

# Tax Reform in Vermont: Politics, Perception, and Reform

Presentation for FTA  
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*Michael Costa, Director*  
*Vermont's Blue Ribbon*  
*Tax Structure Commission*



## Outline

- Politics
  - The Genesis of Reform
  - Vermont's Recent Tax Reform Efforts
  - The Blue Ribbon Tax Structure Commission
- Perceptions
  - A Tax System Perceived by Many as Vermonters as Too Onerous and Complex
- Reform
  - Proposals Under Consideration
  - The Way Forward



## Politics: *The Genesis of Reform*

- Legislature created the Commission in 2009 while simultaneously enacting personal income tax changes.
  - Legislature ended the highly preferential treatment of capital gains.
    - Former law excluded 40% percent of all capital gains from taxable income
    - Converted to a flat exclusion
    - Reduced personal income tax rates across the board



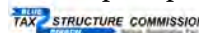
## Politics: *Recent Tax Reforms*

- Personal Income Tax
  - 1980-2001, piggyback on federal liability
  - 2002 – present, progressive system on Taxable Income base
  - 2009, capital gains changes broadened base and lowered rates
- Sales Tax
  - Sales tax rose from 5% to 6% in 2003 to help fund education
- Property Tax
  - Vermont began unique Statewide Education Property Tax in 1997
  - Made modifications strengthening statewide nature in 2003
- Corporate Income Tax
  - Became first state in twenty years to adopt Unitary Combined Reporting in 2004 since then 6 states have also adopted it for a total of 23



## Politics: *Tax Structure Commission*

- Commission asked to prepare a structural analysis of the state's revenue system, offer recommendations for improvements and modernization, and provide a long-term vision for the tax structure
  - Specific questions address whether to move tax base from TI to AGI, the process for examining tax expenditures, the proper role of fees, and a review of consumption and business taxes
- 3 member panel appointed by Governor, Pro Tem, and Speaker
  - Former Chief of Staff and Cabinet Secretary to Gov. Howard Dean
  - Business Owner/Public Intellectual
  - Small Business Executive/Leader of Business Trade Organization
    - Credible community voices but none are economists or have a tax background
- Receptive legislative audience
  - Commission may be positioned at the nexus of politics and perception



## Perception: *Is the Tax System Too Onerous and Complex?*

- Income Tax: high marginal rates versus low effective rates
- Sales Tax: neighbors with no tax New Hampshire
- Property Tax: a unique statewide education property tax. Like any education tax system, it has been controversial.
- Corporate Income Tax: recent reform to Unitary Combined Reporting is in the mainstream but not appreciated by business groups.



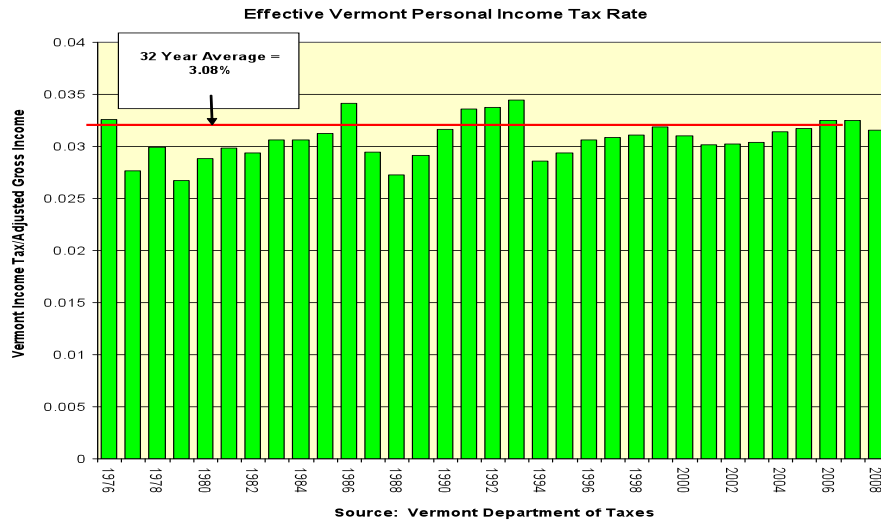
### Perception: *Income Tax*

- Perceptions driven by high marginal rates ignore fact that few Vermonters pay that rate. Vermont 18<sup>th</sup> in per capita income tax.
- Problematic comparisons to neighboring states
  - New Hampshire does not levy an income tax.
  - Other New England states and New York use AGI as their tax base
- Pervasive belief in anecdotal reports of tax flight by wealthy Vermonters

### Perception: *Income Tax*

<b>Current Brackets (Federal Taxable Income)</b>	<b>2008 Marginal Rates</b>	<b>Phase I – 2009 Marginal Rates</b>	<b>Phase II – 2010 Marginal Rates</b>
<b>\$ 0 to \$54,400</b>	<b>3.6%</b>	<b>3.55%</b>	<b>3.55%</b>
<b>\$54,400 to \$131,450</b>	<b>7.2%</b>	<b>7.00%</b>	<b>6.80%</b>
<b>\$131,450 to \$200,300</b>	<b>8.5%</b>	<b>8.25%</b>	<b>7.80%</b>
<b>\$200,300 to \$357,700</b>	<b>9.0%</b>	<b>8.90%</b>	<b>8.80%</b>
<b>Over \$357,700</b>	<b>9.5%</b>	<b>9.40%</b>	<b>8.95%</b>

## Perception: *Income Tax*



## Perception: *Income Tax*

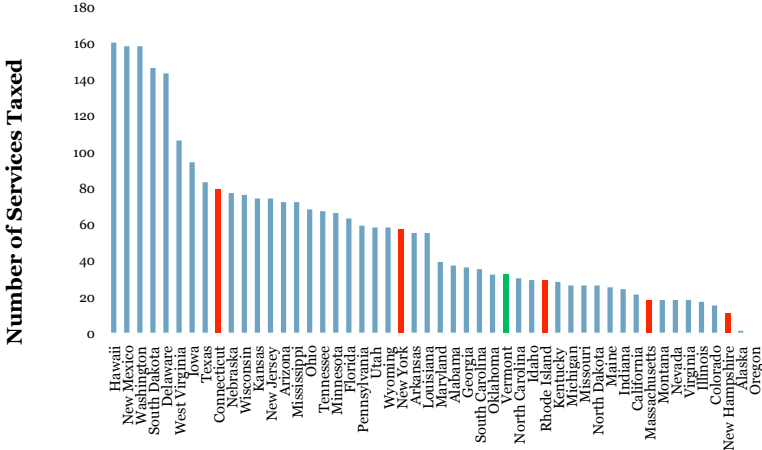
- Connecticut
  - 3.5% \$0-\$10,000
  - 5% \$10,001-\$500k
  - 6.5% \$500k+
- Maine
  - 2% \$0-\$4,850
  - 4.5% \$4,851-\$9700
  - 7% \$9,700-\$19,450
  - 8.5% \$19,451+
- Massachusetts
  - Flat 5.3%
- New Hampshire
  - No Income Tax
- Rhode Island
  - 3.75% \$0-\$55,000
  - 4.75% \$55,001 - \$125k
  - 5.99% \$125,001+

# Perceptions: Sales Tax

- Constant comparison to New Hampshire drives perception of very high sales tax.
- Mainstream approach to taxing services.



Number of Services Taxed, by State



Source: Federation of Tax Administrators

- 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: *Sales Tax*

- Vermont's 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 Median is 6% & Mean is 5.1%
- Nominal New England + NY Average is 4.9% at state level
  - Considerations:
    - New Hampshire does not have a sales tax.
    - County and local option sales taxes make New York's 4% rate misleading. Majority of New Yorkers pay > 8%
    - Average effective rate of neighboring states that tax sales is 6.375%



## Perceptions: *Property Tax*

- Vermont has assessed a statewide education property tax to fund public education since 1997
- Initially, the House bill which became Act 60 used an income tax to raise education revenue
- When that approach was rejected, a homestead exemption was considered
- Ultimately, the legislature passed a system where some taxpayers were eligible to pay based on income above and beyond traditional circuit breaker program



## Perceptions: *Property Tax*

- Local schools set the education spending level. The State subtracts non-property tax revenue dedicated to the Education Fund from the locally controlled spending amount. This covers about 1/3 of education spending. The remaining 2/3 is covered by property taxes.
- Next, the State divides property owners into two groups, - homestead owners and non-resident owners. Each year, the property tax rate is set to cover this education spending plus a reserve of 5%. The tax rate calculation reflects the fact that some Vermonters choose to support education through their income.
- *Got it?*





## Perception: *Property Tax*

**Rebate Program  
(Circuit Breaker)**  
Eligible homeowners pay property tax and apply for rebate.

**Prebate Program  
(Income Sensitivity)**  
Homeowners have the option to pay for education through their income tax.

**Property Tax**  
Homeowners pay for education based on property value.

Household  
Income  
\$0-\$47,000

Household Income  
\$47,000 - \$90,000

Household Income  
> \$90,000

70% of households support education based on income.

30% of households support education based on property value.

## Perceptions: Property Tax *What do you see?*

- A dual system of education funding where many property owners pay based on their income.
- OR**
- A property tax system that provides tax relief for homeowners with an income up to \$90,000.

**What you see here is the fundamental insight that drives your views, issues, and options for considering how residential property owners should fund public education.**

## Perception: *Corporate Income Tax*

- Why Unitary Combined Reporting?
- Revenue loss—Vermont and other single reporting states had seen steady erosion in corporate tax revenues even as profits rose
- Fairness—Evidence of increased tax sheltering activities by multistate corporations. Vermont companies paying disproportionate share.
- Competitiveness—Adopting fairer system for taxation allowed lowering of tax rates



## Perception: *Corporate Income Tax*

- Corporate Income Tax Reform
- Mandatory unitary combined reporting, effective for tax years beginning January 1, 2006
- Corporate tax rates reduced from 7%/8.1%/9.2%/ 9.75% over two years:
  - Tax year 2006—6%/7%/8.75%/8.9%
  - Tax years 2007 and after—6 %/7%/8.5% (highest two brackets collapsed)
- Apportionment formula changed from equal-weighted 3-factor to double-weighted sales factor
- Elimination of law that limited corporate income tax of holding companies to minimum tax



## Perception: *Corporate Income Tax*

- Effects of Combined Reporting.
- Tax year 2001, Vermont companies with 100% apportionment accounted for 48% of total corporate taxpayers but 58% of VT taxable income; for 2003, the percentages were 46% of taxpayers and 55% of taxable income
- For tax year 2007, those corporations with 100% apportionment accounted for 52% of total taxpayers but only 39% of VT taxable income
- For the period FY1999-2004, corporate tax revenues averaged \$45M, or 4.9% of GF revenues; for FY05-10, corporate revenues averaged \$68.8M, or 5.4% of GF revenues

## Perception: Is This Perception Fair?

- ITEP's *Who Pays* lauds the equity of Vermont's tax system
- Public tax grievances seem more complicated
- Reforms must balance perception of system with reality of system

## Reform: *Proposals Under Consideration*

- Income Tax
- 12 income tax models examined thus far
- Where the Commission has reached consensus
  - Switch tax base to AGI
  - Cap itemized deductions
  - Progressive system
  - Lower rates
- Open questions
  - How to cap itemized deductions?
  - Should VT collapse its five brackets?
  - Where and how to lower rates?



## Reform: *Proposals Under Consideration*

- Sales Tax
- Modeling adjustments to the tax base that would permit a substantial rate cut. Ideally, rate would be cut from 6% to 3%.
- Where the Commission has reached consensus:
  - Eliminate nearly all tax expenditures for individuals
  - Expand sales tax to services (with business to business exemption)
- Open questions
  - How deep can rates be cut?
  - How best to exempt business to business transactions?
  - How to address regressivity of sales tax base expansion?



## Reform: *Proposals Under Consideration*

- Property tax
- 8 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
- Open questions
  - Everything else



## Reform: *Proposals Under Consideration*

- 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 lowering rates and replacing progressive structure with a flat tax.
- Future hearings focused on resolving this dilemma.



## Reform: *The Way Forward*

- Commission is required to submit its recommendations by January 31, 2011.
- Hearings will continue this Fall along with public outreach.
- Commission has set a goal of delivering recommendations before the end of the year.
  - Timeline would allow recommendations to be drafted into legislation for start of the 2011 legislative session.
- The months ahead:
  - Will commission reach consensus ?
  - What will final recommendations be?
  - What will the legislature do with them?



## Questions?

Michael Costa, Director  
Blue Ribbon Tax Structure Commission  
1 Baldwin Street  
Montpelier, VT 05633  
(802) 828-3099

Thank you!

