

# FEDERAL TAX CHANGES AND VERMONT IMPACTS 2025-2026

Kirby Keeton, Legislative Counsel  
2026

# Outline

- ▶ Changes that do not flow through.
- ▶ PIT changes that flow through.
- ▶ Corporate and business tax changes that flow through.
- ▶ Decoupling.

# Above the line or below the line?

## 26 U.S.C. § 63(b) Taxable Income Defined

- ▶ (b) Individuals who do not itemize their deductions - In the case of an individual who does not elect to itemize his deductions for the taxable year, for purposes of this subtitle, the term "taxable income" means adjusted gross income, minus—
  - ▶ (1) the standard deduction,
  - ▶ (2) the deduction for personal exemptions provided in section 151, ← personal exemptions
  - ▶ (3) any deduction provided in section 199A, ← qualified business income deduction
  - ▶ (4) the deduction provided in section 170(p), ← charitable contributions for non-itemizers
  - ▶ (5) the deduction provided in section 224, ← qualified tips
  - ▶ (6) the deduction provided in section 225 and ← qualified overtime compensation
  - ▶ (7) so much of the deduction allowed by section 163(a) as is attributable to the exception under section 163(h)(4)(A). ← qualified passenger vehicle loan interest

# Vermont Taxable Income Starts with Federal AGI

## 32 V.S.A. § 5811(21)

(21) “Taxable income” means, in the case of an individual, **federal adjusted gross income** . . .

## Do Not Flow Through:

- ▶ Personal Exemption for Taxpayers Aged 65 and Older
- ▶ Taxation of Tip Income
- ▶ Taxation of Qualified Overtime Compensation
- ▶ Interest on Passenger Vehicle Loans
- ▶ Charitable Contribution Deduction for Non-Itemizers

# Personal Exemption for Individuals Aged 65 and Older

Establishes a temporary personal exemption tax deduction of up to \$6,000 for individuals aged 65 and older. The deduction phases out starting at \$75,000 of AGI for individuals and \$150,000 for joint filers. The new deduction is temporary for tax years 2025–2028.

Also - Makes permanent the TCJA elimination of the personal exemption tax deduction.

# Taxation of Tip Income

Creates a new deduction of up to \$25,000 for qualified tip income. Available for occupations that customarily and regularly receive tips. The deduction is not an itemized deduction but is made from federal taxable income, which means it does not flow through to Vermont. Phaseout for taxpayers with MAGI exceeding \$150,000 (individuals) and \$300,000 (joint filers). Claiming the deduction requires a Social Security number and for married taxpayers to file jointly.

The new deduction is temporary for tax years 2025–2028.

# Taxation of Qualified Overtime Compensation

Creates a new deduction of up to \$12,500 (individuals) and \$25,000 (joint filers) for qualified overtime compensation. The amount paid in excess of the regular rate can be deducted, up to the cap. The deduction is not an itemized deduction but is made from federal taxable income, which means it does not flow through to Vermont. Phaseout for taxpayers with MAGI exceeding \$150,000 (individuals) and \$300,000 (joint filers). Claiming the deduction requires a Social Security number and for married taxpayers to file jointly.

The new deduction is temporary for tax years 2025–2028.

## Interest on Passenger Vehicle Loans

Creates a new deduction of up to \$10,000 for interest paid on a qualified passenger vehicle loan. Limited to vehicles with final assembly in the U.S. Phase out for taxpayers with MAGI exceeding \$100,000 (individuals) and \$200,000 (joint filers). The deduction is not an itemized deduction but is made from federal taxable income, which means it does not flow through to Vermont.

The new deduction is for interest paid or accrued in the taxable year on indebtedness incurred after 2024. The deduction is temporary for tax years 2025–2028.

## Charitable Contribution Deduction for Non-Itemizers

Creates a permanent federal charitable contributions deduction for taxpayers who do not itemize. The deduction is up \$1,000 for single filers and up to \$2,000 for joint filers. Limited to certain cash contributions.

Applies starting in tax year 2026.

## Personal Income Tax

Flows through:

- ▶ Expanded Phasedown for the Child and Dependent Care Credit

## Child and Dependent Care Credit

Expands the phasedown for the federal child and dependent care credit. The maximum credit rate is increased to 50 percent (from 35 percent) for AGIs of \$43,000 or less.

## Child and Dependent Care Credit

The 50 percent rate begins to phase down at \$15,000 of AGI. For AGIs between \$43,001 and \$75,000 for an individual return, and \$86,001 and \$150,000 for a joint return, the credit rate is 35 percent. The credit rate is phased down to 20 percent between \$75,001 and \$105,000 for an individual return and between \$150,001 and \$210,000 for a joint return.

## Child and Dependent Care Credit

The expanded phaseout of the federal credit will flow through to Vermont. Vermont allows a credit equal to 72 percent of the federal credit.

# Business Tax Flows through:

- ▶ Accounting Changes for Residential Construction
- ▶ Expanded Exclusion of Gains from Qualified Small Business Stock

## Residential Construction

Previously, the law allowed income from certain home construction contracts to be reported at the end of the contract (uniform capitalization) instead of when the income accrues (percentage of completion). The treatment was limited to home construction contracts for building four or fewer dwelling units or contracts completed within two years by taxpayers with \$31 million or less of gross receipts. This section expands that treatment to all residential construction contracts and all contracts completed within two years.

This change will flow to Vermont and will change the timing of when income is taxed so that it is taxed later than it would have under previous law.

## Gains from Qualified Small Business Stock

Applies to the personal income taxes of individuals, trusts, and pass-through entities that hold qualified small business stock (QSBS) and receive income by selling it.

Taxpayers who hold QSBS can exclude gains from sales of the stock on their federal tax returns, if they held it for long enough, up to a certain cap.

## Gains from Qualified Small Business Stock (cont.)

The change expands the federal exclusion for gains from QSBS to allow a 50 percent exclusion for QSBS held for three years, 75 percent exclusion for QSBS held for four years, and 100 percent exclusion for QSBS held for five years.

This section increases the per-issuer exclusion cap for QSBS from \$10,000,000 to \$15,000,000.

## Gains from Qualified Small Business Stock (cont.)

The aggregate-asset ceiling to be recognized as a “Qualified Small Business” is increased to \$75,000,000 in assets. This means more businesses will qualify to issue QSBS.

The expanded exclusion and increased exclusion cap flow through to Vermont.

# Corporate Income Tax

Flows through:

- ▶ Domestic Research and Experimental Procedures
- ▶ Amended Limitation on Business Interest Deduction
- ▶ Exceptions from Limitations on the Business Meals Deduction
- ▶ Increased Limitation on Expensing of Depreciable Business Assets
- ▶ Special Depreciation Allowance for Qualified Production Property
- ▶ Foreign-Derived Income

## Corporate Income Tax (cont.)

Flows through:

- ▶ Changes to Pro Rata Share Rules
- ▶ Renewal and Expansion of Opportunity Zones
- ▶ Charitable Deduction for Corporations

# Domestic Research and Experimental Procedures

Federal law will now allow a deduction for domestic research and experimental expenses in the year in which expenses are incurred.

Starting in 2022, domestic research and experimental expenses were required to be capitalized and amortized over five years. That meant that the tax benefit from the deduction was delayed as it incrementally took effect over those years.

## Domestic Research and Experimental Procedures

The section also allows taxpayers with up to \$31 million of gross receipts to retroactively deduct expenditures made since 2022. Other taxpayers may deduct remaining expenditures over the next two years.

## Amended Limitation on Business Interest Deduction

Federal law allows a corporate income tax deduction for the interest paid on loans used for a business purpose during the tax year. Taxpayers may deduct interest expenses paid or accrued but only up to a certain limit. The Reconciliation Act expands that limit, which will result in taxpayers claiming larger deductions. It further requires the limitation to be calculated before any unpaid interest is added to the principal of the debt.

## Amended Limitation on Business Interest Deduction

This deduction is for the interest on indebtedness and the changes provide a tax benefit to corporations that take on more indebtedness.

## Exceptions from Limitations on the Business Meals Deduction

The TCJA eliminated the general deduction of business entertainment expenses under 26 U.S.C. § 274(a) but kept a similar deduction for food and beverage expenses.

The Reconciliation Act kept the restrictions from TCJA and created exceptions for expenses relating to goods or services sold for adequate and full value (when the employee pays the same for the item as the general public), meals provided to crews on commercial vessels and oil platforms, and meals provided on certain fishing vessels and facilities.

## Increased Limitation on Expensing of Depreciable Business Assets

Increases the maximum amount that a taxpayer may expense for the costs of a qualifying depreciable business asset in lieu of recovering the costs through depreciation.

The maximum amount that can be expensed is increased from \$1,000,000 to \$2,500,000 and is indexed for inflation.

## Increased Limitation on Expensing of Depreciable Business Assets

The maximum amount of deduction is reduced after a certain amount of investment, which means this deduction is only used by “small business” taxpayers with no more than a few million dollars of investment.

The increased maximum amount for expensing qualifying depreciable business assets flows through to Vermont.

## Special Depreciation Allowance for Qualified Production Property

Allows an additional first-year depreciation deduction equal to 100 percent of the adjusted basis of qualified production property. Allows a taxpayer to claim the deduction for certain nonresidential real property acquired after January 19, 2025, and before January 1, 2029.

# Special Depreciation Allowance for Qualified Production Property

- ▶ Allows a taxpayer to claim 100 percent bonus depreciation for nonresidential property used in manufacturing, production, or refining of tangible personal property.
- ▶ Limited to properties that are being used for the first time for a qualified production purpose and is limited mostly to agricultural and chemical production.
- ▶ These properties are usually depreciated over 39 years instead.
- ▶ Depreciation is recaptured in full if the property is sold.
- ▶ Sunsets in 2028.

## Foreign Sourced Income

- ▶ The calculations used for taxing foreign sourced income included a deduction for 10 percent of the tax basis of qualified tangible assets in other countries (called qualified business asset investment (QBAI)).
- ▶ These sections eliminate QBAI from the calculation, which reduces the amount of earnings that may be deducted.
- ▶ Also increases the amount of credit that can be claimed for foreign taxes imposed on controlled foreign corporations of the taxpayer – the credit does not flow through to Vermont.

## Foreign Derived Income

The only change that flows through (QBAI) has a positive revenue impact.

## Changes to Pro Rata Share Rules

New rule - if a foreign corporation is a controlled foreign corporation (CFC) at any time during a taxable year, each U.S. shareholder that owns stock in the corporation must include in gross income their pro rata share of the corporation's passive income for the CFC's tax year.

Overall, taxpayers with stock in CFCs will have to report more gross income from those stocks than they would under the previous law.

# Renewal and Expansion of Opportunity Zones

Permanently renews and modifies the opportunity zones system created by TCJA. Starting in 2027, OZ designations will be implemented on a 10-year rolling basis.

- Allows investors to invest in a Qualified Opportunity Fund to support real estate development in areas designated as opportunity zones.
- A taxpayer can elect to defer the gain from these investments as long as they hold them.
- The longer an investor holds the investment before selling or exchanging it, the greater the tax benefit. It's possible to completely exclude the gain if the investment is held for at least 10 years.

# Renewal and Expansion of Opportunity Zones

35

Opportunity zones were set to expire at the end of 2026, but this act made them permanent. After these changes, state governors will propose new qualified opportunity zones every 10 years, which will require certification by the U.S. Treasury Secretary. The qualification requirements for what areas qualify were slightly tightened and some new reporting requirements were added.

## Renewal and Expansion of Opportunity Zones

Also creates Qualified Rural Opportunity Funds, which involve larger tax benefits for investing in certain zones that meet the requirements.

Most of the changes take effect on January 1, 2027.

## Charitable Deduction for Corporations

Previously, corporations could make deductible contributions of up to 10 percent of taxable income.

This change means that a corporate taxpayer may only claim deductions that exceed one percent of taxable income (floor) and that do not exceed 10 percent of taxable income (ceiling). Deductions that exceed the ceiling may be carried forward five years, but contributions that are disallowed because of the floor can only be carried forward if the ceiling was exceeded in that year.

# VT Decoupling from Federal Tax Laws

- Vermont Annual Link Up – 32 V.S.A. § 5824
- Pre-2002 - Vermont's PIT tax base was a percentage of federal taxable income.
- 2002 – Act 140 amended the starting point for Vermont's PIT tax base to federal taxable income.
- 2017 – Act 73 changed the starting point for Vermont's PIT tax base to federal AGI.
- 2018 (Spec. Sess.) – Act 11 made further structural changes to Vermont's PIT tax base in direct response to the federal Tax Cuts and Jobs Act of 2017.

# VT Decoupling from Federal Tax Laws

- The administrative challenges to decoupling vary according to each federal change.
- Mostly due to how the relevant federal sections are drafted and implemented by the U.S. government.

# VT Decoupling from Federal Tax Laws

Easier to decouple:

1. Deduction for domestic production.
2. Child and Dependent Care Credit Expansion

# VT Decoupling from Federal Tax Laws

Harder to decouple:

1. Expensing of domestic research and experimental procedures
2. Expanded business interest deduction
3. Expensing of small business assets
4. Opportunity zones