March 29, 2006

**Income Tax Proposal**
*by Governor’s Office of Planning and Budget*

**Introduction**

Tax reform has been a top issue to Utah lawmakers for several years. In November of 2004, Governor Olene Walker issued a report that made 16 recommendations to address Utah’s declining tax base. When Governor Huntsman was elected, he made tax reform a central priority of his administration. In October of 2005, Governor Huntsman proposed a personal income tax reform package as part of the Legislature’s Tax Reform Task Force that was based on the recommendations of the Walker Tax Advisors. The proposal meets the goals of the task force to create a simple, stable, broad-based, and responsive tax system for the state.

The proposal is based on a flat tax of about 5% on federal adjusted gross income (AGI), and includes a tax payer credit, and credits for charitable contributions and mortgage interest expenses. The proposed income tax will position the state for the 21st century by broadening the tax base, lowering the rate, and providing a simplified income tax system.

**Broaden the Base**

Utah’s current individual income tax uses federal taxable income (FTI) as the basis on which income taxes are imposed. Federal taxable income is also the tax base used by the federal government to calculate income tax liability. FTI is computed by subtracting federal deductions and exemptions from AGI. The tax reform plan will broaden the income tax base to adjusted gross income. AGI consists of gross income from taxable sources minus certain items, such as payments to a qualified Individual Retirement Account (IRA), or an employer-sponsored 401(k) account. These are often called “pre-tax” contributions because they are not part of the AGI calculation.

If Utah were to maintain its current income tax system and simply move from FTI to AGI, the change would increase revenue collections to the state. By broadening the base, lawmakers have the ability to reduce the tax rate. The plan also incorporates a $70 million tax cut in the income tax system.

In addition to broadening the tax base, basing the income tax system on AGI has other positive effects. First, it will largely decouple the state from the federal tax system. It would make little sense to do away with many of the destabilizing federal deductions in exchange for three simple credits, and then use FTI as the tax base. This would allow for the deductions to creep back into Utah’s tax system. Many states already use AGI in order to broaden and simplify their tax base. Of the 41 states that impose an income tax, two-thirds use AGI as the base.

Second, it will stabilize future revenue flow. The economic surge in the late 1990s was followed by the dramatic downturn of the early 21st century. This caused major fiscal impacts for both the states and the federal government. Although Utah fared well compared to many other states, elected officials were still forced to make many difficult fiscal decisions when revenues did not meet expectations. By tying the income tax to AGI, Utah’s income tax will provide a more stable revenue stream. Government growth will be slower in good times, and the downside risk will be smaller in bad times.

**Lower the Rate**

There are many problems with the current income tax system. On paper it is a system with...
progressive rates, but in practice it is a flat-rate system with a number of detrimental loopholes. Utah needs a tax system that fosters growth and innovation and that recognizes the economic realities of the 21st century. Utah’s current top marginal income tax rate is not only one of the highest in the West, but also in the nation. The personal income tax is an important factor in many business owners’ and private citizens’ decisions to relocate to a new state; it is vitally important that Utah has a competitive income tax system.

Currently, Utah’s personal income tax system consists of six brackets, with top rate of 7% imposed at an income level at or above $8,600 per year. The tax reform proposal will remove the brackets from the tax system, creating a marginal tax rate that is flat for all taxpayers. The proposal will also lower the tax rate from 7% to about 5% for all Utahns.

The current top rate of 7% ranks Utah fourth highest among western states levying personal income taxes. By lowering the tax rate to a flat 5%, Utah’s top marginal rate will become the second lowest in the West. The state will also go from having the 14th highest rate in the nation, to having the 14th lowest rate in the nation. Lowering the income tax rate will make Utah more competitive, both in the West and in the nation.

Simplify the Tax System
Due to a lack of specific planning or design, Utah’s personal income tax has become burdened by numerous deductions and special credits. These deductions have the effect of increasing volatility and complexity in Utah’s tax system. In addition to having its own complexities, Utah’s tax system stands on the shoulders of Federal law, which provides loopholes for non-compliance and aggressive shelters. By removing special credits and deductions, the income tax will no longer give favor to special interests, and Utah will have a fairer tax system.

The proposed plan would remove many of the volatile “piggyback” federal deductions in favor of three tax credits: a tax payer credit, a homeowner credit, and a charitable contribution credit. The tax payer credit will replace the current standard deduction and personal exemptions. This credit ensures that low and middle income Utahns don’t receive large tax increases, thereby offsetting the regressivity of a pure flat tax. A portion of this credit phases out as income increases, however, and everyone will still receive a per person credit. Also, in order to encourage charitable giving and home ownership, the proposal includes tax credits based on charitable contributions and mortgage interest.

Not only will this plan simplify the income tax, it will also provide benefits to Utah’s taxpayers. Although there will be fewer credits and deductions, it will be simpler for taxpayers to benefit from them. Under the current system, only those who itemize deductions on their federal income taxes, about 40% of tax filers, are able to receive a deduction from their income for charitable contributions. Under the proposed plan, it will be simpler for tax payers to receive this benefit.

Conclusion
The individual income tax reform plan proposed by Governor Huntsman and advanced by members of the Utah State Legislature is the culmination of years of analysis and debate. The tax plan will make Utah more competitive regionally, and it will enable the state to better position itself for the 21st century.