Analysis of an Income-Based Education Property Tax for Vermonters

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Act No. 185, Section 16

of the 2006 Legislative Session

Prepared by the Joint Fiscal Office

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I. Statutory Charge

Legislation enacted during the 2006 session directed the Joint Fiscal Office to "create a fiscal model of Proposal #1 as presented in the December 15, 2005, Report of the House Legislative Study Committee on Income-Based Education Property Tax for Vermonters to the general assembly, with the ability to vary property and income tax rates and compare outcomes." The full text of this legislation is included in the appendix on page 23 of this report. The report of the House legislative study committee is available on the Joint Fiscal Office website.

II. Overview of Proposal #1

"Proposal #1" would create an education income tax and dedicate the revenue to the education fund to reduce reliance on the homestead property tax. The education income tax base would be "taxable income" as reported on the Vermont personal income tax return. The education income tax rate would be fixed at 1.5% of taxable income for all Vermont personal income tax filers who are subject to the tax. Which filers would be subject to the education income tax is discussed below.

A modified version of the education property tax created under Act 68 would be retained under Proposal #1. Under current law, taxable real property is divided into two distinct property classes: homestead property and nonresidential property. Homestead property is owner-occupied primary residences and all contiguous land. Nonresidential property is all other taxable real property including businesses, second homes, apartment buildings, and non-contiguous land.

The existing tax on nonresidential property would be retained without any modification under Proposal #1. However, the existing tax on homestead property would be modified in the following ways:

- The base tax rate on homestead property would be reduced to provide property tax relief to Vermonters.
- The spending adjustment to the base tax rate on homestead property would be weighted.
- The property tax adjustment would be repealed to simplify the education tax system for Vermonters.

III. Analysis of Proposal #1

Proposal #1, as presented in the study committee's report, is more of a concept than a specific proposal. Consequently, it was necessary to make a number of assumptions in order to prepare this analysis. These assumptions are discussed below where appropriate. Whenever possible, the fiscal impact of alternative assumptions has been quantified within this section. An outline of Proposal #1 that was distributed at public hearings is included in the appendix on page 24 of this report.

Analysis of Proposal #1 is based on the most recent data currently available. Analysis of the income tax component is based on preliminary tax year (TY) 2005 data provided by the Vermont Department of Taxes.[1] Analysis of the property tax component is based on preliminary fiscal year (FY) 2007 data provided by the Vermont Department of Taxes and the Vermont Department of Education.

[1] The preliminary personal income tax data provided will not match statistics published in January 2007 because approximately 700 extension returns are not included. The missing returns tend to be larger ones.

a. Education Income Tax

Proposal #1 would create an education income tax of 1.5% on Vermont taxable income,[2] however, the study committee left a number of issues related to the education income tax unresolved. First, would the amount of income subject to the education income tax be limited? Second, would nonresident Vermont personal income tax filers pay the education income tax? Finally, would Vermont residents who rent, rather than own, their homes pay the education income tax? Each of these unresolved issues is discussed below.

High-income Vermonters. This analysis assumes that there would be no limit on the amount of income subject to the education income tax. The study committee wrestled with this issue since Vermont's highest marginal personal income tax rate is currently the second highest nationally at 9.5%. High marginal income tax rates are a concern since they may affect the residency decisions of high-income taxpayers.

Limiting the amount of income subject to the education income tax would reduce revenue. In TY2005, there were 1,672 returns in the top marginal personal income tax bracket that began at $326,450 for all filers except married taxpayers who chose to file separately. The revenue forgone by limiting the amount of income subject to tax at $326,450 per return (or $113,225 per return for married taxpayers filing separately) would have been almost $11 million. The average education income tax paid by filers in this bracket would have fallen sharply from $11,455 to $4,897 per return.

Nonresidents. This analysis also assumes that nonresidents with Vermont taxable income would not be subject to the education income tax. Whether nonresident taxpayers should pay the education income tax is an issue because these taxpayers do not pay the homestead tax; if they happen to own taxable real property in Vermont, it is subject to the nonresidential property tax.

[2] Vermont taxable income is federal taxable income modified by the inclusion or exclusion of certain taxable and nontaxable income of the filer. See the appendix on page 25 for a full definition.

Consequently, unlike resident homeowners, nonresident taxpayers would not realize any offsetting reduction in property taxes under Proposal #1.

Requiring nonresidents with Vermont taxable income to pay the education income tax would increase revenue. In TY2005, Vermont personal income tax returns were filed by 46,514 nonresidents; of these, 39,949 reported Vermont taxable income. After apportioning the taxable income of nonresidents to Vermont, a fixed tax rate of 1.5% would have raised an estimated $11 million or an average of $275 per return.

Renters. This analysis also assumes that resident occupants of rental housing would be subject to the education income tax. Whether renters should pay the education income tax is an issue because renters pay the existing nonresidential property tax indirectly through their rents. Under Proposal #1, the nonresidential tax would be retained without modification, so renters would not realize any offsetting reduction in the education property taxes they pay through their rents.

The revenue that would be forgone if all renters were exempted from the education income tax is uncertain, but it would be significant. Consequently, the study committee considered exempting only those renters with household income under $47,000.[3] However, this issue was never resolved, and whether all renters or only low-income renters would be exempt from the education income tax was left for further discussion.

The 2005 American Community Survey (ACS) reported that there were 71,965 renter-occupied housing units in Vermont with total household income of $2.493 million. Although renter-occupied housing units accounted for almost 29% of all occupied housing units in Vermont, renters accounted for only 17% of total household income. The average household income for renter-occupied

[3] Presumably, a limit at $47,000 limit was considered because the household income limit for the existing renter rebate program is $47,000.

housing units was $34,646 per household compared to $68,729 per household for owner-occupied housing units.

More than one-half of renter-occupied households in Vermont had household income under $25,000 in 2005; four-fifths had household income under $50,000. The percent of housing units occupied by renters declined steeply as household income rose; however, there were renters at all levels of household income. For example, there were 2,294 renter-occupied units with household income over $100,000 in 2005.

Housing Tenure by Household Income

Household income in 2005	Renter-occupied units	Percent of all rental units	Percent of all housing units
$0 to $24,999	35,327	49.1%	54.9%
$25,000 to $49,999	22,564	31.4%	32.3%
$50,000 to $74,999	8,988	12.5%	17.7%
$75,000 to $99,999	2,792	3.9%	10.3%
$100,000 or more	2,295	3.2%	6.2%
Total	71,965	100.0%	28.9%

Source: U.S. Census Bureau, 2005 American Community Survey

Estimating the amount of revenue that would be forgone if renters were exempted from the education income tax is difficult. Although the ACS includes data that relate housing tenure to income, it reports household rather than taxable income. Household income is defined more broadly than taxable income and the relationship between the two measures of income varies widely across households.[4] Among low-income households, taxable income is a smaller percentage of household income; many low-income households have no taxable income at all.

[4] See the appendix on page 25 for definitions of both household income and taxable income.

Assuming that total taxable income for renters is roughly two-thirds of total household income, the revenue forgone by exempting all renters from the education income tax would be roughly $25 million or $347 per renter-occupied household. Although exempting renters with household income under $47,000 would exclude most renters from the education income tax, the revenue forgone would likely be roughly half that amount, since taxable income is a higher percentage of household income for high-income renters.

b. Homestead Property Tax

The existing tax on homestead property would be retained under Proposal #1, but it would be modified in several ways. First, the base tax rate on homestead property would be significantly lowered to reduce reliance on the property tax. Second, the spending adjustment to the base homestead tax rate would be weighted. Finally, the homestead property tax adjustment would be repealed to simplify the education tax system. Each of these modifications to the homestead property tax is discussed below.

Base tax rate on homestead property. Under Act 68, the statutory base tax rate on homestead property is $1.10 per $100 of fair market value. However, this tax rate is adjusted in any year in which there is a projected surplus or deficit in the education fund. Projected surpluses have allowed the base tax rate on homestead property to be reduced every year since the enactment of Act 68 in FY2005. In FY2007, the actual base tax rate on homestead property was $0.95.

Presumably, Proposal #1 would continue to adjust the base tax rate on homestead property whenever there is a projected surplus or deficit in the education fund. However, the study committee did not address this question directly in its report nor did it determine the amount at which the base homestead tax rate would be set. For the purpose of this analysis, the actual base homestead tax rate is set at $0.24 or $0.71 less than the base tax rate under Act 68 in FY2007.

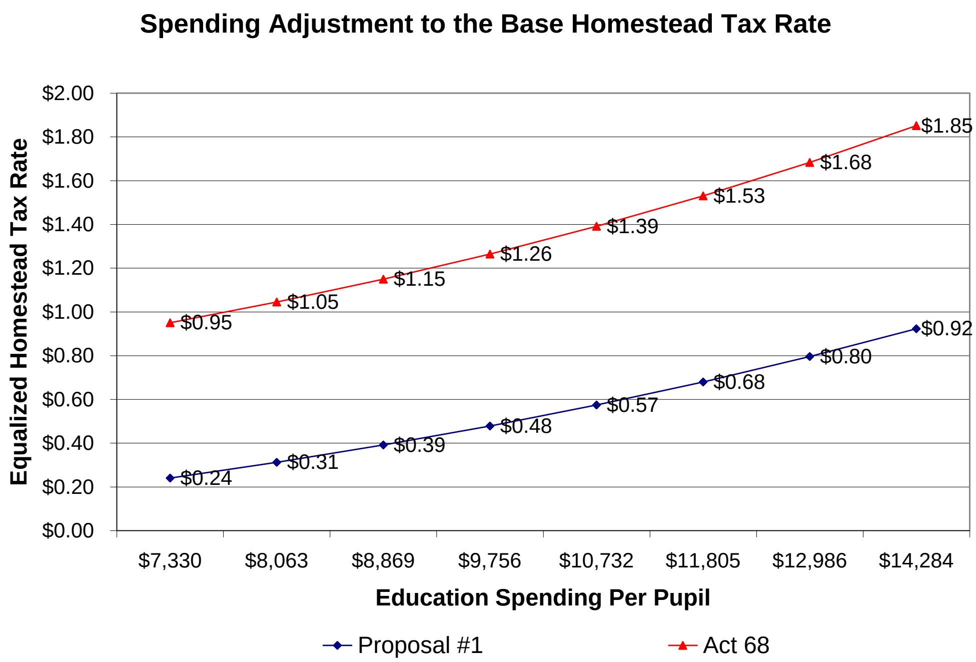
Spending adjustment to the base homestead tax rate. Under Act 68, the base homestead tax rate is adjusted by school district in proportion to education spending per equalized pupil. This adjustment is accomplished by multiplying the base homestead tax rate by the ratio of a school district's per-pupil education spending to the base education payment.[5] The study committee report did not specifically set the amount of the base education payment or the mechanism for adjusting it annually. For the purpose of this analysis, the base education payment is set at $7,330 per equalized pupil, its FY2007 level.

Proposal #1 would continue to apply a spending adjustment to the base homestead tax rate. However, that portion of a school district's per-pupil education spending that is in excess of the base education payment would be weighted. The study committee decided to weight education spending above the base education payment by a factor of three to approximate the increase in the homestead tax rate that would result from an increase in per-pupil education spending under Act 68.[6]

For example, an additional $100 in per-pupil education spending would have raised the homestead tax rate by about 1.3 cents under Act 68 in FY2007. Because the base homestead tax rate under Proposal #1 is $0.24 rather than $0.95, using the same unweighted spending adjustment would have raised the homestead tax rate by only 0.3 cents. With the weighted spending adjustment, an additional $100 in per-pupil spending would have raised the homestead tax rate under Proposal #1 by about 1 cent in FY2007.

[5] In FY2007, the homestead tax rate equals $0.95 x (education spending per pupil / $7,330).

[6] Under Proposal #1, the homestead tax rate would have equaled $0.24 x (1 + 3 x (*above-base* education spending per pupil / $7,330)).



In addition, weighting the spending adjustment would initially provide a larger homestead tax reduction for low-spending school districts than for high-spending school districts. Under Proposal #1, the average spending-adjusted homestead tax rate would have been reduced by almost 60% in FY2007. However, the percent reduction in the spending-adjusted homestead tax rate would vary by per-pupil spending level. For example, the homestead tax rate would have declined by 75% in a school district spending $7,330 per pupil but would have declined by only 52% in a school district spending $12,986 per pupil.

Equalized Homestead Property Tax Rates

Per-Pupil Spending	Equalized Homestead Tax Rates		Percent change
	Act 68	Proposal #1	
$7,330	$0.95	$0.24	-75%
$8,869	$1.15	$0.39	-66%
$10,732	$1.39	$0.57	-59%
$12,986	$1.68	$0.80	-52%

Calculations showing what homestead tax rates would have been under Proposal #1 in FY2007 for each school district are included at the end of this report. The average spending-adjusted homestead tax rate for a school district spending $10,473 per pupil would have been $0.55 compared to $1.37 under Act 68. Those school districts with the lowest education spending, at $7,330 per pupil or less, would have had a tax rate of $0.24 compared to $0.95 under Act 68; the school district with the highest education spending, at $14,650 per pupil, would have would have had a tax rate of $0.96 compared to $1.90 under Act 68.

Homestead property tax adjustment. Under Act 68, most Vermonters do not pay the homestead property tax on their "housesite," which includes the primary residence and up to two acres of contiguous land. Instead, they pay an education tax on their housesite that is based, at least in part, on their household income. The mechanism through which this is accomplished is the property tax adjustment. Proposal #1 would repeal the property tax adjustment to simplify the education tax system. In FY2007, total property tax adjustments amounted to an estimated $107 million.

Under current law, Vermonters with household income under $85,000 may pay an education tax on their housesite that is based entirely on their household income.[7] Vermonters with household income over $85,000 may pay an education tax based partially on their household income and partially on the value of their housesite in excess of $200,000. However, once household income reaches $105,556, taxpayers are better off simply paying a homestead tax that is based on the full value of their housesite.

There are two related provisions of Act 68 that should also be discussed here. The first provision, the "homestead exemption," allows Vermonters with household income under $47,000 to pay the homestead property tax after deducting $15,000 from the fair market value of their housesite *instead* of paying the homestead tax based on household income. The second provision, the

[7] In FY2008, the household income limit will increase to $90,000.

“acreage adjustment,” entitles Vermonters with household income under $85,000 to an *additional* adjustment of $10 per acre for up to five acres in excess of the two-acre housesite.

Both the homestead exemption and the acreage adjustment are technically part of the homestead property tax adjustment under Act 68. Moreover, both provisions serve to further complicate an education property tax system that the study committee intended Proposal #1 to simplify. Although the study committee did not specifically address either of these related parts of the homestead property tax adjustment, it is assumed for the purpose of this analysis that both would be repealed.

c. Nonresidential Property Tax

The existing tax on nonresidential property would be retained under Proposal #1 without any modification. Under Act 68, the statutory tax rate on nonresidential property is $1.59 per $100 of fair market value. However, like the base tax rate on homestead property, the nonresidential tax rate has been reduced every year in which there has been a projected surplus in the education fund. In FY2007, the actual nonresidential tax rate was $1.44.

Presumably, Proposal #1 would continue to adjust the statutory tax rate on nonresidential property whenever there is a projected surplus or deficit in the education fund. However, the study committee did not specifically address this question in its report. For the purpose of this analysis, the actual nonresidential tax rate is set at its FY2007 level. Unlike the tax rate on homestead property, the nonresidential tax rate is not adjusted in proportion to per-pupil education spending.

d. Homeowner Rebate Program

Under Act 68, Vermonters with household income under $47,000 may be eligible for a homeowner rebate if their *adjusted* education property tax and their municipal property tax exceed a certain percentage of their household income. Proposal #1 would retain the homeowner rebate, but the calculation of the rebate would exclude the education income tax. Since the homestead property tax would be significantly reduced under Proposal #1, the cost of the homeowner rebate would also be much lower.

Analysis of the homeowner rebate program in FY2007 is complicated by the passage of Act 185 last session. Under Act 185, the property tax adjustment and the homeowner rebate programs were consolidated and the first payment under the consolidated program is not due until July 1, 2007. As a result, taxpayers will not receive the homeowner rebates to which they otherwise would have been entitled in FY2007 until FY2008. For the purpose of this analysis, the homeowner rebate is excluded from consideration.

IV. Education Fund Analysis

In this analysis, the base homestead property tax rate was reduced to the point at which the operating results under Proposal #1 and Act 68 would be roughly equal. Since the base homestead tax rate was adjusted by whole cents, there is a $1.1 million difference in the operating results. In addition, the operating result shown for Act 68 varies slightly from actual current law because, as discussed above, the cost of the homeowner rebate program in FY2007 is excluded. An education fund balance sheet for FY2007 is presented below.

a. Expenditures

This analysis compares Proposal #1 to Act 68 for one year only. However, with the single exception of the homeowner rebate program, it is assumed that total education fund expenditures would remain unchanged under Proposal #1. Consequently, any impact that implementation of Proposal #1 might have on the rate of growth in education spending is not reflected in this analysis. Since the enactment of Act 68 in FY2005, education fund expenditures have grown at an average annual rate of 5.9%. In FY2007, total education fund expenditures were over $1.2 billion.

How Vermonters who vote on school budgets would react to Proposal #1 is uncertain, but it is likely that Proposal #1 would tend to increase the rate of growth of education spending. First, the 60% reduction in the average homestead tax rate would mean that the property tax cost would be significantly lower at any given level of per-pupil education spending. Although weighting the spending adjustment would result in increases in the homestead property tax rate that are close to the increases that would result under Act 68, the increase would be on a much smaller base tax rate.

Second, under Proposal #1, 44% of the education tax on homesteads would no longer be related to per-pupil education spending at all. Under Act 68, the homestead tax increases in proportion to per-pupil education spending whether the tax is based on property value or household income. Under Proposal #1, the income tax component of the education tax would remain constant regardless of the level of per-pupil education spending. Consequently, the impact of higher per-pupil spending on the total education tax bills of Vermonters would be diminished.

b. Revenue

Income tax revenue. Unlike the Vermont personal income tax, which has a progressive rate schedule, the education income tax would be proportional to taxable income across income brackets. In TY2005, the education income tax would have raised an estimated $139 million or an average of $581 per resident personal income tax filer. As indicated above, this revenue estimate assumes that there would be no limit on the amount of taxable income subject to the tax; that nonresident filers would not be subject to the tax; and that all resident renters would be subject to the tax.

Education Income Tax in 2005

Marginal income tax bracket	Number of returns	Taxable income (millions)	Income tax revenue (millions)	Average tax per return
0.0%	60,596	$0	$0	$0
3.6%	167,936	$2,884.7	$43.3	$258
7.2%	60,216	$3,589.2	$53.8	$894
8.5%	7,007	$864.6	$13.0	$1,851
9.0%	3,026	$667.4	$10.0	$3,305
9.5%	1,672	$1,276.8	$19.1	$11,455
Returns	300,456	$9,257.6	**$139.2**	$581[8]

Source: Vermont Department of Taxes

Property tax revenue. Under Act 68, *net* property tax revenues amounted to $769 million or about 64% of education fund sources in FY2007. Net property tax revenue was composed of $314 million in net taxes on homestead property and $455 million in taxes on nonresidential property. The *gross* homestead property tax was $421 million; however, an estimated $107 million of this amount was returned to Vermonters through the property tax adjustment or “prebate” described above.

Under Proposal #1, property taxes would have been about $629 million or about 52% of total education fund sources in FY2007. Nonresidential property tax revenue would have remained constant at $455 million. However, net homestead property tax revenue would have fallen from $314 million to $174 million in FY2007, reducing net homestead property taxes by $140 million or by nearly 45% as compared with Act 68.

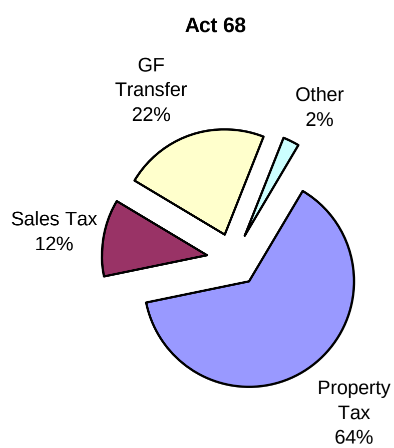
[8] The average per return for resident filers excludes the 60,596 returns reporting no Vermont taxable income.

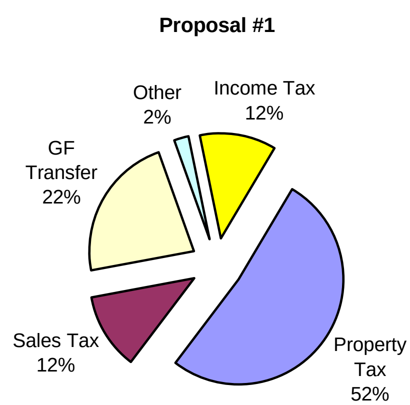
Homestead Property Tax in FY2007 (millions)

	Act 68	Proposal #1	Difference
Gross homestead	$421.0	$173.7	$247.3
Property tax adjustment	-$107.0	NA	-$107.0
Net homestead property	$314.0	**$173.7**	$140.3

For the purpose of this analysis, the base homestead tax rate under Proposal #1 was set at $0.24 in FY2007 in order to raise the $174 million necessary to match the actual education fund operating result under Act 68. If any of the assumptions made in this analysis were changed, it would be necessary to adjust the base homestead tax rate accordingly. Under Proposal #1, one cent on the base homestead tax rate would have raised $7.2 million in FY2007.

Composition of education fund revenue sources. As the following pie charts illustrate, reliance on the education property tax to finance school spending would have declined under Proposal #1 in FY2007. Nevertheless, total property taxes would have continued to account for more than one-half of all education fund revenue sources. Moreover, the tax burden on nonresidential property would have remained unchanged.





Reliance on the property tax would have declined from 64% of total education fund sources under Act 68 to 52% under Proposal #1. The 12% reduction in the property tax share would have been made up entirely by new education income tax revenue. The share of all other revenue sources, which accounted for 36% of total education fund sources in FY2007, would have remained unchanged under Proposal #1.

Although the homestead property would be reduced initially, it is likely that reliance on the property tax would continue to grow under Proposal #1. Since the implementation of Act 68 in FY2005, non-property tax revenues have grown at an average annual rate of only 3.6%. Since TY2002, the taxable income base has grown at an average annual rate of 5.6%.[9] If non-property tax revenue sources do not keep pace with growth in education spending, the property tax must make up the difference under both Act 68 and Proposal #1.

[9] The respective base years were chosen for these calculations because in FY2005 the mix of non-property tax revenues dedicated to the education fund changed significantly and in TY2002 Vermont decoupled from the federal income tax.

Education Fund Outlook - Act 68 Compared to Proposal #1

(millions of dollars)

Note: This is a hypothetical education fund outlook based on FY2007 data. It is a working document and is only intended to illustrate how an education income tax might work.

Assumptions	*Act 68*	*Proposal*	*Difference*
Homestead Tax Rate *(rate varies with spending)*	$0.95	$0.24	-$0.71
Tax Rate on Taxable Income *(rate is flat)*		1.5%	1.5%
Uniform Non-Homestead Tax Rate	$1.44	$1.44	-
Base Education Payment Per Pupil	$7,330	$7,330	-
Base Rate on Household Income	1.80%	Homestead property tax adjustment is repealed.	
Household Income Limit	$85,000		
Housesite Value Limit	$200,000		

Sources

Homestead Education Tax	421.0	173.7	(247.3)
Property Tax Adjustment	(107.0)		107.0
Education Income Tax		139.2	139.2
Non-Homestead Education Tax	455.0	455.0	-
Sales & Use Tax	113.1	113.1	-
Purchase & Use Tax	27.0	27.0	-
General Fund Transfer	268.7	268.7	-
Lottery Transfer	21.5	21.5	-
Medicaid Transfer	6.3	6.3	-
Vermont Yankee Education Tax	1.9	1.9	-
Fund Interest	(0.8)	(0.8)	-
Total Sources	**1,206.7**	**1,205.6**	**(1.1)**

Uses

Education Payment	1,018.4	1,018.4	-
Special Education	125.1	125.1	-
State-Placed Students	14.4	14.4	-
Transportation	14.0	14.0	-
Technical Education	10.6	10.6	-
Small Schools	5.4	5.4	-
EEE Block Grant	4.8	4.8	-
Capital Debt	0.4	0.4	-
Adult Education & Literacy	1.0	1.0	-
Homeowner Rebate *(transition year)*	0.0	0.0	-
Renter Rebate	5.2	5.2	-
Reappraisal & Listing	3.2	3.2	-
Total Uses	**1,202.5**	**1,202.5**	**-**

Fund Balance

Operating Result	**4.2**	**3.1**	**(1.1)**
Prior Year Fund Balance	29.5	29.5	-
Total Fund Balance	**33.7**	**32.6**	**(1.1)**

V. Distribution of Property and Income Tax Burdens

a. Resident Homeowners

Analyzing the distribution of education income and property tax burdens for resident homeowners under Proposal #1 as compared to Act 68 is problematic. In order to prepare a systematic analysis of relative tax burdens, it would be necessary to know household income, taxable income, homestead and housesite value, and the homestead tax rate for each owner-occupied household in Vermont. As discussed below, this information is not available by household.

Under Act 68, the education tax paid by resident homeowners, whether based on homestead value or household income, is assessed on households. Under Proposal #1, the homestead property tax would also be assessed on households; however, the education income tax would be assessed on taxable income as reported on the Vermont personal income tax return. Since there are many situations in which multiple tax returns are filed for individual households, data on taxable income is not readily available *by household*.

To get a sense of the distribution of income and property tax burdens, this analysis calculates education tax liabilities for hypothetical homesteads under Act 68 and Proposal #1. However, this approach also has significant limitations. First, it is necessary to make assumptions about the relationship between current income and house value. However, as the following data from the 2003 American Housing Survey (AHS) indicate, this relationship varies widely between households.

Ratio of House Value to Current Income

Ratio of value to current income	Total occupied units	Rural	Mobile Homes	Elderly	Below poverty level
Less than 1.5	23.1%	30.1%	65.1%	13.0%	7.8%
1.5 to 1.9	11.9%	11.9%	8.0%	5.9%	1.9%
2.0 to 2.4	10.7%	10.2%	5.4%	6.5%	1.9%
2.5 to 2.9	9.4%	8.3%	3.1%	7.1%	2.5%
3.0 to 3.9	12.4%	10.5%	4.7%	11.7%	4.2%
4.0 to 4.9	7.5%	6.7%	3.4%	9.1%	3.4%
5.0 or more	23.3%	20.3%	7.9%	43.9%	58.2%
Zero or negative	1.8%	1.9%	2.1%	2.7%	20.1%
Median ratio	**2.7**	**2.3**	**1.1**	**4.5**	**34.1**

Source: 2003 American Housing Survey for the United States

For example, the AHS reports that although fewer than 24% of all homeowners own homes that are worth at least five times their current income, more than 44% of the elderly own homes worth at least five times their current income (presumably because they have retired and are living on fixed incomes). The AHS also reports that among all homeowners, 23% own homes that are worth less than 1.5 times their current income while 23% own homes worth more than five times their current income. Although the AHS reports national data, it is likely that similar disparities between income and home values exist in Vermont.

Second, it is necessary to make assumptions about the relationship of household income to taxable income. Although Vermont household income and Vermont taxable income both use federal adjusted gross income as a starting point, Vermont household income is defined much more broadly. Consequently, the relationship between household and taxable income also varies widely between households. The definitions of both household and taxable income are included in the appendix on page 25.

Finally, this analysis of the distribution of income and property burdens for resident homeowners addresses only the initial impact of Proposal #1. If education spending continues to grow at historical rates, reliance on the homestead property tax would increase over time. To the extent that growth in property values exceeded growth in household income, resident homeowners who currently pay a homestead tax that is based on household income would likely assume a larger portion of the homestead property tax burden over time.

Hypothetical resident homeowners. FY2007 homestead tax liabilities are presented in the following tables for three hypothetical resident homeowners. The taxable income and housesite value assumptions are *averages* for actual resident homeowners with household income within $5,000 of the target household income level. Calculations are presented for a school district with education spending at the 50th percentile or $10,468 per pupil in FY2007.[10]

Two simplifying assumptions were made in calculating homestead taxes for these hypothetical taxpayers. First, it was assumed that the homesteads of these hypothetical taxpayers consist entirely of their housesite – residence and two acres of contiguous land. Under Act 68, the property tax adjustment is limited to the housesite; any additional contiguous acreage would be subject to the homestead property tax rate.

Second, taxpayers with household income under $47,000 may be eligible for the homeowner rebate if their adjusted education tax and their municipal tax exceed a certain percentage of their household income. The potential effect of the homeowner rebate is not considered in this analysis; however, under Proposal #1 the education income tax would be excluded from the homeowner rebate calculation, so including the homeowner rebate here could only increase the education tax for this taxpayer under Proposal #1.

[10] Calculations for school districts with higher and lower per-pupil education spending are included in the appendix on pages 27-29.

Assumptions

	Household 1[11]	Household 2	Household 3
Target household income	$40,000	$60,000	$100,000
Housesite value	$157,212	$184,236	$249,129
Taxable income	$21,932	$37,884	$67,611
Ratio of housesite value to household income	3.9	3.1	2.5
Ratio of housesite value to taxable income	7.2	4.9	3.7

Education Spending at $10,468 per Pupil

Current law			
Homestead property tax	$2,133	$2,499	$3,380
Property tax adjustment	-$1,105	-$957	-$143
Total tax on housesite	$1,028	$1,542	$3,237
Proposal #1			
Homestead property tax	$865	$1,013	$1,370
Education income tax	$329	$568	$1,014
Total	$1,194	$1,582	$2,384
Difference	**$165**	**$39**	**$-853**

The higher-income taxpayer in this Illustration would pay $853 less under Proposal #1. Under Act 68, this taxpayer would pay a homestead tax partially based on household income and partially based on housesite value.[12] Under Proposal #1, the income tax base would be smaller and the income tax rate would be lower than under Act 68. In addition, the homestead property tax rate would be lower under Proposal #1 than it would be under Act 68. The magnitude of the homestead tax reduction for this taxpayer under Proposal #1 would increase with per-pupil spending.

[12] For this taxpayer, the spending-adjusted tax rate on household income would be applied to $100,000 of household income and the spending-adjusted homestead property tax rate would be

On the other hand, the two lower-income taxpayers in this illustration would pay more under Proposal #1. Under Act 68, these taxpayers pay a homestead tax that is based entirely on household income, so they do not benefit from the lower property tax rate under Proposal #1. The income tax base would be smaller and the income tax rate would be lower under Proposal #1, but not enough to offset the portion of the education tax that would be based on housesite value. The magnitude of the homestead tax increase for these taxpayers under Proposal #1 would also increase with per-pupil spending.

Hypothetical higher-income resident homeowners. FY2007 homestead tax liabilities are presented below for three hypothetical higher-income resident homeowners. Household income data for these taxpayers is not available. Since taxpayers at this income level are not eligible for a property tax adjustment, whether the acreage contiguous to their housesites exceeds two acres is not relevant. Calculations are presented for a school district with education spending at the 50^{th} percentile or $10,468 per pupil in FY2007.

Housesite value for these taxpayers is initially set at the "break even" point – the homestead value at which the homestead tax liability would be equal under Act 68 and Proposal #1:

Assumptions

	Household 1	**Household 2**	**Household 3**
Target taxable income	$125,000	$250,000	$500,000
Housesite value	$231,481	$462,963	$925,926
Ratio of taxable income to housesite value	1.85	1.85	1.85

applied to $49,129 of housesite value – the amount of housesite value in excess of the $200,000 limit. See the discussion of the homestead property tax adjustment in Section III.

Household Income at the "Break-even Point"

Current law			
Homestead property tax	$3,148	$6,296	$12,593
Proposal #1			
Homestead property tax	$1,273	$2,546	$5,093
Education income tax	$1,875	$3,750	$7,500
Total	$3,148	$6,296	$12,593
Difference	**$0**	**$0**	**$0**

To illustrate the impact that the ratio of taxable income to housesite value has on homestead tax bills, taxable income was increased and decreased by 10% in the following two alternative calculations:

Alternative 1 - Household Income is 10% Higher

Current law	**Household 1**	**Household 2**	**Household 3**
Homestead property tax	$3,148	$6,296	$12,593
Proposal #1			
Homestead property tax	$1,273	$2,546	$5,093
Education income tax	$2,063	$4,125	$8,250
Total	$3,336	$6,671	$13,343
Difference	**$188**	**$375**	**$750**

Alternative 2 - Household Income is 10% Lower

Current law			
Homestead property tax	$3,148	$6,296	$12,593
Proposal #1			
Homestead property tax	$1,273	$2,546	$5,093
Education income tax	$1,688	$3,375	$6,750
Total	$2,961	$5,921	$11,843
Difference	**-$187**	**-$375**	**-$750**

These tables illustrate the impact that the ratio of taxable income to housesite value would have on the homestead tax on the housesites of higher-income taxpayers:

- The first table shows that for taxpayers who own housesites that are worth 1.85 times their taxable income, the homestead tax would be the same under both Act 68 and Proposal #1.
- Alternative 1 shows that if taxable income were 10% higher (so that their housesites were worth only 1.68 times their taxable income), the homestead tax would be *higher* under Proposal #1.
- Alternative 2 shows that if taxable income were 10% lower (so that their housesites were worth 2.06 times their taxable income), the homestead tax would be *lower* under Proposal #1.

b. Renters

Renters effectively pay the existing nonresidential property tax indirectly through their rents. Since Proposal #1 would retain the nonresidential tax without modification, renters, in contrast to homeowners, would not realize any reduction in education property taxes. Consequently, if renters were not exempted from the education income tax, their education tax burden would increase by exactly 1.5% of their taxable income. On the other hand, if renters are exempted from the education income, their education tax burden would remain unchanged.

c. Nonresidents

Nonresidents with Vermont taxable income may own real property in Vermont and pay the existing nonresidential property tax or not. Since Proposal #1 would retain the nonresidential property tax without modification, nonresidents, like renters, would not realize any offsetting reduction in education property taxes. Consequently, if nonresidents were not exempted from the education income tax, their Vermont tax burden would increase by exactly 1.5% of the Vermont portion of their taxable income.

VI. Impact on the Common Level of Appraisal

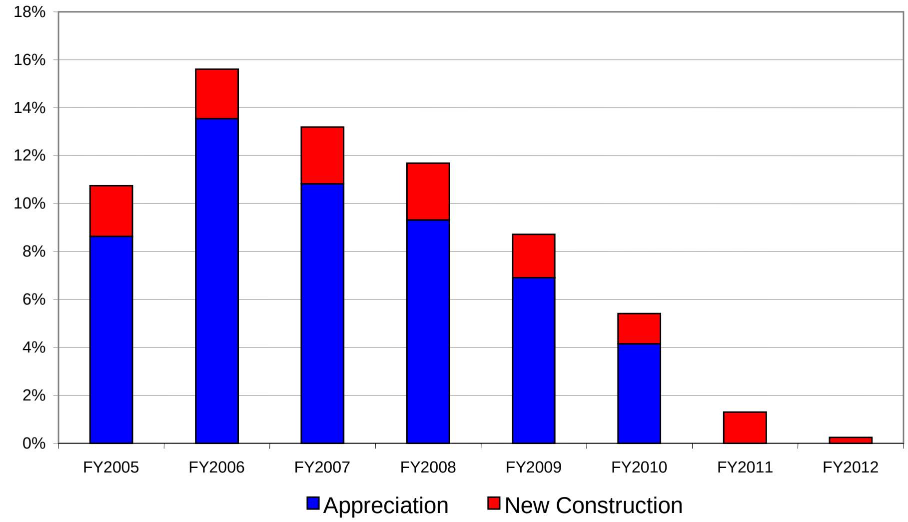
In order to apply the statewide education property tax fairly, it is necessary to uniformly value taxable real property. However, the relationship of assessed or “listed” value to fair market value varies widely between municipalities. The common level of appraisal or “CLA” is a measure, an estimate, of how close a school district’s local appraisals of taxable real property are to fair market value. Dividing listed value by the CLA yields an estimate of fair market or “equalized” value.

Although assessment practices have improved in Vermont, the double-digit rates of appreciation in the value of real property that Vermont has experienced due to market conditions over the past several years have made it more difficult for municipalities to maintain their CLAs at the statutory minimum of 80%. In 2005, there were 115 municipalities with CLAs less than 80%. The farther a municipality’s CLA is from the statutorily set standard of 100%, the greater the impact of the CLA on education tax bills.

Although the CLA and its application have become an issue for many taxpayers, for most resident homeowners the CLA is largely irrelevant because they pay an education tax on their housesite that is based on household income rather than housesite value. The CLA does affect the education tax bills of taxpayers who own nonresidential property, taxpayers who are not eligible for a property tax adjustment, and taxpayers who own homestead property in excess of the two-acre housesite.

The following graph shows historical and projected growth in the value of homestead property. If the projections prove to be accurate, annual appreciation in the value of homestead property peaked in FY2006 and will continue to decline for the foreseeable future. In FY2011 and FY2012, new construction is projected to account for all growth in the homestead grand list. As a result, the magnitude of the CLA-adjustment to homestead tax rates will diminish even under current law.

Growth in the Homestead Grand List



Under Proposal #1, the average homestead property tax rate would be reduced by a significant amount. Consequently, the impact of appreciation in homestead value on education property tax bills, reflected in the CLA adjustment to the homestead tax rate, would also be significantly diminished at any rate of appreciation. Proposal #1 would have no impact on the CLA adjustment to nonresidential tax rates; however, appreciation in the value of nonresidential property is also expected to decline through FY2012.

VII. Administrative Issues

a. Administrative Costs

Since Proposal #1 would retain the nonresidential property tax and a modified version of the homestead property tax, the state and local costs of administering the property tax would remain the same as under Act 68. However, both the repeal of the homestead property tax adjustment and the creation of an education income tax would affect the state's cost of administering the education finance system.

Since Proposal #1 would repeal the homestead property tax adjustment, the tax department would no longer have to process household income applications (Form HI-144) for roughly 60,000 Vermonters who would have been eligible under Act 68. However, the administrative cost savings that would be realized by repealing the homestead property tax adjustment would be small as a result of the passage of Act 185 last session.

Act 185 consolidated the homestead declaration (Form HS-131) and the property tax adjustment application (Form HS-138) into a single new form (HS-22). Since the homestead declaration would continue to be required under Proposal #1, there would be no administrative cost savings from the elimination of the property tax adjustment claim form. In addition, under Act 185 taxpayers will receive homestead property tax bills net of the property tax adjustment, thereby eliminating the current practice of processing and mailing property tax adjustment checks to taxpayers.

On the other hand, the tax department would need to administer a new education income tax. The tax department estimates that the computer programming changes, taxpayer outreach and education, and additional staff in the department's collections and audit units that would be required to implement Proposal #1 would cost an estimated $900,000 to $1.2 million. A memo from the tax department that discusses this estimate in more detail is included in the appendix on page 31. The tax department has identified the following issues that would need to be addressed if an education income tax were implemented:

1. **Withholding tables –** New withholding tables for employers would have to be created to ensure that employees were having enough money withheld to cover both their income tax and their education income tax obligation.

2. **W-2s –** A box on the state W-2 form would have to be allocated to the education income tax amount so that it could be separately authenticated.

3. **Withholding forms –** The forms on which business entities report their withholding to the Department, as well as the EFT files for those who are required or who wish to file electronically, would need to be changed from a one-

line form/transaction to a three-line form/transaction: one line for income tax withholding, a second line for education income tax withholding, and a third line for a total of the two lines.

4. **Income tax forms –** A line would have to be added for the taxpayer to report the amount of education income tax due (1.5% of taxable income).

5. **Refunds –** Other lines would have to be added to the income tax return to calculate the amount to be refunded or amount still to be paid for education income tax as the form does for those who owe income tax or have a refund from their income tax.

6. **Revenue accounting –** A new diversion code would have to be created to separate the education income tax from the general fund income tax.

7. **Audit trail** – The income tax system would have to incorporate the ability to electronically compare the education income tax amount a taxpayer reported on his or her income tax return to the education income tax amount reported as withheld by the taxpayer's employer.

8. **Collections –** Collecting another tax with revenues expected to be in the $100-200 million range would create additional work for our collections system and collections staff.

9. **Audit –** Some level of audit presence would be necessary to ensure that the new tax was being appropriately withheld and remitted to the State by business entities. Whether new staff would be required is difficult to gauge at this time.

b. Withholding

Under current law, most taxpayers have a portion of their wages or salaries withheld from their paychecks to cover their estimated personal income tax liability. Under Proposal #1, taxpayers who are currently subject to income tax withholding would also have a portion of their wages or salaries withheld to cover their education income tax liability. Withholding would eliminate the burden many taxpayers now face in having to pay their entire homestead education tax in one to four installments.

Estimated personal income tax payments are required when a taxpayer's tax liability exceeds withholding and tax credits. Estimated payments must be made in four equal installments. Making estimated payments is particularly important for the self-employed and residents working in another state or nonresidents working in Vermont. Whether these taxpayers would be also required to make estimated payments on their education income tax liability was not resolved by the study committee.

VIII. Appendix

a. Section 16 of Act No. 185 of the Acts of 2006

ANALYSIS OF INCOME-BASED EDUCATION TAX PROPOSAL

The joint fiscal office, with the assistance of legislative council, shall create a fiscal model of Proposal #1 as presented in the December 15, 2005, Report of the House Legislative Study Committee on Income-Based Education Property Tax for Vermonters to the general assembly, with the ability to vary property and income tax rates and compare outcomes. The joint fiscal office shall also

(1) analyze the distribution of income and property tax burdens under Proposal #1 as compared to current income and property tax burdens;

(2) analyze the effect of the proposal on towns' common levels of appraisal;

(3) estimate the administrative costs of transition to a new system;

(4) estimate the ongoing administrative costs of such a system, as compared to administrative costs of the current education property tax system. The joint fiscal office shall present its model and report its findings to the general assembly by December 1, 2006.

b. Outline of Proposal #1

HOUSE LEGISLATIVE STUDY COMMITTEE ON INCOME-BASED EDUCATION PROPERTY TAX FOR VERMONTERS

Two Draft Proposals for Reform of the Income-Based Education Tax System
Public Hearing
November 7, 2005

Proposal #1

1. Homestead property tax rate.

(a) Significantly lower the homestead property tax base rate. The rate has not yet been determined, but could be approximately 30 cents. (This will diminish the effect of the common level of appraisal on tax bills.)

(b) The base rate is then adjusted upward by three times the district's education spending in excess of base education payment per pupil. (For example, if the district spends 10% more per pupil than the base education payment, then the 30 cent rate is increased by 3 x 10%, or 30%, to 39 cents.)

2. Property tax adjustment program.

(a) Eliminate the prebate program.

(b) Keep the rebate program (will still be based on education and municipal property tax, but will not include education income tax in the calculation).

3. Education income tax.

(a) Create an education income tax of 1.5% on taxable income.

(b) The tax would be reported in the same manner as other income tax, but would be stated separately on the tax return; and would be subject to withholding.

4. Further issues to consider:

Tax only residents?
Exempt renters under $47,000 or all renters?
Cap the income which is subject to the tax?
Require quarterly estimated tax payments?

Prepared by Legislative Council
EB 11/1/05

c. Definitions of Income

Vermont household income

Vermont household income is federal adjusted gross income modified by inclusion or exclusion of certain taxable and nontaxable income for members of the household.

Additions:

- Alimony
- Support money
- Cash public assistance and relief
- Cost of living allowances paid to federal employees
- Allowances received by dependents of servicemen and women
- Roth IRA distributions representing investment earnings and not included in adjusted gross income
- Railroad retirement benefits
- Payments received under the federal Social Security Act
- Benefits under Veterans' Acts
- Federal pension and annuity benefits not included in adjusted gross income
- Nontaxable interest received from the state or federal government
- Workers' compensation
- Gross amount of "loss of time" insurance
- Amount of capital gains excluded from adjusted gross income
- Income of a spouse from whom you are not legally separated even if that spouse does not live in the household
- Difficulty of care payments

Exclusions:

- Property tax assistance payments or renter rebates
- $6,500 of income earned by a full-time student who qualifies as taxpayer's dependent
- $6,500 of income received by a parent who qualifies
- Payment made by Vermont for foster care
- Payment made by Vermont to a family for support of developmentally disabled family member
- Gifts from nongovernmental sources
- Surplus good or other relief in kind supplied by a government agency
- The contribution portion of a pension or annuity distribution if the contribution was included in adjusted gross income in the year of contribution
- The income of a person living in the household under a written home sharing agreement
- Income of a person living in the household who is a bona fide employee hired to provide personal care to a household member and is not related to the person to whom the car is provided
- Income of a spouse age 62 or older who does not live in the household and has moved permanently to a nursing home or other car facility

- Income of a person residing with the homeowner who is age 62 or is disabled for the primary purpose of providing attendant care services or homemaker services or companionship services that allow the homeowner to remain in his or her home or to avoid institutionalization

Adjustments:

- Social security and Medicaid taxes withheld and self-employment taxes paid by individual
- Child support money paid if substantiated by receipts or other evidence that the Commissioner may require
- Adjustments to federal adjusted gross income from 1040 line 37 or 1040A line 21

Vermont taxable income

Vermont taxable income is federal taxable income modified by inclusion or exclusion of certain taxable and nontaxable income for the filer. Federal taxable income equals federal adjusted gross income after the standard or itemized deductions and personal and dependent exemptions.

Additions:

- Income from non-Vermont state and local government obligations

Exclusions:

- Interest income from US obligations
- 40% of capital gains
- Angel venture capital gain deferral

Education Taxes on Hypothetical Households

Education Spending Per Pupil at 25th Percentile

Assumptions	Homestead 1	Homestead 2	Homestead 3
Household income	$40,000	$60,000	$100,000
Average housesite value*	$157,212	$184,236	$249,129
Average taxable income*	$21,932	$37,884	$67,611
Ratio of housesite value to taxable income	7.2	4.9	3.7
Ratio of housesite value to household income	3.9	3.1	2.5

Current law

Education spending per pupil	**$9,726**
Base homestead property tax rate	$0.95
Base rate on household income	1.80%
Base education payment	$7,330
Spending adjustment	1.33
Adjusted homestead property tax rate	**$1.26**
Adjusted rate on household income	**2.39%**

	Homestead 1	Homestead 2	Homestead 3
Homestead property tax on housesite	$1,982	$2,322	$3,140
Prebate	-$1,026	-$889	-$133
Total education tax on housesite	**$955**	**$1,433**	**$3,008**

Proposal #1

Flat rate on taxable income	1.5%	*from income tax model*
Base homestead tax rate	$0.24	*from homestead property tax model*
Adjusted homestead tax rate	**$0.48**	*from homestead property tax model*

	Homestead 1	Homestead 2	Homestead 3
Income tax component	$329	$568	$1,014
Homestead property tax component	$755	$884	$1,196
Total education tax on housesite	**$1,084**	**$1,453**	**$2,210**
Difference	**$128**	**$20**	**-$798**

Education Taxes on Hypothetical Households

Education Spending Per Pupil at 50th Percentile

Assumptions	Homestead 1	Homestead 2	Homestead 3
Household income	$40,000	$60,000	$100,000
Average housesite value*	$157,212	$184,236	$249,129
Average taxable income*	$21,932	$37,884	$67,611
Ratio of taxable income to housesite value	7.2	4.9	3.7
Ratio of housesite value to household income	3.9	3.1	2.5

Current law

Education spending per pupil	$10,468
Base homestead property tax rate	$0.95
Base rate on household income	1.80%
Base education payment	$7,330
Spending adjustment	1.43
Adjusted homestead property tax rate	**$1.36**
Adjusted rate on household income	**2.57%**

	Homestead 1	Homestead 2	Homestead 3
Homestead property tax on housesite	$2,133	$2,499	$3,380
Prebate	-$1,105	-$957	-$143
Total education tax on housesite	**$1,028**	**$1,542**	**$3,237**

Proposal #1

Flat rate on taxable income	1.5%	*from income tax model*
Base homestead tax rate	$0.24	*from homestead property tax model*
Adjusted homestead tax rate	**$0.55**	*from homestead property tax model*

	Homestead 1	Homestead 2	Homestead 3
Income tax component	$329	$568	$1,014
Homestead property tax component	$865	$1,013	$1,370
Total education tax on housesite	**$1,194**	**$1,582**	**$2,384**
Difference	**$165**	**$39**	**-$853**

Education Taxes on Hypothetical Households

Education Spending Per Pupil at 75th Percentile

Assumptions	Homestead 1	Homestead 2	Homestead 3
Household income	$40,000	$60,000	$100,000
Average housesite value*	$157,212	$184,236	$249,129
Average taxable income*	$21,932	$37,884	$67,611
Ratio of taxable income to housesite value	7.2	4.9	3.7
Ratio of housesite value to household income	3.9	3.1	2.5

Current law

Education spending per pupil	**$11,405**	
Base homestead property tax rate	$0.95	
Base rate on household income	1.80%	
Base education payment	$7,330	
Spending adjustment	1.56	
Adjusted homestead property tax rate	**$1.48**	
Adjusted rate on household income	**2.80%**	

	Homestead 1	Homestead 2	Homestead 3
Homestead property tax on housesite	$2,324	$2,723	$3,682
Prebate	-$1,204	-$1,043	-$156
Total education tax on housesite	**$1,120**	**$1,680**	**$3,527**

Proposal #1

Flat rate on taxable income	1.5%	*from income tax model*
Base homestead tax rate	$0.24	*from homestead property tax model*
Adjusted homestead tax rate	**$0.64**	*from homestead property tax model*

	Homestead 1	Homestead 2	Homestead 3
Income tax component	$329	$568	$1,014
Homestead property tax component	$1,006	$1,179	$1,594
Total education tax on housesite	**$1,335**	**$1,747**	**$2,609**
Difference	**$215**	**$67**	**-$918**

Education Taxes on Hypothetical Households

Education spending at the 50th percentile

Act 68

Homestead property tax rate **$1.36**

Proposal #1

Homestead property tax rate **$0.55**

Income tax rate **1.5%**

	Homestead A	Homestead B	Homestead C
"Breakeven" Ratio			
Taxable income	125,000	250,000	500,000
Housesite value	231,481	462,963	925,926
Ratio of taxable income to housesite value	1.9	1.9	1.9
Act 68	3,148	6,296	12,593
Proposal #1			
Income tax	1,875	3,750	7,500
Property tax	1,273	2,546	5,093
	3,148	6,296	12,593
Difference	-	-	-
Income 10% Higher			
Taxable income	137,500	275,000	550,000
Housesite value	231,481	462,963	925,926
Ratio	1.7	1.7	1.7
Act 68	3,148	6,296	12,593
Proposal #1			
Income tax	2,063	4,125	8,250
Property tax	1,273	2,546	5,093
	3,336	6,671	13,343
Difference	188	375	750
Income 10% Lower			
Taxable income	112,500	225,000	450,000
Housesite value	231,481	462,963	925,926
Ratio	2.1	2.1	2.1
Act 68	3,148	6,296	12,593
Proposal #1			
Income tax	1,688	3,375	6,750
Property tax	1,273	2,546	5,093
	2,961	5,921	11,843
Difference	(187)	(375)	(750)

e. Tax Department Memoranda

MEMORANDUM

TO: Joint Fiscal Office

FROM: Ellen H. Tofferi, Deputy Commissioner

DATE: November 13, 2006

SUBJECT: Education income tax

The Tax Department has been asked to delineate the changes and costs of implementing an education income tax to fund education spending in the State of Vermont. Our understanding of the proposal under consideration is that it would supplement the current property tax program with additional revenues from a new education income tax, requiring the Department to maintain a modified version of the statewide property tax program and implement a new income tax.

Attached are high-level changes the Department believes would be required, at a minimum, in order to implement such a system. Assigning a cost to these changes is difficult given the lack of details. Looking at previous significant changes to the property tax system gives us some frame of reference. The Act 68 changes in 2003 resulted in a one-time appropriation to the Tax Department of $734,792. The recent Act 185 changes resulted in a $542,000 appropriation to the Department. It should be noted that neither of these revisions to the property tax programs necessitated additional Tax Department staff.

The changes envisioned by this proposal are far-reaching. The implementation of a new tax type (education income tax) and alteration of existing property tax programs would require major programming changes. A sophisticated program of outreach and education would be necessary to prepare businesses (28,000 withholding filers) and personal income taxpayers (350,000) for their responsibilities under the new system. Finally, transferring the collection of education property tax ($100-$150 million liability) to the Department of Taxes would necessitate additional staff in our collections and audit units. Our estimate of the cost is $900,000-$1.2 million.

MEMORANDUM

TO: Joint Fiscal Office

FROM: Ellen H. Tofferi, Deputy Commissioner

DATE: November 27, 2006

SUBJECT: Administrative savings realized from implementation of an education income tax

After consultation with staff, it is our opinion that there would be no administrative savings from the implementation of an education income tax.

There might be a slight reduction in forms (about 60,000 fewer household income forms) if there were no longer a "prebate" program. Those modest savings would be overwhelmed, however, by the increased collections and audits efforts needed to ensure that businesses are withholding and taxpayers are paying the appropriate amount of education income tax which is estimated to raise an additional $150 million in revenues.

A statutory change also creates the necessity of explaining that change to taxpayers. This change would be very significant and would entail not only educating individual taxpayers but educating employers as well. While most taxpayer outreach programs constitute a one-time expense to the Department and the State, the residual effect of the changes goes on for months – sometimes years. Those effects are reflected in an increased number of telephone calls for assistance, increased errors in returns submitted (in this particular instance returns affected would be personal income and withholding), increased need for assistance from the Department in training individuals who prepare returns, etc.