

Tax Reform in Vermont: Perception and Reform

Joint Fiscal Committee Presentation

November 15, 2010

How to Think about Tax Reform

- Tax system is a collection of certain broad rules.
- These rules have many, many policy exceptions.
- Tax reform is about examining how time and policy exceptions have eroded the broad rules of taxation.
- Why create broad rules?
 - Broad rules push rates down.
 - Exceptions drive rates up.
 - Exceptions tend to create complexity and economic distortions.

Outline

- Perceptions
 - Do perceptions of Vermont's tax system match reality?
- Reform
 - Concepts being considered
 - The way forward



Perception:

Is Conventional Wisdom Wrong?

- Income Tax: choice of starting point for taxation may promote high marginal rates and lower effective rates.
- Sales Tax: border with no tax New Hampshire may warp perceptions.
- Property Tax: a unique statewide education property tax. Like any education funding system, it has been controversial.
- Corporate Income Tax: recent reform to Unitary Combined Reporting is in the mainstream but represents a change for Vermont's corporations. While it lowered rates, it reallocated the tax burden.



Perception: *Income Tax*

- ▣ Two Major Income Tax Perception Issues
 - Where you start (The income tax base)
 - Where you finish (Your tax bracket)

Components of Income Tax

Total
Income

- Wages, Salaries, & Tips; Interest & Dividends; Alimony Received, Capital Gains Income/Losses, IRA Distributions, Pensions & Annuities; Rents, Royalties, & Partnership Income; Farm income & Losses; Unemployment Compensation, and a Portion of Social Security.

AGI

- Subtract the Following from Total Income:
- Self-Employment Tax and Health Insurance, Contributions to IRA/Keogh/MSAs/HSAs; Alimony Paid, Student Loan Interest, Penalty on Early Withdrawal of Saving, Tuition & Fees Deduction, Domestic Production Activities Deduction, Job-Related Moving Expenses, Other Expenses (Educators, Reservists, Performing Artists, and Fee-Basis Government Officials)

Taxable
Income

- Subtract Personal Exemptions & Standard or Itemized Deductions the from Adjusted Gross Income:
- Itemized Deductions Include Medical & Dental Expenses, Taxes Paid (State Income Tax, Sales Tax, & Property Tax), Mortgage Interest, Gifts to Charity, Casualty & Theft Losses, Job Expenses, & Other Specified Expenses.

Perception: Income Tax

Where you Start (The Income Tax Base)

Defining income is a \$5 billion dollar question.

Total Income	Adjusted Gross Income	Taxable Income
• \$15.3 Billion	• \$15 Billion	• \$10.2 Billion

33 states utilize an AGI base.

10 states utilize a Taxable Income base.

Perception: *Income Tax*

Notice Where these States Start (AGI Tax Base)

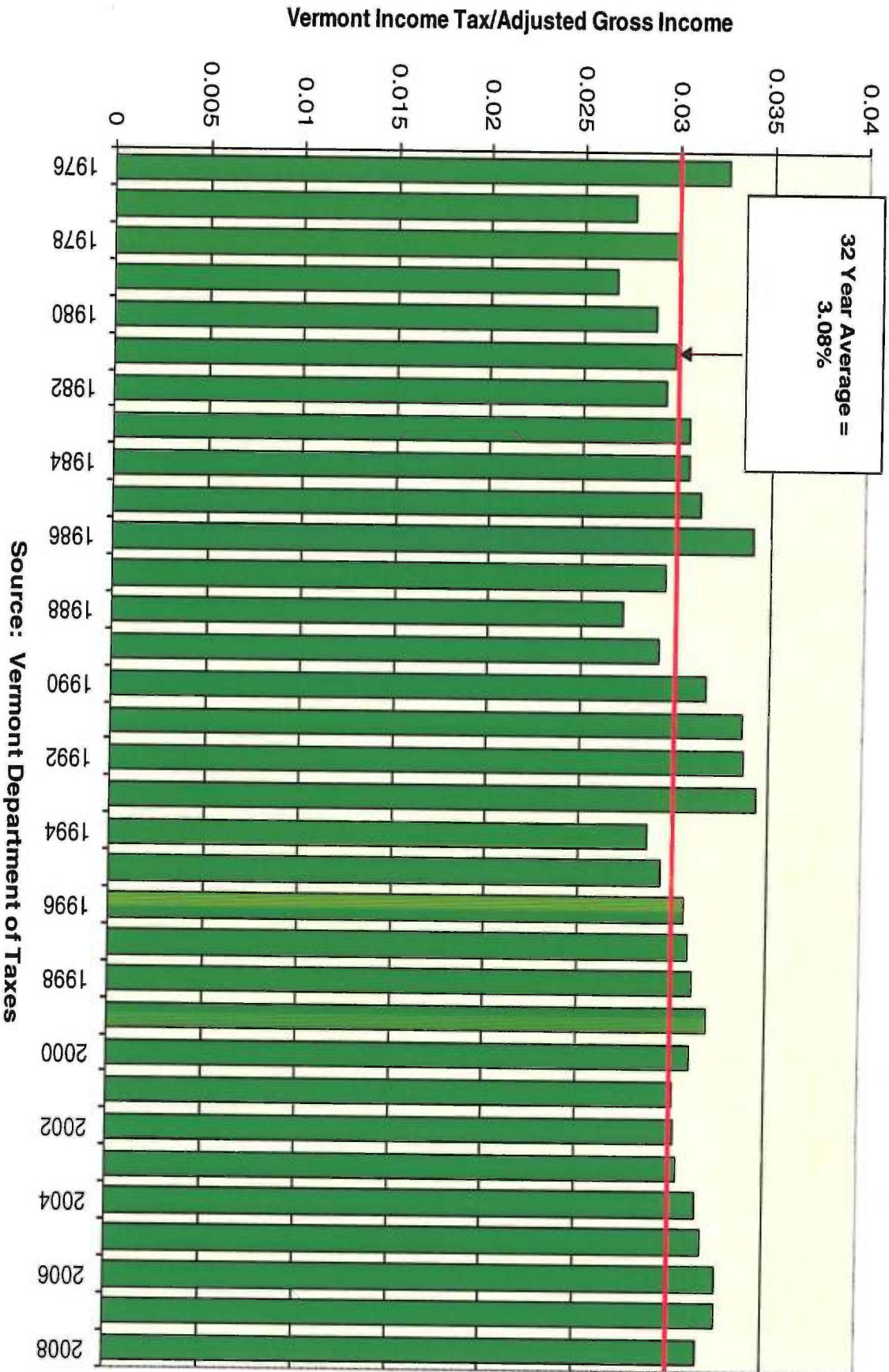
- Connecticut
 - AGI
 - No Itemized Deductions
- Maine
 - AGI
 - Capped Itemized Deductions
- Massachusetts
 - AGI
 - No Itemized Deduction
- New Hampshire
 - No Income Tax
- Rhode Island
 - AGI
 - No Itemized Deductions
- Vermont
 - TI
 - Permissive Deductions

Perception: *Income Tax*

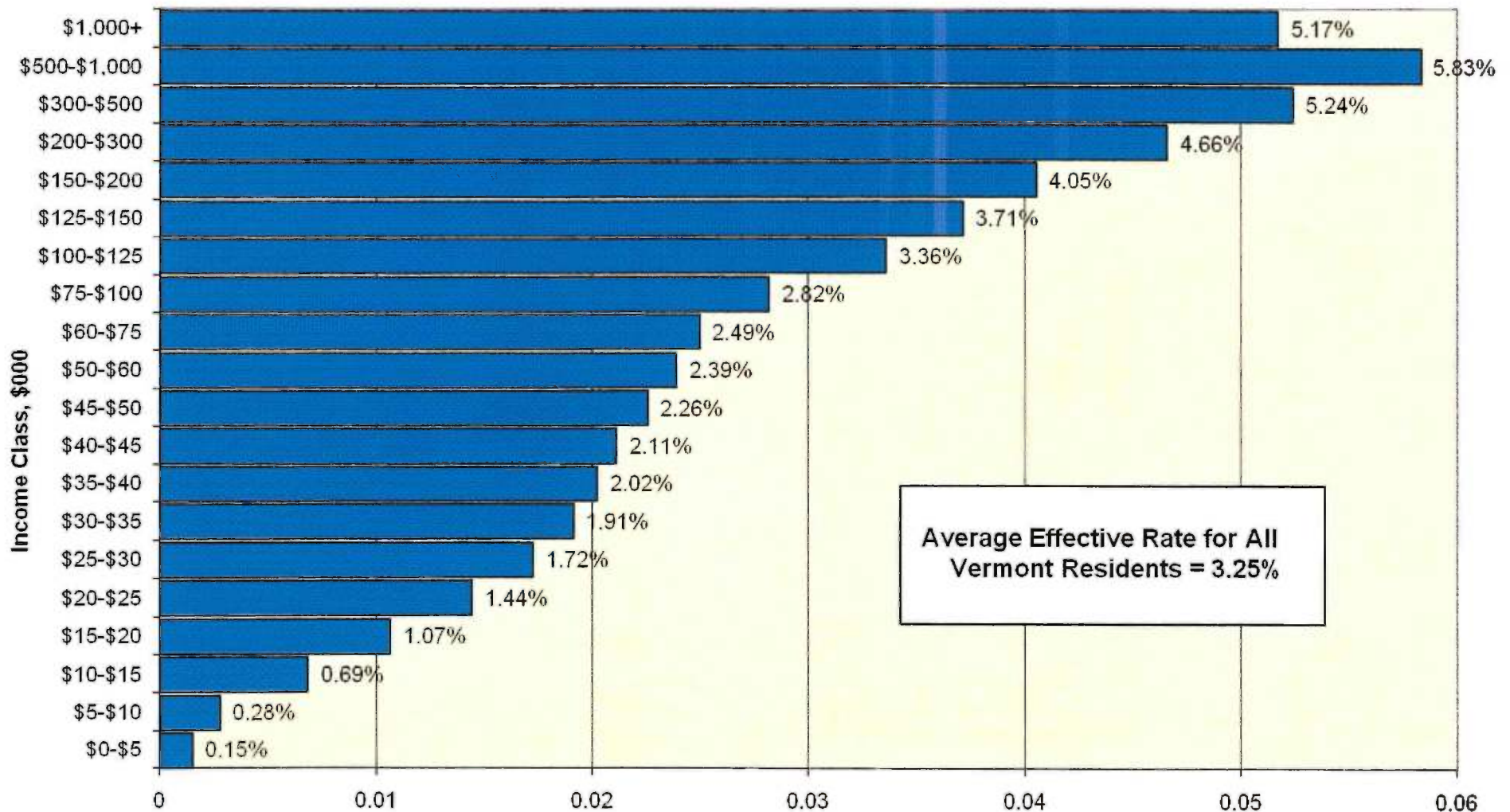
Notice Where You Finish (Tax Brackets)

- Connecticut (AGI + No Itemized Deductions)
 - 3.5% \$0-\$10,000
 - 5% \$10,001-\$500k
 - 6.5% \$500k+
- Maine (AGI + Capped Itemized Deductions)
 - 2% \$0-\$4,850
 - 4.5% \$4,851-\$9700
 - 7% \$9,700-\$19,450
 - 8.5% \$19,451+
- Massachusetts (AGI + No itemized Deductions)
 - Flat 5.3%
- New Hampshire
 - No Income Tax
- Rhode Island (AGI + No itemized Deductions)
 - 3.75% \$0-\$55,000
 - 4.75% \$55,001 - \$125k
 - 5.99% \$125,001+
- Vermont (TI + Permissive Deductions)
 - 3.55%: Under \$34,000
 - 7.00% : \$34,000 -\$82,400
 - 8.00%: \$82,400 – \$171,850
 - 8.90% : \$171,850 – \$373,650
 - 8.95%: Above \$373,650

Effective Vermont Personal Income Tax Rate



Tax Progressivity: Effective Vermont Income Tax Rates in 2008 by Income Class



Net Vermont Tax as a Percent of Adjusted Gross Income

Source: Vermont Department of Taxes



Perception: *Sales Tax*

- Constant comparison to New Hampshire drives perception of very high sales tax.
- Large carve-outs for tax expenditures.
- Distinction between sales of goods and services.

Perception: *Sales Tax*

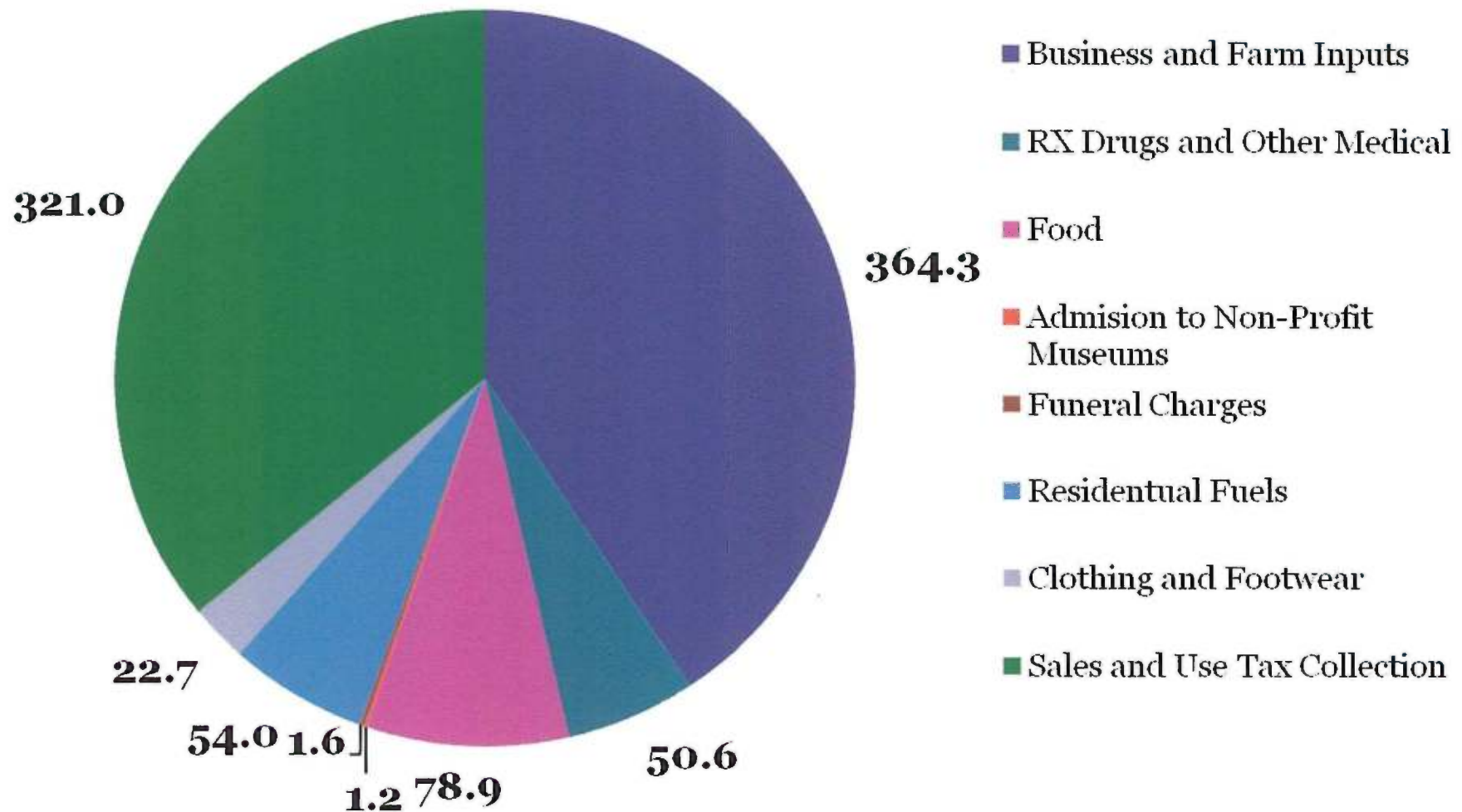
- Vermont's state rate is 6%
 - Limited use of local option sales taxes to date - although expanding. Limited to 10 towns at a rate of no more than 1%
- USA state median is 6% & mean is 5.1%
- Effective New England + NY Average is 6.375%
 - Considerations:
 - New Hampshire does not have a sales tax.



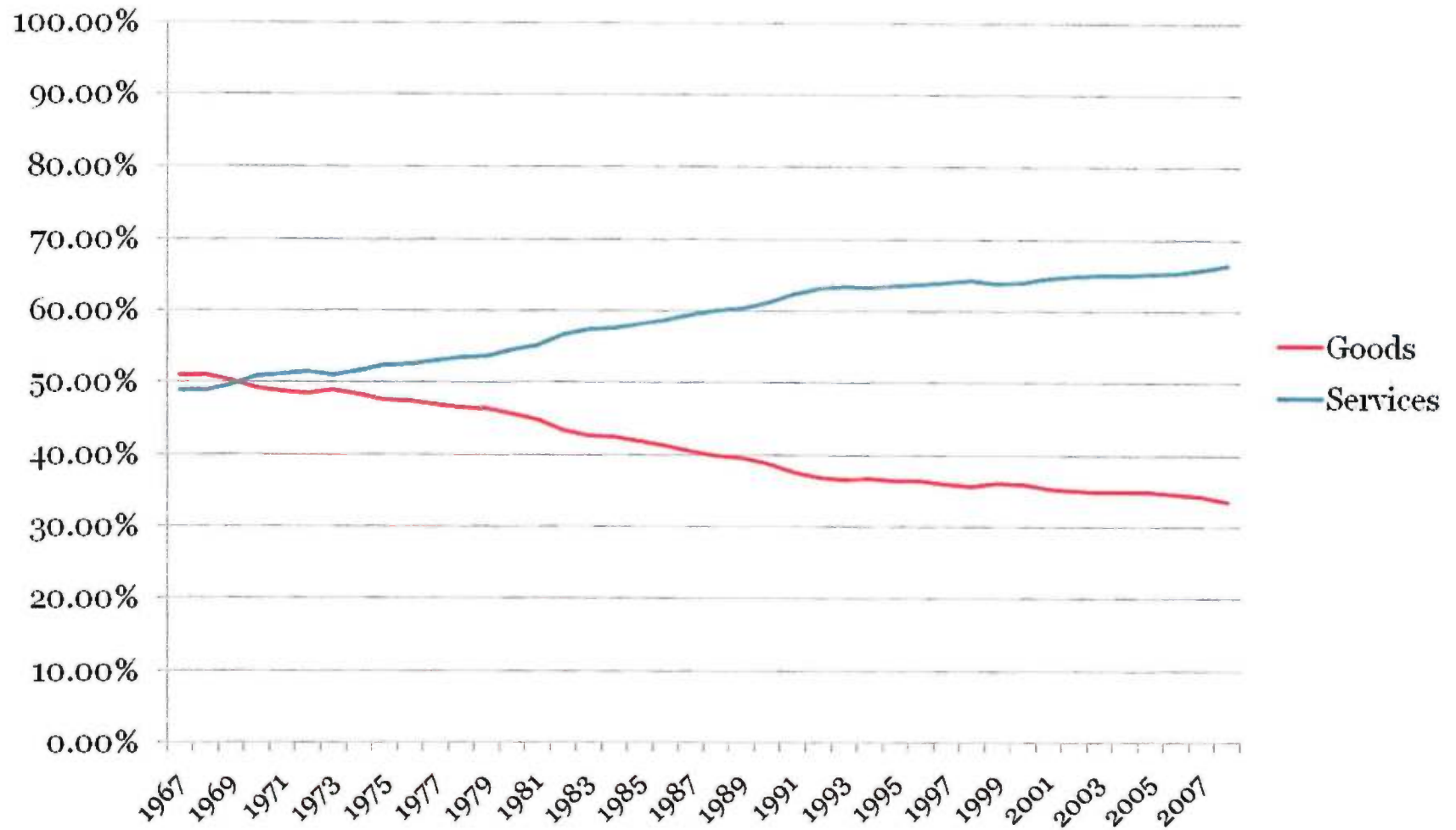
The Scope of the Consumption Tax Base: *Tax Expenditures*

- Tax expenditures, are an exception to the normal rules of the tax structure that take many forms, including “permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates.”
- These policy preferences provide preferential treatment for a particular industry, activity, or class or persons, and they are found throughout the personal income tax, corporate income tax, consumption taxes, and the property tax.

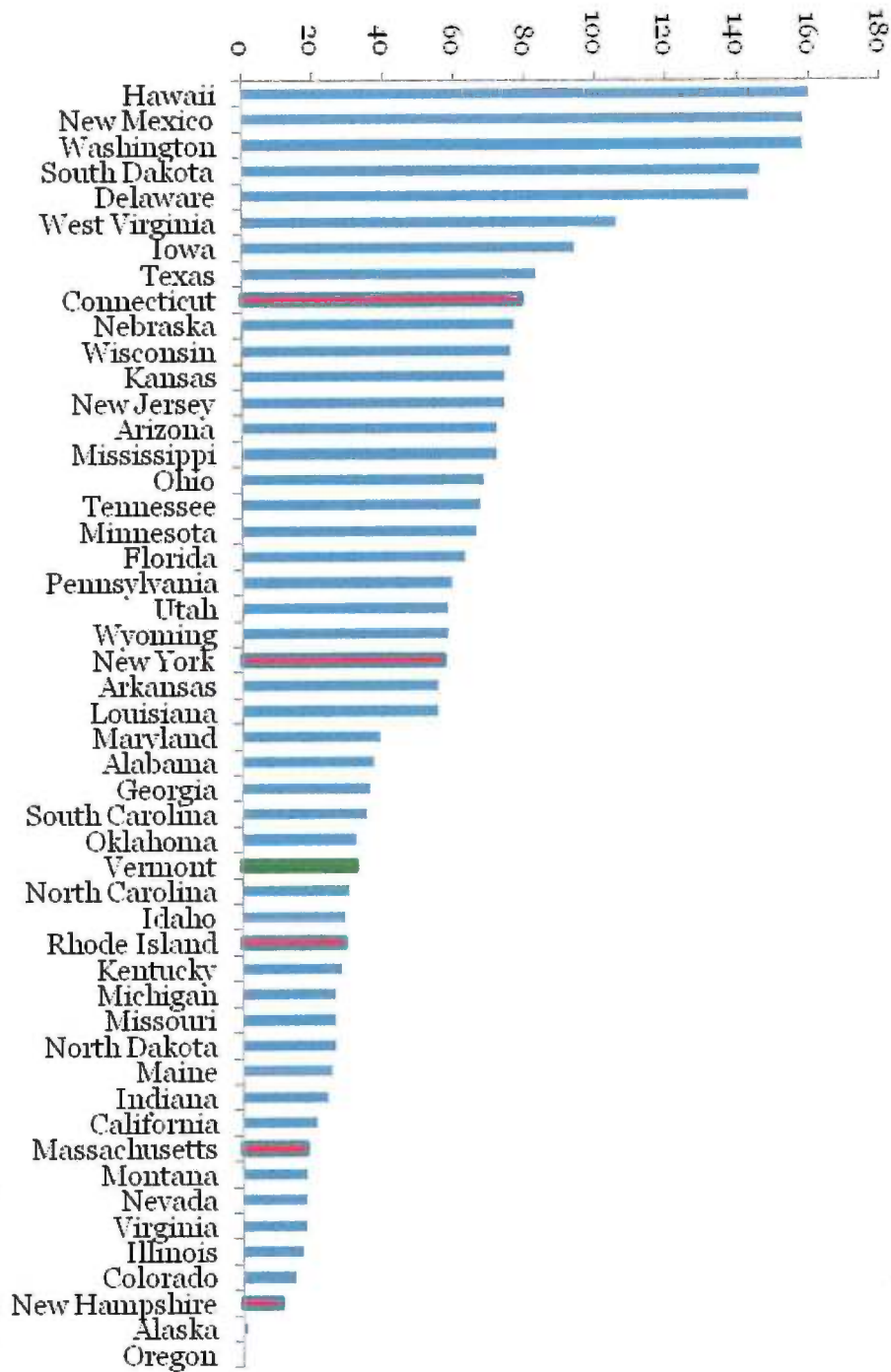
Tax Year 2010 Sales Tax Collected and Tax Expenditure Revenue Foregone in Millions



Spending on Goods and Services as a Percent of Total Consumer Spending 1967-2008



Number of Services Taxed



Source: Federation of
Tax Administrators

Number of Services Taxed, by State

Perception: *Sales Tax*

- Mainstream approach to taxing services.
- Every service taxed in Vermont is taxed in at least 23 other states. Also, Vermont exempts only six services from taxation that are taxed by a majority of states.
 - Tuxedo Rental
 - Commercial Linen Supply
 - Tire Repair
 - Overnight Trailer Park Fees
 - Service Contracts Sold at the Time of Sale of Tangible Personal Property
 - Welding Labor

Perception: The Statewide Education Property Tax

- Two Perception Issues
 - No agreement on whether the tax should be more income based or property based.
 - Taxpayers who pay based on income and taxpayers who pay based on property both think that the other side has a better deal.
- **They're both right.**



The Equity Double Bind

- Taxpayers with an income $< \$90,000$.
 - Income sensitivity and rebate programs are a better deal than paying full amount of educational property taxes; however, they are still regressive taxes. (Lower income Vermonters pay more of their income for education than households with higher income.)
- Taxpayers with an income $> \$90,000$.
 - Current system may be better than paying based on income; however, property tax rates are pushed higher due to income sensitivity and circuit breaker.



Perception: Is This Perception Fair?

- Important to consider total tax burden.
 - Income tax progressivity makes up for less equitable sales and property taxes.
- Public tax grievances seem more complicated.
- Reforms must balance perception of system with reality of system



Ideas for Reform

Reform: *Income Tax*

- 13 income tax models examined thus far
- Concepts under consideration
 - Switch tax base to AGI
 - Limit or eliminate itemized deductions
 - Lower all rates and reduce the number of brackets
 - Keep progressive tax system
- Open questions
 - How best to limit standard/itemized deductions?
 - How to reduce rates and the number of brackets?
 - Do we raise more revenue elsewhere to lower personal income tax rates?

Reform: *Sales Tax*

- Concepts under consideration:
 - Tax all consumer consumption.
 - Eliminate nearly all tax expenditures for consumers.
 - Extend sales tax to consumer services.
 - Pair base expansion with substantial rate cut in sales tax or other taxes.
 - Greater transparency accountability for tax expenditures and credits
 - State intent, measure cost, analyze ROI, & sunset over four year cycle.
- Open questions
 - How best to exempt business to business transactions?
 - How to address regressivity of sales tax base expansion?
 - What is the viability of being the first state to abandon an ad hoc approach to taxing services?

Reform: *Property Tax*

- 12 models examined thus far.
- Asked the Commission to decide whether the system ought to be a pure property tax, income tax, or hybrid tax.
- Where the Commission has reached consensus:
 - Should be a hybrid tax.
 - Better reporting of property tax expenditures.
- Open questions
 - Everything else.
- Two fundamental issues to consider.
 - What is the right tax, income or property?
 - System is affected by the relationship between income and home value which changes for almost everyone over a lifetime.

Reform: *Corporate Income Tax*

- The Commission faces a fundamental dilemma when considering Corporate Income Tax reform
- It is a strong, stable tax, and other states are following Vermont's lead by adopting Unitary Combined Reporting. Yet, CIT rates send strong signals regarding economic competitiveness.
- Commission is considering replacing limited progressive structure with a flat tax.
- Commission interested in signaling competitiveness by reducing corporate income tax rate.
 - Where would the Commission raise taxes elsewhere to reduce corporate income tax?



Reform: *The Way Forward*

- Commission is required to submit its recommendations by January 31, 2011.
- Commission has set a goal of delivering draft recommendations before the end of the year before start of the 2011 legislative session.
- Commission plans public hearings in January for educational outreach and to explain recommendations.



Questions?

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