Definitions of Income

Income-Based Education Tax Study Committee

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Anatomy of a tax

Tax structure basics

Anatomy of a Tax: Tax Base

Tax Base [x] Tax Rate = Tax Liability

A **tax base** is defined by statutory language, minus any **exemptions** and **deductions**.

- An **exemption** is an exclusion from taxation and is usually limited to a particular group of taxpayers or item. An **exemption** can be full or partial.
- A **deduction** is an amount subtracted from the **tax base**.

Anatomy of a Tax: Tax Rate

Tax Base [x] Tax Rate = Tax Liability

- A **tax rate** can be fixed or tiered.
  - Vermont’s 6% 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. The taxpayer only pays the assigned rate for each dollar within that bracket.

Anatomy of a Tax: Tax Rate

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 taxpayer with $10,000 in taxable income would pay $500 in taxes because all income would be in the first bracket, or $10,000 x 5% = $500.

Anatomy of a Tax: Tax Liability

Tax Base [x] Tax Rate = Tax Liability

- The initial **tax liability** is determined by multiplying the **tax base** by the **tax rate**.
- A tax liability can be reduced by a **tax credit**. The final **tax liability** is the dollar amount that the taxpayer owes after subtracting the dollar amount of the **tax credit**.

Definitions of income

Personal income tax

Property tax credit

Renter credit

Personal income tax

Gross income

Adjusted gross income (AGI)

Taxable income

Gross Income

- Under the federal Internal Revenue Code, “gross income means all income from whatever source derived”, with certain exclusions. 26 U.S.C. § 61; *Commissioner v. Glenshaw Glass*, 348 U.S. 426, 431-33 (1955) (income is any accession to wealth).
  - Examples
    - Included in gross income: wages, tips, salaries, commissions, rent, royalties, interest, dividends, IRA distributions, pensions and annuities, capital gains, and cancellation of debt
    - Excluded from gross income: certain Social Security income, interest on State or local bonds, cancellation of certain student loan debt

Adjusted Gross Income (AGI)

- Under federal law, the term “adjusted gross income” means gross income minus certain exclusions and deductions. 26 U.S.C. § 62; 32 V.S.A. § 5811(21).
  - Examples of common federal adjustments to gross income
    - Teacher expenses; IRA deductions; student loan interest; tuition and fees
  - Other adjustments
    - Certain business expenses of reservists, performing artists, and fee-basis government officials; health savings account contributions; moving expenses for Armed Forces; the deductible part of self-employment tax; self-employed SEP, SIMPLE, and qualified plans; self-employed health insurance; penalty on early withdrawal of savings; alimony paid

Taxable Income

- Federal taxable income is gross income minus itemized deductions or the standard deduction and other misc. deductions. 26 U.S.C. § 63.
- Vermont’s personal income tax defines “taxable income” as “federal adjusted gross income determined without regard to 26 U.S.C. § 168(k)”, relating to bonus depreciation, and adds backs certain income and subtracts other types of income. 32 V.S.A. § 5811(21).
- Vermont taxable income is different from federal taxable income. There are certain items of income that federal law and the U.S. Constitution prohibit states from taxing. Other than those items, states can make policy decisions about including or excluding certain types of income from taxation.

Federal Income Tax Definitions …

Federal tax return (form 1040)

<u>Gross Income</u>
Wages, salaries, tips, dividends, capital gains, IRA/pensions, business income, etc.

minus

<u>"Above the Line" Deductions</u>
Examples: teacher expenses, student loan interest, self-employed plans, etc.

equals

<u>Adjusted Gross Income</u>

… Flow Through to Vermont

From federal form 1040

Adjusted gross income

plus

Additions to adjusted gross income

Bonus depreciation, interest from non-Vermont state and local bonds

minus

Subtractions from adjusted gross income

Standard deduction*
$6,350 for single filer,
$12,700 for married filer

Personal exemptions*
$4,350 for taxpayer, spouse, and any dependents

Other subtractions

- Interest income from U.S. bonds
- Capital gains exclusion
- Social Security exemption
- Medical expenses

equals

Vermont taxable income

*Amounts for tax year 2021; indexed annually for inflation

Property tax credit

Household income

Household Income

- Household income is intended to approximate the amount of income that an entire household has available to pay property taxes.
- It is not a tax base, but rather one factor in determining eligibility for and calculating the amount of a homestead property tax credit.
- Vermont’s statewide education property tax law defines “household income” as federal AGI with certain additions and subtractions. 32 V.S.A. § 6061(4)(A) and (5).

Household Income: **Additions** to AGI

- Trade or business losses from pass-throughs, rental losses and certain capital losses
- Alimony received
- Support money other than gifts
- Gifts received in excess of $6,500 in cash or cash-equivalents
- Cash public assistance and relief (not including property tax relief)
- Cost of living allowances paid to federal employees
- Allowances received by dependents of servicemen and women
- Roth IRA distributions representing investment earnings and not included in AGI
- Railroad retirement benefits
- Social Security Act benefits
- Veterans' Acts benefits
- Federal pension and annuity benefits not included in AGI
- Nontaxable interest received from state or federal government or any of its instrumentalities
- Workers' compensation
- Gross amount of “loss of time” insurance
- Amount of capital gains excluded from adjusted gross income
- Interest and dividend relief included in household income above $10K for claimants under 65, regardless of whether included in AGI

Household Income: **Subtractions** from AGI

- Social Security and Medicare taxes withheld
- Self-employment tax paid
- Child support paid
- Gifts from nongovernmental sources under $6,500 in cash
- Surplus food or other relief in kind supplied by a governmental agency
- First $6,500 earned by a full-time student dependent of claimant
- First $6,500 received by claimant's dependent parent or adult child with a disability
- Income attributable to cancellation of debt
- State payments for foster care, adult foster care, or to a family for the support of a person who is eligible and who has a developmental disability.
- Attendant care services with or without compensation, which allow claimant to remain in home or avoid institutionalization
- 6 adjustments to income … [see next slide]

Adjustments that Reduce Household Income

- Certain business expenses of reservists, performing artists, and fee-basis government officials.
- Health savings account deduction
- Deductible part of self-employment tax
- Self-employed health insurance deduction
- Alimony paid
- Tuition and fees

Note that there are also certain individuals whose income is not included because they are not considered to be part of the household.

Renter credit

Income

Income

For purposes of the renter credit, “income” is defined as federal AGI plus:

- Trade or business losses from pass-throughs, rental losses, and certain capital losses
- Exempt interest received or accrued during the taxable year
- 75% of federally nontaxable Social Security benefits
- Most federal adjustments:
    - Teacher expenses; certain business expenses of reservists, performing artists, and fee-basis government officials; health savings account deductions; certain IRA retirement savings deductions; student loan interest deduction; and tuition and fees deduction, etc.

32 V.S.A. § 6061(18)

Income

Like the definition of “household income” for the property tax credit, “income” for purposes of the renter credit is not a tax base, but rather one factor in determining eligibility for and calculating the amount of the renter credit.

Considerations for defining income

Constitutional limits

Existing law

Complexity

Constitutional Limits

- There are certain types of income that federal law and/or the U.S. Constitution prohibit or preempt states from taxing.
  - Example: railroad retirement income
- Vermont law accommodates these limits by statutorily excluding the preempted income or items from taxation.
  - Vermont personal income tax subtracts from AGI: "income exempted from State taxation under the laws of the United States". 32 V.S.A. § 5823(a)(1), (b)(4), (c).
  - Sales and use tax exempts: "[s]ales not within the taxing power of this State under the Constitution of the United States". 32 V.S.A. § 9741(1).
  - Property tax exempts: "real and personal estate owned by the United States". 32 V.S.A. § 3802(1).

Existing Law and Complexity

- Income can be defined in many ways. Creating new definitions, notably for more than one tax on income as a tax base, creates complexity. More complexity in the tax code may cause confusion and challenges for compliance by taxpayers and enforcement by administrators.
- Existing definitions of income, especially for the personal income tax, already have a developed body of federal and state case law that provide precedent and certainty.