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MEMORANDUM

To: Rep. Kornheiser, Chair, Committee on Ways and Means

From: Abby Shepard, Legislative Counsel

Date: February 22, 2023

Subject: H.66 Paid Family and Medical Leave; Income Tax Implications

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Summary

You requested an explanation of the tax implications of H.66, an act relating to paid family and medical leave insurance. This memo addresses the likely tax treatment of contributions made and benefits received by employees, employers, and the self-employed. The tax consequences implicate both federal and state income tax and the State homestead property tax.

Under H.66, employers and their employees would be required to pay equal shares of the employee's contributions to the insurance program. The contributions would be deducted from the employee's wages in the same way that income tax is withheld. Self-employed individuals may elect to contribute to the program by paying in estimated installments, in the same way that self-employed individuals pay income tax on nonwage income. Employers may opt out of the program if providing benefits through a private plan that are equal to or more generous than the State insurance program.

Legal Analysis

I. <u>Tax treatment of contributions to insurance program</u>

Employees

Employee contributions to the insurance program would be treated as a payment of a state income tax for federal tax purposes.[1] This means that contributions to the insurance program would be deductible on an employee's federal income taxes, but only if the employee's deductions are itemized.[2] Of note, since 2018, the federal Tax Cuts and Jobs Act has limited the itemized deduction for state and local taxes paid to $10,000 per married filing jointly filers (or $5,000 for a married filing separately filers).[3] The contributions to the insurance program would also therefore be counted as part of the taxes paid to a state that are subject to the itemized deduction cap. State and local taxes are not deductible on the state level, because Vermont does not allow an itemized deduction for state taxes. The tax benefit for taxpayers who take the standard deduction and do not itemize, is that those taxpayers are only taxed on the amount in excess of

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[1] *See*, Rev. Rul. 81-191; IRS Memorandum 200630017.
[2] 26 U.S.C. § 164(a).
[3] 26 U.S.C. § 164(b)(6); Pub. L. No. 115-97, § 11042.

the employee's own contribution (i.e., the employer contribution). For employees who itemize deductions, the full amount of the contributions is included in their taxable income (but the itemizing employee can take an income tax deduction equal to the amount of their contribution). Note that this also means the contributions would be made post-tax (since a pre-tax withholding cannot be used to claim a deduction).

The income-sensitivity property tax credit uses household income to calculate the amount of a homestead owner's credit. The definition of household income starts with federal adjusted gross income, and there are no applicable exclusions.[4] Therefore, employee contributions would likely count as household income for purposes of calculating an individual's property tax credit.

Employers

For employers, the mandatory contribution would likely be treated as a deductible state tax at the federal level for either taxable unemployment compensation or nontaxable disability based compensation.[5]

II. Tax treatment of benefits claimed from insurance program

Employees

When benefits are paid to an employee or self-employed, the income tax treatment differs depending on whether the benefits are considered unemployment compensation or disability based compensation. Unemployment compensation is taxable for the individual who receives it.[6] Disability based compensation, like workers' compensation, is not taxable for the individual who receives it.[7] If the benefit is received for leave taken for one's own (but not another person's) serious health condition, the benefit would be non-taxable tax as a disability benefit. If the benefit were paid with employer dollars (either as pre-tax salary reduction or otherwise), however, according to IRS guidance, the benefit would be considered "in the nature of unemployment compensation" and thus taxable for the employee.[8]

The income-sensitivity property tax credit uses household income to calculate the amount of a homestead owner's credit. The definition of household income starts with federal adjusted gross income, and there are no applicable exclusions.[9] Therefore, benefits would likely count as household income for purposes of calculating an individual's property tax credit.

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[4] 32 V.S.A. § 6061(4) and (5).
[5] 26 U.S.C. § 164(a); Rev. Rul. 81-194.
[6] 26 U.S.C. § 85.
[7] 26 U.S.C. § 104.
[8] 26 U.S.C. § 85.
[9] 32 V.S.A. § 6061(4) and (5).