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 is their income taxed?

A pass-through entity (PTE) is a special business structure in which the income earned by the entity is passed through to their shareholders, partners, or members (the owners), who are then responsible for paying tax on their share of the income. PTE owners may have residence anywhere in the world and can be individuals, trusts, estates, or other partnerships, corporations, or limited liability companies (LLCs).

S-corporations and partnerships are organized and taxed as pass-through entities, and LLCs can elect to be taxed as a PTE.[1] C-corporations are not PTEs, as they are subject to an entity-level income tax, and their income is often taxed at a higher rate that PTE income. Most U.S. businesses are taxed as pass-through entities.

Vermont, and all other states that levy a personal income tax, require taxation of income that is allocated or distributed to owners of a pass-through entity.[2] The majority of PTEs 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.

How does nonresident withholding work and are there alternatives?

The nonresident withholding (NRW) requirement for nonresident owners is applied 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 shareholders, partners, or members. NRW is a prepayment of tax, similar to wage withholding or estimated income tax payments, which is then claimed as a credit when the

[1] Sole proprietorships are also considered pass-through entities but have only a sole owner.
[2] States vary on which owners of pass-through entities are taxed.

owners file an individual income tax return[3] with the state. 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.

However, 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-sourced 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 may be unable to file a return and utilize tax items such as personal deductions, credits, or losses from other businesses to offset their income tax liability.

A recent federal tax change included in the 2017 Tax Cuts and Jobs Act (TCJA), which capped the amount of state and local income taxes that individuals may deduct for federal tax purposes, has spurred some states to find a legislative workaround that would protect individual owners of pass-through entities. These efforts are summarized later in this paper.

What is Vermont's tax process for PTEs 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.[4] Although there have been some minor changes to the law since enactment, the process for collecting taxes on all state-sourced allocable income has changed little in the last 20 years.

Vermont requires every entity with pass-through status and engaging in business activity in the state[5] to make estimated payments on behalf of shareholders, partners, or members who are not residents.[6] The withholding amount is calculated by applying the applicable rate, currently 6.6%,[7] to the estimated Vermont-sourced income that the business expects to distribute or allocate 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.

Annually, these businesses are required to file a business income tax return (Form BI-471) and attach either a composite or non-composite schedule. PTEs that elect, or are required, to file a composite schedule relieve their nonresident owners 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 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

[3] Depending on the type of owner, they may instead be filing a corporate, estate or fiduciary return.
[4] Publicly traded partnerships (PTP) have never been taxed in Vermont. The exemption was made explicit in 2015 (Act 57) when language to that effect was added to statute, which included a reporting requirement on each partner with VT-sourced income greater than $500. This information is apparently not being transmitted to the Department.
[5] See TB-70 for further information on activity that creates income tax nexus in Vermont.
[6] The schedule of payments is the same as for individuals.
[7] This is the second lowest individual income tax rate, dropped in 2018 from 6.8%.

portion of nonresident owners. Only about a quarter of the filing entities with nonresident owners filed a composite return, but they accounted for the lion's share of Vermont net income claimed by pass-through entities in 2017.

Although a composite return may be attractive to many nonresident owners, some 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, given the all-or-nothing provision for composite filers with fewer than 50 nonresident owners, most of the pass-through entities in Vermont submit a non-composite schedule when filing their business income tax return, and each owner is 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.

Pass-through entities that filed a non-composite schedule with their business tax return in 2018 (for tax year 2017) were responsible for $28 million in NRW payments, according to data from the Department of Taxes (DOT). Individuals filing a Vermont tax return that year claimed over $16 million in NRW payments, about 57% of the total, and the balance of payments were made for other types of owners—C-corps, other pass-through entities, trusts, or estates.[8] Nonresidents who are included in a composite return and wish to file an individual tax return may take a credit for their allocated share of the tax paid.

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. 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 explained in the next section.

Are only Vermont-based PTEs required to make NRW payments?

A PTE located in another state may have sufficient economic nexus with Vermont to impose the requirement to file an income tax return and remit NRW payments on behalf of its nonresident owners.[9] Tax department data indicates that about half of all PTE taxpayers that filed the business income tax return are based out of state.[10] Such out-of-state businesses operating in Vermont, for example, those engaged in banking, investment management, or real estate,[11] probably account for the surprisingly large number of owners reported on recent business tax returns. The approximately 20,000 PTEs 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.

[8] According to the DOT, 72% of NRW payments were made on behalf of individuals and C-corporations in 2017.
[9] 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.
[10] This population does not include those PTEs that file the short form, have no nonresident owners, and owe only the minimum tax of $250.
[11] See Footnote #10 for additional information from federal returns data.

Business entities that filed with a Vermont address accounted for only 1% of the total number of owners but 82% of all resident owners.[12]

Nationwide, PTEs 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.[13] 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 partnership filings in Vermont during the period,[14] 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.

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 PTEs have a multi-tiered ownership structure, where owners are other pass-through entities or C-corps, 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.

[12] 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.
[13] Data from Joint Committee on Taxation (2017) and quoted by the Tax Policy Center. These figures exclude sole proprietorships. The Brookings Institution states that 95% of all businesses in 2015 were PTEs.
[14] 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.

When was the NRW requirement last reviewed?

The DOT initiated a PIVOT[15] project in 2017 in response to external and internal feedback on how it processes nonresident withholding. 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. Although the PIVOT team evaluated all aspects of NRW, it identified the rules for making payments, penalty rates for noncompliance, and abatement as areas that needed particular attention. Their conclusions and recommendations, which followed a review of Vermont's and other state practices, addressed all three topics and suggested changes to rules and statute to reduce unnecessary billing, as well as taxpayer confusion and frustration. All the suggested changes have been implemented.

One argument for repealing the NRW requirement assumed that most of the money withheld was refunded to taxpayers when they filed their return, thus incurring considerable staff and taxpayer time and resources for little in net revenue to the State. The PIVOT team found that this was not the case. 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, according to the most recent complete tax data.[16] 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 team also considered a recommendation that Vermont offer the option of an exemption from the NRW requirement for nonresidents who have no tax liability, such as that offered by New York state. After research and consulting with administrative officials in that state, the team concluded that it imposed a considerable burden on audit resources and made identifying, tracking, and ensuring that state-sourced income is properly taxed more difficult, especially in multi-tiered entities.

As a result of the PIVOT team's work, the Department reaffirmed the need for NRW, though it recommended a drop in the withholding rate. DOT has found it to be a useful tool in ensuring proper tax filing due to the complexity of pass-through organizational structures and their diffuse ownership. Without it, enforcement of nonresidents' tax obligations would prove very challenging, especially when a nonresident has few to no assets or ties to Vermont other than ownership in a business operating in the state.

Are there other models for taxing PTEs?

One alternative to NRW has come about as an unintended consequence of a provision in recent federal tax legislation. As part of the Tax Cuts and Jobs Act (TCJA) of 2017, Congress 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 have enacted changes to the way pass-through entities are taxed to allow an option for them to pay tax on all state-sourced income at the entity level. These workarounds differ in their specifics, including whether the entity-level tax is mandatory or elective, but all aim to preserve the federal deduction for state income taxes

[15] Governor Scott's Program to Improve Vermont Outcomes Together.
[16] The data is from 2015, the most recent tax year with complete personal and corporate income tax data available at the time.

paid by pass-through businesses. To avoid double taxation, states allow PTE owners an offsetting credit for taxes paid by the entity or the ability to exclude income from their individual returns that has been taxed at the entity level.

These new laws—in Connecticut, Wisconsin, Oklahoma, Louisiana, and Rhode Island[17]—create tax systems for pass-through entities similar to composite filing, in effect if not intent, but it's too early to tell whether IRS rules or court challenges will slow or reverse state efforts to enact entity-level taxes. These initiatives are worth monitoring. Although a mandatory entity-level tax may be controversial in Vermont, whether patterned on one of the new state-level taxes or as an extension of our existing composite tax, it holds the promise or relieving the burden on taxpayers if coupled with an offsetting credit or the ability for owners to recompute income on their tax return, and on administrators by simplifying the process of ensuring this income is fairly and effectively taxed.

[17] Similar laws have been considered in Arkansas, Michigan, Minnesota, and New Jersey.