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William Schubart, Chair
Blue Ribbon Tax Structure Commission
115 State Street
Montpelier, VT 05663

Dear Bill:

I was glad to be able to attend the session of your commission on Tuesday and to see the thoughtful way in which the commission is addressing your charge.

I attended because I have been serving as a member of the Business Roundtable's Tax and Fiscal Task Force. As you will have noted from our presentation, we have clear ideas on the principles that should be applied, but we have not yet agreed on specific directions or changes that we are prepared to recommend. Pending that sort of recommendation from the Task Force, I would like to share with you and the Commission some purely personal thoughts in response to your questions at the hearing and your request for specific proposals.

You asked several of the witnesses for their views on tax structure neutrality. True neutrality of a tax structure is impossible. Any taxes, by their nature, are likely to provide incentives or disincentives for certain behaviors. What we need to do is to structure them so that, to the extent possible, they encourage desirable behaviors and discourage the opposite. That is easier said than done.

I would submit that it is a much better practice to use tax policy to discourage undesirable behavior than to use it to induce a desired behavior. Obvious examples would be the so-called "sin taxes" on tobacco or alcohol that serve to reduce consumption and the accompanying undesirable health or social effects. Punitive taxes such as these, once they are embedded in the tax code tend to remain and serve their purpose. Similarly, however, tax provisions enacted to promote or benefit a particular activity often have no sunset date and become a permanent part of the code long after their purpose or public benefit has disappeared. I believe that targeted benefits to any specific person or group or purpose would better be handled by the state in the annual appropriations process where the putative benefit would be weighed against all other claims on the public purse. We certainly need to be strategic in our balance of taxes on income, assets and events (as you put it), but we should avoid targeted special benefits being buried in the tax code.

Now let me identify a three areas where I believe the existing tax structure provides questionable special benefits or, at least, forgoes revenue that could be directed to more useful purposes or could be used to reduce other taxes that are deemed to be unfair, excessive or inefficient.

1. Some of the provisions for income sensitivity in the statewide school property tax seem overly generous to me. I know from my Tax Department experience that there have been taxpayers with very valuable homestead properties that received sizeable property tax rebates. I see no humanitarian or social purpose in subsidizing individuals to own and hold high value homesteads if they can't afford to pay a normal tax on them. I would suggest that the rebate program should calculate rebates based on actual homestead values up to but not above the median homestead value in the state or some modest multiple of that. I believe this would reduce the cost of the rebate program significantly.
2. There is a very significant value of property in Vermont that is now exempt from property taxation or escapes taxation through the lack of clarity in the law related to property tax exemption. In addition to public, religious and charitable property, there is a variety of specific exemptions in our statutes. A study committee reported its examination of this issue to the legislature in 1999 and I know, from my presence there, that the House Ways and Means Committee spent a great deal of time and effort to develop a bill that would rationalize and clarify the law. The bill passed the House and died in the Senate at the end of the 2000 session and apparently has not been revisited. In addition to policy questions as to what organizations provide commensurate public benefits and should get a free ride, we encountered examples of property owners who seemed to be clearly taxable who made a deal with their town to pay an amount in lieu of taxes for municipal services in consideration of the town not listing them on the Grand List to pay school taxes. The 2000 bill or one like it should clarify property tax exemptions and the result should significantly increase the tax base.
3. The state spends a lot of money annually to reimburse the towns for forgone municipal taxes on land enrolled in the Use Value Taxation (UVA) program and the Education Fund forgoes even more as a result of the enrolled land being taxed at its use value. This is a policy decision that I support, but one part of the way the program is administered is problematic. The law provides that any landowner who has received the benefits of lower taxes on the enrolled property must pay a penalty or recapture amount if and when the land is withdrawn from the program or if it is not managed in conformity with the requirements of the program. This is called the Land Use Change Tax (LUCT). The tax is either 10% or 20% of fair market value depending on how long the land has been enrolled. In principle, I believe that the charge for removal of the land from the program should be the full recapture of all forgone taxes, but that seems to have been politically impossible. As the law is now administered, for LUCT purposes, the Tax Department calculates the market value of the portion of the land removed from the program to be the same proportion of the town's assessed value of the total parcel as the acreage removed is to the total parcel acreage. Frequently this results in a LUCT that is only a small fraction of what it would be if the tax was assessed on the true fair market value of the removed parcel. This has made the law a convenient vehicle for some owners to hold land for speculative purposes without paying a fair share of the costs of public services. Legislative change is needed to address this.

In another area, I think that the changes made in the Vermont Statutes relative to the taxation of long term capital gains are ill-advised and unfair. There were good and reasonable reasons for the traditional Federal code's differential treatment of long term capital gains. The system was not precise, but it encouraged longer term investment and tended to ameliorate the taxation of phantom gains that were merely the result of inflation. When Vermont discontinued its piggyback tax rate on Federal tax liability, it introduced the 40% exclusion of long term gains from Vermont taxation as an approximate way to continue the Federal Code's preference. It appears that the recently passed Vermont law provides a temporary preference for senior citizens (70 plus) and a special deal for farmers. Even though this is personally beneficial, I believe that taxes should treat citizens uniformly and think that these special preferences are inherently unfair. In view of the rampant game-playing that is done to convert ordinary income to long term capital gains for Federal tax purposes, I believe that it is probably warranted to tax capital gains more like ordinary income. What is unfair, however, is to impose income taxes on phantom gains that are solely the result of inflation. I suggested when a change in capital gains taxation was being considered -- without any warm response, I might add -- that substantial sums could be raised by the elimination of the arbitrary 40% exclusion and replacing it with tiered and more modest exclusions that would exclude from taxation any gains that were only caused by inflation. Such a system would be inherently fair and it would tend to address the problem of tax burdens on intergenerational transfers of long held family farms or businesses. It is not too late to correct the misguided changes in the law of the last session.

I support, as do most Vermonters, the concept of a progressive tax structure. I believe, however, that Vermont has gone overboard and that the highest brackets of the Vermont personal income tax are inefficient and unproductive. We don't seem to have data to prove that thesis or to disprove it. I would, however, recommend the elimination of the two top bracket rates of the tax which would still keep Vermont's among the highest income tax rates of all states. While I believe that over the long term this change would increase rather than decrease revenues, I would propose that any potential short term reduction in revenue or need for additional revenue should be made up by broadening the base of the sales tax to include a variety of exempted items and to include services performed in the state. Despite Vermont's competitive problem with sales-tax-free New Hampshire, there are many dollars worth of untaxed services performed in Vermont that cannot be exported to New Hampshire.

This letter is far too long already. As one who has helped to write the tax laws, tried to administer them and has been paying them for most of my 80 years, I feel that they a central statement of our government philosophy. I encourage you and the Commission to be bold, tell the public the truth and make recommendations that will lead to an even fairer and more efficient system.

Sincerely yours,
Richard W. Mallery