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Fiscal Note

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S.45 – An act relating to an elective pass-through entity income tax and credit

As passed by the Senate[1]

Bill Summary

This bill would create a new elective, entity-level tax on certain pass-through businesses, including partnerships and S-Corporations.[2] This tax structure is often called a "SALT Cap Workaround" because the pass-through business member's share of entity-level tax paid would be considered a business expense for federal individual tax purposes. The amount of PTE tax that could be deducted from federal taxes would not be limited by the $10,000 State and Local Taxes (SALT) deduction cap implemented by the federal Tax Cuts and Jobs Act of 2017 (TCJA). The bill also creates a State personal income tax credit equal to 90% of the PTE tax paid by an individual. Taxpayers could receive a 90% credit for PTE tax paid to other states, as well. All members and officers of a pass-through entity would have to elect to be liable for the PTE tax and renew their election annually. The bill includes language that would repeal the PTE tax if federal limitations on the SALT deduction are repealed.[3]

Overall, this structure could significantly reduce a pass-through owner's federal taxable income and tax liability. JFO estimates that the PTE tax would reduce federal tax liabilities for members of a pass-through entity that pays the tax by approximately $10 to $20 million annually.

Fiscal Impact

JFO estimates the bill would increase Vermont General Fund revenues by approximately $800,000 annually in fiscal years 2024 through 2026. TCJA provisions that limit the size of the SALT deduction are currently set to sunset at the end of tax year 2025, limiting State revenue generation to those three fiscal years. S.45 would sunset the State PTE tax and credits once the federal SALT Cap is repealed.

There will be some administrative costs associated with setting up the new tax, but the Department of Taxes does not predict a need for additional staff.

[1] https://legislature.vermont.gov/Documents/2024/Docs/BILLS/S-0045/S-0045%20As%20passed%20by%20the%20Senate%20Official.pdf

[2] The rate is set in statute as the second highest marginal tax rate in 32 V.S.A. §5822, which in tax year 2023 is equal to 7.6%

[3] For an example of how the PTE Tax would work in the case of one hypothetical taxpayer, please see the Appendix at the end of this fiscal note.

Background and Details

Before 2018, the SALT deduction allowed a taxpayer itemizing deductions to deduct the full amount of certain taxes paid to state and local governments, including state income, sales, and local property taxes.

The TCJA made sweeping changes to the federal Internal Revenue Code, effective tax year 2018. Among the changes was the "SALT Cap," which limited the SALT deduction on personal income taxes to $10,000. The SALT Cap provision effectively increased the federal tax liability of taxpayers in states with high state-level tax burdens since they previously had the largest SALT deductions. However, it is important to note that the bill also included numerous other provisions that resulted in large aggregate tax decreases that more than offset the SALT cap's effect for many taxpayers.

The SALT Cap provision prompted states with higher state and local taxes to create workarounds. In 2019, Connecticut became the first state to introduce a PTE tax in response to the cap. As of March 2023, 32 states and New York City have a PTE tax.[4]

Estimate of State Revenues

The amount of State revenues that could result from the PTE tax depends on the relationship between the rate of the PTE tax and the corresponding credit on a shareholder's personal income tax.[5] Given the relatively small amount of State revenues gained from each taxpayer, and the small number of taxpayers who would benefit from this construct, JFO estimates an additional $800,000 in annual General Fund revenue in fiscal years 2024 through 2026 would be generated by the PTE tax as proposed.

This estimate depends on the number of pass-through businesses that elect to pay the new PTE tax. While taxpayers with large amounts of pass-through income would generally save money on their federal taxes if they elect the PTE tax, it may not be advantageous for all pass-through businesses. If fewer taxpayers elect to take the PTE tax due to the specifics of their tax situation or the structure of the PTE tax and corresponding credit, the revenue received by the State will decrease accordingly.

Estimate of Total Federal Benefits

JFO estimates that a PTE tax would reduce federal tax liabilities for taxpayers who are owners or shareholders of pass-through entities that elect to pay the PTE tax by $10 to $20 million annually.[6] Because most pass-through net income is earned by taxpayers with higher income, more than 70% of the estimated federal liability reduction would accrue to taxpayers with an average gross income above $500,000.

References

For more information about the evolution of SALT Cap workarounds nationally and the overall distribution of pass-through income in Vermont, please see the JFO Issue Brief "Passthrough Entity Taxes and SALT Cap Workarounds." https://ljfo.vermont.gov/assets/Subjects/Issue-Briefs-Relating-to-RevenueTax/da7a1411e3/GENERAL-363854-v1-SALT_Cap_Workaround_Issue_Brief.pdf

[4] https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-pte-map.pdf

[5] To better understand the mechanics of this relationship, one could think of the 90% credit as a 10% tax since the State would retain 10% of the PTE tax paid. Since that 10% is always higher than the marginal rates of the personal income tax system, the PTE tax would generate a relatively small amount of revenue from each pass-through business that elects the tax.

[6] https://ljfo.vermont.gov/assets/Subjects/Issue-Briefs-Relating-to-RevenueTax/da7a1411e3/GENERAL-363854-v1-SALT_Cap_Workaround_Issue_Brief.pdf

Appendix: Individual Taxpayer PTE Tax Example

The Vermont PTE tax as proposed in S.45 would generally follow this structure:

1. The business pays the PTE tax on its net income.
2. Shareholders divide the business' net income depending upon their shares and pay personal income tax on their share of the net income.
3. Each shareholder receives a refundable personal income tax credit for their share of PTE tax paid. This credit is meant to offset the personal income tax paid and avoid double taxing of the same net income, which would be taxed at the entity level.

Federally, the Vermont PTE tax would have the following impacts for shareholders of a pass-through entity:

- The PTE tax is deductible as an expense from their net income. When the profits of the business are divided amongst the shareholders, their share of the total net income is reduced by their share of the PTE tax paid.
- The deduction of the PTE tax lowers taxable income on their federal tax return and therefore reduces their tax liability.

In effect, the PTE tax allows a taxpayer to deduct state taxes as a business expense rather than as a traditional itemized deduction, reducing overall net income. Business expenses are not limited by the SALT Cap.

The following is an example of the PTE Tax. A business split equally between two partners would pay $152,000 in PTE tax on $2 million in net income. Each partner would be responsible for $76,000 of PTE tax paid. Note that in this example, the partners of the business are unrelated, and the calculations will only follow the tax situation of one of the owners of this business.

Table 1: Entity Tax Example, Vermont	
Business Net Income	**$2,000,000**
Partners	2
Split	50%
PTE Tax Rate	7.6%
PTE Tax Paid	**$152,000**
Partner Share of PTE Tax	**$76,000**

Table 2 shows how the credit for PTE taxes paid would apply to one partner's Vermont personal income taxes. At the federal level, each partner would be able to deduct $76,000 of PTE tax paid from net business income. Their net income would decrease from $1,000,000 to $924,000. The 90% credit for PTE taxes paid reduces the partner's personal income tax liability by $68,400, from $72,018 to $3,618.

Table 2: Vermont Personal Income Tax after Entity Tax Example	
Net Income	$1,000,000
Partner PTE Tax Deduction	($76,000)
Adjusted Gross Income	**$924,000**
Filing Status	Married

Children	0
Exemptions	2
State Income Tax Before PTE Tax Credit	$72,018
PTE Tax Credit (90% of PTE entity tax paid)	($68,400)
Total State Income Tax	**$3,618**

Finally, Table 3 shows the taxpayer's final federal and Vermont income tax liability with the PTE tax. The final liability includes both the shareholder's entity tax liability of $76,000 and $3,618 of state income tax remaining after applying a 90% credit for PTE tax paid. The impact of this proposal would mean the taxpayer pays $950 more in state taxes, saves approximately $22,500 in federal income taxes, for a net reduction in taxes of $21,546.

Table 3: Difference Between Total Taxes Paid by Scenario			
	Current Law	**With PTE Tax**	**Difference**
State Taxes			
State Entity Tax	0	$76,000	
State Income Tax	$78,668	$3,618	
Total State Taxes	$78,668	$79,618	**$950**
Federal Income Tax	$219,449	$196,953	**-$22,496**
Net tax liability			**-$21,546**