Pass-through Entity Taxation

Abby Shepard, Legislative Counsel

Ways and Means – January 31, 2023

What is a “pass-through entity?”

- Business structures
  - Sole proprietorships, partnerships, limited liability companies, S Corporations
    - C Corporation or individual who does not have business income is NOT a pass-through entity.
- Generally, income tax is not imposed on pass-throughs at the entity level.
  - Instead, income passes through directly to the members (or partners, owners, sole proprietor, etc.), who are then taxed under the personal income tax.

Types of pass-through entities

- Sole Proprietorships
  - A business with a single owner
  - Sole proprietorships do not file a separate tax return, but rather report net income on the individual's tax return (Sch. C of Form 1040).
  - Generally, all net income from sole proprietorships is also subject to payroll taxes and federal self-employment tax.
  - Advantages
    - Lack of formalities
      - No state filings required
      - Business is dissolved when owner decides to stop
    - Owner is taxed on income and can take losses
  - Disadvantages
    - Owner has unlimited liability and can lose personal assets

Types of pass-through entities

- Partnerships
  - Partnerships file an entity-level tax return, but profits are allocated to owners who report their share of net income on the individual's tax return (Sch. E of Form 1040).
  - Different types of partnerships: general, limited, and limited liability.
    - General partners are involved in day-to-day management, but have unlimited liability.
    - Limited partners are not involved in day-to-day management, but are protected by limited liability.
    - Limited liability partners are all involved in day-to-day management, and are protected by limited liability.

Types of pass-through entities

- General Partnership
  - No State filing required.
    - Created by oral or written agreement between 2 or more people.
    - Dissolution occurs by agreement of partners or disassociation by partner.
  - General partners equally liable for debts of partnership unless partnership agreement specifies otherwise.
  - Income and losses pass through.
- Limited Partnership and Limited Liability Partnership
  - Must file for certificate with Secretary of State.
  - Income and losses pass through.
  - Dissolution occurs under terms of agreement, when certificate expires, or when court orders.

Types of pass-through entities

- Limited Liability Companies (LLCs)
  - LLCs are formed as authorized under State law.
  - LLC owners are called members, who may include individuals, corporations, other LLCs, and foreign entities.
  - There is no maximum number of members. Most states also allow single-member ownership.
  - Certain activities, such as banking and insurance, are usually disallowed.
  - LLCs may elect to be taxed as a C corporation, partnership, or as part of their members' tax return (a "disregarded entity").
    - Members of disregarded entities are subject to payroll taxes on their earnings.

Types of pass-through entities

- Limited Liability Companies (LLCs)
  - Advantages
    - Members not liable for debts of LLC, unless specified otherwise in its foundational documents or if there is fraud or severe mismanagement
    - Income and losses pass through to members
  - Disadvantages
    - Formalities required
      - Must file articles of organization with Secretary of State, for which fees are charged.
      - Dissolution occurs under terms of agreement, or when court orders.

Types of pass-through entities

- S Corporations
  - Owners are shareholders.
  - Eligible domestic corps that elect S corp status file a federal corporate tax return, but profits flow through to shareholders and are reported on individual shareholders' tax return.
  - S corps can have only one class of stock and cannot have more than 100 shareholders, who must be US citizens or resident individuals.
    - However, certain estates, trusts, and tax-exempt organizations are also allowed.
  - Shareholders do not pay self-employment tax on their profits but are required to pay themselves "reasonable compensation," which is subject to Social Security or Federal Insurance Contributions Act (FICA) withholding.

Types of pass-through entities

- S Corporations
  - Advantages
    - Shareholders typically not liable for debts of corporation unless fraud or severe mismanagement
    - Income and dividends pass through to shareholders
  - Disadvantages
    - Formalities required
      - Business formation and dissolution documents must be filed with Secretary of State
      - Must write bylaws and hold annual meetings

When does an entity pay?

- $250 minimum tax
- Different rules apply when a pass-through entity has:
  - Members who are not residents of Vermont; or
  - More than 50 members.
- Potentially required:
  - Composite (entity-level) filing of tax returns and quarterly payments
  - Estimated installment payments for nonresident members
- These rules apply to:
  - S Corps
  - Partnerships
  - LLCs that elect federally to be taxed as partnerships

Entity pays: composite filing

- A pass-through entity files a “composite return,” which is one income tax return for entire entity showing income allocable to each member, when:
  - Entity elects to file a composite return for some or all nonresident members; or
  - Commissioner of Taxes requires entity to file composite, because entity has more than 50 members who are not residents of Vermont.
- Composite filing by the entity is paid:
  - At the middle marginal income tax rate of 7.6%; and
  - Generally, in quarterly payments on the 15th day of April, June, September, and January.
- Members do not have to file or pay individually when the entity files a composite return and makes estimated payments, unless the member has other income.

Entity pays: nonresident members

- If a pass-through has nonresident members, entity must make estimated installment payments for all nonresident members.
  - Entity with nonresident members can elect (or, if larger than 50 members, will be required) to file a composite return.
  - Entity cannot delegate payment to individual nonresidents.
- Nonresident estimated payments by the entity are paid:
  - At the next-to-lowest marginal income tax rate of 6.6%; and
  - Generally, in quarterly payments on the 15th day of April, June, September, and January.
- Safe harbor for penalties on nonresident estimated payments:
  - To avoid penalties, entities must make quarterly payments of at least 90% of current year's liability or 100% of prior year's liability, then pay any remaining liability for current year liability by non-extended return due date.

Entity pays: minimum tax

- A $250 minimum tax is generally owed by all S Corps, partnerships, and limited liability companies electing to be taxed as a partnership under federal law and required to file a return in Vermont.
  - Exceptions:
    - No Vermont activity / income
    - Investment management partnerships whose annual investment income is less than $5,000 and whose total assets are less than $20,000

Recent changes

- 20% deduction in Tax Cuts and Jobs Act (TY2018-2025)
- Allows qualified pass-through businesses a 20% deduction, with some limits, of business income from individual taxable income.
  - For example, a taxpayer with $100,000 in net business income would be taxed on $80,000.
- This does not flow through to Vermont.

Recent changes

- SALT deduction cap in Tax Cuts and Jobs Act (TY2018-2025)
  - state and local tax (SALT) itemized deduction. I.R.C. § 164(b)(6).
  - $10,000 cap for individuals, but not for businesses

Recent changes

- Federal law granted IRS authority to audit and bill partnerships at entity-level in 2015.
  - This applied to all partnerships. Within partnership agreement, partners decide how to allocate tax, rather than requiring I.R.S. to bill each individual partner.
- Act 179 of 2022 authorized Dept. of Taxes to require Vermont reporting or to assess tax on partnerships following federal audits and adjustments and change in federal tax liability. 32 V.S.A. §§ 5866(c) and 5866a.

Conclusion

- Passthroughs are:
  - Businesses not structured as or electing to be taxed as a C Corporation
    - Big and small businesses
    - Individuals earning business income
- Members generally pay on personal income tax
  - But lots of exceptions to the rule, including $250 minimum tax (which itself has exceptions)
  - Larger pass-throughs are required to file composite