Tax Reform in Vermont: Politics, Perception, and Reform

Presentation for FTA
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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 18th 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

<table>
<thead>
<tr>
<th>Perception: <em>Income Tax</em></th>
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<tbody>
<tr>
<td><strong>Current Brackets (Federal Taxable Income)</strong></td>
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<tr>
<td>$0 to $54,400</td>
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<td>$54,400 to $131,450</td>
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<tr>
<td>$131,450 to $200,300</td>
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<td>$200,300 to $357,700</td>
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<td>Over $357,700</td>
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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.
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: 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
- $47,000-$90,000
- > $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.
- 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

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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?

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Thank you!