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Analysis of Utah's Tax Reform

Enacted during the 2007 Legislative Session

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Introduction

The Legislature enacted major changes to the tax system during the 2007 General Session. Senate Bill 223 (SB 223), an omnibus tax bill,provides for a variety of tax changes. While changes were enacted regarding the taxation of business inputs, renewable energy tax credits, tax credits for qualified research expenses, tourism tax, sales tax exemptions, business personal property taxes and various other taxes, we will examine the changes to the income tax and the sales tax. The following paper will describe how tax liability is calculated under the single-rate system for individuals with different filing statuses, family sizes and income levels. Changes in the General Sales Tax and the Tax on Food will also be discussed.

Income Tax Reform: Single Rate Individual Tax Act

Prior to the 2007 General Session, the Legislature passed a single tax rate option during the 2006 4th Special Session (SB4001). Currently, taxpayers can choose to calculate their tax liability using the progressive rate or "bracket" system previously in effect, or calculate their liability using a flat 5.35% rate based on federal adjusted gross income (AGI). For tax year 2007, taxpayers will continue to have this choice.

Effective January 1, 2008, SB 223 eliminates the dual track system and establishes a single 5% tax rate (reduced from 5.35%). As is the case currently, taxpayers will report their federal Adjusted Gross Income (AGI) as it appears on their federal tax return. Federal AGI is the sum of all of the taxpayer's sources of income less certain allowable deductions, such as the IRA contribution, moving expenses, health savings account contributions, and student loan interest. The only adjustments to federal AGI that will be allowed under the new system will be those required under Section 59-10-1204 or 1205 of the Utah Uniform Code (Section 59-10-1204 refers to Section 59-10-114 for the adjustments and 1205 addresses double taxation). These adjustments include the following additions and subtractions to taxpayers' federal AGI:

Additions to Federal AGI:

- Medical Savings account withdrawals and penalties deducted from state income
- Adoption expenses deducted on a state or federal return
- Bond interest from other states' bonds
- Particular lump sum distributions
- Deductions from AGI by a trust or estate
- A child's income reported but not included in AGI
- Educational savings plan withdrawals that were deducted but not used for higher education purposes
- Trust distributions received by a resident beneficiary

Subtractions from Federal AGI:

- State tax refund included in AGI
- Deductions required by federal law (US bond interest, American Indian income, railroad retirement income)
- Uinta-Ouray reservation income

Nonrefundable Taxpayer Credit

The taxpayer calculates “state taxable income” by incorporating the adjustments indicated above and then applies a flat 5% rate to arrive at the base tax liability. This tax liability is then reduced by a nonrefundable taxpayer credit depending on their income level, filing status and family size. This is a significant departure from the previous deduction-based system that allows the taxpayer to make deductions to arrive at taxable income. The new taxpayer credit is a dollar-for-dollar reduction in the taxpayer’s tax liability. The credit is nonrefundable and limited to the taxpayer’s income tax liability. The taxpayer credit is calculated by first adding together the federal standard or itemized deductions (other than state income tax) and 75% of the federal personal exemption. The taxpayer then multiplies this amount by 6% to arrive at the initial credit amount.

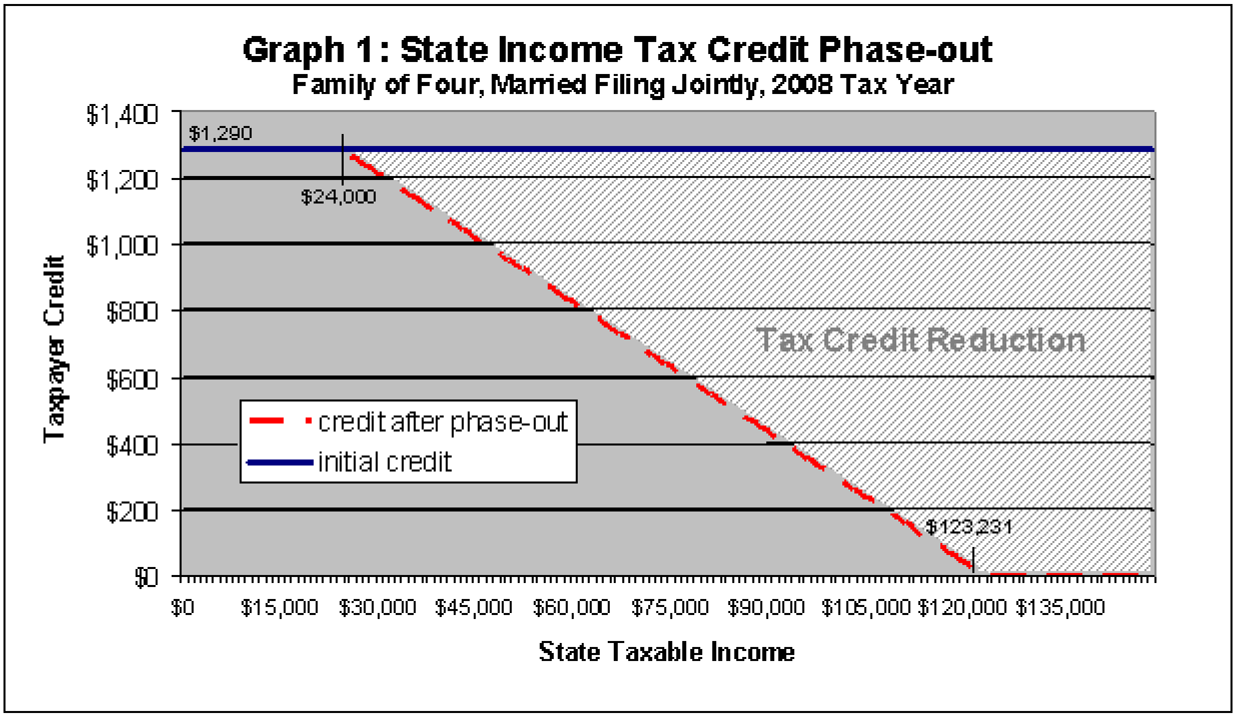
The credit is phased out as income increases by $0.013 for every additional dollar of taxable income. The phaseout begins at $12,000 for a single filing status, $18,000 for a head of household filing status, and $24,000 married filing status. These thresholds will be indexed for inflation. Table 1 displays the initial credit and phaseout period for various filing statuses.

Table 1: Credits and Phaseouts for Various Taxpayer Profiles

Filing Status	*Single*	*Head of Household*	*Married Filing Jointly**	*Married Filing Separately*
Dependents	0	2	2	2
Initial Credit	$488	$956	$1,290	$803
Phaseout Begins	$12,000	$18,000	$24,000	$12,000
Phaseout Complete	$49,500	$91,500	$123,231	$73,731

*The credit for this taxpayer profile is illustrated in the graph “State Income Tax Credit Phaseout. “

Graph 1 illustrates the reduction of the credit available for a family of four filing jointly for increasing levels of income. Families with less than $24,000 in taxable income receive the full credit of $1,290. The credit is reduced by 1.3 cents for every dollar of increase in taxable income until it is reduced to zero for income levels above $123,231. Taxpayers that are married and filing jointly with two dependents with incomes exceeding this amount will pay the full 5% tax on state taxable income.



Example of Tax Liability Calculations under the Current Deduction-Based Bracket System
As mentioned above, the new single-rate credit-based system is a significant departure from the current deduction-based bracket system. Assuming the current deduction-based bracket system were in effect in 2008, Table 2 below shows the calculation of tax liability under the current bracket system. While taxpayers currently have the choice to calculate their tax under a single flat rate, we have assumed for illustrative purposes that the taxpayer will use the existing bracket system.

For a taxpayer earning $50,000 in AGI, married, and filing jointly with two dependents, the standard deduction is $11,000 and the personal exemptions are $10,500 (75% of the federal personal exemptions). The taxpayer may also deduct one-half of federal taxes paid. Taxable income is then calculated by subtracting these deductions from federal AGI. In the case presented in Table 2, state taxable income is $27,000.

The amount of tax liability is calculated using a progressive bracket based system. The tax for the first $11,000 of income is $480. All income above $11,000 is taxed at a rate of 6.98%, for a total amount of tax liability of $1,597. The effective tax rate is 3.2%.

Table 2: Current State Income Tax Policy Projected to 2008*
for a Married Filing Jointly Taxpayer with Two Dependents

Federal Adjusted Gross Income (AGI)	$50,000
Minus: Standard Deduction	($11,000)
Personal Exemption ($2,625 times 4)	($10,500)
One Half of Federal Income Tax ($3,000 divided by 2)	($1,500)
Utah State Taxable Income (Federal AGI minus the three items above)	$27,000
State Income Taxes Due (for income bracket “over $11,000”) Tax for first $11,000 (about 4.4%)	$1,597 $480 $16,000

Taxable Income over $11,000 Tax on Income over $11,000 ($16,000 times 6.98%) Total ($1,117 plus $480)	$1,117 $1,597
Effective Tax Rate (Taxes Due divided by Federal AGI)	3.2%
* This tax scenario is based on Utah's 2006 state income tax policy, except that 2008 values of the standard deduction and personal exemption are used for comparability to other calculations in this article. *Key assumptions:* federal income tax amount of $3,000 (each additional dollar of federal taxes reduces the final tax bill by 3.5 cents); no itemized deductions on state or federal tax return; no other deductions, exemptions, credits, etc. except those listed in table.	

Examples of Tax Liability Calculations under the Single-Rate, Credit-Based System

Table 3 provides the calculations of tax liability under the single-rate credit-based system for 2008 for a range of income levels for a family of four filing jointly. In this example, the taxpayer does not make any adjustments to AGI, but applies a 5% rate to determine their flat tax before applying the non-refundable taxpayer credit. For a taxpayer with $50,000 in state taxable income (which for simplicity we assume equals federal AGI), married filing jointly with two dependents (Case 2 in Table 3), the 5% flat tax is equal to $2,500.

The next step in determining tax liability is to calculate the amount of the Initial Credit. The Initial Credit is determined by multiplying 6% by the total amount of the Standard Deduction and 75% of the federal Personal Exemption. In Case 2, the Initial Credit is $1,290. Since $50,000 in income exceeds the beginning income of the phaseout period of $24,000 (See Table 1), the taxpayer must reduce the amount of their credit against their income liability by 1.3% of the difference between $50,000 and $24,000. The Initial Credit of $1,290 will be reduced by 1.3% of $26,000, or by $338. The credit that the taxpayer will be allowed to apply to his or her tax liability will be $1,290 minus $338, or $952. The final tax liability is $2,500 (flat 5% tax) minus $952, or $1,548.

In this example the taxpayer pays approximately the same amount of tax under each system (compare to Table 2). Approximately 90% of taxpayers will pay the same or less in taxes under the new system as compared to the system that will be in place in 2007 that allows a choice between the bracket and single rate option, according to estimates published by the Legislative Research. In comparison to the tax system in place for 2005, 95% of the taxpayers will pay the same or less in tax liability under the new system.

Table 3: 2008 Taxpayer - Married Filing Jointly with Two Dependents

	Case 1	*Case 2*	*Case 3*	*Case 4*	*Case 5*
State Taxable Income	$25,000	$50,000	$75,000	$100,000	$150,000
5% Flat Tax before Credits	$1,250	$2,500	$3,750	$5,000	$7,500
Federal Standard Deduction*	$11,000	$11,000	$11,000	$11,000	$11,000
Personal Exemption	$10,500	$10,500	$10,500	$10,500	$10,500
Deduction plus Exemption	$21,500	$21,500	$21,500	$21,500	$21,500
Initial Credit (6% of Deduction plus Exemption)	$1,290	$1,290	$1,290	$1,290	$1,290
Phaseout Beginning Point	$24,000	$24,000	$24,000	$24,000	$24,000
Income in Phaseout Range (Income minus Beginning Point)	$1,000	$26,000	$51,000	$76,000	$126,000

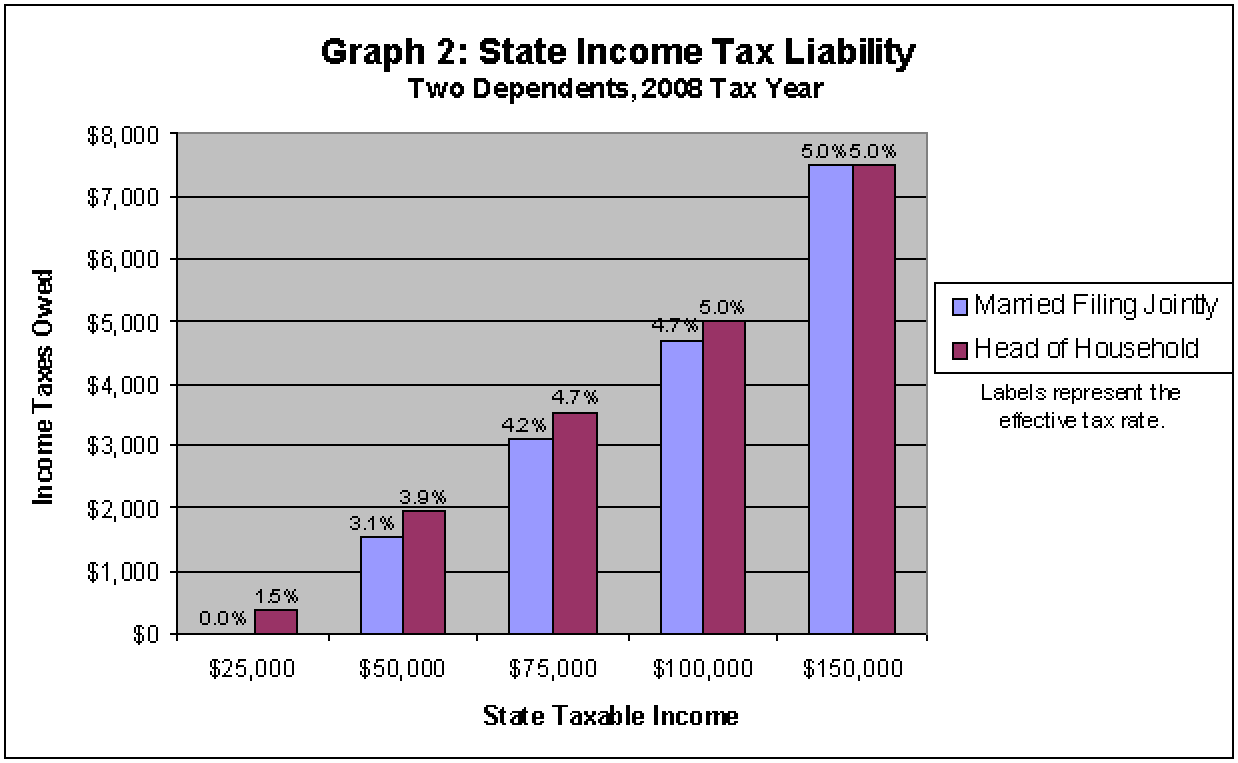
Credit Phaseout Reduction (1.3% of Income in Phaseout Range)	$13	$338	$663	$988	$1,638
Credit with Phaseout Reduction (Initial Credit minus Reduction)	$1,277	$952	$627	$302	$0
State Income Taxes Due (Flat Tax minus Credit with Reduction)	$0	$1,548	$3,123	$4,698	$7,500
Effective Tax Rate (Taxes Due divided by State Taxable Income)	0.0%	3.1%	4.2%	4.7%	5.0%
*If taxpayer itemizes on federal tax return, Federal Standard Deduction is replaced by total Itemized Deductions minus state income tax.					

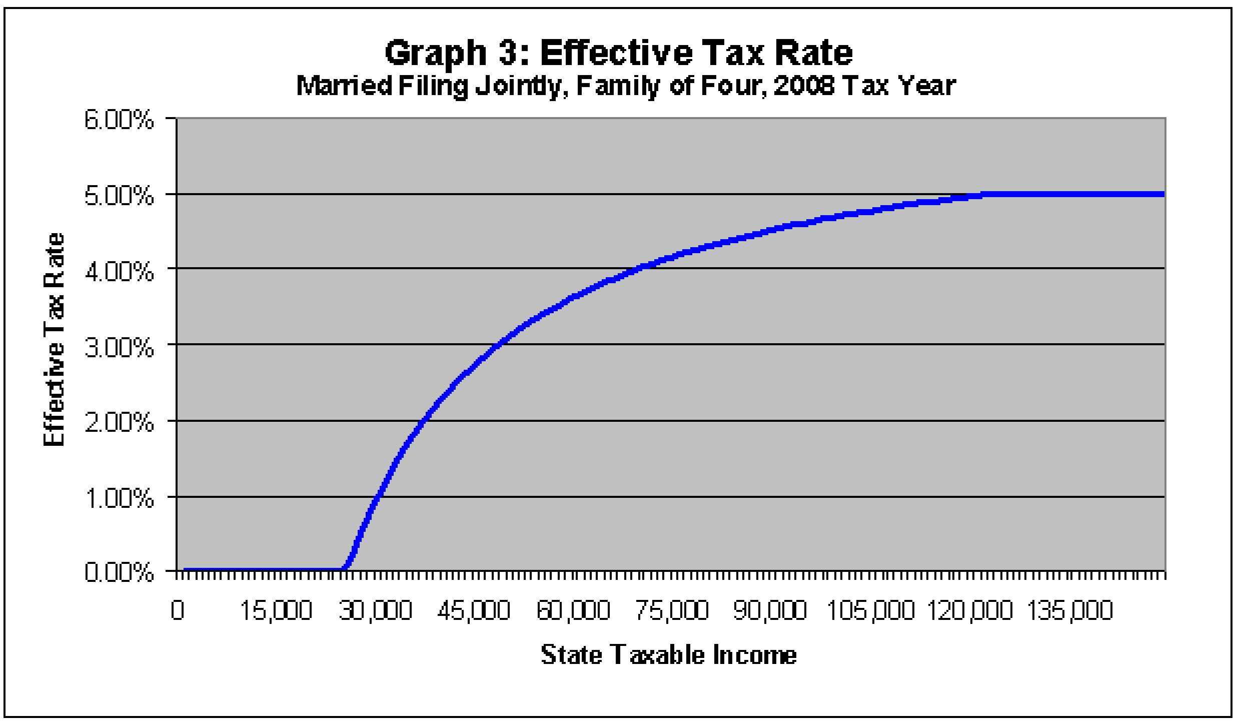
Table 4 illustrates the calculation of tax liability under the single-rate credit-based system for a Single Head of Household with two dependents.

Table 4: 2008 Taxpayer – Single Head of Household with Two Dependents

	Case 1	*Case 2*	*Case 3*	*Case 4*	*Case 5*
State Taxable Income	$25,000	$50,000	$75,000	$100,000	$150,000
5% Flat Tax before Credits	$1,250	$2,500	$3,750	$5,000	$7,500
Federal Standard Deduction*	$8,050	$8,0 50	$8,050	$8,050	$8,050
Personal Exemption	$7,875	$7,875	$7,875	$7,875	$7,875
Deduction plus Exemption	$15,925	$15,925	$15,925	$15,925	$15,925
Initial Credit (6% of Deduction plus Exemption)	$956	$956	$956	$956	$956
Phaseout Beginning Point	$18,000	$18,000	$18,000	$18,000	$18,000
Income in Phaseout Range (Income minus Beginning Point)	$7,000	$32,000	$57,000	$82,000	$132,000
Credit Phaseout Reduction (1.3% of Income in Phaseout Range)	$91	$416	$741	$1,066	$1,716
Credit with Phaseout Reduction (Initial Credit minus Reduction)	$865	$540	$215	$0	$0
State Income Taxes Due (Flat Tax minus Credit with Reduction)	$386	$1,961	$3,536	$5,000	$7,500
Effective Tax Rate (Taxes Due divided by State Taxable Income)	1.5%	3.9%	4.7%	5.0%	5.0%
*If taxpayer itemizes on federal tax return, Federal Standard Deduction is replaced by total Itemized Deductions minus state income tax.					

Graphs 2 below presents the tax liabilities calculated in Tables 3 and 4. Graph 3 illustrates the effective tax rate for a family of four, married filing jointly with increasing levels of income.





Tax Liability and Effective Tax Rate Matrix for the Single-Rate Credit-Based System
Under the single-rate credit-based system, the tax liability for any individual taxpayer will vary according to filing status, AGI and the number of dependents. Table 5 presents a matrix for the tax liability and the effective tax rate for a married taxpayer filing jointly for different income levels and number of dependents. A taxpayer that is married filing jointly with an income of $25,000 and no dependents will incur a state tax liability of $288, for an effective tax rate of 1.2%. A taxpayer with the same filing status, no dependents and $100,000 in state taxable

income will incur a lax liability of $5,000 for an effective rate of 5%.

A taxpayer with $100,000 in state taxable income who claims five dependents will pay $4,226 in state taxes for an effective rate of 4.2%. This is a 15.48% reduction in tax liability from that of a taxpayer making the same income but claiming no dependents. A taxpayer with taxable income of $50,000 and no dependents will pay $1,863 in taxes. With five dependents and $50,000 in taxable income, the tax liability decreases to $1,076, a 42.24% decrease. The lower the income level, the greater the percentage decrease in tax liability with increases in family size. Families with incomes greater than the phaseout completion income level (at which point the Taxpayer Credit has been reduced to zero), shown in Table 1, will pay a flat 5% of their income regardless of family size.

Tax liability and effective tax rates increase with income level. For instance, for a taxpayer that is married filing jointly with two dependents, the effective tax rate increases from 0% with $25,000 in income to 3.1% with $50,000 in income, to 4.7% with $100,000 until the effective rate flattens out to 5% for income levels above $124,000. For a taxpayer with five dependents, the effective rate increases more slowly than for the taxpayer with two dependents. With $25,000 in income, the effective rate with five dependents is also 0%. With $50,000 in income, the effective rate rises to 2.2%, as compared to 3.1% for a taxpayer with two dependents. With an income level of $100,000, the effective rate is 4.2%, as compared to 4.7%, and the effective tax rate does not flatten out to 5% until income reaches $160,000.

Table 5: 2008 Taxpayer Married Filing Jointly

State Income Taxes Due

(Effective Tax Rate)

		State Taxable Income					
		$25,000	$50,000	$75,000	$100,000	$150,000	$200,000
Dependents	None	$288 (1.2%)	$1,863 (3.7%)	$3,438 (4.6%)	$5,000 (5.0%)	$7,500 (5.0%)	$10,000 (5.0%)
	One	$131 (0.5%)	$1,706 (3.4%)	$3,281 (4.4%)	$4,856 (4.9%)	$7,500 (5.0%)	$10,000 (5.0%)
	Two	$0 (0.0%)	$1,548 (3.1%)	$3,123 (4.2%)	$4,698 (4.7%)	$7,500 (5.0%)	$10,000 (5.0%)
	Three	$0 (0.0%)	$1,391 (2.8%)	$2,966 (4.0%)	$4,541 (4.5%)	$7,500 (5.0%)	$10,000 (5.0%)
	Four	$0 (0.0%)	$1,233 (2.5%)	$2,808 (3.7%)	$4,383 (4.4%)	$7,500 (5.0%)	$10,000 (5.0%)
	Five	$0 (0.0%)	$1,076 (2.2%)	$2,651 (3.5%)	$4,226 (4.2%)	$7,376 (4.9%)	$10,000 (5.0%)

Note: State Income Taxes Due and the Effective Tax Rate are calculated by the process demonstrated in Tables 1 and 2. The Effective Tax Rate, shown in parentheses, equals State Income Taxes Due divided by State Taxable Income.

Retiree Credit

Retirees receive a tax credit for “eligible retirement income” in addition to the standard taxpayer credit. A taxpayer can only be eligible for this credit if he or she was born before 1953. Eligible retirement income includes certain pensions and annuities. For taxpayers over 65 years in age, an additional nonrefundable credit of $450 is allowed. For taxpayers under the age of 65, the retiree may claim a credit in an amount equal to the lesser of either $288, or the retiree’s eligible retirement income multiplied by 6%. This credit is also subject to a phaseout equal to $0.025 for each dollar increase in “modified AGI”. The thresholds for the retiree credit phaseout are as follows: $16,000 for married filing separately, $25,000 for single, and $32,000 for married filing jointly and head of household.

Additional Credits
Refundable and nonrefundable credits that were available under the previous system remain in addition to the new taxpayer and retiree credits. Voluntary check-off contributions already allowed, such as non-game wildlife contributions, homeless trust fund contributions, election campaign fund contributions for education, and children’s organ transplants also remain.

Revenue Implications
According to the Legislative Fiscal Analyst Office, the Income Tax provisions of SB 223 will result in a loss of revenue to the Education Fund of $27,175,000 in FY2008 and $108,700,000 in FY2009.

Sales Tax Reform
SB 223 enacted significant changes with respect to state and local sales taxes. In addition to a reduction in the general state sales tax rate from 4.75% to 4.65%, the state sales tax on food will be reduced to 1.75% in 2008 from 2.75% in 2007 (SB4001). There were also changes to local sales taxes that will result in a uniform statewide sales tax on food of 3% effective in 2008 (1.75% State Rate, 1% Local Option Rate, 0.25% County Option Rate) The 3% effective rate is established by removing food and food ingredients from the sales and use tax base for the following local options sales and use taxes:

- Basic and Additional Public Transit
- Basic and Additional Resort Community
- Rural County Health Care Facility and Rural City Hospital
- Municipal and County Botanical, Cultural, Recreational, and Zoological
- Municipal Highway
- Town Option
- County Option for Highways, Fixed Guideways, or Systems for Public Transit
- County Option for Transportation

In order to compensate localities for the loss in revenue due to removing food from the base of the above taxes, SB 223 allows for the following:

- A county or municipality to increase its basic transit sales and use tax rate from .25% to .30%.
- A municipality to increase its Basic Resort Community Sales and Use Tax rate from 1% to 1.1%.
- A municipality to increase its Municipal Highways Sales and Use Tax rate from .25% to .3%.
- A county to increase its County Option Sales and Use Tax for Highways, Fixed Guideways, or Systems for Public Transit from .25% to .3%.

Tables 6 and 7 below show the sales tax rates for food and the general sales tax rates that will be in effect for years 2006 through 2008. Rates for 2008 incorporate the changes as provided for under SB 223.

Table 6: Sales Tax Rates for Food

	2006	*2007*	*2008*
State Rate	4.75%	2.75%	1.75%
Local Option Rate	1.00%	1.00%	1.00%
County Option Rate	0 - 0.25%	0 - 0.25%	0.25%
Other Local Rates	0 - 2.10%	0 - 2.35%	0.00%

Table 7: General Sales Tax Rates

	2006	*2007*	*2008*
State Rate	4.75%	4.75%	4.65%
Local Option Rate	1.00%	1.00%	1.00%
County Option Rate	0 - 0.25%	0 - 0.25%	0.25%
Other Local rates	0 - 2.10%	0 - 2.35%	0 - 2.50%

Source for Tables 4 and 5: "Tax Relief and Reform: What Does it Mean For Taxpayers," Office of Legislative Research and General Counsel, March 2007

Revenue Implication
The Legislative Fiscal Analyst Office projects a loss in FY2008 to the General Fund of $19,642,800 due to the reduction of the State Sales Tax Rate from 4.75% to 4.65%, and a loss of $19,427,000 as a result of the Food Tax reduction from 2.75% to 1.75%. The loss to the General Fund in FY2009 is projected to be $40,857,000 for the State Sales Tax rate reductions and $40,408,200 for the Food Tax rate reduction.

Summary and Conclusion
As enacted, Senate Bill 223 makes significant changes in both the income and sales tax beginning in January 1, 2008. As a result, the State of Utah will move from a deduction based, progressive rate system with different rates for different income brackets to a single rate, credit-based system. Under the new single rate system, the "progressive" nature of the income tax will be preserved by the phaseout of the taxpayer credit as income increases while reducing the top marginal tax rate to 5%. In other words, effective tax rates increase as income rises up to a maximum 5% effective rate. The most significant changes to the sales tax were the decrease in the state sales tax rate for food from 2.75% to 1.75%, the removal of food from the sales and use tax base for a variety of local option sales taxes, and a decrease in the general sales tax rate from 4.75% to 4.65%. Revenue loss to the Education and General Fund as a result of the Income Tax and Sales Tax reform is estimated to total $66,244,800 in FY2008 and $189,965,200 in FY2009.

The reform described in this paper with respect to both the income tax and sales tax will have an impact on how the tax burden in Utah is distributed among different classes of taxpayers. The reform will impact how much of the overall tax revenue is paid by taxpayers in each income group as well as how much tax each taxpayer pays as a percentage of his or her income. A thorough tax burden analysis of the tax reform implemented in the 2007 Legislative Session will be the subject of a later paper to be published by the Center.

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Utah Tax Commission: Economic and Statistical Data; Income Tax Rates
Utah Code: Title 59, Chapter 10-Individual Income Tax Act

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