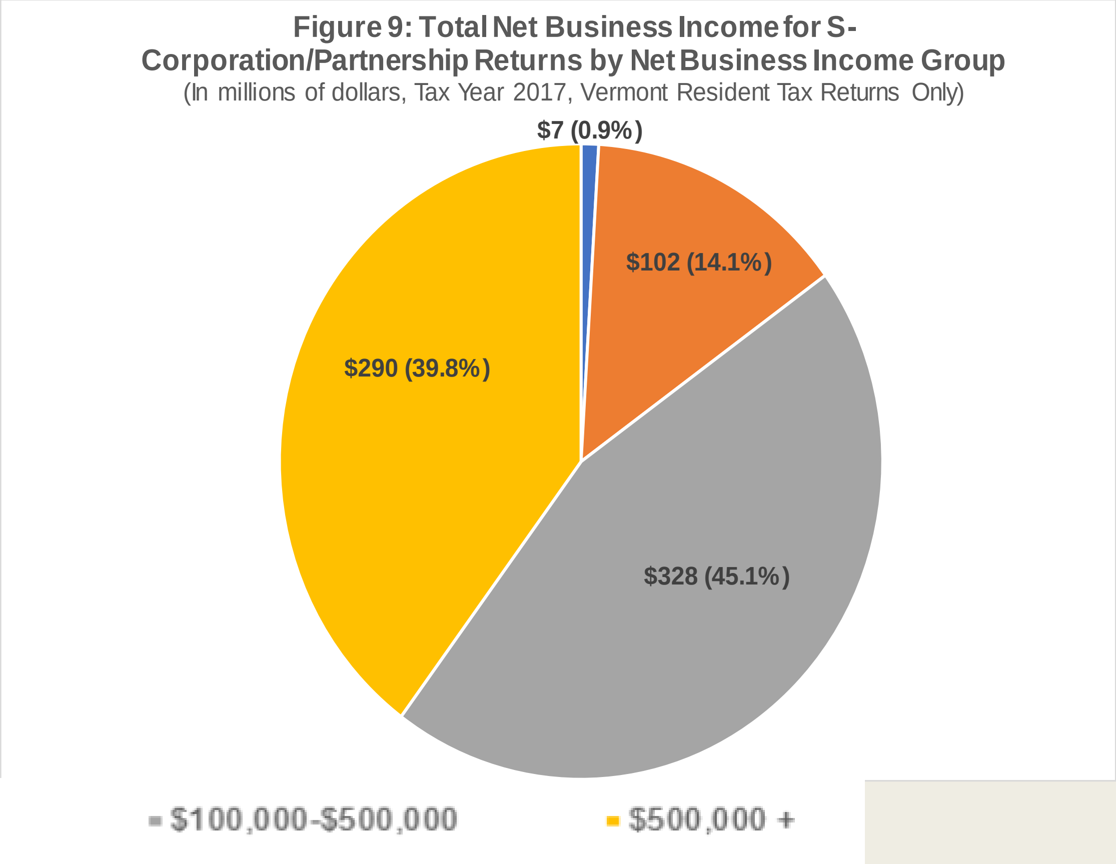


0 to $50,000 | $50,000 to $100,000 | $100,000-$500,000 | $500,000 +

Partnership/S-corps by Net (Taxable) Income

- 14,530 returns (82%) had net income of $50,000 or less. These returns accounted for $7 million in net income or 0.9% of the total net income
- 247 returns (1.4% of the total) had net income above $500,000. These 247 returns accounted for 40% of net income ($290 million).





Is pass-through income a primary source of income for most?

- Only about 20% of sole props rely on sole prop income for more than 75% of their total income
  - This percentage increases as the sole prop becomes more profitable
    - Only 18% of sole props with less than $50,000 in sole prop income rely on that income for more than 75% of their total income.
    - 73% of sole props with $500,000+ in sole prop income rely on sole prop income for 75% or more of total income.
- Less than 10% of individuals with partnership/S-corp income rely on that income for more than 75% of total income.
  - This percentage increases with greater partnership/S-corp income as well.
    - Only 7% of partnership/S-corp returns with net income below $50,000 rely on that income for more than 75% of their total income.
    - 62% of partnership/S-corp returns with $500,000+ in net income rely on that income for 75% or more of total income.

Major Finding #4

- **The 20% business deduction created by the 2017 Tax Cuts and Jobs Act, while not having a direct impact on Vermont tax revenue, may create future uncertainties for Vermont's personal and corporate income taxes.**
- Overview of the 20% Qualified Business Income (QBI) deduction:
  - 20% deduction of pass-through income on an individuals federal income tax return.
  - Deduction is limited for "specified service businesses" which include but aren't limited to the fields of: healthcare, law, accounting, actuarial sciences, performing arts, consulting, and financial services
  - For these businesses, the deduction is phased out after certain income limits
  - For non-specified service businesses, once the income limits are surpassed, the deduction is limited to generally 50% of W2 wages paid by the businesses.
- **This deduction does not flow through to Vermont personal income taxes because we start at AGI. The QBI deduction occurs after AGI.**

Who benefits from QBI deduction?

- Estimates based upon 2017 tax year data using Chainbridge Tax Model
- These are estimates of the Federal tax benefit of the deduction at current Federal tax rates (Tax Year 2020).

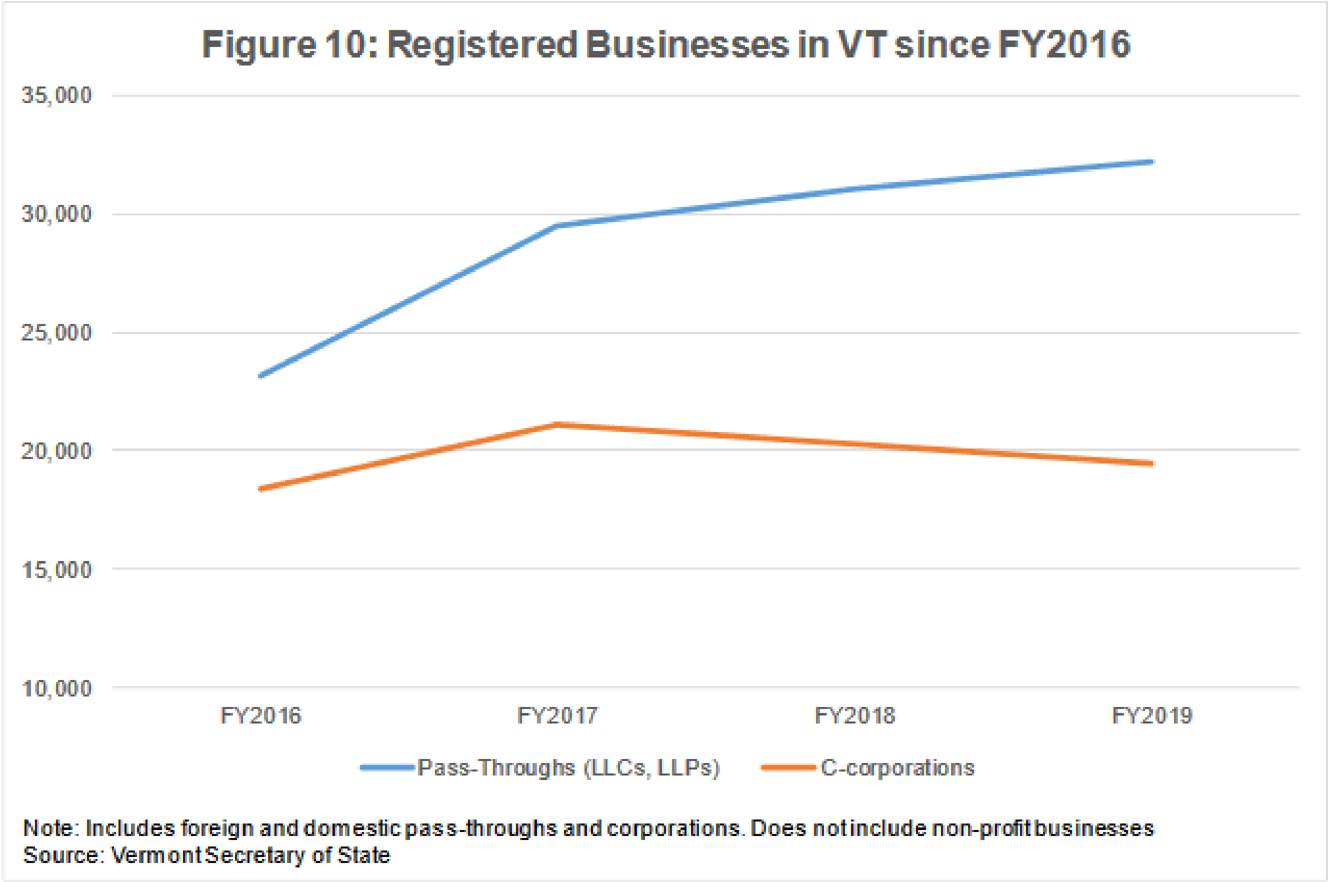
Table 4: Federal Tax Benefits of Pass-Through Deduction: VT Resident Pass-Through Returns (based upon tax year 2017 data)					
Adjusted Gross Income		Number of Returns	Total Federal Tax Change (in millions of dollars)	Average Tax Benefit	Change in Effective Tax Rate
Less than $0		0	$0.00	…	0.00%
$0	$10,000	37	$0.00	-$29	0.00%
$10,000	$20,000	1,953	-$0.11	-$57	-0.11%
$20,000	$50,000	8,241	-$1.66	-$201	-0.32%
$50,000	$100,000	11,215	-$5.36	-$478	-0.42%
$100,000	$150,000	6,082	-$6.58	-$1,082	-0.62%
$150,000	$200,000	2,596	-$4.80	-$1,850	-0.76%
$200,000	$300,000	2,071	-$6.37	-$3,074	-0.88%
$300,000	$500,000	1,129	-$4.64	-$4,109	-0.72%
$500,000	$1,000,000	315	-$2.43	-$7,708	-0.43%
Greater than $1,000,000		178	-$15.57	-$87,491	-1.07%
Total		**33,817**	**-$47.52**	**-$1,405**	**-0.69%**

How could this impact Vermont revenues?

- Switching of business classifications
  - Small businesses currently structured as C-corps might see the QBI deduction as a reason to switch to a pass-through.
    - In almost all cases, the corporate income tax rates are higher than the effective rates on pass-throughs, so this would reduce revenues
  - Alternatively, the Tax Cuts and Jobs Act also Federal corporate income tax rates to 21% which may cause some pass-throughs to switch to C-corps.
    - One study found estimated that 17.5% of pass-throughs in the U.S. could switch to C-corps.
- Shifts towards consultant or contracted labor
  - The deduction might create an incentive for some workers to leave their employers and instead become independent contractors.
  - Could affect personal income taxes and payroll taxes.

Possible Vermont Effects of the QBI Deduction

- Likely too early to tell whether either of these two effects are happening
- Not a whole lot of movement on business registrations by type since TCJA passage



Questions?

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