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ISSUE BRIEF

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Pass-Through Businesses in Vermont: A Snapshot

Vermont, like the Federal government, taxes the net income or profits of businesses differently depending on how they are structured. Sole proprietorships (single-owner businesses), partnerships, and S-corporations do not pay the corporate income tax. Instead, all profits are "passed through" to the individual or shareholder's personal income tax return, where they are taxed at personal income tax rates. For this reason, these businesses are called "pass-throughs."

This Issue Brief analyzes the landscape of the two major types of pass-through businesses (sole proprietorships and S-corporations/partnerships) using two data sources. Key findings:

A) Pass-throughs are an important source of personal income tax revenue for the State.

- In 2017, 53,429 resident Vermont tax returns reported some amount of income from a sole proprietorship, while 17,794 reported income from a partnership or S-corporation.[1]
- These resident pass-throughs had total net business income[2] of $1.8 billion, which is approximately 8.5% of total Vermont resident income, and it is estimated that they will contribute at least $109 million in personal income tax (PIT) revenue in FY 2020, equal to 12% of total PIT revenues for the year.

B) Between 2009 and 2017, sole proprietor income stagnated while S-corporation/partnership income rose significantly.

- Real income of sole proprietorships grew only 5%, while growth of S-corporation/partnership income was 39%. Total S-corporation/partnership income surpassed sole proprietorship income in 2014 for the first time.
- The number of returns reporting pass-through income was virtually flat during this time period. There were 776 fewer sole proprietorship returns in 2017 compared to 2009, while there was a gain of 385 S-corporation/partnership returns.

C) The vast majority of pass-throughs report modest amounts of income. However, to a much greater extent than income taxes as whole, a very small number of large pass-throughs account for most of the total profits.

- In tax year 2017, 93% of sole proprietorships reported net business income of less than $50,000. However, 73 returns with greater than $500,000 in net income (0.1% of the population) accounted for 25% of the total profits.
- 82% of S-corporation/partnership returns reported net business income of less than $50,000. 247 returns with greater than $500,000 in net income (1.3%) accounted for almost 40% of the total profits.
- For most individuals with pass-through income, business income is not a primary source of overall income. Only about 20% of tax returns with sole proprietorship income rely on business income for more than 75% of their total income. For S-Corps/partnerships, that number is only 10%.

D) The 20% business deduction created by the 2017 Tax Cuts and Jobs Act[3], while not having a direct impact on Vermont tax revenue, may create future uncertainties for Vermont's personal and corporate income taxes.

- An estimated 33,817 resident tax returns benefitted from the deduction, lowering their Federal taxes by almost $50 million.
- This significant tax advantage may induce C-corporations to structure as pass-throughs and give rise to more contract employment amongst workers or vice versa. Such changes could impact Vermont's tax revenues.

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[1] These numbers should not be interpreted as the number of businesses in Vermont. Rather, they should be interpreted as the number of individual income tax taxpayers who receive business income. Data source: Chainbridge Tax Model.
[2] "Net business income" and "profits" are used interchangeably in this brief. "Profits" should be interpreted as pre-tax.
[3] The new deduction allowed qualified pass-through businesses a 20% deduction, with some limits, of business income from individual taxable income. For example, a taxpayer with $100,000 in net business income would be taxed on $80,000.

I. Overview of Business Taxation

Businesses at both the Federal and Vermont level pay taxes based upon how they are structured. Depending on that structure, a business' profits will be subject to either the Corporate Income Tax or will be passed through to the personal income tax.[4]

C-corporations pay Vermont's corporate income tax. Profits of a C-corporation accrue at the business level and those profits are taxed using a bracket structure with increasing rates from 6% to 8.5%. Most C-corporation businesses pay the 8.5% rate (Table 1).

Table 1: Vermont Corporate Income Tax Table	
Taxable Income Bracket	**Tax rate**
$3,751 up to $10,000	6%
$10,000 up to $25,000	7%
$25,000 and over	8.5%

After paying the corporate income tax as a business, any remaining profits are distributed to the shareholders of the business as dividends. Those shareholders are required to pay personal income tax rates on those dividends. In theory, this double-taxation of profits is a tax disadvantage for C-corporation shareholders. However, in practice, much of C-corporation stock ownership is held in tax-exempt accounts such as individual retirement accounts (IRAs)[5].

There are numerous reasons why a business might structure itself as a C-corporation. C-corporations generally are better suited for businesses looking to raise money in public markets. C-corporations also have access to some deductions, particularly for employee benefits, that pass-through entities do not.

Pass-through entities, on the other hand, do not pay the corporate income tax. Instead, business profits are "passed through" to the owner's or shareholder's personal income tax returns. That income is taxed at Federal and Vermont personal income tax rates along with other earned and unearned income such as wages, capital gains, pensions, and Social Security income. The following are examples of pass-through entities:

- *Sole Proprietorships:* business is owned by a single owner to whom all profits accrue. The owner files a Schedule C when completing his or her income taxes each year.
- *Partnerships:* two or more individuals own and operate a business. All partners have equal ownership rights, and profits accrue to the partners.
- *S-corporations:* Similar to partnerships but S-corporations are not allowed to have more than 100 shareholders. S-corporations are also prohibited by law from being owned by another corporate entity. These corporations, along with partnerships, file Schedule E when completing their income taxes each year. An S-corporation can have a single owner or many shareholders.

Partnerships and S-corporations often will further structure themselves as Limited Liability Corporations (LLCs) in order to receive the same liability advantages as a C-corporation.

Once the owner's or shareholder's income is passed through to their personal income tax return, the resulting income after relevant deductions is subject to Vermont's individual income tax rates (Table 2).

[4] In less common instances, the income can be passed through to estates and trusts as well.
[5] "Is Corporate Income Double-Taxed?" *Tax Policy Center*. https://www.taxpolicycenter.org/briefing-book/corporate-income-double-taxed

Table 2: Vermont Personal Income Tax Table (Married Filing Jointly, 2018)		
If VT Taxable Income is over	**But not over**	**Tax rate**
$0	$64,600	3.35%
$64,600	$156,150	6.6%
$156,150	$237,950	7.6%
$237,950	-	8.75%

From a tax perspective, there are advantages to structuring a business as a pass-through. Consider the following example in Box 1 for a business with $500,000 in profits[6] and a single owner:

Box 1: 2018 Vermont Taxes on $500,000 in Net Business Profits: Pass-through vs C-Corporation		
	C-Corporation	**Sole-Proprietorship**
Marital Status (married)		
Net Income	$500,000	$500,000
Taxes		
Corporate Income Tax (entity level)	$41,800	Not Applicable
Personal Income Tax (owner/shareholder level)	$31,919	$35,576
of which: Business Income	$0.00	$35,576
of which: Dividends	$31,919	$0.00
Total Vermont Taxes	$73,719	$35,576
Effective VT Tax Rate Net Business Income	**15%**	**7%**

If this business were to structure itself as a C-corporation, it is first required to pay Vermont's corporate income taxes at the entity level. This means that the business, with profits of $500,000, pays $41,800 in Vermont corporate income tax. However, if the owner does not reinvest after-tax profits in the business, he or she would need to pay $31,919 in personal income tax once he or she distributes the after-tax profits to shareholders in the form of dividends[7] (in the case of a single-owner, all dividends would go to a single shareholder). In sum, this owner would pay $73,719 in Vermont taxes on the $500,000 profit, an effective State tax rate of 15%. In practice, many corporations will reinvest profits in the business rather than distributing all profits in the form of dividends. In some cases, the profits will be tax-deferred to future years until the owner sells the business and pays capital gains taxes on the appreciation in the value of the business. In other cases, the owner might pass the business onto a family member, so the profits are indefinitely tax-deferred.

However, if the business were to structure itself as a sole-proprietorship, it is eligible to pass those business profits directly to the owner's personal income tax return. The profits would be reported on Schedule C of the owner's federal tax return, which would flow through to Vermont's personal income tax return. That income, after deductions, would be subject to a total of $35,576 in Vermont personal income taxes.[8] As a pass-through, this business does not pay any corporate income tax, so the effective Vermont tax rate on the owner's profit is 7%, significantly lower than if the business were structured as a C-corporation.

This favorable tax treatment can help explain why the majority of businesses in the United States and Vermont are pass-throughs. Over the past 40 years, the number of pass-through businesses has grown significantly. Excluding sole

[6] Assume the $500,000 profit is net of any improvements and investments in the business. Also assume there are no other sources of income.
[7] As stated earlier, in reality, much of C-corporation stock ownership is held in tax-exempt accounts such as individual retirement accounts (IRAs), so dividends are distributed to tax-free vehicles.
[8] Note: these businesses also pay self-employment (SECA) taxes to the Federal government.

proprietorships, the share of U.S. businesses organized as pass-throughs went from 47% in 1980 to 80% in 2014. Pass-through businesses now account for more than half of total business income in the U.S., up from 20% in 1980.[9]

II. Major Findings

This Brief relies upon data from two sources:

- *JFO's Chainbridge Tax Model:* contains 2017 tax year data for personal income tax returns. This Issue Brief relies upon resident tax filers, largely due to the difficulties in interpreting business income information from nonresident tax returns.[10]
- *The Internal Revenue Service's state Statistics of Income*: contains information on income sources from federal personal income tax returns with a Vermont filing address. This does not necessarily mean the return was from a full-time Vermont resident. This dataset is advantageous because it contains multiple years of data.

These datasets have different figures for the number of pass-throughs and total income of pass-throughs. In general, the figures from both datasets are similar. Data from Chainbridge show a smaller number of pass-throughs, likely because the population used for this brief is limited to only resident returns.

A) Pass-throughs are an important source of personal income tax revenue for the state.

According to the latest data, pass-throughs are an important source of income for Vermonters and therefore, represent an important source of personal income tax revenue for the State.

In 2017, 53,429 resident Vermont tax returns reported having some level of **sole proprietorship** income on their personal income tax return, which is about 1 in 6 resident tax returns. The total net business income generated by those returns was $1.07 billion. That is approximately 5% of total Vermont resident income. It is important to note that these pass-through returns, while from resident Vermont taxpayers, could be from either in-state or out-of-state businesses income.

In that same year, 17,794 resident tax returns, or about 1 in 20 Vermont resident returns, reported some level of **S-corporation/partnership** income generating approximately $727.1 million worth of net business income. This is 3.5% of total Vermont resident income. It is important to note that an individual can report sole proprietorship and S-corporation/partnership income on a single tax return.

Together, it is estimated these pass-through returns will generate at least $109.4 million in personal income tax revenue in Fiscal Year (FY) 2020.[11] $61.2 million was from sole proprietorships and $48.2 million was from S-corporations/partnerships. However, these numbers are likely understated for two reasons:

- They do not include pass-through income from nonresident returns.
- There is evidence from 2018 tax returns from the Department of Taxes that tax year 2018 saw a large increase in business income. This $109.4 million estimate is based upon tax year 2017 data.

[9] "What are pass-through businesses?" Tax Policy Center. https://www.taxpolicycenter.org/briefing-book/what-are-pass-through-businesses

[10] One example is apportionment of income. Suppose a nonresident taxpayer had $100,000 in AGI, of which 25% was apportionable to Vermont. Suppose $15,000 of that $100,000 was from a pass-through based in Vermont. This situation could be accurately described as either a taxpayer with $25,000 in AGI with a $15,000 business in Vermont, or a $100,000 taxpayer with a $15,000 business in Vermont. Furthermore, the Chainbridge Tax Model does not allow JFO to analyze what portion of business income is Vermont-attributable.

[11] Note, this is an estimate based upon tax year 2017 forecast forward.

As with the distribution of pass-through income (covered in the next section of this brief), the total tax paid by pass-throughs is heavily-concentrated amongst higher-income taxpayers:

- 69% of total tax revenue from sole proprietorships comes from taxpayers with AGI above $500,000.
- 80% of total tax revenue from S-corporations/partnerships comes from taxpayers with AGI above $500,000.

For reference, only 20% of total personal income tax revenue comes from filers with more than $500,000 in AGI, which represent about 0.6% of total resident tax returns.

B) Between 2009 and 2017, sole proprietor income stagnated while S-corporation/partnership income rose significantly.

Data from the IRS from 2009 to 2017 seem to indicate a significant shift in the makeup of Vermont's pass-through landscape.

The number of returns with pass-through income was remarkably flat over the 2009-2017 period. In 2017, there were 776 fewer sole proprietorship returns than in 2009, while there were 385 more S-corporation/partnership returns.

Despite the number of pass-through returns being relatively flat, it appears as though the 2009 to 2017 period was one of strong profit growth for S-corporations/partnerships, while sole proprietorship profits were stagnant (Figure 1).

- Adjusted for inflation, real S-corporation/partnership net business income grew from $659.4 million in 2009 to $916.5 million in 2016, equal to 39% growth.
- Sole proprietor net business income increased from $782.7 million in 2009 to $818.5 million in 2017, equal to 6% growth.

It is not entirely certain why this is the case. Nationally, S-corporations and partnerships are the most common business type in the fields of construction, real estate, and professional, scientific, and technical services.[12] According to the Vermont Department of Labor, the percent of total private employment in these three industries has increased from 20.6% in 2005 to 21.6% in 2018, with the bulk of this growth coming in professional services. It is possible that the transition towards a more service-based economy has led to greater income for S-corporations and partnerships.

Both pass-through types saw their overall profits decline in tax year 2017 from a peak in 2016. It is likely that many pass-through owners in 2017 chose to shift their income into tax year 2018 to take advantage of lower tax rates and more generous deductions as part of the federal Tax Cuts and Jobs Act passed in late December 2017.

For reference, the largest source of income in Vermont, wages and salaries, saw real growth of 7% over the period.[13] Most of the real income growth during this period was from capital gains (148%), S-corporation/partnership income (39%), and dividends (41%).

Unlike S-corporation/partnership income, the data on sole proprietorship net business income is available pre-recession. As Figure 1 shows, by 2017, sole proprietorship net business income had still not achieved its 2007 pre-recession peak. In 2014, for the first time, total S-corporation/partnership profits surpassed that of sole proprietors.

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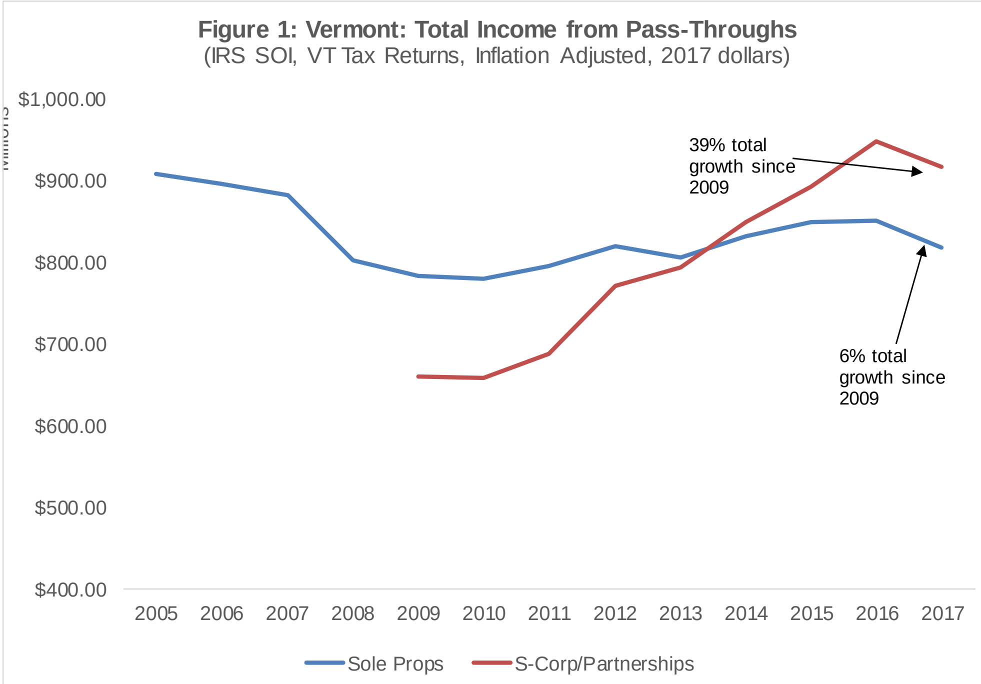
[12] "Background On Business Tax Reform." Joint Committee on Taxation. April 22, 2016. https://www.jct.gov/publications.html?func=startdown&id=4903

[13] According to the latest IRS data.



C) The vast majority of pass-throughs report modest amounts of income. However, to a much greater extent than income taxes as whole, a very small number of large pass-throughs account for most of the total profits.

Over the past thirty years, pass-throughs have become an increasingly important part of the business landscape in the United States. Research by the Joint Committee on Taxation in 2012[14] found that while the majority of pass-through businesses report modest amounts of income, a small number of very large pass-throughs account for a significant portion of total receipts.

As in the U.S., most of Vermont's pass-throughs are small businesses. However, that does not mean that all pass-throughs report modest profits (less than $50,000). Most of the net business income earned by pass-throughs in Vermont accrues to a very small number of large (greater than $500,000 in profits) pass-throughs.

There are different ways to measure the size of a business. This paper relies upon two measures:

- *Gross Income*: This is generally defined as income before any deductions and expenses, such as depreciation, car and truck, legal, meals, and wage expenses. This can be thought of as a proxy for total sales.
- *Net Income:* Defined as the income that remains after all deductions and expenses. This can be thought of as a proxy for pre-tax profits.

[14] "Background On Business Tax Reform." Joint Committee on Taxation. April 22, 2016. https://www.jct.gov/publications.html?func=startdown&id=4903

Measuring first by gross income, most pass-through income comes from a very small number of returns:

- *Sole Proprietorships*: In 2017, there were 53,429 resident tax returns reporting sole proprietorship income. 43,156 or 81% of these returns reported gross income of less than $50,000. These returns accounted for only 18.7% of total sole proprietorship gross income. At the other end of the distribution, 553, or 1%, sole proprietorship returns had gross income above $500,000, but accounted for 40% of total sole proprietorship gross income (Figures 2 and 3).

Figure 2: Number of Vermont Resident Sole Proprietorship Returns by Gross Business Income Group
(Tax Year 2017, Vermont Resident Tax Returns Only)

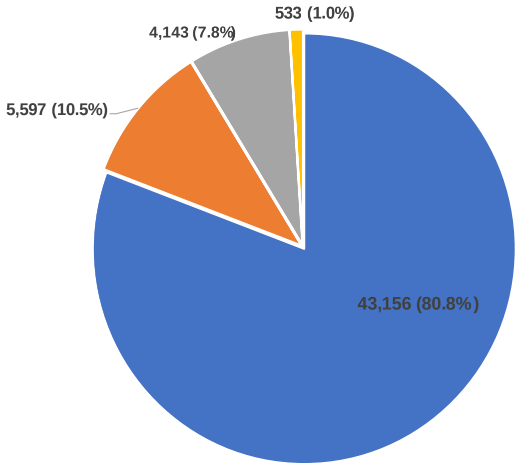
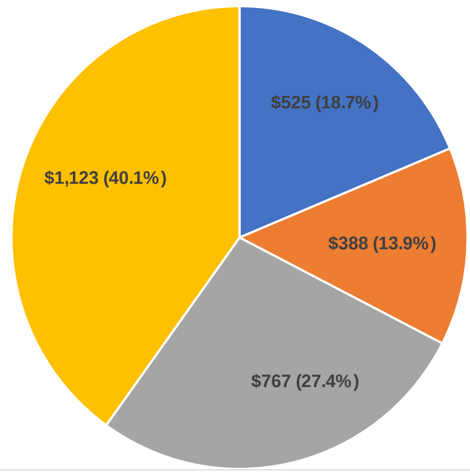


Figure 3: Total Gross Business Income for Sole Proprietorship Returns by Gross Business Income Group
(In millions of dollars, Tax Year 2017, Vermont Resident Tax Returns Only)



- *S-corporations/partnerships*: In that same year, there were 17,794 resident tax returns reporting S-corporation/partnership income. 13,886 or 78% of these returns reported gross income of less than $50,000, accounting for 12.7% of total gross income. At the same time, 320 or 1.8% of S-corporation/partnership returns had gross income of over $500,000 but accounted for more than 35% of total gross income (Figure 4 and 5).

Figure 4: Number of Vermont Resident S-Corporation/Partnership Returns by Gross Business Income Group
(Tax Year 2017, Vermont Resident Tax Returns Only)

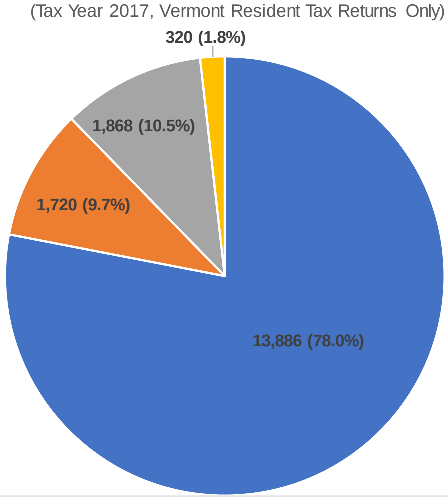
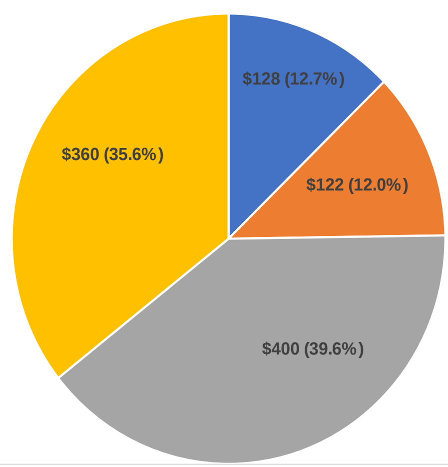


Figure 5: Total Gross Business Income for S-Corporation/Partnership Returns by Gross Business Income Group
(In millions of dollars, Tax Year 2017, Vermont Resident Tax Returns Only)



Measuring by net income, it becomes immediately clear that many businesses, after accounting for expenses and available deductions, reduce their taxable net business income by a significant amount. In fact:

- Sole proprietor gross income in 2017 was $2.8 billion for resident tax returns, but net income was only $1.07 billion. The largest sources of deductions appear to be wages, depreciation, and vehicle expenses. In any given tax year, more than 1 in 5 sole proprietor returns reports profits of zero or less.
- Resident S-corporation/partnership gross income in 2017 was just over $1.01 billion. but net income was $727 million. 32% of S-corporations/partnerships reports profits of zero or less.

Like the distribution of returns by gross income, most of the tax revenue comes from a very small number of returns with significant net income.

- *Sole Proprietorships:* 93% of returns had net business income of less than $50,000 and reported a total of $313 million in net business income (28% of the total). On the other end of the distribution, 73 sole proprietorship returns with greater than $500,000 in net business income (0.14% of total returns) accounted for more than 25% of total sole proprietorship profits (Figures 6 and 7).

Figure 6: Number of Vermont Resident Sole Proprietorship Returns by Net Business Income Group
(Tax Year 2017, Vermont Resident Tax Returns Only)

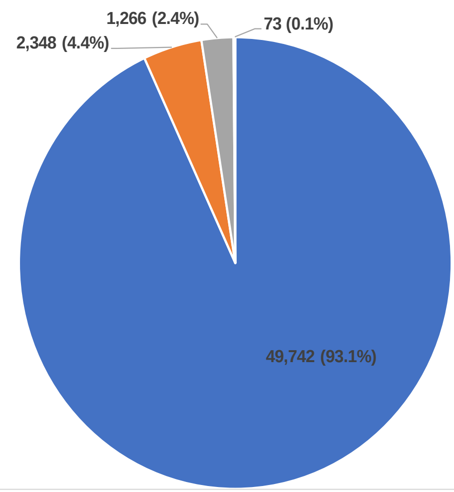
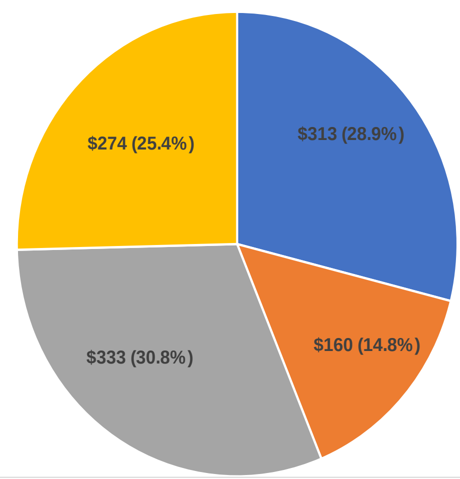


Figure 7: Total Net Business Income for Sole Proprietorship Returns by Net Business Income Group
(In millions of dollars, Tax Year 2017, Vermont Resident Tax Returns Only)



0 to $50,000 | $50,000 to $100,000 | $100,000-$500,000 | $500,000 +

- *S-corporation/partnerships:* Over 82% of S-corporation/partnership returns reported net income of less than $50,000, with aggregate net business income of $7 million. On the other end of the distribution, S-corporations/partnership returns with over $500,000 in net business income account for 1.3% of returns, but 40% of total profits (Figures 8 and 9).

Figure 8: Number of Vermont Resident S-Corporation/Partnership Returns by Net Business Income Group
(Tax Year 2017, Vermont Resident Tax Returns Only)

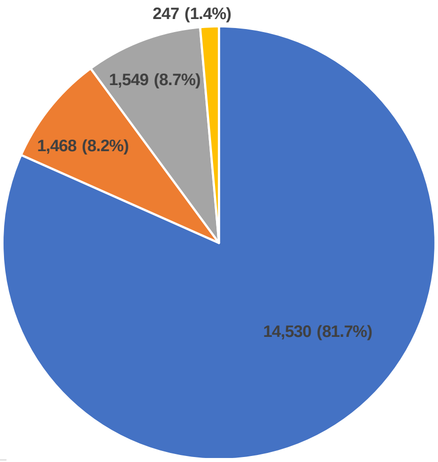
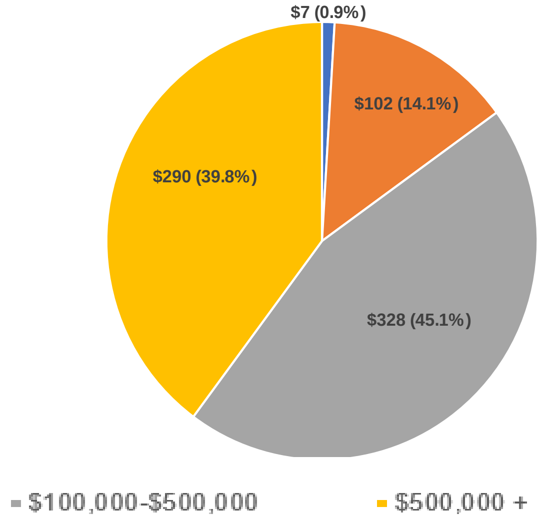


Figure 9: Total Net Business Income for S-Corporation/Partnership Returns by Net Business Income Group
(In millions of dollars, Tax Year 2017, Vermont Resident Tax Returns Only)



Pass-throughs can take many different forms. For instance, a person with a full-time job might sell crafts online as a hobby and structure their business as a sole proprietorship. On the other end of the spectrum, a multigenerational, highly profitable business could file taxes as the same type of entity. This analysis has found that most pass-through returns do not rely on business income as a major source of income.

Among sole proprietorship returns, only 20% relied on that income for a significant portion (greater than 75% of total income) of their overall income (Table 3). As net income of sole proprietorship returns rises, taxpayers are more likely to rely on that income for their livelihood. Sole proprietorship returns with greater than $500,000 in net business income were most likely to rely on business income as the primary source of income. However, even though only 20% of sole proprietor returns rely heavily on business income, those same business income-reliant returns make up 62% of total sole proprietor income.

The story is similar for S-corporations/partnerships. Less than 10% of total returns relied on business income for greater than 75% of total reported income. As with sole proprietorships, as the S-corporation/partnership business gets larger, the more likely the taxpayer is to rely on that income for a significant portion of their overall income. However, unlike sole proprietors, only 38% of total S-corporation/partnership income comes from these mostly business income returns (Table 3).

Table 3: Characteristics of 2017 VT pass-throughs with at least 75% of their total income from net business income									
	Sole Proprietorships					S-corporations/partnerships			
Net Income Group	Number of Returns with 75%+ Business Income	Percent of Total Sole Prop Returns	Net Income from These Returns (millions)	Percent of Total Sole Prop Net Income		Number of Returns with 75%+ Business Income	Percent of Total S-Corp Returns	Net Income from These Returns (millions)	Percent of Total S-Corp Net Income
Less than $50,000	9,131	18%	$139.01	45%		1,033	7%	$9.69	142%
$50,000 $100,000	1,050	45%	$73.04	46%		214	15%	$16.98	17%
$100,000 $500,000	625	56%	$118.44	60%		346	22%	$86.77	26%
Greater than $500,000	165	73%	$338.82	83%		152	62%	$162.06	56%
Total	**10,971**	**20.6%**	**$669.31**	**62.4%**		**1,745**	**9.8%**	**$275.51**	**37.9%**

Note: The "percent of total net income" columns may be near or over 100% for the group of returns under $50,000 because a significant number of returns in this group report negative income. As such, the total amount of income for the overall group may be less than the total amount of income for the 75% pass-through income group.

D) The 20% business deduction created by the 2017 Tax Cuts and Jobs Act[15], while not having a direct impact on Vermont tax revenue, may create future uncertainties for Vermont's personal and corporate income taxes.

In December 2017, Congress passed H.R.1, the Tax Cuts and Jobs Act (TCJA). The bill was a significant overhaul of personal and corporate income taxes. On the personal income tax side, the bill adjusted rates, and changed deductions, exemptions, and credits. On the corporate income tax side, the primary change was a lowering of the corporate tax rate from 35% to 21%. The bill was effective in tax year 2018.

One major change was the introduction of a new deduction available to individuals who have income from a pass-through entity. Formally called the Section 199A deduction, it allows for a 20% deduction of pass-through income on the individual's federal return. For example, if an individual had pass-through profits of $100,000, only $80,000 would be taxable at the federal level. The provision sunsets in 2025.

The deduction is limited for individuals who derive income "specified service businesses." These types of businesses include, but are not limited to, those in the fields of healthcare, law, accounting, actuarial sciences, performing arts, consulting, and financial services. For those individuals, depending on their taxable income, the deduction is phased out depending on the wages paid out to employees of the business.

Vermont's personal income tax code is largely decoupled from the federal tax code. Adjusted Gross Income (AGI) is the starting point for Vermont income taxes. The pass-through deduction allowed at the federal level is applied after AGI and, therefore, does not flow through to Vermont personal income taxes. This means Vermont pass-through returns do not receive any additional State tax benefit on top of the Federal deduction.

JFO estimates that among resident tax returns, the federal tax benefit of the pass-through deduction is approximately $47.5 million.[16] Almost 34,000 resident pass-through returns benefitted from the deduction for an average federal tax benefit of just over $1,400.[17] Because the income of pass-through entities is heavily concentrated towards the top parts of the income distribution, the federal tax benefits also accrued most to those groups (Table 4).

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[15] The new deduction allowed qualified pass-through businesses a 20% deduction of business income from individual taxable income. For example, a taxpayer with $100,000 in net business income would only be taxed on $80,000.

[16] This estimate is based upon tax year 2017 data forecast forward to tax year 2018.

[17] Because this estimate is based upon resident tax returns and relies upon 2017 tax data, it is likely that the tax benefit is higher. Including nonresident returns would increase the number of pass-through returns and there is early data from the Department of Taxes that tax year 2018 business income was higher than tax year 2017.

Table 4: Federal Tax Benefits of Pass-Through Deduction: VT Resident Pass-Through Returns (based upon tax year 2017 data)					
Adjusted Gross Income		Number of Returns	Total Federal Tax Change (in millions of dollars)	Average Tax Benefit	Change in Effective Tax Rate
Less than $0		0	$0.00	…	0.00%
$0	$10,000	37	$0.00	-$29	0.00%
$10,000	$20,000	1,953	-$0.11	-$57	-0.11%
$20,000	$50,000	8,241	-$1.66	-$201	-0.32%
$50,000	$100,000	11,215	-$5.36	-$478	-0.42%
$100,000	$150,000	6,082	-$6.58	-$1,082	-0.62%
$150,000	$200,000	2,596	-$4.80	-$1,850	-0.76%
$200,000	$300,000	2,071	-$6.37	-$3,074	-0.88%
$300,000	$500,000	1,129	-$4.64	-$4,109	-0.72%
$500,000	$1,000,000	315	-$2.43	-$7,708	-0.43%
Greater than $1,000,000		178	-$15.57	-$87,491	-1.07%
Total		**33,817**	**-$47.52**	**-$1,405**	**-0.69%**

Because this deduction is not a part of Vermont's personal income tax code, the State does not forgo any tax revenue directly. However, this new deduction could incentivize Vermont workers and businesses to structure themselves as pass-throughs. This might have indirect consequences on Vermont's tax system and labor markets. Possible examples include:

- *Switching of business classification:* It is unclear what effect tax reform will have on business classification.
  - Smaller businesses currently structured as C-corporations paying the corporate income tax may decide it is more advantageous to become a pass-through such as an S-corporation.[18] In almost all cases, Vermont's corporate income tax rates are higher than the effective rates a pass-through business would pay through the personal income tax. For almost any given amount of net business income, the State receives less tax revenue if the business is structured as a pass-through versus a C-corporation, as noted in Box 1.
  - On the other hand, there is also some evidence that because the federal government lowered the corporate income tax rate to 21%, there is less incentive to be structured as a pass-through, particularly for high-income pass-throughs. One study found that 17.5% of total U.S. pass-through income will switch to C-corporations.[19] If this were to be the case, it would be advantageous to Vermont overall tax revenue because Vermont's effective corporate income tax rates are higher for most levels of business income.
- *Shifts towards consultant, contracted labor:* The new deduction could create an incentive for a worker to set up a pass-through and contract with an employer rather than becoming a full-time employee. The contractor's pass-through business would qualify for the pass-through deduction.[20] In practice, this option may be limited to certain types of workers. Vermont and Federal laws restrict the ability of firms to use independent contractors

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[18] "Eliminate The Deduction For Qualified Business Income And Require Most Firms To Be Taxed As Pass-Throughs" Tax Policy Center. June 2018. https://www.taxpolicycenter.org/taxvox/eliminate-deduction-qualified-business-income-and-require-most-firms-be-taxed-pass-throughs

[19] "Projecting the Mass Conversion from Pass-Through Entities to C-Corporations" Penn Wharton Budget Model. June 2018. https://budgetmodel.wharton.upenn.edu/issues/2018/6/12/projecting-the-mass-conversion-from-pass-through-entities-to-c-corporations

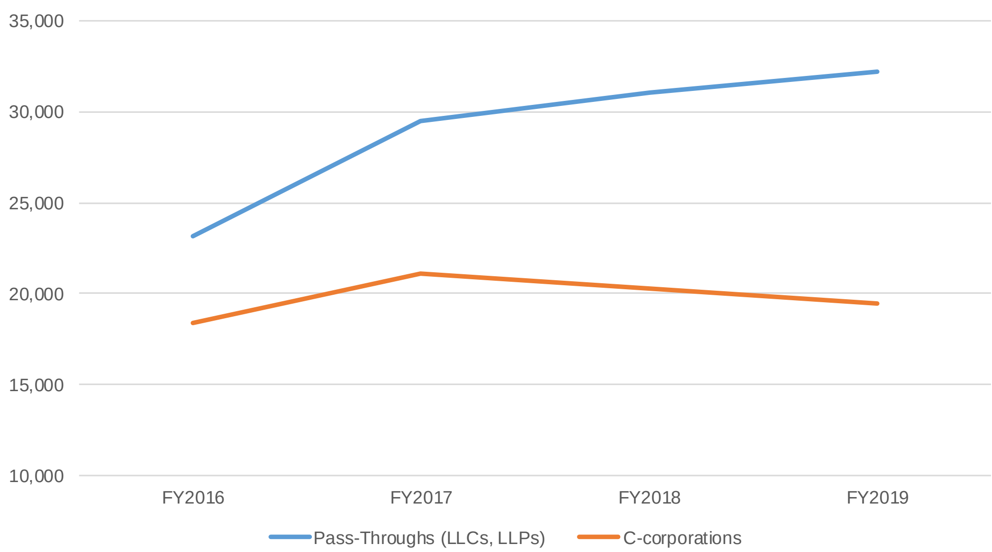
[20] "Pass-Through Deduction in 2017 Tax Law Could Weaken Wages and Workplace Standards." Center on Budget and Policy Priorities. December 2018. https://www.cbpp.org/research/federal-tax/pass-through-deduction-in-2017-tax-law-could-weaken-wages-and-workplace

if those contractors perform very similar work to actual employees and those contractors provide those services to only that specific firm.[21]

The impact to Vermont's personal income tax is uncertain, depending on how a contractor would be paid versus a regular employee. Such a shift could also impact payroll taxes, which are used to fund unemployment insurance benefits in Vermont, and potentially a host of non-revenue related issues such as overall employee benefits and compensation.

It is difficult to determine whether either of these effects is currently occurring in Vermont. Data from the Secretary of State's Office show that the number of registered pass-through businesses has grown at a rapid pace since FY 2016. This growth has far outstripped that of businesses registered as C-corporations. In FY 2019, the first year the new tax reform was effective, there was no discernable jump in the number of businesses registered as pass-throughs (Figure 10). However, it is possible that if businesses were switching registration status, it might take multiple years to see the impact.

Figure 10: Registered Businesses in VT since FY2016



Note: Includes foreign and domestic pass-throughs and corporations. Does not include non-profit businesses
Source: Vermont Secretary of State

[21] For instance, a worker can only be classified as an independent contractor if they meet the "ABC Test." This states that a worker is only an independent contractor if a) they are free from the control and direction of the firm in relation to the performance of the work, b) perform work that is outside the usual course of the firm's business and c) customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed by the firm.