Tax Workshop: Income Taxes and Federal Reform

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Anatomy of a tax

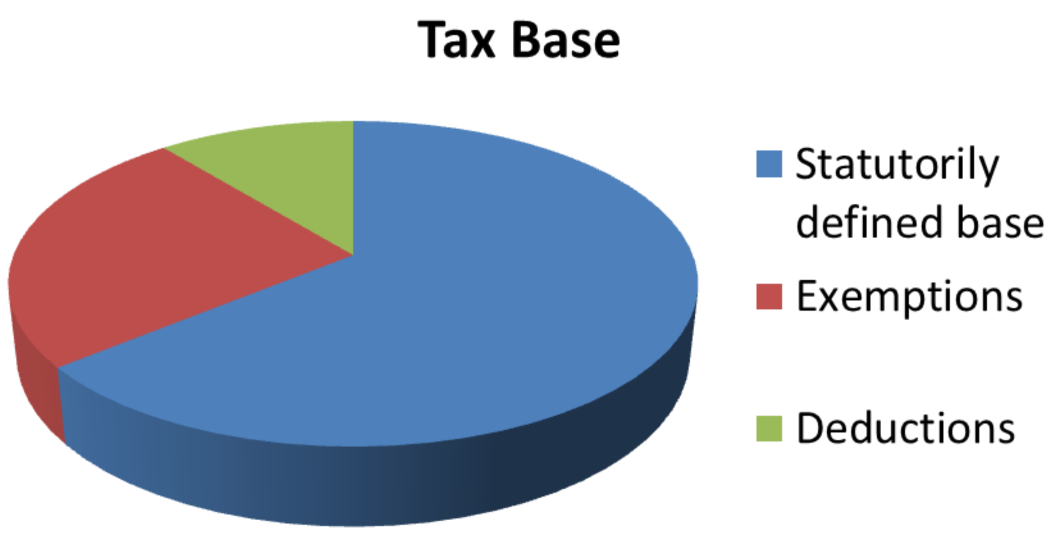
Tax Base (x) Rate = Liability (minus credits)

The bigger the base, the lower the rate.

A smaller base requires a higher rate to generate the same amount of revenue.

Tax Base

- A **tax base** is what is subject to the tax, as defined in statute, 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 paying the tax, even if their property would otherwise be taxable.

- An exemption can be a **full exemption** or a **partial exemption**. Full exemptions cost more to the State, while partial exemptions require more compliance work by both the taxpayer and the Department of Taxes.

Deductions

A ***deduction*** is an amount that a taxpayer can subtract from their tax base, which typically has the effect of reducing their liability.

BASE (x) RATE = LIABILITY

(minus the 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 their income would be in the first bracket, or $10,000 x 5% = $500.

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%

- If the same person had $20,000 in income, under a progressive tax structure, they would pay $500 in taxes on the first $10,000 income, but on the second $10,000 in income, they would pay $1,000 in taxes, or $10,000 x 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 they would be paying 10% on their 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 amount of tax owed.

- Credits can be either refundable or nonrefundable. A ***refundable credit*** means that the taxpayer receives a payment if the credit reduces their liability below zero.
  - $100 tax liability, but a $150 refundable credit = zero liability + $50

- A ***nonrefundable credit*** can reduce a liability to zero, but no further. Some credits allow a taxpayer to "carry forward" the credit so that it may reduce a future year's tax liability.
  - $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.
- Major changes to three federal taxes: personal income tax, corporate income tax, and gift/estate tax.
- Two types of impacts on Vermont:
  - How much individual taxpayers pay, given their particular situation.
  - How much State revenue are generated, because Vermont's tax bases are tied to federal tax 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 changes were the move from a modified worldwide system to a territorial system, with the simultaneous repatriation of profits, and the decrease in corporate income tax rates.
- The biggest gift/estate tax change was the doubling of the unified gift/estate tax exclusion from \$5 million/\$10 million to \$10 million/\$20 million, adjusted for inflation to 2011.

How did Vermont react?
PERSONAL INCOME TAXES

- Prior to 2018, Vermont was more directly linked to the federal definitions, which meant that the changes to the federal personal income tax base would have caused Vermonters to pay approximately $30 million more in State taxes than they would have expected to pay under the former law.
- Vermont decided to “decouple” from many of the federal provisions, meaning the Vermont tax code shifted to definitions and a structure independent from the federal tax code.
- Moving forward, many fewer federal tax code changes will “flow through” to Vermont.

How did Vermont react?
CORPORATE INCOME TAXES

- Rates
  - There were numerous business-related tax changes, but one of those significant, the federal corporate income tax rate changes, did not require any state-level changes because Vermont's income tax rates are already decoupled from the federal rates.
- Income
  - 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 2019)

Federal Tax Return (Form 1040)

<u>Gross Income</u>

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

minus

<u>"Above the line" Deductions</u>

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

equals

<u>Adjusted Gross Income (AGI)</u>

Personal Income Tax- What is it?

(based on Tax Year 2019)

Federal Form 1040

Adjusted Gross Income

minus

Subtractions from Adjusted Gross Income

Standard Deduction
$6,150 for single filer, $12,300 for married filer

Personal Exemptions
$4,250 for you, your spouse, and any dependents

Other Subtractions

- Capital Gains Exclusion
- Social Security Exemption
- Medical Deduction

plus

Additions to Adjusted Gross Income

Examples included: interest from VT state and local bonds, 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 Separately				
Taxable Income				
over	But not over	Pay	+ % on Excess	of amt over
0	33,725	0.00	3.35%	0
33,725	81,500	1,130.00	6.60%	33,725
81,500	124,175	4,283.00	7.60%	81,500
124,175	-	7,526.00	8.75%	124,175

Single Individuals				
Taxable Income				
over	But not over	Pay	+ % on Excess	of amt over
0	40,350	0.00	3.35%	0
40,350	97,800	1,352.00	6.60%	40,350
97,800	204,000	5,143.00	7.60%	97,800
204,000	-	13,215.00	8.75%	204,000

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 2019)

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 2019)

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

Based upon property, payroll, and sales in Vermont

Equals

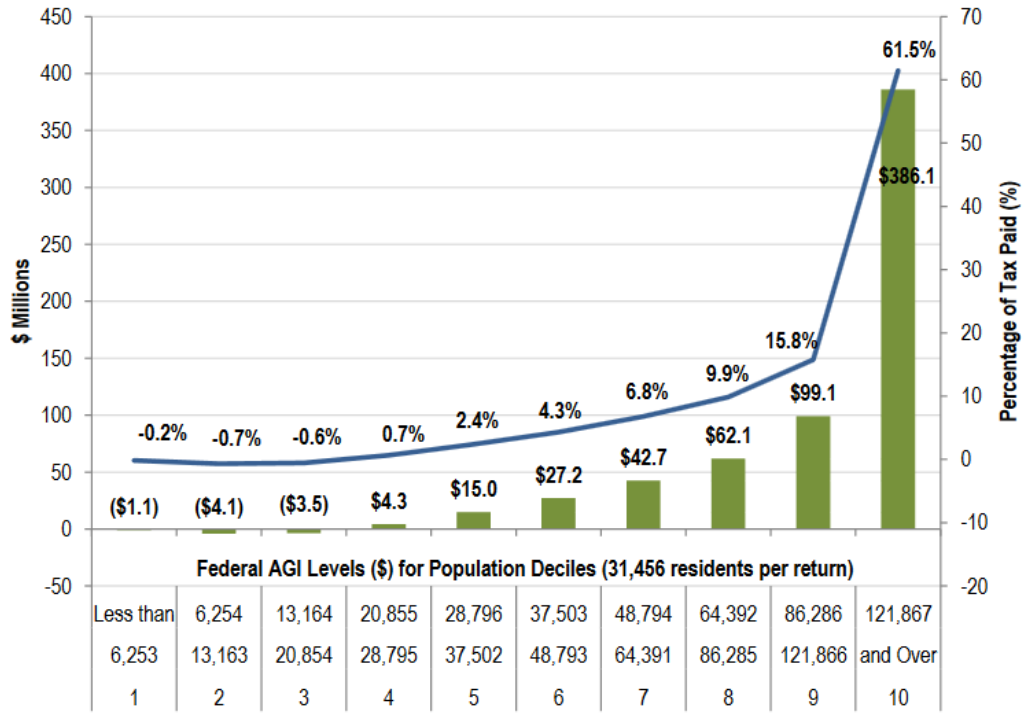
Vermont Corporate Taxable Income

Vermont-Specific Changes

Vermont Individual Income Taxes Quick Facts

- Just over 370,000 Vermont income tax returns
  - 86% (just over 320,000) were resident taxpayers
- Higher income taxpayers ($150k+) 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

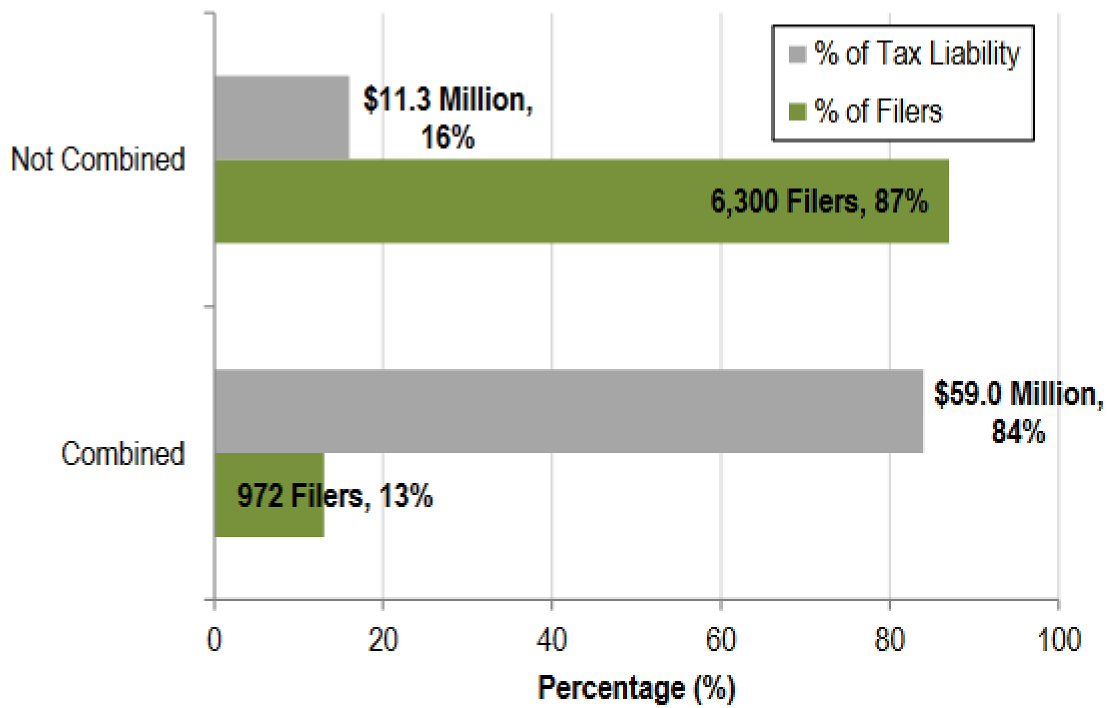
- 7,272 corporate income tax returns filed in tax year 2014.
- Two types of business:

  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

Sustainability/ Reliability

Fairness

Economic Competitiveness

Simplicity

Tax Neutrality

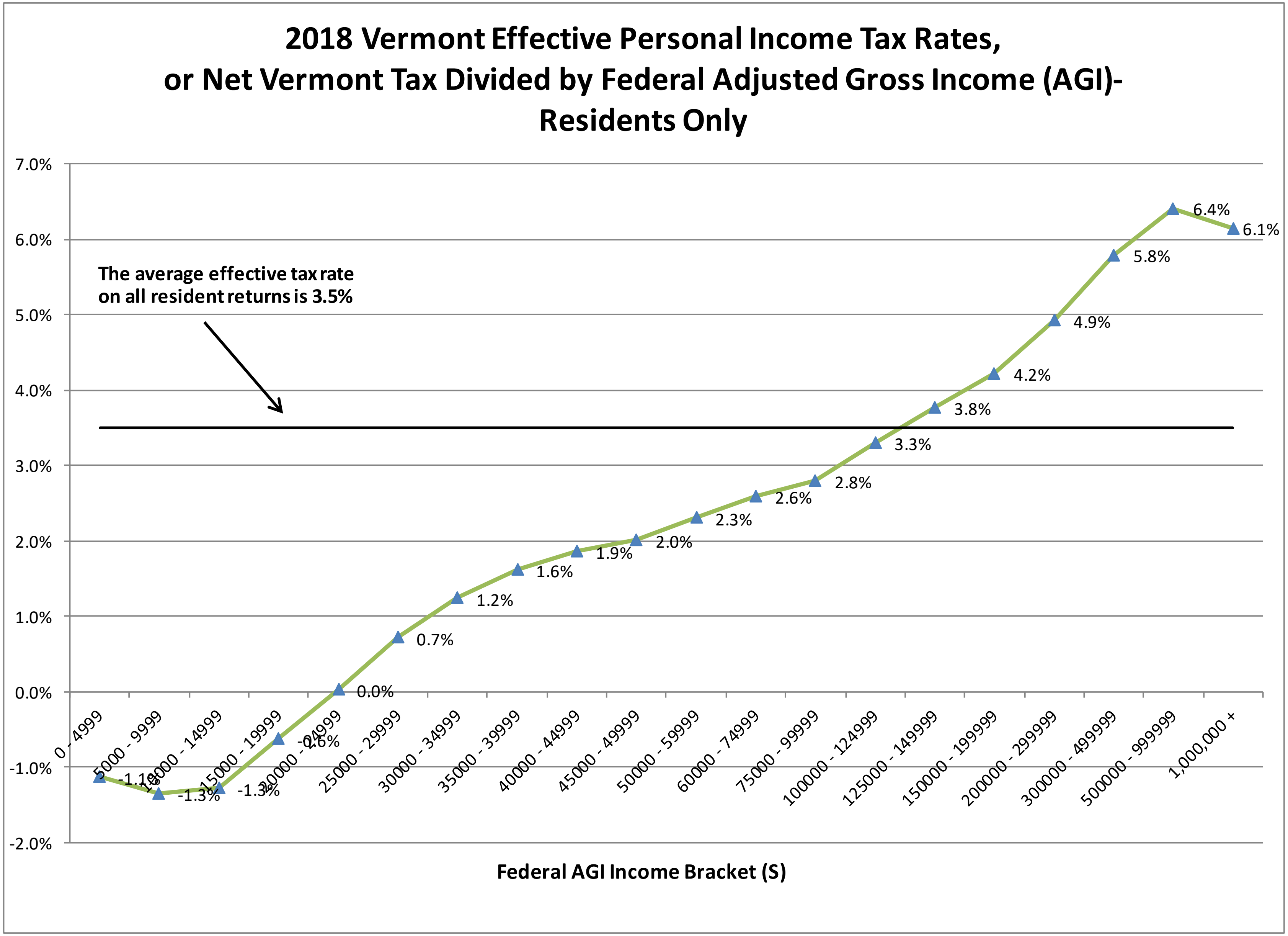
Accountability

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.
    - Exemptions/deductions related to this group will grow in cost
  - Income distribution: greater income inequality=greater percentage of tax revenue comes from high income filers
  - Changes to the economy: automation, shared economy
  - Federal Policy: stimulus bills, enhanced unemployment benefits

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
  - ITEP: Vermont's tax system is one of the "fairest" in the country, largely due to our personal income tax structure.
- **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

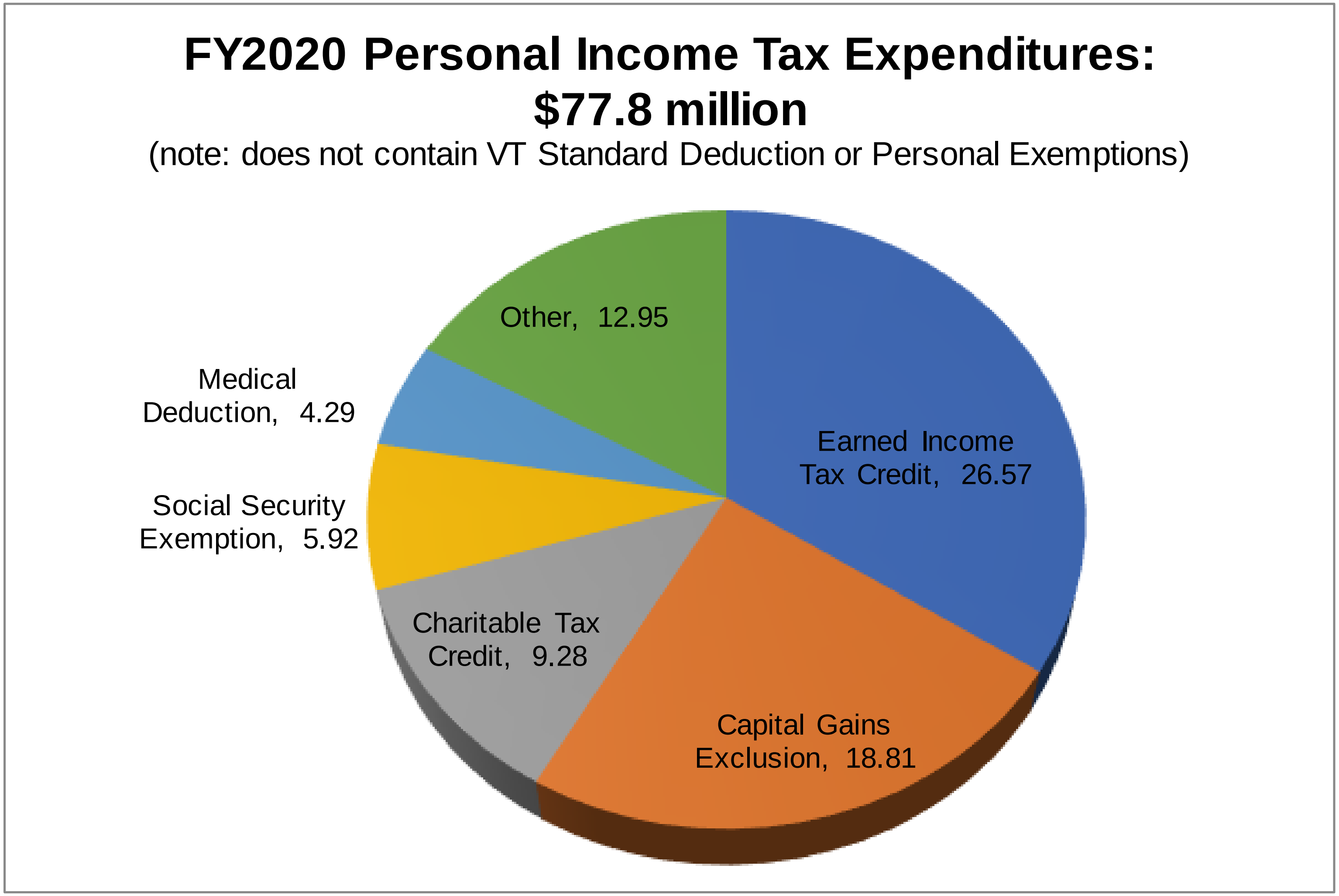


Source: Department of Taxes

Income Tax: The 6 Pillars

- **Accountability**
  - Vermont publishes a report on all tax expenditures every two years
    - Aside from personal exemptions and standard deduction, in 2020, VT had 24 income tax expenditures that cost $77.8 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.

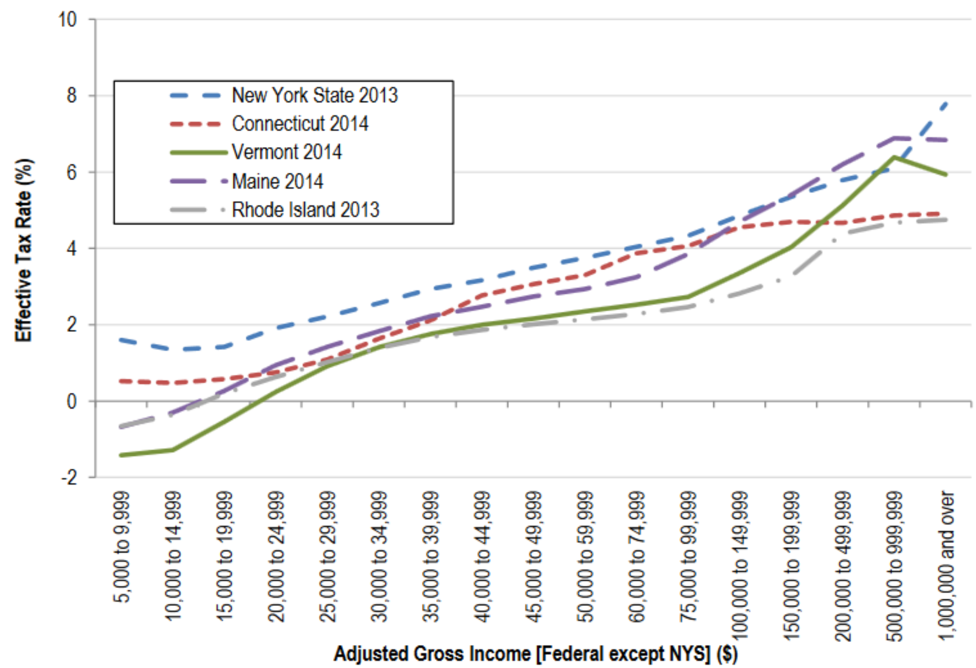
Accountability: Tax Expenditures



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
  - Difficult to compare across states because tax competitiveness is determined by more than just the tax rate:
    - How does your state define income of a corporation?
    - Does your state use unitary reporting?
    - How does your state determine whether the corporation has nexus?