

S.45 Fiscal Considerations

House Committee on Ways and Means

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Outline

1. Key features of proposed legislation
2. Distribution of pass-through income
3. State revenue impact
4. Considerations for Legislators



Who is a pass-through business

- Pass-Through Business: Profits get “passed through” to owners who pay on their own personal income taxes
 - S-Corporations: Can have 1-100 share holders
 - Prohibited by law from being owned by another corporate entity
 - “S” stands for small business corporation
 - File Schedule E
 - Partnerships: two or more individuals own and operate a business. All partners have equal ownership rights.
 - File Schedule E
 - Sole Proprietors: Profits go to a single owner as their own income.
 - File a Schedule C



Pass-through businesses vary significantly

Examples of pass-through businesses:

- Handy man who earns income as a side-business
- HVAC and plumbing business with one owner and 2 employees
- Small accounting firm with 3 partners
- Local restaurant group with 10 equity investors
- Medium sized manufacturing firm with 100 employees with a single owner
- A large, multi-state financial firm with \$10 billion in assets and 10 partners



Features of S.45

1. Creates an 7.6% entity-level tax that can be paid by certain types of pass-through businesses
2. Creates a refundable 90% personal income tax credit for PTE taxes paid
3. Credit also includes amount of pass-through entity (PTE) taxes paid to other states
4. Tax is elective and must be elected by all members of a pass-through entity
5. Effective January 1, 2023



PTE tax example

Entity Tax, Vermont	
Business Net Income	\$2,000,000
Partners	2
Split	50%
Entity Tax Rate	7.60%
Entity Tax Paid	\$152,000
Shareholder PTE Tax	\$76,000

Vermont Personal Income Tax after Entity Tax	
Net Income Before PTE Tax Deducted	\$1,000,000
Net Income After PTE Tax Deducted	\$924,000
Net Pass-Through Income	\$924,000
Adjusted Gross Income	\$924,000
Filing Status	Married
Children	0
Exemptions	2
State Income Tax Before Entity Credit	\$72,018
State PTE tax Credit	\$68,400
Total State Income Tax (Tax minus PTE tax credit)	\$3,618

Total State Taxes with Entity Tax	
	With PTE Tax
Total State Taxes	\$79,618
of which: State Income Tax	\$3,618
of which: State Entity Tax	\$76,000



Distribution of pass-through income



Who reports pass-through income in Vermont?

VT Federal S-Corp and Partnership Returns, 2020			
AGI Group	Number of Returns with S-Corp/Partnership Income	Share of VT Returns with S-Corp/Partnership Income	Total Amount of Income Reported (in thousands)
Under \$1	1,080	10%	-80,879
\$1 under \$10,000	580	1%	-4,439
\$10,000 under \$25,000	1,280	2%	364
\$25,000 under \$50,000	2,350	3%	10,650
\$50,000 under \$75,000	2,400	5%	17,872
\$75,000 under \$100,000	2,280	7%	31,480
\$100,000 under \$200,000	5,570	12%	135,807
\$200,000 under \$500,000	3,870	30%	320,086
\$500,000 under \$1m	900	51%	203,199
\$1m or more	520	69%	540,554
Total	20,830	6%	1,174,694

Source: IRS Historical Table 2, Data for Vermont, 2020

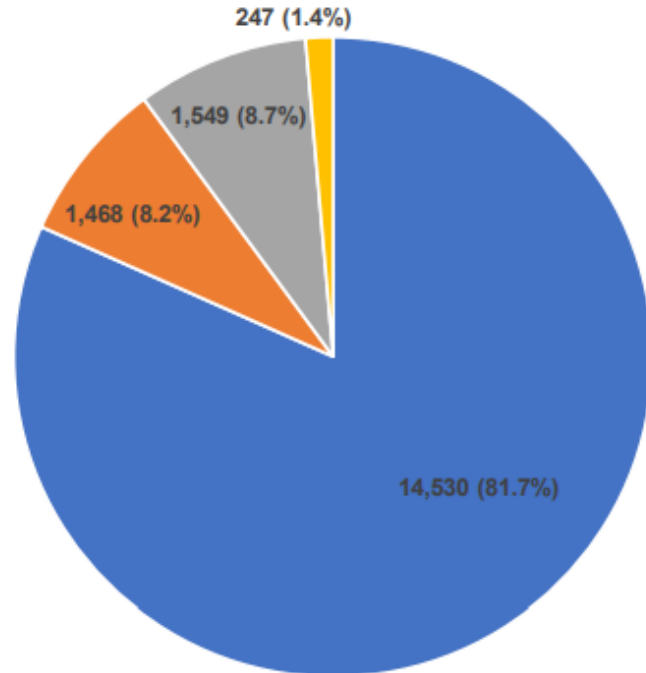
- Small number of returns in Vermont report pass-through income
- High income individuals are much more likely to report pass-through income



Pass-through income is highly concentrated

S-Corps/Partnerships

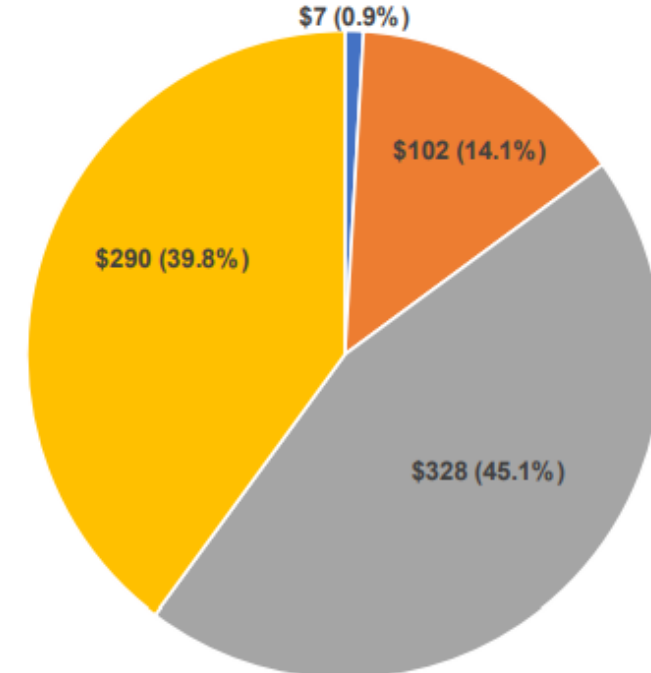
Figure 8: Number of Vermont Resident S-Corporation/Partnership Returns by Net Business Income Group
(Tax Year 2017, Vermont Resident Tax Returns Only)



■ 0 to \$50,000

■ \$50,000 to \$100,000

Figure 9: Total Net Business Income for S-Corporation/Partnership Returns by Net Business Income Group
(In millions of dollars, Tax Year 2017, Vermont Resident Tax Returns Only)



■ \$100,000-\$500,000

■ \$500,000 +

- In 2017, 82% of returns with S-corp/Partnership income reported net income of less than \$50,000.
- However, the 247 returns with net income above \$500,000 reported almost 40% of the total net income on S-Corp/Partnership returns



Who is impacted by the SALT Cap?

- The SALT Cap allows only up to \$10,000 of the paid state and local taxes to be deducted from a tax payer's federally taxable income
- Impact of SALT Cap kicks in above \$200,000 of AGI
 - Using 2017 data, only 44% of resident returns reporting \$150,000 to \$200,000 in income impacted
 - Increases to 72% of returns with \$200,000 to \$300,000 in income
- 21,000 or 6% of VT resident returns impacted by the SALT Cap



Who is impacted by the SALT cap?

Table 1: Estimated Impact of SALT Cap on Vermont Resident Returns (Tax Year 2017 Returns)				
Income Group		Number of Returns Impacted	Share of VT Resident Returns Impacted	Total VT Resident Returns
Negative	\$100,000	2,425	1%	296,765
	\$100,000 - \$125,000	2,250	11%	19,634
	\$125,000 - \$150,000	2,449	22%	11,006
	\$150,000 - \$200,000	4,739	44%	10,735
	\$200,000 - \$300,000	4,909	72%	6,778
	\$300,000 - \$500,000	2,614	82%	3,207
	\$500,000 - \$1,000,000	1,165	87%	1,341
	\$1,000,000 - Infinity	466	76%	614
Total		21,017	6%	350,080

Source: JFO Analysis of Chainbridge Income Tax Model

- Changes in the Tax Cuts and Jobs Act of 2017 mean that most filers take the standard deduction
- Majority of filers in 2017 with an AGI above \$200,000 paid more than \$10,000 in state and local taxes



JFO estimate of federal tax benefits

- If the SALT Cap was repealed for S-corps and partnership returns, Vermont tax filers in that group would experience an estimated aggregated \$33.84 million reduction in federal tax liability
- More than 70% of these tax savings would accrue to tax filers with an AGI of \$500,000 or more, or only .23% of total returns
- **JFO estimates an annual aggregated \$10-\$20 million in reduced federal tax liability for Vermont resident filers**
 - Take-up matters: since the PTE tax is elective, the overall impact depends on who chooses to participate



Federal tax benefits to S-corps and partnerships by income group

Table 11: Estimated Impact of SALT Cap Repeal, S-Corp and Partnership Returns (Tax Year 2017 Returns)						
Income Group		Number of Returns Impacted	Share of VT Resident Returns Impacted	Total VT Resident Returns	Total Federal Tax Impact (in millions)	Average Federal Tax Impact
Negative	\$100,000	298	0%	296,765	\$0.23	\$772
\$100,000	\$125,000	321	2%	19,634	\$0.30	\$935
\$125,000	\$150,000	335	3%	11,006	\$0.48	\$1,433
\$150,000	\$200,000	809	8%	10,735	\$1.38	\$1,706
\$200,000	\$300,000	1,145	17%	6,778	\$3.13	\$2,734
\$300,000	\$500,000	785	24%	3,207	\$4.44	\$5,656
\$500,000	\$1,000,000	520	39%	1,341	\$8.27	\$15,904
\$1,000,000	Infinity	276	45%	614	\$15.61	\$56,558
Total		4,489	1.3%	350,080	\$33.84	\$7,538

Source: JFO Analysis of Chainbridge Income Tax Model

- Smaller group of filers have positive S-corporation or partnership income
- Majority of benefits accrue to filers with more than \$500,000 in AGI



State revenue impact



State revenue impact mechanics

- State revenue depends on the design of PTE tax and credit
- Impact is going to be positive as proposed in S.45 because of the relationship between the credit and the highest marginal personal income tax rate
 - With a 90% credit, the State of Vermont withholds 10% of PTE tax paid
 - Since that is more than the highest marginal personal tax rate of 8.75%, the PTE tax as proposed will generate positive revenue for the State



JFO State revenue estimate

- JFO estimates the proposed PTE tax would generate \$500,000 per year in additional General Fund revenue
 - Limited data are available, and estimates would depend on take-up rates of a voluntary tax structure
 - Other states that have created PTE taxes in response to the SALT Cap either do not have revenue estimates or forecast minimal changes
 - Revenue would be available for three years under current law – the TJCA, which established the SALT Cap, is scheduled to sunset at the end of 2025.



Impacts of PTE tax rate changes

- Increase of PTE tax rate results in:
 - Decreased Federal liability (increased Federal tax savings)
 - Increase PTE tax and credit in Vermont
- Decrease of PTE tax rate results in:
 - Increased Federal liability (decreased Federal tax savings)
 - Decrease PTE tax and credit in Vermont
- Overall, federal liabilities generally change more than Vermont liabilities as a result of PTE tax rate changes



Impacts of PTE tax credit changes

- Increase of PTE tax credit results in:
 - Unchanged Federal tax liability
 - Decreased Vermont liability
- Decrease of PTE tax credit results in:
 - Unchanged Federal tax liability
 - Increased Vermont liability



State revenue impact – 90% credit

Entity Level	
Business Net Income	\$2,000,000
Partners	2
Split	50%
Pass-through Income	\$1,000,000

Difference Between Total Taxes Paid with 90% Credit			
	Current Law	With PTE Tax	Difference
Total State Taxes	\$78,668	\$79,618	\$950
of which: State Income Tax	\$78,668	\$3,618	
of which: State Entity Tax	0	\$76,000	
Federal Income Tax	\$219,449	\$196,953	-\$22,496

Relatively small positive revenue impact for the State

Federal Tax Difference	-\$22,496
State Tax Difference	\$950
Total Tax Difference	-\$21,546



State revenue impact – 87.5% credit

Entity Level	
Business Net Income	\$2,000,000
Partners	2
Split	50%
Pass-through Income	\$1,000,000

Difference Between Total Taxes Paid by Scenario			
	Current Law	With PTE Tax	Difference
Total State Taxes	\$78,668	\$81,518	\$2,850
of which: State Income Tax	\$78,668	\$5,518	
of which: State Entity Tax	0	\$76,000	
Federal Income Tax	\$219,449	\$196,953	-\$22,496

Positive revenue impact for the State

Federal Tax Difference	-\$22,496
State Tax Difference	\$2,850
Total Tax Difference	-\$19,646



Considerations

- A PTE tax treats classes of income differently
- Do the Legislature's goals of vertical equity in income taxes extend beyond the Vermont tax code to the federal code, or the overall income distribution?
- Legislators should consider the consequences of creating tax policy solely in response to changes in federal tax policy
- The PTE tax introduces a third business tax option into the tax code



A PTE tax treats classes of income differently

- PTE tax only available to S-Corporation or partnership income
 - Only 6% of returns
 - Taxpayers who earn income exclusively through wages or social security would not be able to access the tax
 - Sole proprietors are a type of pass-through entity but also cannot access the tax



State and federal tax policy interactions

- How important is the progressivity of the overall tax code? And the income distribution of all Vermonters?
- Traditionally, Vermont tax policy has generally sought to maintain as much progressivity in the income tax code as possible
 - Remember, 70% of the federal tax benefits would accrue to a small number of filers with an AGI of more than \$500,000
 - However, it would not change the distribution effects of the tax code at the state level



State and federal tax policy interactions

- PTE tax is explicitly designed in response to federal changes in the Tax Cuts and Jobs Act of 2017
- However, Act 11 of 2018 decoupled from federal income tax code by using AGI as a starting point, and created new Vermont standard deductions and personal exemptions
- Policy is set to expire after tax year 2025 – S.45 would also sunset



The PTE tax introduces a third business tax option

- One of the six pillars of a good tax system is simplicity
 - Simplicity maintains that revenue systems should be easy to understand, minimize compliance costs and be as simple as possible to administer
 - Nonresident pass-throughs pay at entity level *to reduce complexity for them and the tax department*
- Businesses can pay corporate income taxes or personal income taxes depending on structure -- the PTE tax would add another tax option
- The new tax will require some additional compliance costs
 - Compliance costs could be unequally distributed: is this workaround accessible or easy to any individual/business who does their own taxes?
- Could introduce distortionary incentives around business structure decisions



Questions?

For further information, please see JFO Issue Brief “Passthrough Entity Taxes and SALT Cap Workarounds”

