8. Income Tax Reform

PERSONAL INCOME TAX

Throughout the history of Vermont Taxation, Income Tax has proven to be the best indicator of a person's ability to pay. Paul Gillies mentions this in his paper "The Evolution of the Vermont State Tax System" which the Vermont Historical Society published in 1997.[1]

Personal Income Tax is the largest General Fund source of revenue in Vermont, accounting for 56-59% 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 solicited comments and the option to give testimony from a list of stakeholders regarding the tax system as it stands now, what parts of the system are troubling and suggestions from these stakeholders on improvements. Stakeholders include members of the business community, CPAs, the Vermont and Lake Champlain Chamber of Commerce, and many other groups.

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.

In 2018, 372,821 tax returns were filed. Of those, 207,166 returns, which represents 56% of returns filed, were filed showing Adjusted Gross Income (AGI) of less than $60,000. Of all returns filed, 80,901 were filed showing no tax which is 22% of all returns filed. An Earned Income Credit was claimed on 39,625 returns, which represents 11% of all returns filed. For those reporting AGI of $150,000 or greater, 24,916 return were filed which is 6.7% of all returns filed.

According to the JFO Ten Year Tax Study published in 2017 for years 2005-2015, of the total **income** taxes collected in 2015, personal income (PIT) tax was 86% of that total. This percentage stayed the same in Tom Kavet's

[1] Gillies, P. (1997). The Evolution of the Vermont State Tax System.

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report dated August 2, 2019. For FY 2018, the percentage increased to 89.7%. For FY 2018, PIT was 41% of total General Fund Revenues. In FY 2020, this tax is forecast to be 40.8% of General Fund sources by Tom Kavet in this same report.

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 allows personal exemptions across all four filing statuses, 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 modified 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. It does not, however, allow a deduction for fees to long-term care facilities.

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 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%

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,

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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:

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

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- 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 all brackets by .2% and reduced the number of tax brackets from five to four.

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 Country. 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 has not studied in-depth and is not recommending a wealth tax at this time although many European Countries have a form of wealth tax and some states are exploring some form of Wealth Tax.

- Continue to promote the remote workers living in Vermont and provide the things needed for remote work such as high speed broadband and expanded cell phone service. 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.

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- Continue to review the tax expenditures to ensure these expenditures are accomplishing the purpose for which they were intended. For instance, the Tax Department and JFO issued the Biennial Report, Vermont Tax Expenditures, on January 15, 2019. This report is done every Biennium. There are some expenditures that have remained at zero for FY 2016, 2017 and are project for FY 2020 to also be zero. Such expenditures, should be looked at more closely to see if they are obsolete and should be repealed, or if changes need to be made to modernize them.

Income Taxation related to Pass Through Entities (PE)

The taxation of PEs, 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. It is important for the reader to understand that Vermont Income Tax is either Individual or Corporate and not Individual and Business.

The Commission solicited testimony from various stakeholders as previously mentioned but received no public testimony regarding PEs.

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:

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	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. The main difference is that an LLC can elect to be taxed as either a flow through entity (partnership) if it has more than one member, a Disregarded Entity (DRE) if it is single member, a C Corporation subject to the Corporate income tax, or an S Corporation which is taxed as a PTE. An LLP is almost always taxed as a PTE. The other main difference is that an LLC member has limited liability whether part of management or not, and an LLP has general and limited partners. A general partner does not have limited liability protection and a limited partner cannot participate in management. This table illustrates the shift from C Corporations which are taxed at the entity level, to 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.

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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. The IRS has now ruled that these entity level tax structures will be respected.

Recommendations of this Commission:

- Study the effect on Vermont PEs of an entity level tax for the reasons stated above to replace the present system of non-resident withholding and composite return filing with the knowledge that the cap on SALT deductions for individuals at the federal level will sunset at the end of 2025 without a legislative extension. The entity level tax would have to add to the Principles of a Good Tax System, be efficient, and not be just to try and solve the SALT deduction cap at the federal level, bearing in mind that the federal cap on SALT deductions expires at the end of 2025..
- Consider mandatory composite filing for all PE 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

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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.

In FY 2020, this tax was forecast to be 2% of General Fund sources and 1% of total revenue sources.

The Commission solicited public testimony from stakeholders but received no public comments or 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:

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- 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 a 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:

1. Continue to monitor what our neighboring states are doing relative to the estate tax and also recommendations of the Multistate Tax Commission and 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

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Federal exemption since the Vermont exemption is set and not scheduled to change with any changes in the Federal estate tax exemption.

2. Study the possible elimination of the present estate tax structure and replace it with a “deemed sale” type of tax on death, similar to the Canadian structure. In Canada, the tax is assessed on the decedent’s final tax return and taxes fifty percent of the gain on the decedent’s estate property as if the estate property was sold at the fair market value at date of death, subject to certain rules such as marital transfers at death not being taxable until the second of the spouses dies. 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. There is also no US State data to model the effects of such a change, but there is data available from the Canada Revenue Agency (CRA).

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. 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. 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 comments or testimony from the solicitation sent to stakeholders regarding the corporate income tax.

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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 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. Legislation was passed and will become effective Januray 1, 2021 changing Vermont's sourcing of service revenue to Market Based.

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).

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The difference between the “Joyce” and “Finnigan” methods is receipts factor calculation. Under “Joyce,” a unitary member not having any apportionment factors in Vermont is not taxed in Vermont. Under the “Finnigan” method, taxation of the combined group is as though all of the members of the combined group are taxed in Vermont. 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.

Pursuant to Act 51, The Vermont Department of Tax (DOT) prepared “Act 51 Vermont Corporate Income Tax Report” and submitted it to the Legislature on December 16, 2019. In this report, the DOT studied a Single Sales Factor Apportionment and also the experience of states that switched from a multi-factor to a single factor, the exclusion of overseas business income of an affiliated group, changing the Bank Franchise Tax to tax banks under the Corporate Tax, and alternatives to the Corporate Tax such as a Gross Receipts Tax. Ther DOT’s conclusion was the following:

Each of these changes on its own will alter the landscape of Vermont corporate income and requires delicate consideration before abrupt delineations are made. Further, adjustments to tax regulations and/or statutes cannot be viewed in isolation as the impacts can spread over several tax types and taxpayers.

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.

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