

Vermont Legislative Joint Fiscal Office

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ISSUE BRIEF

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Income Sensitivity Changes and Implementation Issues

As part of the 2010 legislative session, the Legislature and the Administration agreed on a number of changes to the income sensitivity provisions of Vermont's education finance system. These changes will be implemented in state fiscal years 2011 and 2012.

This year, the most financially significant of these changes impact homeowners and increase the available balance of the Education Fund. In so doing they help to enable the level funding of the education property tax rate. They include the following:

Change	2011 Estimate ¹	2010 Homeowners Impacted
1. An increase in the value assigned to interest and dividends in calculating household income: Interest and dividend income over \$10,000 is counted twice in the calculation of household income	\$2.7 million	5,500 households with an average impact of \$500
2. A cap of \$500,000 on housesite valuation that can receive income sensitivity	\$1.0 million	850 households with an average impact \$1,200
1 and 2 together: Households impacted by both the interest and dividend change and the cap on homestead valuation at the first \$500,000 of equalized value	\$1.5 million	500 households with an average impact of just under \$3,000
3. The elimination of the \$10 per acre payment for homesteads with more than two acres (this was capped at 5 acres or a \$50 maximum benefit) over the housesite - a house and two acres	\$1.3 million	32,000 households with an impact of \$50 or less to each household depending on acreage
Total Value	\$ 6.5 million	

Each \$10.7 million of reduced costs for the education fund can reduce the education tax rates one penny so the value of these changes helped to offset what otherwise would have been a higher education property tax rate.

What follows are some details on each of the three changes that occurred this year:

¹ July 2010 estimates of dollars and households from tax department data. During the session the JFO estimated impact was closer to \$9.5 million.

1. **An increase in the value assigned to interest and dividends in calculating household income:**

Vermont's income-sensitive property tax is designed to adjust education property tax levels to a household's ability to pay. The income-based system does not in itself take into account household assets which can also impact ability to pay. The increase in valuation of interest and dividend income was intended to reflect capital assets not being taken into account. The legislative change valued interest and dividend income above \$10,000 at twice its contribution to household income. For example, if a household had \$60,000 in income of which \$20,000 was interest and dividends, for the purpose of income sensitivity calculations, the income would be computed to be \$70,000 (\$60,000 plus an additional \$10,000 which is the amount of income and dividend income over \$10,000). Among those who are impacted by this Legislative change the average interest and dividend income is about \$21,700 with the median being \$17,400. It should be noted that this treatment does not apply to 401k or related retirement income which is taxed as normal income.

As an illustration for tax year 2009:

- The average dividend yield for the Standard and Poor's stocks was about 2.75%. In July 2010, the average dividend yield for the Standard and Poor's 500 stocks is 1.8%. This is an average of all Standard and Poor's stocks as opposed to just those that pay dividends. An average of those stocks would have a yield of 3.73% in 2009.
- The three year money market average rate is about 2.17% with an average rate in 2009 of less than 1%. Currently, three year CDs are paying about 2%.

A portfolio of 50% index funds, and 50% at an average rate of 2.25% would have produced an average return of 2.5%. In order to achieve the \$25,000 in dividends with a 2.5% interest rate \$1,000,000 in invested assets would be needed.

Some homeowners may receive higher dividends and therefore have fewer assets than this illustration. Some examples are below:

Interest/dividend income	Average Return	Amount of investment before double count	Investment assuming 2.5% return
\$10,000	2.5%	\$ 400,000	Threshold depending on return
\$21,700	2.5%	\$ 868,000	Average of those effected
\$30,000	2.5%	\$1,200,000	Average interest and dividends of those households affected by both changes

As a very rough estimate to have the average increase in property taxes of \$500 an individual would have to have an increase in income of about \$17,000 or about \$27,000 in dividend and interest income and likely in excess of \$1,000,000 in invested assets.

In addition to the change occurring in the current tax year, the transition was marred by an error in the informational letter from the Tax Department. While the calculations sent to those who had interest and dividend income was correct, 7,166 of these households received a letter which explained the adjustment incorrectly. Not all these households would have been eligible regardless of explanation or law change.

2. A \$500,000 cap on the equalized value of a housesite (house plus two contiguous acres) that is eligible for income sensitivity:

The limit on homestead value for income sensitivity eligibility is considered a soft cap in that all homesteads are eligible up to the \$500,000 cap. The equalized value above that level is not eligible for income sensitivity payments. As indicated on the chart above, this cap impacted 1350 households, consisting of those only impacted by the cap and those impacted by both changes.

The cap is effectively applied to households between \$47,000 and \$90,000 as those households below \$47,000 are eligible for the homeowner rebate program. The \$500,000 value cap has differential impacts as it will have a higher effect on communities with high property values. As indicated above, the combined impact of this change, coupled with the higher valuation for interest and dividends creates a large increase in education property tax obligations for about 500 households.

For households with incomes above \$90,000 the equalized value eligible for income sensitivity is \$200,000 creating a limited slope to the benefit.

3. The elimination of the \$10 per acre payment for more than two acres of contiguous land:

In 2003, as part of Act 68, a supplement to income sensitivity was added for homesteads that had more than two acres of land. The additional payment was \$10 per acre for up to five acres. This payment did not adjust with income and would be received by those otherwise eligible for income sensitivity. The elimination of this payment has a maximum impact of \$50 to any one household.

For 2012 there will be additional changes to the definition of household income which will result in more income being counted and a lower level of income sensitivity. The change disallows a number of what are called Line Q deductions.

Household income is intended to be a broad measure of ability to pay and includes many sources income from both taxable and nontaxable sources. Nontaxable social security, railroad retirement and veteran's benefits are included, along with nontaxable interest on US, state and municipal obligations. Additionally, many losses are limited to zero, such as those from businesses, capital gains, rental income and farms. Lastly, household income, which more closely matches adjusted gross income (AGI) does not reflect itemized deductions. In recent years, the federal tax code has included many more "above the line" deductions in Line Q or deductions that do not have the same limitations as itemized deductions. For FY 2012, the definition of Vermont household income for property tax purposes was expanded to exclude all but four of these deductions.