Feedback to Tax Structure Commission from Joint Fiscal Office on Chapter 5 (formerly 4) – Income Tax -received by 12/10/2020

Commissioner Trenholm's Draft on Income, Estate Taxes – v11-16-2020

Status: Minimal changes since being discussed with Commissioners on 11/9. New additions (only p5) are in red font.

Chapter 54: Income Tax Reform

PERSONAL INCOME TAX

Personal Income Tax is the largest General Fund source of revenue in Vermont, accounting for nearly two thirds of those funds. It is also the largest "income tax" source of revenue in Vermont. The Personal Income Tax in Vermont tends to be more resilient to the aging population effect the entire country is facing as compared to other states, partially due to its treatment of income items as taxable which closely follows the federal treatment.

The Commission received only one item of public comment regarding the personal income tax. That comment was regarding the medical expense deduction which the legislature addressed in its 2019 session.

According to the JFO Ten-Year Tax Study, of the total income taxes collected in 2015, individual income tax was 86% of that total. In FY 2020, this tax is forecast to be 66% of General Fund sources.

The legislative change made to use federal adjusted gross income as the taxable starting point makes it easier to compare Vermont to other states because that is the most common tax base used by states as a starting point for taxable income. The legislature retained personal exemptions as well as a standard deduction for all taxpayers. This system puts all taxpayers in the same filing category with the same number of exemptions in parity, contributing to the "fairness" goal of our personal tax structure. The legislation retained a credit up to $1,000 for voluntary charitable contributions and a medical expense deduction which was added to give residents with high medical expenses, the primary population being older residents, the "fairness" our system strives to achieve.

There are four filing statuses with rates ranging from 3.35% to 8.75% with the highest rate starting at $200,200 of taxable income for single individuals, $121,875

Commented [A1]: I get 56-59%

Commented [A2]: He should probably use the data from Tom Kavet's forecast. It's still 86%.

Commented [A3]: This number is 56-59%. See the "Available General Fund" table in Tom's forecast.

Commented [A4]: Not sure what this means. Does this mean that the personal exemptions are the same across filing status? There are 4 filing status' still.

Commented [A5]: A modified one, where the deduction after the SD and PE are taken into account. Also, entrance fees to LTC facilities cannot be deducted.

for married filing separately, $243,750 for married filing jointly and $221,950 for head of household.

The Vermont income tax is a tiered rate tax which by its nature is a progressive tax. According to the JFO's Ten Year Tax Study, in 2015 with the top tax bracket of 8.95%, the average tax rate was 3.4%. The average tax rate takes into account all income taxes paid divided by all Vermont taxable income. For example, a person whose VT taxable income is $300,000 and is married filing jointly, would have a total Vermont tax of $ 19,698. The average tax rate in this case would be 6.6%, even though each dollar of taxable income over $243,750 is taxed at 8.75% because income below this threshold is taxed at lower marginal rates.

The Study also concluded that the upper 5% of taxpayers paid 48% of the individual income tax in 2015. This also supports other research done that shows the majority of the Vermont population is in the lower income cohorts, the higher the effective tax rate, more taxpayers would be in the upper income cohorts. It is important to note that pass through entity business income is part of the personal income tax revenue stream because, although the income may be generated from business activities, it is reported as personal income because it passes through to the individual owners.

The Ten-Year Tax Study also looked at Income Tax Expenditures by value. A tax expenditure is a tax deduction or credit that is available to decrease taxable income in the case of a deduction or exemption, or the actual tax itself, in the case of a tax credit. These expenditures are used to aid certain individuals or to incentivize certain behavior. According to the Ten Year Tax Study prepared by the JFO, in 2015, the Earned Income Tax Credit accounted for 49% of Vermont income tax expenditures, the 40% capital gains exclusion accounted for 18%, the flat $5,000 capital gain exemption accounted for 13%, the exclusion of income from Vermont Municipal Bond interest accounted for 5% and all others accounted for 15%. The legislature has reduced the 40% capital gain exclusion by placing a ceiling on the amount of gain that is subject to the exclusion which will bring down the cost to Vermont of this tax expenditure.

Recommendations of this Commission:

Commented [A6]: This is close, but again, there is more recent data here, like the annual income tax statistics from the Department of Taxes. Also, the top bracket is 8.75%.

Commented [A7]: Semantics, but I would call this the average effective tax rate, not the average tax rate.

Commented [A8]: Again, there is updated data on this, although this is likely pretty close.

Commented [A9]: This data should be updated with either the latest Tax Expenditure Report (2019 although a new one is coming out January 2021).

The Commission has few recommendations regarding the Personal Income Tax. The Legislature restructured the personal income tax within the last three years which incorporated the shift in the tax base from federal taxable income to federal adjusted gross income but retained the standard deduction and personal exemptions, added a tax credit for charitable contributions with a maximum credit of $1,000 and a formula based medical expense deduction. This was a major change to Vermont Personal Income Tax. These changes were recommended by the Blue Ribbon Tax Structure Commission in their 2011 report.

Recommendations made by the Blue Ribbon Tax Commission in that same report that were not adopted by the Legislature were:

- Implement a lower, flatter rate and bracket structure
- Implement a residential credit as a transparent alternative to deductions
- Evaluate all remaining personal income tax expenditures for removal
- Reduce the number of filing statuses from four to two, single and joint

In response to the first bullet point, the Legislature did reduce the top bracket by 0.2%.

In response to the second bullet point, the Legislature left in the standard deduction.

Vermont has one of the most progressive personal income tax structures in the cCountry. As this is one of the goals of a fair tax system, this Commission has minor recommendations to change the structure.

The Commission discussed a wealth tax in the spirit of progressivity. Many states have studied some form of wealth tax but have found that it is extremely difficult to administer and very subjective when it comes to valuation of assets that are not publicly traded or available. Florida had a form of wealth tax which it eliminated a few years ago because of its complexity in administration. The Commission does not recommend a wealth tax.

- Review the current system of renter rebate which is complicated and difficult to administer. The Commission recommends simplification to the calculation as well as restructuring the credit to conform to this Commission's recommendations within the Education Funding section of this report. The rebate can retain its character as a refundable credit with a scale based on income and eliminate the arduous verification process that

Commented [A10]: It also reduced the number of brackets from 5 to 4.

Commented [A11]: Worth mentioning that this is one reason for the property tax?

Also, at least six countries in Europe have a wealth tax plus British Columbia and Argentina: https://en.wikipedia.org/wiki/Wealth_tax

Commented [A12]: Does "current system of renter rebate" refer to the old system or the renter rebate reform package that was passed in 2020? It sounds like it is referring to the old system. If so, this section should be updated to address and analyze the new policy. Also, the new law takes effect 1/1/21, so it will be the current system when this report comes out on 1/15.

For another model that addresses both owners and renters, see the Maine Property Tax Fairness Credit Program https://www.maine.gov/revenue/taxes/tax-relief-credits-programs/income-tax-credits/property-tax-fairness-credit

requires landlords to issue a form to the tenant that must be included with the tenant's tax return.

- Continue to promote the remote worker program through incentives to move to Vermont. This will increase the taxpayer base in the state, providing additional personal income tax revenue and future stability to the personal income tax. It is also a climate conscious approach to increasing the population and tax base of the state which minimizes the amount of motor vehicle traffic which helps to minimize our carbon footprint.
- Study the "Benefits Cliff" and find ways to lessen the steepness of that cliff since it is a disincentive for taxpayers to earn more money due to the steep drop off of benefits which in many cases costs the taxpayer more in lost benefits than is made in additional wages.
- Continue to review the tax expenditures to ensure these expenditures are accomplishing the purpose for which they were intended.

PASS-THROUGH INCOME TAX

The Pass Through Income Tax (PIT), although more of a business income tax, generally falls under the Personal Income Tax structure due to its pass-through nature. Nationwide as well as in Vermont, most small businesses are organized as some form of pass-through entity, which passes taxable income and loss to its owners to be reported on the owner's personal income return. Therefore, this income although business related, is recorded as personal income and not business income.

The Commission received no public testimony regarding the PIT.

The Commission prepared a Backgrounder on the taxation of pass-through entities and non-resident withholding. Reference is made herein to that Backgrounder.

As with the rest of the country, the growth in pass-through entity as a choice of business entity for taxation has grown in popularity over the years. The following chart is from Table 1 of the Backgrounder for illustration purposes:

	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

Most LLCs are taxed as partnerships, LLPs are taxed also as partnerships. This table illustrates the shift from C Corporations which are taxed at the entity level, to

Commented [A13]: Still needed? Better to invest in broadband?

Commented [A14]: Which benefits cliff are we talking about here?

Commented [A15]: Be careful here, because there is no such thing as the Pass Through Income Tax. The Pass Through Income Tax is the personal income tax, with the exception of the business income tax BIT471 that pass-throughs file.

Commented [A16]: Confusing because PIT almost always means personal income tax.

Commented [A17]: JFO did an issue Brief on pass through entities in VT if interested on background.

pass-through entities, which are taxed at the individual level. This also accounts for the decrease in the percentage of total tax revenue that the corporate tax has exhibited.

The challenge in the tax collection from pass-through entities is not with entities that are owned by Vermont residents, rather with those that are owned by non-residents. Vermont presently has two ways to collect the tax from these non-residents at the entity level. The first is mandatory non-resident withholding required by the entity for entities with 50 or less non-resident shareholders, partners or members. Pass-through entities (PTEs) with more than 50 non-resident shareholders, partners or members are required to file a composite return, and business entities with less than 50 non-resident shareholders, partners or members may elect to file a composite return. The difference between non-resident withholding and composite filing is that owners who are included in a composite return are relieved of the obligation to file their own income tax return, provided there is no other income or activity that creates a requirement to file in Vermont.

In 2017, the Department of Tax initiated a Program to Improve Outcomes Together (PIVOT) project to study how it processes Non-Resident Withholding. The Department of Tax has implemented all changes that were recommended.

The Non-Resident Withholding is a very important part of the individual income tax collection structure. Although it places some administration on the pass-through entity itself, it is necessary to ensure collection of the tax from non-resident owners as well as parity with resident owners who are required to pay estimated taxes.

As a result of changes in federal tax law in the Tax Cuts and Jobs Act of 2017, the federal itemized deduction for state and local income, real property and other deductible taxes for individuals is capped at $10,000. This has led a handful of states to institute a tax at the entity level which is deductible on the entity level federal return, some mandatory and some elective. This entity level tax could be controversial in Vermont but could be a solution to the administrative burdens on the businesses as well as the Vermont Department of Tax through simplification of the process and the elimination of the need for non-resident individuals to file a Vermont return if that is the only Vermont source income they have. At present, many PTEs have tax-exempt partners that are exempt also from Vermont income tax. Unfortunately the Tax Department has no way of knowing if a member of a PTE is tax exempt unless they file a Vermont tax return, which many feel they do not have to due to their tax exempt status. This results in automatic assessments

against the business for the non-resident withholding that would be due on the income passed through to the tax-exempt member, if they were not tax exempt. This can be a major source of frustration for the business owner to have to resolve. Taxation at the entity level would eliminate that. The IRS has now ruled that these entity level tax structures will be respected.

Commented [A18]: This is really in the weeds tax stuff. Taxation at the entity level for pass-throughs is a good thing to explore.

Recommendations of this Commission:

- Study the effect on Vermont PTEs of an entity level tax for the reasons stated above to replace the present system of non-resident withholding and composite return filing.
- Consider mandatory composite filing for all PTE with non-resident members. Continue to allow the individual non-residents to file a Vermont return and take a credit for their share of the taxes paid. This would allow the individual to utilize available Vermont losses against the PTE income included in a composite return. This option would eliminate the burden on the business of justifying that a member is exempt from the withholding, and shifts the burden to the member to get a refund of the tax deemed paid on their behalf as part of the composite return and all of the correspondence that the Tax Department must generate to ensure compliance.

ESTATE TAX

Vermont is one of only twelve states that has an estate tax. Six other states have an inheritance tax. The only state in the geographic region of Vermont, i.e. New York and New England, only New Hampshire does not have an estate tax. According to the Ten-Year Tax Study conducted by JFO (2005-2015), the average annual estate tax revenue was $22.3M with years ranging from a high in 2011 of over $35M to a low in 2015 of less than $10M. By its nature, the estate tax is not a predictable and stable source of tax revenue as evidenced by the large swings from year to year in actual tax collected. According to the ~~In FY 2020, this tax is forecast to be 2% of General Fund sources and 1% of total revenue sources.~~

JFO Ten Year Tax Study, of the total income taxes collected in 2015, estate tax was 1% of that total. In FY 2020, this tax is forecast to be 2% of General Fund sources and 1% of total revenue sources.

The Commission received no public testimony regarding the estate tax.

The Vermont Estate Tax is assessed based on taxable estate before exemption, less a $5M exemption, with a flat tax rate of 16% on taxable income after applying the exemption.

The Vermont Estate Tax has been overhauled by the Legislature over the last four years and presently is in line both in rate and exemption amount with our neighboring states. For these reasons, the Commission did not study the Estate Tax in great depth.

The Commission discussed Inheritance Taxes as compared to the Estate Tax. The difference between the two taxes is as follows:

- The Estate Tax is assessed against the decedent's estate based on the fair market value of the decedent's taxable estate less the Vermont exclusion.
- An inheritance tax is assessed against the person receiving the inheritance, subject to certain exclusions depending on the relationship to the decedent.

The Estate Tax is assessed against the estates of both Vermont residents and non-residents who own property in Vermont. This effectively taxes the wealth transfer of assets located in Vermont, either by physical location or ownership by a Vermont resident. The decedent's property that is included in their estate receives what is known as a step up in basis to the fair market value of the property at the date of death. This stepped up basis becomes the new basis for the beneficiaries of the estate. There is a perceived fairness to the step up because the decedent acquired in most cases those assets with funds that had already been subject to the income tax. Elimination of the basis step up would subject the asset to both the estate tax and personal income tax when the property is disposed of by the beneficiary of the estate.

An inheritance tax would be paid by residents of Vermont who are beneficiaries of an estate, the estate being resident or non-resident of Vermont makes no difference. An inheritance tax coupled with the estate tax has the potential to tax the same assets twice. Also an inheritance tax would be much harder to enforce than the estate tax, since death is a matter of public record whereas an inheritance from a nonresident would need another layer of individual reporting which adds complexity to the system.

Recommendations of this Commission:

- Continue to monitor what our neighboring states are doing relative to the estate tax and also the federal estate tax legislation. Although the Vermont

Estate Tax has completely decoupled from federal, it is important to make sure the Vermont exemption is not greater than the Federal exemption since the Vermont exemption is set and not scheduled to change with any changes in the Federal estate tax exemption.

- Study the possible elimination of the present estate tax structure and replace it with a "capital gain" type of tax on death, similar to the Canadian structure. This type of structure would still need to have some form of exemption to maintain the progressivity of Vermont's overall tax structure. This would be a major change and would have to be carefully analyzed since no other state has this structure.

Commented [A19]: More explanation would be helpful: As there is no inheritance **tax** in **Canada**, all **income** earned by the deceased is **taxed** on a final return. ... Any resulting **capital gains** are 50% taxable and added to all other **income** of the deceased on their final return where **income tax** will be calculated at the applicable personal **income tax** rates (Turbotax)

- Consider updates to Vermont Estate Tax Statutes as federal changes are made.

CORPORATE INCOME TAX

The corporate income tax is a tax levied on the taxable income of a corporation that is taxed as a C Corp, thus not a PTE and the corporation, not the individual pays tax on the taxable income. Vermont is one of 45 states, as well as the District of Columbia that levy a corporate income tax on business profits. According to the JFO Ten Year Tax Study, of the total income taxes collected in 2015, corporate income tax was 13% of that total. Reference is made to the **Personal Income Tax** and **Pass-Through Income Tax** sections of this report which discusses the shift to pass through entities as the most common entity structure which explains why the corporate tax collections are low when compared to the total income tax collections. In FY 2020, this tax is forecast to be 8% of General Fund sources and 5% of total revenue sources.

The Commission received no public testimony regarding the corporate income tax.

One controversial source of corporate tax revenue as a result of the 2017 Tax Cuts and Jobs Act has been the repatriation of foreign earnings. It is the opinion of both the Vermont Department of Tax and Legislative Council that this repatriated income is subject to Vermont tax and has accounted for an uptick in 2019 and expected 2020 fiscal corporate tax collections. The Commission did not study this element as it is considered to be a one-time ~~affect~~ effect based on a major change in federal tax law.

The Vermont Corporate Income Tax Brackets are as follows:

Tax Bracket (taxable income)	**Tax Rate** (%)
$0+	6.000%
$10,000+	7.000%
$25,000+	8.500%

The starting point in calculating Vermont taxable income is federal taxable income plus or minus state specific differences.

The Commission prepared a Backgrounder entitled Corporate Income Tax-Sourcing of Sales of Services in May of 2019. The legislature decided to take up this same topic and before the session ended, had passed legislation to change the way income is apportioned to Vermont for services revenue. Vermont had been using the cost of performance rule, apportioning the income based on where the cost of performance of the services is incurred. This was the traditional way of apportioning service revenue. Market based sourcing apportions the service revenue to the state which the benefit of the service is received or will be used. Reference is made to the Backgrounder for a more in-depth discussion of the different approaches. The legislation changed~~change~~ the sourcing of revenue to Market Based Sourcing.

Vermont, like many states, is a unitary tax state. Under a unitary tax approach, governments treat a multistate corporation as a group made up of all its local branches, instead of treating each local branch as an individual entity separated from the global chain. The profits that the multinational corporation declares as a group are then apportioned to each state where it operates based on how much of its real economic activity took place in that state. Further, under unitary tax, there are two approaches to determine what is included in the receipts factor numerator of each member, Joyce and Finnegan (both named after California Administrative Tax Decisions).

The difference between the “Joyce” and “Finnigan” methods is receipts factor calculation. ... Under “Joyce,” the receipts factor numerator of each member is calculated on its own. Under the “Finnigan” method, the numerator of the combined group is calculated as though the members of the combined group are a single entity. Vermont is a member of the Multistate Tax Commission (MTC) and

both Vermont and the MTC use Joyce. Currently, the MTC is hearing testimony and considering adopting Finnegan to replace Joyce.

Vermont currently uses a three-factor sales apportionment formula based on sales/receipts, property in Vermont and Payroll in Vermont all versus total sales/receipts, total property and total payroll. As of January 1, 2020, eighteen of the forty-seven states and DC that levied a corporate income tax still use the multi weighted factor approach. The rest use a single sale factor approach. The base for taxable income is federal taxable income with certain additions and subtractions for deductions Vermont does not allow like bonus depreciation. The Vermont differences between federal and state taxable income are in line with most other states.

Recommendations of this Commission:

- Request that the Tax Department study the effect of adopting Finnegan with respect to Unitary Tax apportionment. As a member of the MTC, if Finnegan is adopted by the MTC, although Vermont does not have to adopt it, conformity with the MTC as a member is important provided the switch is either revenue positive or at a minimum, revenue neutral.
- Request that the Tax Department study the effect of adopting a Single Sales factor approach to apportionment for multistate corporations. If feasible, this would put Vermont in a more competitive position since Vermont is one of only eighteen of forty-seven states with a form of corporate income taxation that uses the three factor approach. This could also add a competitive advantage to Vermont based businesses that are multistate businesses by not increasing their Vermont apportionment factor due to the fact the business is located in Vermont, its property is in Vermont and its payroll is primarily or exclusively in Vermont. This change, unless the legislature sees the competitive factor for Vermont businesses as the driving factor, should be at a minimum revenue neutral.

Continue to study tax expenditures related to the corporate tax to ensure they are still serving their intended purpose.

Commented [A20]: Some more normative statements here. Not a whole lot of academic literature out there that single sales factor boosts a state's manufacturing. Also, during the legislative wrangling over this, the MTC recommended that states have at least two factors for sales apportionment.