Vermont Tax Structure Commission

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Backgrounder

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Taxation of Pass-Through Entities: Nonresident Withholding

What are pass-through entities and how are they taxed?

Most U.S. businesses are taxed as pass-through entities, which is a special business structure used to reduce the effects of double taxation. Pass-through businesses are not subject to an entity-level income tax, as C-corporations are, but instead allocate their income among the owners, who are responsible for paying tax on their share of the income.

Vermont, and all other states that levy a personal income tax, require taxation of income allocated or distributed to owners of a pass-through entity.[1] The majority of pass-through entities in the U.S. have owners that reside outside the state where the business is located, and more than three-quarters of the taxing states, including Vermont, require withholding of estimated tax for nonresident owners, which places the tax filing requirement on the owners.

Vermont, as well as other income-taxing states and the federal government, has found that nonresident withholding (NRW) against the income of nonresident owners of pass-through businesses is an effective and efficient way to ensure proper tax collection.

S-corporations, partnerships, and limited liability companies (LLCs) are all pass-through entities, which means that income is generally passed through to their shareholders, partners, or members (their owners), who are then responsible for paying tax on their share of that income.[2] The owners of pass-through entities can be individuals, trusts, estates, and other forms of corporations and partnerships, and owners may have residence anywhere in the world.

The withholding requirement for nonresident owners is at the entity level and has been adopted to ensure that tax is paid on all state-sourced business income that is passed through to their shareholders, partners, or members. Withholding is a prepayment of tax, similar to wage

[1] States vary on which owners of pass-through entities are taxed (i.e., individuals, corporations, partnerships, LLPs, LLCs, trusts, and/or estates).
[2] Sole proprietorships are also considered pass-through entities but have only a sole owner.

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withholding or estimated income tax payments, which is then claimed as a credit when the owners file an individual income tax return[3] with the state. A few states opt for a less complex approach by skipping the withholding requirement and requiring the business entities to file a single return, called a composite return, that reports, and pays tax, on the state income of all its nonresident owners. This approach spares owners the compliance burden of filing, but it is often less advantageous for taxpayers because the income is often taxed at the highest marginal rate and the owners are unable to utilize tax items such as personal deductions, credits, or losses from other businesses to offset their income tax liability.

A major wrinkle in what has been generally accepted practice of taxation for these types of businesses was introduced after Congress passed major tax legislation in 2017, entitled the Tax Cuts and Jobs Act (TCJA), which contained a provision that capped the amount of state and local income taxes that could be deducted for federal tax purposes. The cap applies to individuals, not businesses, and several states, most recently Rhode Island, have enacted changes to the way pass-through entities are taxed to allow an option for them to pay tax on the income at the entity level in order to preserve the federal deduction for state income taxes

How does Vermont tax pass-through entities and how much revenue is collected?

Vermont enacted legislation in 1996 to tax the pass-through income of S-corporations, partnerships, and LLCs, which included a provision for withholding an estimated tax for nonresident owners of the business. Vermont is one of over 30 states that requires nonresident withholding for out-of-state owners, and although there have been some minor changes to the law since enactment, the process for collecting taxes due on the allocable income has changed little in the last 20 years.

For tax year 2017, the most recent year of complete income tax data, the total tax due from all pass-through entity filers was $44 million, some paid in advance through estimated payments remitted on behalf of nonresident owners, and the remaining paid at the time of filing, either on a composite return or as additional payment. This amount does not necessarily match the total tax revenue from business income that the state collects after all income tax returns are processed, as we explain in this paper.

Vermont requires every entity with pass-through status and engaging in business activity[4] in Vermont to make estimated payments on behalf of shareholders, partners, or members who are not residents of the state.[5] The amount businesses must withhold is calculated by applying the applicable rate, currently 6.6%,[6] to their estimated Vermont-sourced income to be distributed or allocated to nonresident owners. In Vermont, these payments are submitted to the Department of Taxes (DOT) quarterly, on the same schedule as individuals who make estimated payments.

[3] Depending on the type of owner, they may instead be filing a corporate, estate or fiduciary return.
[4] See TB-70 for further information on activity that creates income tax nexus in Vermont.
[5] The schedule of payments is the same as for individuals.
[6] This is the second lowest individual income tax rate, dropped in 2018 from 6.8%.

Annually, these businesses are required to file an income tax return and attach either a composite or non-composite schedule. Owners who are included in a composite return are relieved of the obligation to file their own tax return, provided they have no other income or activity that creates a requirement to file in Vermont. Composite filing is mandatory in Vermont for entities that have more than 50 nonresident owners, and since 2014, entities below that threshold cannot file a partial composite return that includes only a portion of nonresident owners. Although composite filers account for only about a quarter of the filing entities with nonresident owners, they accounted for the lion's share of Vermont net income from pass-through entities in 2017.

Although a composite return would seem attractive to nonresident owners, many prefer to have the income pass through to them in order to take advantage of personal exemptions, other business losses, or itemized deductions to reduce their tax liability. Not surprisingly, then, most of the pass-through entities in Vermont with nonresident shareholders, partners, or members submit a non-composite schedule when filing their business income tax return, and their owners are required to file an income tax return. At that time, they claim the estimated payments submitted on their behalf by the business entity and pay any additional tax that is due or receive a refund if estimated payments exceed their tax liability.

Business entities that filed a non-composite schedule with their tax return in 2018 (for tax year 2017) paid about $28 million in NRW payments, according to data from the Department of Taxes. Individuals claimed over $16 million in NRW payments on their income tax return, and the balance of payments were made for other types of owners—C-corps, other pass-through entities, trusts, or estates.[7]

A business does not have to be based in Vermont to meet the requirement to make NRW payments for nonresident owners and to file an income tax return.[8] Out-of-state businesses engaging in activities that impose a requirement to file a return, e.g., banking, investment management, or real estate companies operating in Vermont,[9] probably account for some surprising data from recent business tax returns. The approximately 20,000 business entities that filed a return for tax year 2017 reported a total of nearly 590,000 shareholders, partners, and members, 95% of them identified as nonresidents. Business entities that filed with a Vermont address accounted for only 1% of the total number of owners but 82% of all resident owners.[10]

Nationwide, pass-through entities now account for more than 50% of total business net income, up from about 20% in 1980. More than 80% of businesses were organized as pass-through entities in 2014, up from 47% in 1980.[11] Similar to other states, Vermont has witnessed a shift in the types of businesses filing tax returns in the past eight years. Table 1 shows a 21% increase in

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[7] 72% of NRW payments were made on behalf of individuals and C-corporations in 2017, according to the DOT.

[8] Public Law 86-272 places some restrictions on states' ability to tax the net income of businesses located out of state but engaging in business activity within state borders, but there exists substantial rule-making and case law establishing the conditions for nexus.

[9] See Footnote #10 for additional information from federal returns data.

[10] It's not surprising that some businesses based outside of Vermont but having regular activity in the state would have some Vermont owners. The Tax Department does not verify the data on these lines of the form because it does not affect the tax calculation.

[11] Data from Joint Committee on Taxation (2017), and quoted by Tax Policy Center. These figures exclude sole proprietorships.

partnership filings in Vermont during the period,[12] while the number of C corp filings has declined 8% and the number of S corporations has stagnated.

Table 1: Growth in Different Business Types—Vermont 2009-2017

	2009	2010	2011	2012	2013	2014	2015	2016	2017
C Corp (1120)	10,436	10,386	10,285	10,121	9,798	9,738	9,777	9,637	9,559
S Corp (1120S)	14,649	14,620	14,213	14,208	14,233	14,331	14,608	14,568	14,468
Partnership (1065)	9,384	9,406	9,864	9,778	9,899	10,188	10,737	10,989	11,327

Source: Vermont Department of Taxes; data on LLCs and LLPs not available.

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Estimating the total amount of income generated by the business income tax in any calendar or fiscal year is probably impossible. The amount of withholding by pass-through entities for nonresident owners is carefully tracked by the Department of Taxes, as is the tax calculated and remitted on the business income tax forms. Data from the individual income tax return is easily accessible by the department and relatively straightforward to calculate. The difficulties arise when owners are C-corps or other pass-through entities, and the allocable or distributed income from one pass-through entity is mixed with other income, losses and gains, and other applicable deductions and credits.

When was the NRW requirement last reviewed?

The Department of Taxes has found that nonresident withholding from businesses operating in Vermont has proven to be a useful tool to ensure proper tax filing. Due to the complexity of pass-through organizational structures and their diffuse ownership, enforcement of nonresidents' tax obligations would prove very challenging without the requirement for nonresident withholding. This is especially true when a nonresident has few to no assets or ties to Vermont other than ownership in a business operating in the state.

That conclusion is shared by most states that tax pass-through income. However, the nonresident withholding requirement can be challenging to comply with and to administer. In response to external and internal feedback, the DOT initiated a PIVOT[13] project last year to review how it

[12] The IRS Statistics of Income (SOI) division annually publishes partnership data from federal tax returns. The latest publication was for tax year 2016 data and shows that 60% of all partnerships are classified in two industries—1) Finance and insurance and 2) Real estate rental and leasing—and they account for 77% of total assets owned by partnerships in the U.S.

[13] Governor Scott's Program to Improve Vermont Outcomes Together, initiated in 2017.

processes NRW and to make recommendations for improvement. The goals of the project were to identify and analyze the actual and perceived complexities, inconsistencies, and inefficiencies of the NRW process and to propose the most effective solutions.

Based on feedback from external stakeholders and leveraging the institutional knowledge within the Department, the PIVOT team identified several areas that needed particular attention. Although the team evaluated NRW from initial payment through filing, refunding, and billing, it focused on the rules for making payments, penalty rates for noncompliance, and abatement. Their conclusions and recommendations, which followed a review of other state practices, addressed all three topics, suggesting changes to rule and statute that should reduce unnecessary billing, as well as taxpayer confusion and frustration.

One argument to repeal the NRW requirement has been made on the assumption that most of the money is refunded to taxpayers when they file their return, thus incurring considerable staff and taxpayer time and resources for what results in little revenue to the State. The PIVOT team found that this was not the case. Using the most recent complete tax data, [14] they found that only 16% of all pass-through entities pay NRW and 67% of NRW payments were applied to pay the tax liability for individuals and corporations. This rate is not significantly different from that of estimated payments made by individuals and corporations, with 72% of payments applied directly to pay tax.

The subject of pass-through business taxation and nonresident withholding is complicated and presents administrative and compliance burdens. However, the growing presence of these types of businesses in our economy and the amount of income they generate is significant, and Vermont has a responsibility—both fiscally and as good tax policy—to ensure this income is fairly and effectively taxed.

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[14] The data is from 2015, the most recent tax year with complete personal and corporate income tax data available at the time.