

Property Tax Adjustment Study

December 2003

Prepared in accordance with
Act 68, Sec. 73.
of the 2003 Legislative Session

Prepared by:
The Joint Fiscal Office

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I. *Statutory Charge*

2003 Act 68. Sec. 73. PROPERTY TAX ADJUSTMENT STUDY

The Joint Fiscal Office shall study and recommend possible methods and costs of providing all education property tax adjustment through a system based upon percentages of household income, with no limit on household income. The Joint Fiscal Office shall report its findings and recommendations by December 15, 2003, to the House Committee on Ways and Means.

II. *Executive Summary*

- The current system for adjusting household education property taxes or “income sensitivity” is an amalgamation of an income-based approach and a property tax, and a great deal of complexity is derived from the interaction between the two.
- Current estimates of the impact of expanding income sensitivity are very rough because there are no reliable data linking household income to homestead values for Vermont residents not enrolled in the program. Next spring, after homestead declarations are filed for all resident homeowners, significantly more information will be available, linking taxpayer income levels above \$75,000 and homestead values.
- Income sensitivity does not benefit all households. For some, the property tax liability is lower than the tax would be as a percentage of household income. Generally, homeowners with incomes that are 55% or less of their home value benefit by paying based on income. Homeowners with incomes greater than 55% of their home value are better off paying based on property value. This rule does not apply for households qualifying for the \$15,000 homestead exemption or those that are subject to the homestead value cap.
- The \$75,000 household income threshold and the \$160,000 homestead value cap are fixed limits without indexes or other automatic adjustments. Over time, they may not keep pace with economic changes and could be reexamined periodically.
- One option of providing all education property tax adjustments through a system based upon percentages of household income with no household income limit is to eliminate the \$75,000 household income threshold and \$160,000 homestead value cap, but otherwise continue current law through the prebate system. This would cost approximately \$20.6 million. There are other possible changes to current law and the associated revenue impacts that are also discussed in the study.
- A second method of providing all education property tax adjustments through a system based upon percentages of household income with no limit on household income would be to shift to a pure income-based approach and either establish a statewide or local income based tax. This could be designed to be revenue-neutral for the Education Fund, but might have additional administrative costs for the Tax Department.
- If education financing is shifted to income taxes, two major policy decisions are essential: 1) Would the taxpayer owe the lesser of the property tax amount or the income tax percentage (as current law) or be required to pay the amount determined as a percentage of income only? 2) Would the link between homesteads and household income be abandoned in favor of a pure personal income tax system?

III. Introduction

Eligible Vermont residents may receive one or two types of income-related adjustments to their property tax bill; an education property tax adjustment known as a “prebate” and a homeowner rebate. Prebates are so named because the checks from the Tax Department are received in the mail approximately 30 days prior to the due date for the first payment of property taxes. The prebate system is designed to scale the impact of the education property tax burden to household income level, or “income sensitize” the tax burden, based upon a community’s level of spending per pupil. Prebate benefits are realized by households with less than \$75,000 in income, and to some degree, households with up to \$88,000 in income. Homeowner rebates are available to Vermont homeowners with household incomes under \$47,000 and limit the total property tax bill, municipal and education, to a percentage of the household income.

This study will focus on the education property tax adjustment, or prebate, and examine possible methods of providing education income sensitivity to all Vermont households, regardless of income.

IV. Current Law Overview

School tax rates for Vermont resident homeowners are directly linked to local spending per pupil; as spending increases, the tax rates increase proportionally. The base tax rate for homestead property is \$1.10.¹ Resident Vermont homeowners pay the least of 1) the property tax liability due for the homestead, 2) the tax due as a percentage of their household income, or 3) if their household income is less than \$47,000, the property tax liability of the homestead less \$15,000. The table below shows the link between spending and tax rate:

Table 1. Tax Rates for Various Levels of Spending

Act 68*	Tax Rates	
	Property Rate	Income Percentage
Spending Per Pupil		
\$6,800	\$1.10	2.0%
\$7,480	\$1.21	2.2%
\$8,000	\$1.29	2.4%
\$8,500	\$1.38	2.5%
\$9,000	\$1.46	2.6%
\$9,500	\$1.54	2.8%
\$10,000	\$1.62	2.9%

*2003 Session

For example, a school district that spends \$7,480 or 10% more than the base payment amount will have an education tax rate of \$1.21 that is 10% higher than the \$1.10 and an income sensitivity percentage of 2.2% which is 10% more than the 2.0%.

¹ The base tax rates of \$1.10 and the \$1.59 may be adjusted annually, based on the fiscal standing of the Education Fund.

Nonresidential property is taxed at a base rate of \$1.59 of fair market value. All non-property owners either do not pay education taxes or pay indirectly.

The education property tax payment, or prebate check, is the mechanism employed each year to adjust property tax bills based on household income. The prebate amount is the difference between the education tax liability due on property value and the tax as a percentage of household income. Homeowners with less than \$47,000 household income may also pay the property tax liability due on the value of the homestead less \$15,000 if it is lower than the income-determined amount. A supplementary benefit, added in the 2003 session, is a \$10 payment per acre for each additional acre above the two-acre housesite size, up to a maximum of five additional acres. This program is very limited and does not correlate the benefit amount to local education spending, household income, or the value of the additional land.

The benefits of income sensitivity phase out for homeowners with incomes between \$75,000 and \$88,000 because the homestead value is capped at \$160,000. This “slope” for households above \$75,000 was added in Act 49 of the 1999 legislative session. Under current law, if a taxpayer does not qualify for income sensitivity or the household income is greater than \$88,000, there is no mechanism for a property tax adjustment.

The following chart and graph show tax calculations at the \$1.10 property tax rate and the 2.0% income sensitivity percentage for households at various income levels. In this example, the tax liability as a percentage of income is less than the property tax amount due on a \$127,000 value homestead for households with less than \$80,000 household income. The breakeven point is at \$70,000. Above \$70,000 household income, the property tax liability is less.

Table 2. Education Tax Liability
\$127,000 homestead; \$1.10 tax rate; and 2.0% income sensitivity

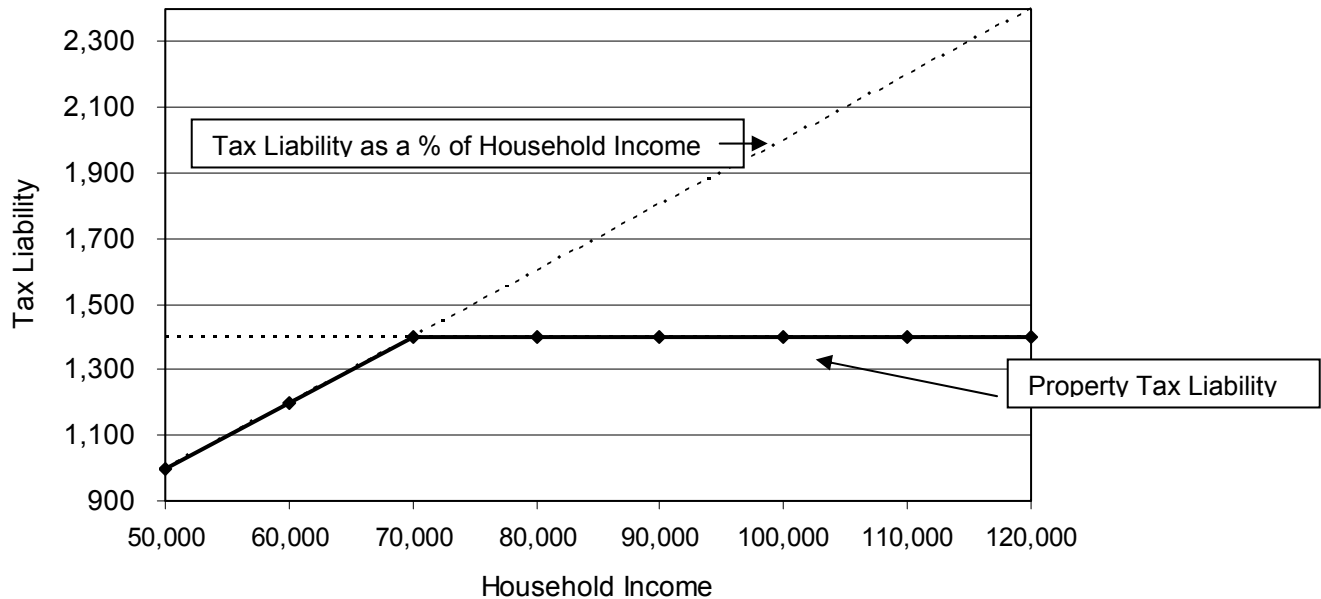
<u>Household Income</u>	<u>Property Tax</u>	<u>Income Percentage</u>	<u>Difference</u>
50,000	\$1,397	1,000	\$397
60,000	\$1,397	1,200	\$197
70,000	\$1,397	1,400	(\$3)
80,000	\$1,397	1,600	(\$203)
100,000	\$1,397	2,000	(\$603)
110,000	\$1,397	2,200	(\$803)
120,000	\$1,397	2,400	(\$1,003)

The **bold** tax liability indicates the lesser amount, either property tax or the income percentage.

* Note: \$70,000 household income is 55% of the \$127,000 homestead value

In general, the type of household that benefits from a tax based on income is one with income less than 55% of the homestead value. Homeowners with incomes greater than 55% of their homestead value will find the property tax bill is lower than the income adjusted bill and therefore will not receive a prebate. This general rule does not apply for households qualifying for the \$15,000 homestead exemption or those that reach the homestead value cap.

Chart 1. Education Tax Liability
 \$127,000 homestead; \$1.10 tax rate; and 2.0% income sensitivity



This table shows the same tax calculations at a fixed household income of \$70,000 and various homestead values:

Table 3. Property Tax Liability Compared to Income Percentage Liability
 \$70,000 household income; \$1.10 tax rate; and 2.0% income sensitivity

<u>Homestead Value</u>	<u>Property Tax</u>	<u>Income Percentage</u>	<u>Difference</u>
70,000	\$770	1,400	(\$630)
90,000	\$990	1,400	(\$410)
110,000	\$1,210	1,400	(\$190)
130,000*	\$1,430	1,400	\$30
150,000	\$1,650	1,400	\$250
170,000	\$1,870	1,400	\$470
190,000	\$2,090	1,400	\$690
210,000	\$2,310	1,400	\$910
230,000	\$2,530	1,400	\$1,130

The **bold** tax liability indicates the lesser amount, either property tax or the income percentage.

* Breakeven point

Currently, there are no reliable Vermont data showing the relationship between income and property for those households with incomes above \$75,000. Act 68 of 2003 requires all homeowners to file a homestead declaration each year and will provide new information for evaluating proposals to expand income sensitivity and their associated fiscal impacts. These forms will provide new taxpayer income data not necessarily household income data.

Income vs. Property Taxes

There are a number of issues when considering a shift away from property taxes to income-based taxes. Tax Policy Handbook for State Legislators, by NCSL, offers principles for evaluating state tax sources. These are reliability, equity, compliance, and administration, responsiveness to interstate and international competition, economic neutrality, and accountability. This report will use these principles as a method to evaluate the general shift from property-based to income-based taxes as well as in evaluating the specific options.

- *Reliability:* The property tax is often considered one of the most stable revenue sources. Income tax revenue can fluctuate more dramatically, especially at the highest income levels. A portion of the education tax base in Vermont is already dependent on income, and an expansion of income sensitivity provisions to all income levels would increase this vulnerability.
- *Equity:* Taxpayer equity is of concern when the total tax burden is shifted more to income and less emphasis is on a variety of taxes. Taxpayers who are highly dependent upon income will likely have higher total tax burdens than taxpayers with other forms of wealth, such as property.

A shift to income taxes could result in expanding the tax base to include non-property owners. Renters, especially, would see an impact since most landlords pass their property tax costs through rents. Renters would be dependent on the renter rebate program, which is intended to scale the indirect property taxes renters pay to income levels, in order to prevent double taxation.

- *Compliance and Administration:* Property tax compliance is not difficult, and various mechanisms make avoidance nearly impossible. Income is a much more fluid and mobile tax base. Avoidance through accounting and other measures is more common and difficult to enforce. The property tax is often administered at the local level where each town has management and collection capabilities. An income tax would require state-level administration. The current Vermont prebate system is a combination of both types of administration.
- *Interstate competition:* An additional tax on income would increase the marginal rates for Vermont and could make the state appear to have extraordinarily high income taxes in 50-state comparisons. Some taxpayers may choose to reside in a state with a lower income tax burden.
- *Economic neutrality:* An economic distortion caused by a low property tax burden and a high income tax burden may create a significant benefit to owning valuable homestead property. The tax structure could also create disincentives to subdivide or sell property.
- *Other:* Property taxes are collected in large sums periodically which can make this tax less palatable. Income taxes are paid in smaller increments by most wage-earners and, on a perception level, might be more acceptable. There is also a perspective that income is a better measure of “ability to pay” than property wealth.

V. Discussion of Options

This report examines two general options for “providing all education property tax adjustments through a system based upon percentages of household income, with no limit on household income.” These are:

Option 1. Continue the current prebate system and eliminate the income threshold and homestead value cap or other variations of current law.

Option 2. Shift to a pure income-based approach, and either establish a statewide or local income-based tax.

All of the options discussed here assume that nonresidential property owners continue to pay a statewide education property tax based solely on the fair market value of their property and the nonresidential education tax rate. In addition, the definitions of a homestead and household income which are crucial to the property tax adjustment programs have been assumed to be the same as current law for the purposes of these discussions, as well as the treatment of acreage beyond the two-acre housesite.

For each option, there will be a discussion of the following considerations:

- *Taxpayer impact*: which groups of taxpayers will be required to pay more or less tax depending on the proposed changes and their tax status/circumstances?
- *Accountability*: how is a link maintained between spending levels and tax rates?
- *Administration*: state level, local, or both?
- *System complexity*: does the public understand the system? is it transparent?
- *Education Fund impact*: what is the revenue impact of the proposal?
- *Implementation*: what are the costs and issues associated with these changes?

Option 1: Eliminate the \$75,000 threshold and \$160,000 Homestead Cap

One method of allowing all resident Vermonters to pay education taxes based on household income is to eliminate the current law \$160,000 homestead cap and the \$75,000 household income threshold. The adjustments would continue to be made through the prebate system.

Households with less than \$47,000 utilizing the \$15,000 homestead exemption and households that pay the amount of the property tax bill will continue to pay less than the household income percentage determined by local spending.

- *Taxpayer impact*: All resident Vermont homeowners would have the option to pay education taxes based upon the household income percentage determined by their local spending level, if it is lower than their property tax liability.
- *Accountability*: This option would maintain the same direct link between spending and tax levels.

- *Administration:* The existing prebate system would remain in place and there would be no administrative changes at either the local or state level.
- *System Complexity:* No change from current law; more homeowners will qualify for an education property tax adjustment. Vermont taxpayers would not experience any significant change in the way education is financed in the state.
- *Education Fund impact:* The impact of this expansion of the income sensitivity program would be approximately \$20.6 million in foregone revenue to the Education Fund.
- *Implementation:* Because these proposals are within the context of the prebate program, the changes at the state and local levels would be minimal, and the administrative costs negligible.

Variations on Option 1:

Several adjustments could be made to lower the cost of this proposal, reduce the level of complexity for taxpayers, or expand income sensitivity benefits to some, but not all, higher income households.

- Eliminate the \$15,000 homestead exemption*
 - Requires households under \$47,000 to pay the income-determined tax liability.
 - Removes and simplifies a component of the program.
 - Saves \$2.6 million for the Education Fund.
- Increase the amount of the \$160,000 homestead value cap for those above \$75,000*
 - If the cap was increased from \$160,000 to \$200,000 – an effective household income equivalent increase from \$88,000 to \$110,000 – the cost to the education fund would be \$5.8 million.
- Set a homestead value cap for all households*
 - The \$75,000 threshold could be removed, and all households could be capped.
 - The benefit amount for households under \$75,000 in income would be limited to the new \$200,000 cap level, and the benefits for households up to \$110,000 would be expanded.
 - If a \$200,000 homestead cap was set for all households, there would be \$4.3 million additional revenue for the Education Fund.

Table 4. Possible Homestead Cap Levels

	<u>Homestead Cap</u>	<u>Effective Household Income Limit</u>
<i>Current Law</i>	160,000	88,000
	170,000	93,500
	180,000	99,000
	190,000	104,500
	200,000	110,000
	No cap	Unlimited

- Increase the \$75,000 threshold and eliminate or increase the homestead cap*
 - This would function exactly the same as current law, for higher income thresholds.

Implication of “Caps”

Capping the homestead value is similar in concept to capping the amount of the prebate check. Each results in a limit to the amount of income-related benefit for some households.

If the homestead value is capped, all homeowners receive the full income sensitivity benefit up to the amount of the capped value of their home, regardless of local education spending. If the value is capped, homeowners in low value communities might be less likely to reach the cap level whereas homeowners in high value towns are more likely to be impacted by the cap.

Options 2: Shift from Property to Income Taxes for Education

Another method of raising funds for education would be to tax Vermont residents directly on income. There are several variations of this concept and the possible ways it could be administered as well as economic and taxpayer equity issues to address.

Currently, resident Vermont homeowners pay the lower tax liability of either a percentage of their household income or a straight property tax. A system based solely upon income could remove this choice with different implications for taxpayers depending upon the relationship between their property value and income. The result would be a shift in the level of tax burden between different types of taxpayers.

The income test for determining the current law education property tax adjustment is for households, not personal income taxpayers, because the property tax being adjusted is for a homestead. Personal income tax filers often reflect household makeup, but this is only true in some instances. If the tax is purely income-based, it would also be more practical to tax personal income rather than household income.

For purposes of discussion, the following two options, which utilize solely the income tax to pay for education, will be based on personal income, have a mandatory income formula for all taxpayers, and be administered through the income tax withholding system.

2A. Statewide Personal Income Tax for Education

A single statewide income tax rate could be implemented to raise revenue for all education in Vermont.

- *Taxpayer impact:* All Vermont resident households would be required to pay a percentage of their income for education financing. This would increase the tax burden for a) non-property owners, and b) homeowners whose property tax liability would be lower than a percentage of their income.

- *Accountability:* The relationship between local spending and tax levels would no longer exist. This could eliminate the incentive to control costs related to education by school boards since the rate would be determined by total state spending.
- *Administration:* Administration of the income tax would be entirely at the state level. There would be little involvement at the local level because of concerns about confidentiality.
- *System complexity:* Once in place, the system would be straightforward.
- *Education Fund impact:* This proposal could be made revenue-neutral for the education fund.
- *Implementation:* This would be a major change from the current system of funding education and could require significant time and resources for start-up.

2B. Local Income Tax for Education

A local income tax could utilize income percentages determined by each town or district's local level of education spending. For purposes of analysis, the income percentages determined for current law local education spending were maintained. These percentages could be altered as long as the spending-rate relationship was continued.

- *Taxpayer impact:* All Vermont resident households would be required to pay a percentage of their income for education financing. This would increase the tax burden for a) non-property owners, and b) homeowners whose property tax liability would be lower than a percentage of their income.
- *Accountability:* This system would retain the link between tax levels and local spending while having all Vermont households pay education taxes based on percentages of household income without limits.
- *Administration:* Administration of the income tax would be entirely at the state level. There would be little involvement at the local level because of concerns about confidentiality. There would be a different local income rate from town to town. Administering this, including such issues as withholding, could make this complex and costly for the Tax Department and very difficult for employers.
- *System complexity:* The links between spending, liability and income would be clear.
- *Education Fund impact:* If all taxpayers are required to pay the income-determined liability, the estimated total revenue would be \$324 million, within range of current law residential property tax collections less income sensitivity adjustments. This could be revenue-neutral for the Education Fund.

Conclusion

The current system of financing education is an amalgamation of income and property taxes. There are many issues to consider before moving to a new system. More data will be available next year which will allow for improved analysis of the fiscal impacts.

Appendix A.**Summary of Cost Estimates**

<u>Option 1 – Current Law Changes</u>	<u>Revenue Impact</u>
1. Eliminate the \$160,000 homestead cap =	- \$20.6 million
2. Increase homestead cap to \$200,000 > \$75,000 only =	- \$5.8 million
3. Cap ALL applicants at \$200,000 homestead value =	+ \$4.3 million
4. Eliminate the \$15,000 homestead exemption =	+ 2.6 million

Appendix B:**Homestead Value, Household Income, and Applicable Percentage Data**

There are three factors necessary for determining the amount of a prebate which also limit the income sensitivity program: homestead value, household income, and the applicable percentage.

Homestead Value

The definition of a homestead has historically limited homestead property to two acres of land. There is a cap of \$160,000 on the maximum homestead value for households above \$75,000 in income.

Additional Acreage

A homestead is an integral part of the formula for calculating income sensitivity benefits. For many homeowners, the two acre limit translates into a limit on the value of the homestead and therefore the amount of property tax relief. There has been considerable discussion in the legislature over the past several years about expanding the definition of a homestead to include more land.

Increasing acreage beyond the current two-acre limit as part of the homestead will allow households under the \$75,000 threshold the full benefit of the value of the additional land. All other households will realize the value of the additional acreage, until the homestead reaches the \$160,000 value cap.

Fair Market Values

Homestead values have increased rapidly since Act 60 was passed in 1997, with the homestead value cap being set at \$160,000 in 1999. Recent property transfer data shows that the median sales price for a residential home on less than six acres of land has increased from \$105,000 in 1999 to \$144,500 in 2003 or a 36% increase in four years. For residential property on six or more acres of land, the increase was 35%, from a median sales price of \$137,000 in 1999 to \$189,500 in 2003.

Equalized education grand list values also show substantial growth with a 19% increase in average value between 1999 and 2002 for properties with less than six acres and a 21% increase in average value for properties with more than six acres. Since the \$160,000 homestead value cap is fixed, it is likely that an increasing number of homesteads are receiving a limited benefit due to this provision.

Homestead Value Data
Property Transfer Data 1996 - 2003

Year	Median		Average	
	R1	R2	R1	R2
2003*	144,500	189,500	165,287	263,362
2002	130,000	166,400	150,296	226,167
2001	122,500	160,000	137,082	209,557
2000	110,000	150,000	126,704	197,681
1999	106,500	140,000	118,705	181,711
1998	105,000	137,000	115,705	181,889
1997	98,144	125,000	110,552	160,202
1996	95,000	120,000	108,535	144,096

Year	% change Median		% change Average	
	R1	R2	R1	R2
2003*	10.0%	16.4%	11.2%	13.9%
2002	9.6%	7.9%	6.1%	4.0%
2001	8.2%	6.0%	11.4%	6.7%
2000	6.7%	8.8%	3.3%	7.1%
1999	2.6%	-0.1%	1.4%	2.2%
1998	4.7%	13.5%	7.0%	9.6%
1997	1.9%	11.2%	3.3%	4.2%
1996	0.9%	-4.8%	0.0%	-4.0%

* YTD 10/31/03

R1 = residential property < 6 acres

R2 = residential property on 6 or more acres

Source: Property Transfer Reports, statewide summaries

Average Equalized Grand List Value 1999 - 2002

Category	1999	2000	2001	2002
R1	109,358	113,124	119,971	130,632
R2	160,662	167,110	178,554	193,610

% change	1999	2000	2001	2002
R1	n/a	3.4%	6.1%	8.9%
R2	n/a	4.0%	6.8%	8.4%

Source: EEGL by Category (total value/property count)

Household Income

The definition of household income has been used for many years in the rebate program and was carried over to school property tax program. A majority of income sensitivity benefits are provided to households with income of \$75,000 or less.

While there are no data specific to Vermont households that do not qualify for an education property tax adjustment, data from the Census show that in 2001, the Vermont median household income was \$40,794. Therefore, income sensitivity benefits end at approximately 172% of the median level.

Household incomes have increased moderately in recent years. The average household income for Vermont taxpayers receiving an education property tax adjustment has increased from \$36,143 in 1998 to \$40,125 in 2001 (11% over four years or 2.8% per year). Household income for all Vermonters, as defined by the Census, increased an average of 3.7% per year between 1995 and 2001.

Applicable Percentage/Household Income Percentage

The applicable percentage is a direct ratio between the base payment amount and local education spending. If a town spends 20% more than the base payment amount, its household income percentage will also be 20% higher. The percentage determined for the town is the same for every household within that town applying for an education property tax adjustment.

Adjusting the definitions of any of these three factors - household income, homestead value, and the applicable percentage - has a significant impact on the education property tax adjustment.

Household/Filer Income Data

Median Household Income in Vermont www.census.gov			
<u>Year</u>	<u>Median HI</u>	<u>% change</u>	<u>7 yr avg % change</u>
2001	40,794	0.6	3.7
2000	40,537	2.4	
1999	39,571	4.3	
1998	37,947	7.8	
1997	35,210	5.6	
1996	33,352	3.1	
1995	32,350		

Average Household Income for Vermont Taxpayers Receiving a School Property Tax Adjustment[1]		
<u>Year</u>	<u>Average</u>	<u>% change</u>
2001	40,125	1.4
2000	39,553	2.6
1999	38,538	6.6
1998	36,143	

Vermont Personal Income Tax Returns - (in-state only)[1]				
<u>Year</u>	<u># of Returns</u>	<u>AGI/Total Income</u>	<u>Average \$ per Filer</u>	<u>% Change</u>
2001	289,095	12,110,619,680	41,891	-1.6
2000	284,100	12,092,332,733	42,564	5.0
1999	283,925	11,508,945,011	40,535	4.0
1998	277,528	10,816,839,677	38,976	6.6
1997	272,096	9,946,781,685	36,556	4.8
1996	265,957	9,276,068,673	34,878	7.6
1995	261,750	8,485,164,142	32,417	

[1] Source: Vermont Department of Taxes