Vermont Tax Conformity to Federal H.R. 1

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Notable Tax Provisions of H.R. 1

- Personal Income Tax
  - No tax on tips
  - No tax on overtime
  - Auto interest deduction
  - Enhanced senior deduction

- These items to not translate to the Vermont individual tax system as they are “below the line” deductions for federal tax purposes. No expectation of conformity.

Notable Tax Provisions of H.R. 1

- Business Income Tax – applies to all entity types (sole proprietors, LLCs, partnerships, S corporations, C corporations)
  - Section 168 bonus depreciation
  - Section 179 depreciation
  - Section 163(j) interest deduction limitation
  - Section 174 research and development (R&D) expense capitalization
  - Foreign tax provisions – Global Intangible Low-Taxed Income (GILTI) and Foreign-Derived Intangible Income (FDII)

- Section 168 bonus depreciation – Vermont has never conformed, no expectation of current conformity.

Section 179

- Changes under H.R. 1: expanded depreciation and phaseout limitations:
  - Old law: Expense limit $1M, Phaseout threshold $2.5M
  - New law: Expense limit $2.5M, Phaseout threshold $4M (indexed for inflation)

- Vermont already conforms to the old law; the new law simply updates the limits. Decoupling from H.R. 1 would keep the old limitations stale and not reflective of rising prices, while also causing costly additional calculations to track the different rules for federal and Vermont purposes.

Section 163(j) Interest Deduction Limitation

- Changes under H.R. 1: restored the calculation to pre-2021 terminology.
  - Old law: 2022-2024, interest limitation calculation done on an EBIT basis.
  - New law: beginning in 2025, interest limitation calculation done on an EBITDA basis (which was the law prior to 2022).

- Vermont has always conformed with this federal law. Decoupling would be a first. It would limit business' ability to deduct interest expense and cause costly additional calculations to track the different rules for federal and Vermont purposes.

Foreign Tax Provisions: GILTI and FDII

- Changes under H.R. 1: changed some elements of the calculation (complex)
  - Old law: contained 10% QBAI deduction, 50% sec 250 deduction, foreign tax credit expense allocation of R&D, etc.)
  - New law: removed 10% QBAI deduction, changed to 40% sec 250 deduction, removed foreign tax credit expense allocation of R&D, etc.)

- Vermont already conforms to the old law. Parts of the new law are taxpayer favorable and parts are unfavorable. Decoupling adds significant complexity to calculations with unclear results. (emphasis added on complexity)

Section 174 Research and Development (R&D) Expense Capitalization

- Changes under H.R. 1: revert to pre-2022 deductibility rules.
  - Old law: domestic R&D expense required to be capitalized and amortized over 5 years
  - New law: domestic R&D expense is currently deductible (pre-2022 law)

- Vermont has always conformed to federal law, and notably, current deductibility of R&D was federal and Vermont law for decades prior to 2022. R&D capitalization requirements have caused significant distortion between taxpayer's taxable income and actual economics. Further, it has costed significant dollars in professional fees. This impacts all taxpayers in business in a wide variety of industries (manufacturing, software, brewers, engineering, construction, research grant recipients, etc.)

Section 174 – Example

	Pre TCJA	TCJA	
	2021	2022	*applies to 2022 - 2024
Revenue	1,000,000	1,000,000	
Expenses	(700,000)	(700,000)	
R&D Expenses*	(500,000)	(50,000)	*remaining $450K of deductions over the next 5 years
Taxable Income	(200,000)	250,000	
*R&D Intangible Asset	500,000		
Year 1 Amortization	50,000		
Year 2 Amortization	100,000		
Year 3 Amortization	100,000		
Year 4 Amortization	100,000		
Year 5 Amortization	100,000		
Year 6 Amortization	50,000		

Section 174 – Small Business "Snag"

- For federal purposes for tax years 2022-2024, "small business taxpayers" (less than $31M in gross receipts) can amend their tax returns to remove the impact of capitalizing R&D costs (currently deducting R&D in those years).
- Vermont does not conform as of today; therefore, this amending option is currently unavailable for Vermont tax returns.
- Further, 2025 Vermont tax returns that begin with 2025 federal taxable income (which no longer reflects capitalized R&D) have no place to capture the 2022-2024 amended changes OR the remaining amortization on capitalized R&D for 2025 and beyond.
- Without legislative action, those R&D expenses are permanently lost for Vermont tax purposes. Said differently, taxpayers spent dollars on R&D and will never get a tax deduction for those expenses (e.g. wages, etc.).
- Note – this snag <u>only impacts small business taxpayers</u> who needed cash refunds and amended their federal tax returns. Large taxpayers will not be impacted by this. Perhaps an unintended consequence to penalize small businesses.

Thank you for your time!

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