Including Federal Expenditures in a Vermont Expenditures Report

Introduction

This report is in response to a legislative requirement from the 2010 Vermont Legislature.

Act 160 Section 1b

> *No later than January 15, 2012, the department of taxes, the joint fiscal office, and legislative council shall research other state tax expenditure reports and federal tax code to determine which federal exemptions, exclusions, deductions, and other adjustments that pass through to Vermont should be included in future tax expenditure reports. The report shall include specific recommendations with respect to further development of tax expenditure reporting.*

What Is Income?

Vermont relies on federal definitions of income to determine what is and is not subject to Individual and Corporate income tax. There are many types of income, including wage compensation, business income, capital gains and dividend income, pension and social security benefits, and unemployment compensation. The Internal Revenue Code (IRC) provides rules to determine if and when the different types of income and benefits are subject to taxation. In many cases, an alternate rule would change the taxability treatment, and each of these rules can therefore be considered a tax expenditure.

One specific example is the treatment of Social Security income. Federal taxable income requires the application of a complex formula to identify the portion of social security payments that are subject to taxation at the federal level. In Vermont, there is no modification to the federal treatment of social security benefits. Non-taxed social security benefits paid to Vermont residents total more than $500 million (from 2009 federal tax year data). Application of the Vermont income tax to that figure produces the expenditure value to Vermont.

Other IRC rules typically affect a much smaller number of taxpayers. Educational assistance programs indirectly provide a tax benefit to employees when a business pays the cost of educational programs for their employees. If these expenses had been included as compensation, the employees would have it included in taxable income; instead, it is a nontaxable benefit to the employee and an expense that the business can write off as a cost.

Other examples of income deemed non-taxable include

- The proceeds from the sale of a primary residence not subject to capital gains (capped at $500,000)
- The receipt of gifts up to a federally determined threshold ($13,000 in 2011)
- The receipt of assets from an estate
- The receipt of a monetary payment from an insurance claim

- A portion of income from dependents living at home

Still other examples of tax reductions include the deductions from wages to pay for certain benefits:

- Employee contributions to health insurance
- Employee contributions to health care payments
- Employee contributions to dependent care
- Employee contributions to retirement accounts

How to Define Federal Tax Treatment as a State Expenditure?

One of the dilemmas faced by state revenue agencies attempting to identify and quantify federal tax treatment that states pass through in their tax code is business income taken at the individual level. This constitutes a significant source of income claimed by nearly 20 percent of Vermont taxpayers. The federal tax code defining business income is complicated, but in broad terms is the net amount after deducting business expenses from gross receipts. Hundreds of pages of federal guidance help business owners and their accountants determine what business expense is appropriate for reducing the year's taxable income. Examples include:

- A proportion of household expenses are deductible when a part of your house is used for business purposes
- Interest payments on loans used to operate your business
- Expenses for operating your car (when the car is used to help carry out the business)
- Travel expenses for business related meetings

There is a certain logic to only considering net income when determining taxable income and yet some of the expenses are common to non-business households, so the question arises as to whether business expenses should be considered tax expenditures. The tables at the end of this report representing tax expenditures identified by the Joint Committee on Taxation (a joint committee of the U.S. Congress) do not include these examples of business expenses as tax expenditures.

Federal tax credits are not a subject for this analysis. Any federal tax credit passed through to the Vermont income tax return is explicitly noted in Vermont statute and already reported in the biennial expenditure reports.

Review of Other State Tax Expenditure Reports

According to the Center for Budget Policy and Priorities in May of 2011, 44 states have some version of a tax expenditure report. Of those states, 14 (including Vermont) provide some data on federal expenditures. The Appendix lists the federal expenditures reported by each of the 14 states. Of the 188 federal tax expenditures listed in the Appendix, almost one-third were reported by only one state and less than a third were reported by five states or more. The wide range of choices made by other states means that no there is no common agreement for identifying and reporting on federal tax expenditures.

The Department of Taxes hired a legal intern in 2010 to research how other states were treating federal tax expenditures for analysis and reporting. He reviewed every state report and contacted state revenue departments to understand their methodology. A review of the reports themselves showed no systematic mechanism for choosing which expenditures to report on, and follow-up conversations offered no clear rationale for why individual states made their reporting choices. Decisions seemed to be based on ease of data collection as well as selection criteria driven by the particular interests of those crafting or requesting the report.

Given this background, what criteria might Vermont employ to choose which federal expenditures to report? The worthy goal of making such information and data available to policy makers to inform policy and budgetary choices must be counterbalanced by resource limitations, and the following approaches have been used by other states or suggested by policy organizations.

> What is the availability of data?
> What are the impacts on Vermont tax revenue collection?
> What is the practical ease of implementing law change?
> What is the political ease of enacting a law change to capture the foregone revenue?
> How successful is the expenditure in meeting policy goals?

What is the availability of data?

There are two general sources of data for evaluating and reporting federal tax expenditures. In Table A of the Appendix, the expenditure value is calculated from the reported reduction in income from Schedule A of the Federal 1040. Vermont, as do other states, has an agreement with the IRS to access tax data on the 1040. In Vermont, we use that data to recalculate Vermont income tax absent the deductions. It is this procedure the Department used in the 2011 Tax Expenditure Report to assign expenditure values to Itemized and Standard Deductions and the Personal Exemption.

For other expenditures representing most of those included in Table C in the Appendix, no federally reported data to the states is available. However, the Joint Committee on Taxation provides an annual expenditure report with estimates for federal tax expenditures.[1] These figures provide states with a basis to estimate the impacts on their own revenues. The estimates provided in the Appendix use the following approach:

- Estimate a proportion of the state's share of the federal expenditure value based on the proportion of the state's reported taxable income to the federal total.
- Compare the federal tax rate to the state tax rate using the federal and state averages for taxpayers.
- Apply the state/federal rate proportion to the state's share of the federally determined expenditure amount.

While not an elegant or a particularly precise methodology, the approach provides a general sense of the revenue impact on the state from each federal tax expenditure. Because of Vermont's expanded income tax rate brackets where a large number of taxpayers do not pay the highest marginal rate, the estimation of an average state rate to be applied to all taxpayers introduces a greater level of variance in the estimate than in other states with smaller brackets where more taxpayers pay the highest marginal rate.

What are the impacts on Vermont tax revenue collection?

A second approach to selecting federal tax expenditures to report in Vermont is to consider only those federal expenditures that meet a certain dollar threshold for impact on Vermont revenues. This approach requires a screening mechanism to identify high impact expenditures, and utilizing the Joint Committee on Taxation report as described above would be the easiest screening device available.

What is the practical ease of implementing law change?

Another way to choose the expenditures to review is to evaluate the added complexity for taxpayers and administrators of decoupling from a particular federal tax treatment compared to the anticipated new revenue. The basis of Vermont Individual Income and Corporate Income taxes are the federal definition of taxable income used in filing federal returns. Most federal expenditures stem from a definition of income that allows taxpayers to reduce their reported income for tax purposes. Particularly regarding business income, the rules are complex and interrelated, so isolating and decoupling from one provision in the federal code to increase taxable income can prove very difficult. Vermont has limited experience in legislating additions to taxable income for Vermont taxation. Recently, the addback of bonus depreciation on

[1] See http://www.jct.gov/publications.html?func=startdown&id=3740 for background history on federal tax expenditure analysis and an excellent description of JCT's methodology. Tax expenditures are defined in the Congressional Budget and Impoundment Control Act of 1974.

individual tax returns[2] has resulted in considerable confusion for taxpayers and tax preparers alike and required additional department staff time examining returns. Although implemented in 2008 with the intent of easing Vermont's budget shortfall by imposing the regular depreciation schedule, it is probable that this confusion has resulted in the state losing some tax revenue. Less problematic is the addition of income from non-Vermont state and local obligations – the interest on bonds that is exempt from federal but not state taxation.[3]

Two characteristics that make changes to the federal definition of taxable income more or less straightforward are whether the change in one year necessarily impacts subsequent years and whether the change impacts more than one entity. Bonus depreciation is taken by a business and requires the use of two different depreciation schedules for Vermont and federal treatment of asset depreciation. However, shareholders, partners, or members of the business are responsible for adjusting their Vermont taxable income by their allocated share of the difference in the depreciation schedules. Reporting income affected by depreciation therefore, requires several years of differing treatment. The situation is more complicated when the business has a fiscal year other than the calendar year.

The legal intern working for the Department of Taxes interviewed officials from several states that have developed reports based on federal tax expenditures. During those interviews, he found no cases where a state successfully changed a state tax policy to eliminate an expenditure resulting from federal tax laws.

How successful is the expenditure in meeting policy goals?

There is logic in using an effectiveness tool to consider the relative value of different tax expenditures. Those that reduce revenues the most and provide the smallest benefit are those most fit for repeal. Unfortunately, there is little, if any, evaluation of the impact of tax expenditures at the federal level and even less in states. Therefore using cost effectiveness as a screening tool to report federal tax expenditures will suffer from a lack of analytic support.

[2] Vermont decoupled from federal bonus depreciation provisions for corporation income tax filers, effective January 1, 2001.

[3] This tax treatment of bond income is common among states with an individual income tax, and although 33 states decoupled from the federal bonus depreciation provisions in 2008, state laws were very inconsistent.

Summary

Our research shows no uniform methodology by the states for analyzing or reporting on federal expenditures. States have adopted different reporting approaches which may evolve in an ad-hoc manner. Future reporting of federal expenditures for Vermont may be based on the expenditures data published by the Joint Committee on Taxation. Further decisions on the content of the report can be developed by the legislature with a balanced approach that considers possible revenue impact to Vermont and the potential for capturing it, as well as the availability of data and the additional staff time required.

Table A – Itemized Deductions	WI	RI	CA	IA	KY	ME	MA	MI	MN	MS	MT	NY	OR	VT	VT Estimate (FY 12)	JCT estimate (FY 12)
Itemized Deductions (lumped together)		X														
Mortgage Interest			X	X	X	X			X	X	X		X	X	$23.0 million	yes
Health care expenses			X	X	X	X	X		X	X	X		X	X	$3.4 million	yes
Taxes																
State and local income			X	X	X	X			X				X	X	$24.6 million	yes
Property				X	X				X	X	X		X	X	$14.2 million	yes
School district				X												yes
Charitable Contributions			X	X	X	X - A			X	X	X		X - A	X	$9.3 million	yes
Employee expenses			X	X	X					X				X-M		
Casualty and Theft				X	X	X			X	X	X		X	X	< $100,000	yes
Other (2%)				X						X				X-M	$4.3 million	
Investment Interest										X				X	$1.6 million	
Standard Deductions		X			X	X-B	X-D		X - I					X	$104.5 mill'n	
Personal Exemption														X	$88.6 million	yes
Differences in filing status (HOH, Qualifying widower)			X													

A - Maine and Oregon differentiate the different charitable organizations (health, education, etc)
B- Maine differentiates the extra exemption for blind and elderly and parental exemption for 19-23 year olds
D - Massachusetts evaluates the deduction when children earn income in a household
I - extra exemption for blind and elderly
M - Vermont combined employee expenses and the other 2% deductions

Table B - AGI calculations	WI	RI	CA	IA	KY	ME	MA	MI	MN	MS	MT	NY	OR	VT	JCT estimate (FY 12)	VT share
Educator expenses	X	X		X			X						X		No dollar amt.	
Certain business expenses for special cases (2106)	X															
Health Savings account deduction	X	X		X	X	X	X		X	X	X	X	X		$1.6 bln	$0.8 million
Medical Savings (Archer)			X	X			X	X		X	X					
Moving expenses	X	X	X	X				X-F					X			
One half of self employment tax	X	X		X							X					
Self employed SEP and similar plans	X	X		X	X	X			X	X	X		X		$133.1 bln	$66.5 million
Self employed health insurance deduction	X	X	X			X	X	X-F	X		X	X	X		$5.5 billion	$2.8 million
Penalty on early withdrawal of savings	X	X		X						X						
Alimony	X			X				X-F								
IRA deduction	X	X	X	X	X	X		X	X	X	X	X	X		$19.1 bln	$9.6 million
Student Loan interest deduction	X	X	X	X	X	X	X	X	X		X	X	X			
Tuition and fees	X	X									X		X			
Domestic production activities deduction	X	X			X						X				$12.2 bln	$6.1 million
F- Michigan combines these three adjustments into one estimate for reporting																

Table C - Other Expenditures	WI	RI	CA	IA	KY	ME	MA	MI	MN	MS	MT	NY	OR	VT	JCT estimate (FY 12)	VT share
Gifts and Inheritances	X					X										
Stepped up basis upon death	X		X	X		X	X		X			X	X		$39 bln	$19.5 mln
Foreign Earned Income	X			X	X	X			X			X	X		$6.8 bln	$3.4 million
Death Benefits	X											X				
Transfer of property to spouse				X												
Business Related Entertainment (not income for recipient)							X									
Insurance reimbursed Living expenses				X												
Payments for damages (injury or sickness)						X										
Foster care payments	X		X	X	X	X	X		X				X		$0.4 bln	$200,000
Social Security Benefits	X			X	X			X	X			X	X		$36 billion	$18 million
Rail Road retirement benefits					X			X				X			see above	see above
Scholarships and Fellowships	X		X	X	X	X	X	X	X			X	X		$2.4 bln	$1.4 million
Life Insurance and Annuity contract proceeds			X			X			X				X			
Sickness and Injury Benefits	X		X													
Public Assistance	X			X	X	X		X	X			X	X			
Unemployment compensation													X			
Medicare benefits						X			X				X-J		$60.3 bln	$30.2 mln
Medicare prescription drug benefit						X							X		$6.7 bln	$3.4 million

J - Oregon breaks down to Hospital (Part A) and Supplementary (Part B)

Table C - Other Expenditures	WI	RI	CA	IA	KY	ME	MA	MI	MN	MS	MT	NY	OR	VT	JCT estimate (FY 12)	VT share
Capital gain from sale of home	X			X	X	X	X	X	X			X	X		$17.5 bln	$8.8 mln
Capital Gain from carryover of gifts				X	X	X	X		X				X		$3.6 bln	$1.8 mln
Capital gain from small business stock												X			$0.4 bln	$200,000
Capital losses	X			X												
Capital gains on lands taken by eminent domain					X											
Educational IRA (Coverdell)	X		X	X		X			X			X	X		$0.1 bln	<100,000
Section 529 Interest Exclusion			X	X		X			X			X	X		$0.7 bln	$350,000
Interest on Certain State and Local Bonds	X											X	X		lots of detail	
Interest on Education bonds						X							X		$0.1 bln	<$100,000
Life Insurance Dividends	X															
Interest on life insurance savings					X		X					X				
Tax Exempt interest			X													
Deferred interest on US Savings bonds					X								X		$1.4 bln	$700,000
Passive Activity Losses	X			X								X				
Losses from small business Corporation Stock													X			
Self employed purchases of pension, annuity et al	X															

Table C - Other Expenditures	WI	RI	CA	IA	KY	ME	MA	MI	MN	MS	MT	NY	OR	VT	JCT estimate (FY 12)	VT share
Awards and Prizes	X			X		X	X		X				X		$0.4 bln	$200,000
Employee stock option purchases (ESOP)					X	X			X				X		$1.6 bln	$800,00
Federal Employees abroad allowances				X		X			X				X		$1.8 bln	$900,000
Employee benefit cafeteria plan			X	X		X			X				X		$32.3 bln	$16.2 mln
Employee benefit childcare (or dependent care)				X	X		X		X			X	X			
Employee benefit for parking expenses				X												
Employee benefit for miscellaneous non cash payments				X		X			X							
Meals and Lodging to Employees	X		X	X	X	X	X		X			X	X		$1.1 bln	$550,000
Group Term Life Insurance for Employees	X		X			X	X		X				X		$1.7 bln	$850,000
Employer contributions to pension plans	X			X	X	X	X	X	X			X	X			
Employer provided health care	X						X		X-G				X			
Employer provided adoption assistance	X						X		X			X	X		no dollar estimate	
Employer contributions to health and accident insurance			X	X	X	X	X-C	X-E	X-G	X		X	X		$3.6 bln	$1.8 mln
Employer contributions for life insurance			X	X				X-E				X				
Employer paid transportation benefits	X		X	X	X	X	X		X			X	X		$4.4 bln	$2.2 mln
Employer contribution for education			X	X	X	X	X		X			X	X		$1.1 bln	$550,000
Miscellaneous Fringe Benefits													X		$8 bln	$4 mln

C- Massachusetts includes accidents and accidental death together
E- Michigan combines health and life insurance contributions for reporting these expenditures
G - Minnesota combines health care and health insurance premiums payments by employers

Table C - Other Expenditures	WI	RI	CA	IA	KY	ME	MA	MI	MN	MS	MT	NY	OR	VT	JCT estimate (FY 12)	VT share
Workers compensation benefits				X	X	X	X	X	X	X		X	X		$7.4 billion	$3.7 million
Workers compensation (coal miners)				X	X		X		X				X		no $ estimate	
Workers compensation (premium payments)				X												
Military benefits and allowances				X	X	X	X		X				X		$4.9 billion	$2.5 million
Military disability pensions and benefits				X		X	X		X				X		$0.2 billion	$100,000
Travel expenses for National Guard						X							X		$0.1 billion	< $100,000
Veteran education benefits				X		X		X	X-L							
Veterans benefits												X	X		$8.7 billion	$4.4 million
Exclusion of medical care and TRICARE for vets						X			X				X		$2.6 billion	$1.3 million
military and federal worker retirement benefits					X											
Reduced Armed Forces Retirement pay	X															
Combat pay and other armed forces exclusions	X				X		X					X				
Insurance Premiums for Public Safety Officers	X															
Business Expenses of National Guard and Reserve Members							X									

L - Oregon separates medical and nonmedical workers comp benefits

Table C - Other Expenditures	WI	RI	CA	IA	KY	ME	MA	MI	MN	MS	MT	NY	OR	VT	JCT estimate (FY 12)	VT share
Fertilizer and soil amendment costs						X							X		unclear	
Dairy and Breeding cattle expenses						X							X		unclear	
Income averaging for farmers					X										unclear	
Solvent farmer discharge of debt				X					X							
Farmer cancellation of debt													X		unclear	
Expensing Certain Capital Outlays of Farmers							X		X			X				
Cash accounting for farmers													X			
Sale of stock to farmers cooperatives													X			
Cancellation of Business Property Indebtedness	X			X												
Income Realized from Debt Cancellation - bankruptcy	X				X											
Net Operating Losses (limitations)		X			X								X			
Bad debt deduction			X			X							X			
Benefits of forming S-corp					X											
Expensing research and experimental costs						X	X		X			X				

Table C - Other Expenditures	WI	RI	CA	IA	KY	ME	MA	MI	MN	MS	MT	NY	OR	VT	JCT estimate (FY 12)	VT share
Research and Development cost (deduction)													X			
Inventory property sales source rule exception						X									$7.6 billion	$3.8 million
Deferral of active income of U.S. - controlled foreign corporations						X							X		$14.1 billion	$7.1 million
Amortizing business start up costs						X	X		X			X	X		$1.1 billion	$550,000
Losses from sale or exchange of business property	X															
Installment sales (deferred tax)					X	X						X	X		$6.1 billion	$3.1 million
Other property depreciation acceleration						X	X		X				X		$0.4 billion	$200,000
Excess of percentage over cost depletion					X	X			X						$1.1 billion	$550,000
Exemptions from imputed interest rules						X			X				X		$0.5 billion	$250,000
Completed contract rules						X			X				X		$0.7 billion	$350,000
deferral of gain on like kind exchanges						X			X				X		$3.2 billion	$1.6 million
Voluntary Employee Beneficiary Company						X							X		$4.2 billion	$2.1 million
Incentive stock options						X	X									
Accelerated cost recovery for equipment							X	X	X			X	X			

Table C - Other Expenditures	WI	RI	CA	IA	KY	ME	MA	MI	MN	MS	MT	NY	OR	VT	JCT estimate (FY 12)	VT share
Deduction for Excess First-Year Depreciation							X									
Five-Year Amortization of Certain Operating Rights							X									
Five-Year Amortization of Pollution Control Facilities							X									
Deduction for Costs Involved in Unlawful Discrimination Suits							X									
Section 179 expensing												X	X		$3.8 billion	$1.9 million
Cash accounting for non-farmers													X		$1.1 billion	$550,000
Income of Controlled Foreign Corporations													X			
Inventory methods of valuation													X			
Spread on acquisition of stock													X			
Structured settlement accounts													X			

Table C - Other Expenditures	WI	RI	CA	IA	KY	ME	MA	MI	MN	MS	MT	NY	OR	VT	JCT estimate (FY 12)	VT share
Timber Growing Cost expenses			X		X				X				X		$0.2 billion	$100,000
Natural Resource Related Cost Sharing Payments	X												X			
Reforestation Expense amortization			X			X	X		X				X		$0.1 billion	<$100,000
Ag soil or water conservation erosion expense			X			X	X						X		no $ estimate	
Cost share payments by forest landowners			X			X										
Oil and gas passive loss exception				X												
small refiner expensing sulfur compliant equipment													X			
intangible development costs for fuels													X			
Tertiary injectants													X			
Capital gains deferral - FERC restructuring requirements													X			
Redevelopment costs in contaminated areas													X			
Recycling equipment depreciation													X		no $ estimate	
Mining reclamation reserves													X		no $ estimate	

Table C - Other Expenditures	WI	RI	CA	IA	KY	ME	MA	MI	MN	MS	MT	NY	OR	VT	JCT estimate (FY 12)	VT share
non fuel exploration and development costs						X							X		$0.1 billion	<$100,000
Advanced mine safety equipment													X			
Excess natural resource depletion							X						X		$0.1 billion	<$100,000
Capital Asset treatment of timber iron ore coal income												X				
Renewal community tax incentives													X			
Utility customer conservation subsidies				X					X							
Fuel exploration and development costs						X	X		X			X			$0.9 billion	$450,000
nuclear decommissioning fund (different tax rate)						X									$1 billion	$500,000
Income from certain energy patents							X									
Deduction for Clean-Fuel Vehicles and Certain Refueling Property							X									
Energy Conservation subsidies													X			
Contributions In Aid of utility construction													X			
energy efficient commercial properties													X		$0.1 billion	<$100,000

Table C - Other Expenditures	WI	RI	CA	IA	KY	ME	MA	MI	MN	MS	MT	NY	OR	VT	JCT estimate (FY 12)	VT share
Payments to Victims of Nazi Persecution	X												X			
Rental Value of Parsonages	X		X	X	X	X	X		X				X		$0.4 billion	$200,000
Jury pay remitted to employers				X												
Residence as limited rental				X												
Travel expenses of state legislators				X					X							
Astronaut Survivor annuities							X									
Public Safety Officer survivor annuities							X						X			
Debt discharge - terrorist victims							X									
Debt discharge - health care professionals							X									
Credit Union Income													X			
Disaster mitigation payments													X			
Film (and television) productions costs						X							X		no $ estimate	
Creation or acquisition of musical compositions													X			
Life insurance company reserves													X			
Bad debt reserves for small financial services													X			
Income earned by precinct workers					X											

Table C - Other Expenditures	WI	RI	CA	IA	KY	ME	MA	MI	MN	MS	MT	NY	OR	VT	JCT estimate (FY 12)	VT share
Mortgage debt cancellation			X													
Rental housing depreciation acceleration						X	X						X		$0.5 billion	$250,000
Deferral of tax on shipping companies						X							X		$4.7 billion	$2.4 million
Qualified retirement planning services							X									
Deduction for Magazine, Record and Paperback Returns									X				X		no $ estimate	
Cancellation of student loans	X												X		$0.1 billion	<$100,000
Recovery of Tax Benefit Items	X															
Regional Economic Development Incentives													X			
Earnings of certain environmental settlement funds													X			
Nonprofit's gain from brownfields													X			
Gains on Involuntary conversion in disaster areas													X			
Removal of Architectural barriers													X		$0.1 billion	<$100,000
Circulation of periodical cost expensing			X										X			
Personal Injury damages				X												