



# INCOME TAX REFORM

## What Does It Mean for Taxpayers?

Office of Legislative Research and General Counsel

### HIGHLIGHTS

- SB 4001, passed in the 2006 4th Special Session, reduces taxes for nearly all residents who pay individual income tax. This tax reduction is the result of adjustments to the tax brackets and creation of a new flat tax option.
- Bracket adjustments provide a tax cut to nearly all resident filers. Single filers generally receive a benefit between \$25 and \$50. Married filers generally receive a benefit between \$50 and \$100.
- The flat tax option provides an additional tax cut, in varying amounts, to about 4% of resident taxpayers.
- Higher income returns generally receive a larger tax cut when measured by dollar amount.
- Lower income returns generally receive a larger tax cut when measured by percent reduction in tax liability and by reduction in the effective tax rate.

### SPECIAL SESSION INCOME TAX REFORM BILL

In the September 2006 4th Special Session, the Utah Legislature passed SB 4001, "Income Tax Amendments." This tax reform bill makes two main adjustments to the state's individual income tax system: bracket adjustments and a new flat tax computation.

**Bracket Adjustments.** Beginning in tax year 2006, the new law expands the tax brackets applied to Utah taxable income under the traditional multiple rate computation and reduces the tax rate for the top bracket. Beginning in tax year 2009, the law also indexes tax brackets for inflation.

**Flat Tax Computation.** Beginning in tax year 2007, the new law allows a taxpayer to utilize an alternative flat tax computation based on a flat rate of 5.35% of federal adjusted gross income (AGI), with certain additions to and subtractions from AGI.

### HOW ARE EFFECTS ESTIMATED?

The Office of Legislative Research and General Counsel analyzed the new law's effects by applying SB 4001's changes to tax year 2005 returns<sup>1</sup>. Even though individual returns may vary from year to year, the trends from tax year 2005 should provide a general indication of SB 4001's impacts<sup>2</sup>.

### WHAT ARE THE BRACKET ADJUSTMENTS?

Beginning in tax year 2006, SB 4001 expands tax brackets and reduces the top bracket rate, as shown in Table 1 and Table 2 (page 2). In addition, the tax brackets are indexed for inflation, as measured by the Consumer Price Index, beginning in tax year 2009.

The top bracket rate reduction from 7.00% to 6.98% provides an additional benefit to those with income taxed in the top bracket (about 80% of resident taxpayer returns).

The Legislative Fiscal Analyst estimates that the new law will reduce individual income tax revenues by between \$78 million and \$85 million in FY 2008 and that a little more than half of this tax cut amount is attributable to the bracket adjustments.

### WHAT IS THE EFFECT OF BRACKET ADJUSTMENTS?

This analysis utilizes three methods for assessing tax liability changes: (1) dollar reduction, (2) percent reduction in liability, and (3) effective rate reduction. Dollar reduction is the estimated amount of the tax cut. Percent reduction in liability is the dollar reduction as a percent of the tax liability prior to the bracket adjustments. Effective rate reduction is the dollar reduction as a percent of AGI. Each of these three measures examines the tax cut in a different way. Taken together, the three measures provide a good sense of the overall effect of the tax changes. For each method of analysis, we provide scatterplot charts in which each tax return is represented by a dot.

**Table 1****Tax Brackets Applied to State Taxable Income – Single and married filing separately**

Tax Year 2005				Tax Year 2006			
Lower	Upper	Add	Rate	Lower	Upper	Add	Rate
\$0	\$863	\$0	2.30%	\$0	\$1,000	\$0	2.30%
\$864	\$1,726	\$20	3.30%	\$1,001	\$2,000	\$23	3.30%
\$1,727	\$2,588	\$48	4.20%	\$2,001	\$3,000	\$56	4.20%
\$2,589	\$3,450	\$85	5.20%	\$3,001	\$4,000	\$98	5.20%
\$3,451	\$4,313	\$129	6.00%	\$4,001	\$5,500	\$150	6.00%
\$4,314	and up	\$181	7.00%	\$5,501	and up	\$240	6.98%

**Table 2****Tax Brackets Applied to State Taxable Income – Married filing jointly and head of household**

Tax Year 2005				Tax Year 2006			
Lower	Upper	Add	Rate	Lower	Upper	Add	Rate
\$0	\$1,726	\$0	2.30%	\$0	\$2,000	\$0	2.30%
\$1,727	\$3,450	\$40	3.30%	\$2,001	\$4,000	\$46	3.30%
\$3,451	\$5,176	\$97	4.20%	\$4,001	\$6,000	\$112	4.20%
\$5,177	\$6,900	\$169	5.20%	\$6,001	\$8,000	\$196	5.20%
\$6,901	\$8,626	\$259	6.00%	\$8,001	\$11,000	\$300	6.00%
\$8,627	and up	\$362	7.00%	\$11,001	and up	\$480	6.98%

The bracket adjustments provide a tax reduction to nearly all resident income tax payers (resident returns with positive tax liability). Higher income returns generally receive a larger tax cut when measured by dollar reduction, due primarily to the drop in the top bracket rate. Lower income returns generally receive a larger tax cut when measured by percentage reduction in tax liability or effective rate reduction, due mainly to the bracket expansion. Returns in lower brackets receive benefits that vary by bracket. A small number of taxpayers may not see a tax reduction because their taxable income falls in the lowest tax bracket or they have a tax liability that rounds to the same whole dollar amount as their previous liability.

**Dollar reduction.** As shown in Chart 1 (page 4), most filers that are single or married filing separately receive a tax cut between \$25 and \$50, with the amount increasing as income rises. Most filers that are married filing jointly or head of

household receive a tax cut between \$50 and \$100, with the amount increasing as income rises.

**Percent of liability reduction.** As shown in Chart 2 (page 5), lower income returns generally receive a higher percentage tax cut from the bracket adjustments. Returns at or near the cutoff for the top bracket receive about a 9% reduction in their tax liability. This reduction percentage declines to a roughly 1% reduction in tax liability for returns with AGI greater than \$100,000.

**Effective rate reduction.** As shown in Chart 3 (page 5), lower income returns generally receive more of an effective rate reduction from the bracket adjustments. In other words, lower income returns generally receive a greater reduction as a percent of AGI. Filers at or near the cutoff for the top bracket receive about a 0.2% to 0.3% effective rate reduction. The effective rate reduction gradually declines to below 0.05% for most higher income returns.

## WHAT IS THE FLAT TAX COMPUTATION?

Beginning in tax year 2007, SB 4001 allows a taxpayer to make a flat tax computation and pay the lesser of the multiple rate computation and the flat tax computation. Under the flat tax computation, a filer begins with AGI and makes certain additions to and subtractions from AGI (see Table 3). After making these adjustments to AGI, a taxpayer multiplies the resulting modified AGI amount by a flat tax rate of 5.35%. The taxpayer pays the lesser of the flat tax computation and the multiple rate computation.

Under the flat tax computation, a taxpayer may not claim deductions from AGI for personal exemptions, the standard deduction, itemized deductions (such as mortgage interest, charitable contributions, and state and local taxes), the deduction for being age 65 or over, or the deduction for one half of the federal tax paid.

**Table 3**

### Flat Tax - Additions to and Subtractions from AGI

Additions to AGI	Subtractions from AGI
Certain medical savings account withdrawals and penalties deducted on state individual income tax return	Deductions required by federal law, treaty, or case law (US interest, certain American Indian income, railroad retirement income)
Certain income tax amounts deducted from AGI by an estate or trust	Uintah-Ouray reservation income
Certain lump sum distributions	State tax refund included in AGI
Child's income reported on a parent's return but not included in AGI	
Educational savings plan withdrawals that were deducted on a state individual income tax return but not used for qualified higher education purposes	
Other states' bond interest, under certain conditions	
Certain trust distributions received by a resident beneficiary	
Certain adoption expenses deducted on a state or federal individual income tax return	

Although in some individual cases the remaining flat tax additions to and subtractions from AGI may be significant, on a statewide basis, the flat tax computation tax base remains close to AGI. Because there are only a few relatively minor deductions allowed, the flat tax computation base is a broader tax base than the multiple rate computation tax base.

The Legislative Fiscal Analyst estimates that slightly less than half of the tax cut enacted under SB 4001 is due to the flat tax computation.

## WHAT IS THE EFFECT OF THE FLAT TAX?

Based on tax year 2005 data, about 30,000 returns initially benefit from the alternative flat tax calculation provided for in SB 4001 (about 4% of resident returns with a positive tax liability or about 3% of all resident returns).

Although flat tax filers represent a fairly small percentage of resident taxpayer returns (4%), they represent a much larger share of AGI (22%) and tax liability (30%).

Through the flat tax computation, taxpayers give up about \$2.1 billion in deductions (approximately 11% of total deductions claimed on resident taxpayer returns). However, this base expansion may be temporary, because it can vary by year as taxpayers annually select the tax computation providing the greatest benefit.

As shown in Chart 4 (page 6), some higher income returns receive a larger tax cut when measured by dollar reduction, likely because these returns claim fewer deductions as a percentage of AGI. Other higher income returns receive tax cuts similar to lower income returns that use the flat tax. Chart 5 (page 6) also shows the distribution in the amount of tax cut.

No obvious pattern emerges when measuring the tax cut by percent reduction in tax liability (Chart 6 on page 7) and effective rate reduction (Chart 7 on page 7). Using these two percentage measures, the benefits appear to be spread across income groups.

Charts 8 through 13 (pages 8 to 10) show that those who benefit from the flat tax computation cross the spectrum of income, family size, and filing status type.

## CONCLUSION

SB 4001 of the 4th Special Session reduces taxes for nearly all residents who pay individual income tax, through changes to tax brackets and through a new flat tax option.

Bracket adjustments provide a tax cut to nearly all resident filers. Single filers generally receive a benefit between \$25 and \$50. Married filers generally receive a benefit between \$50 and \$100.

The flat tax option provides an additional tax cut, in varying amounts, to about 4% of resident taxpayers.

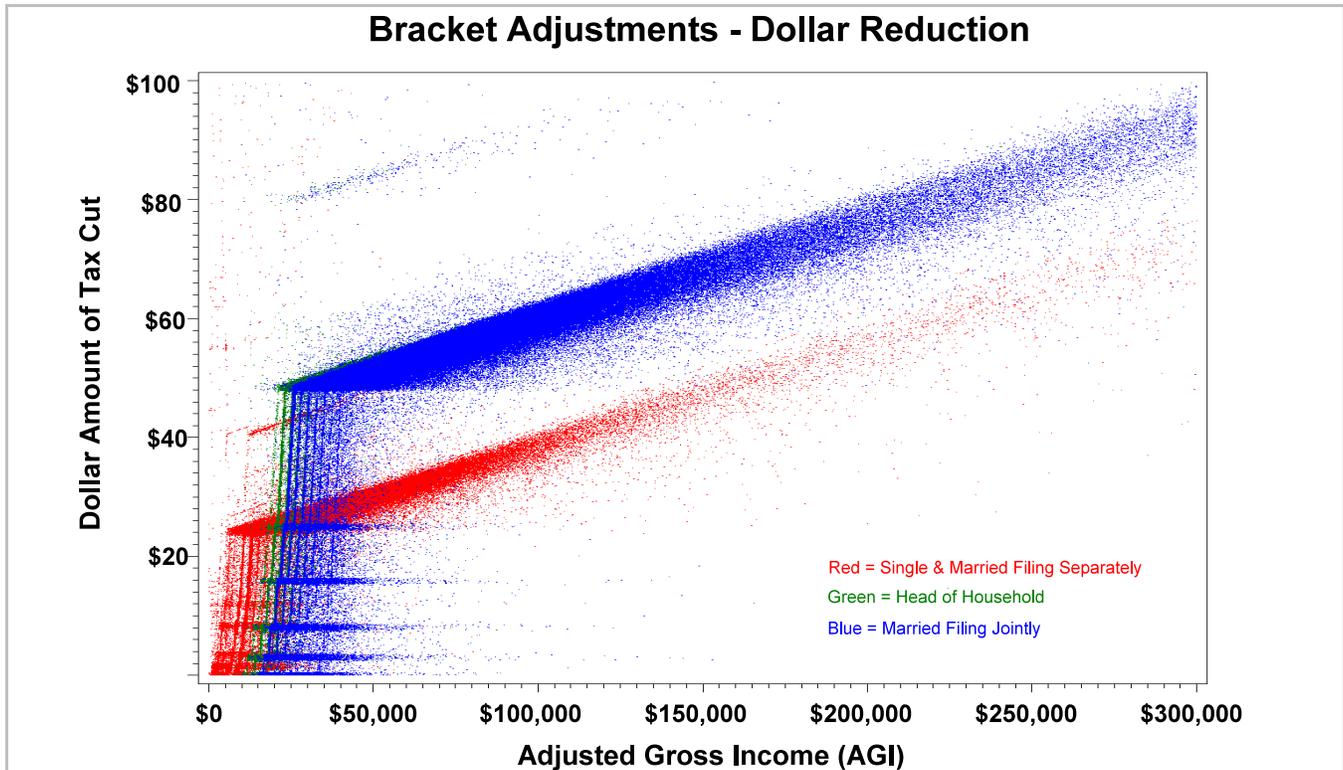
Higher income returns generally receive a larger tax cut when measured by dollar amount, due primarily to the top bracket rate cut and the flat tax.

Lower income returns generally receive a larger tax cut when measured by percent reduction in tax liability and by reduction in the effective tax rate, due primarily to the bracket expansion.

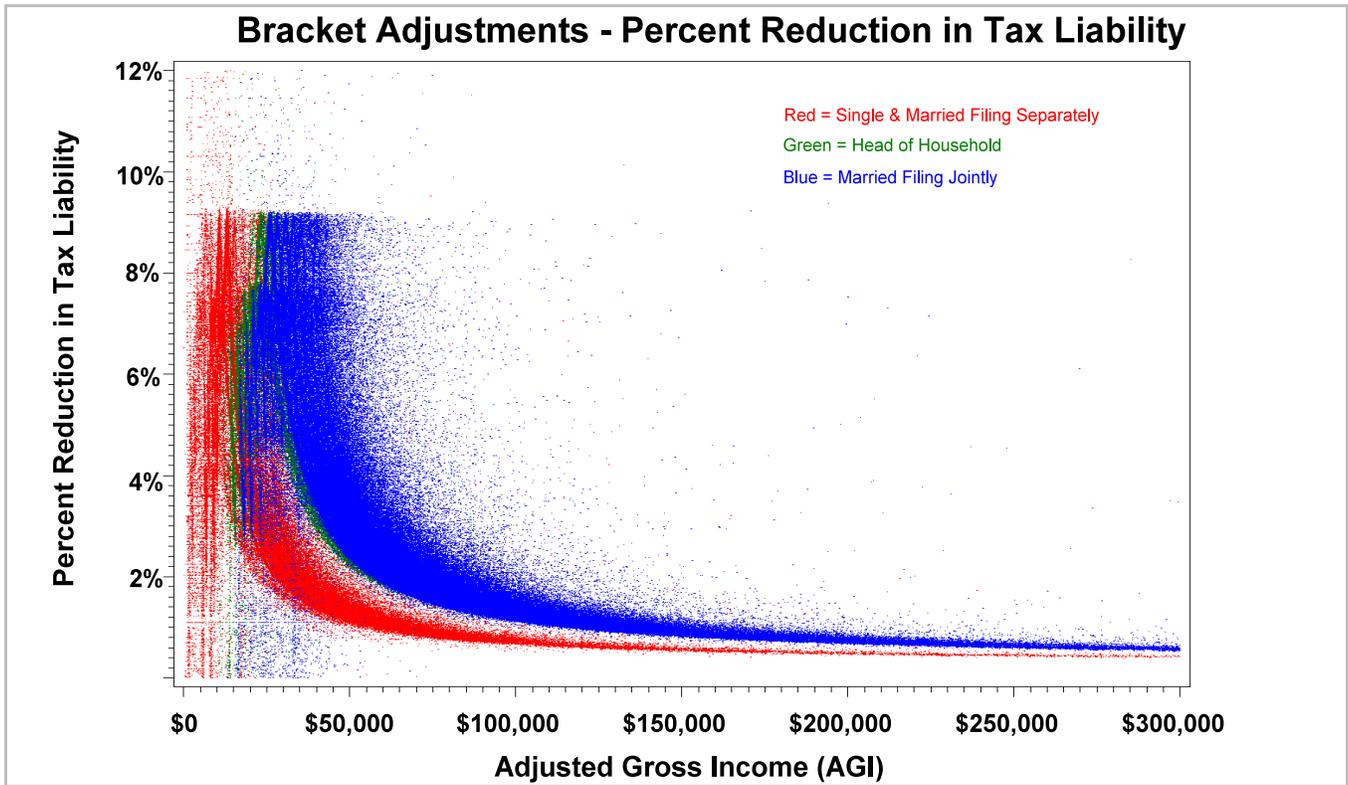
## NOTES

1. SB 3002 of the 2006 3rd Special Session allows the Office of Legislative Research and General Counsel to obtain state tax return information, subject to stringent restrictions that protect taxpayers' privacy. Among these restrictions are: (1) the Tax Commission must remove personal identifying information prior to providing the return data; and (2) the Office may not present data in a way that would allow identification of a particular taxpayer.
2. No analysis of tax year 2005 returns can state precisely what will happen in the future when the enacted changes take place. Changes in income, deductions, credits, and tax for each individual return are likely, due to changes in personal circumstances and federal tax law. However, the general trends are likely to be similar between tax year 2005 and tax years 2006 and 2007 (when the enacted changes take place). It is also worth noting that an analysis using tax year 2004 returns produced substantially similar results.

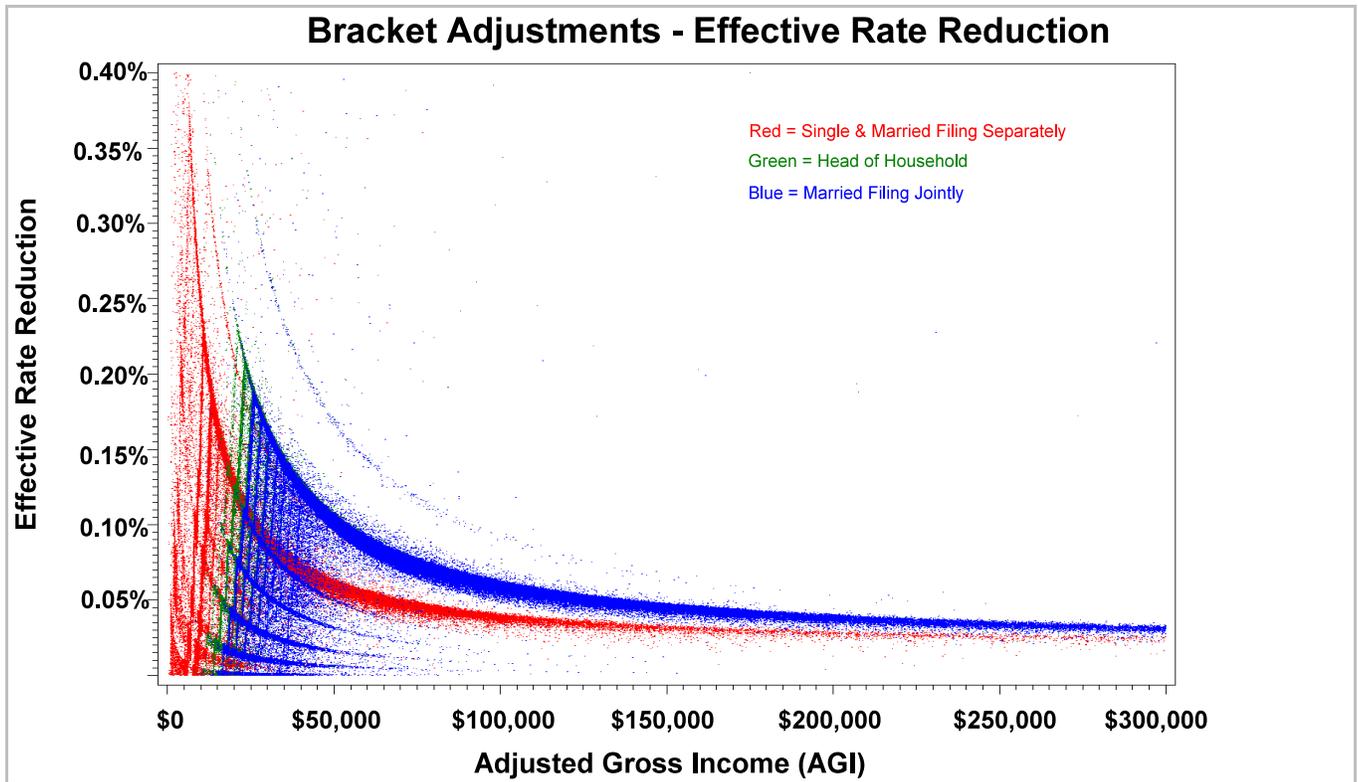
Chart 1



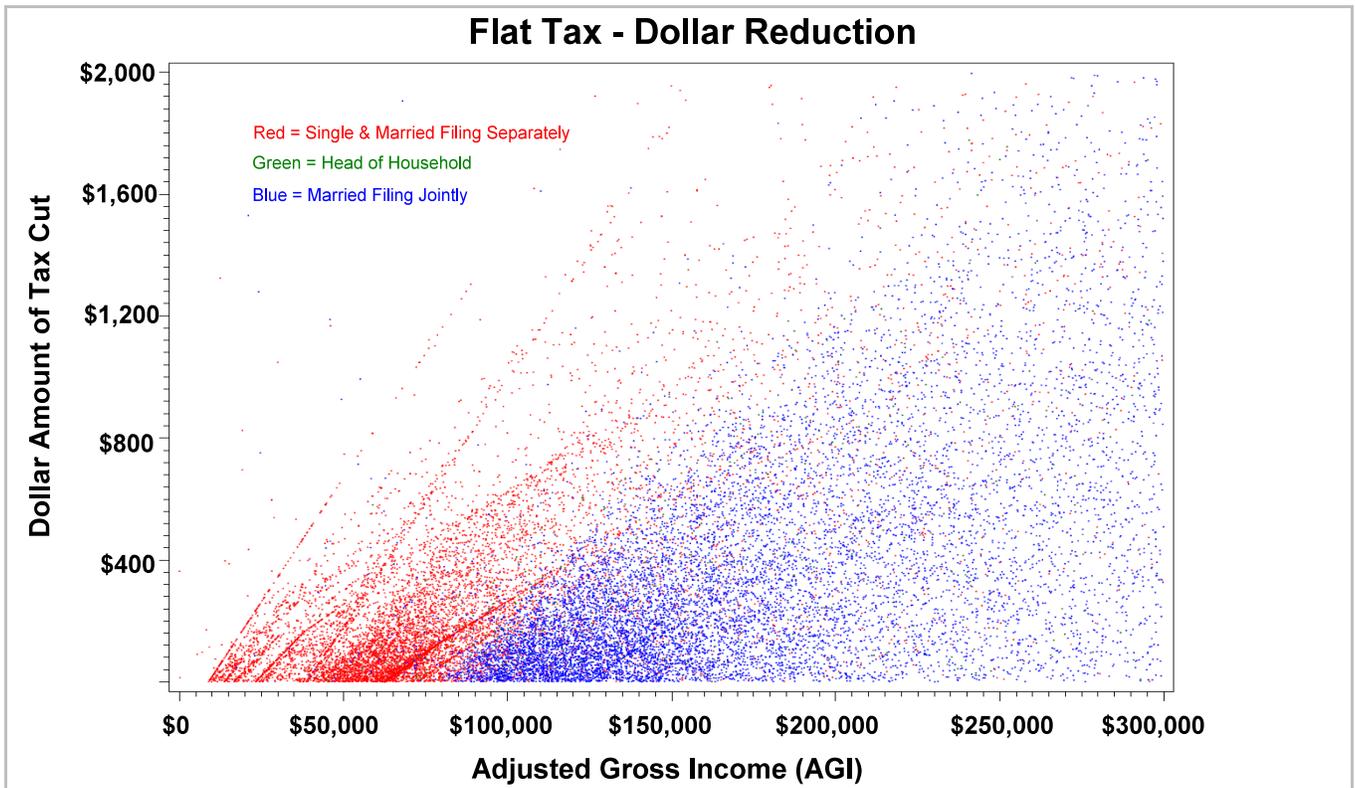
**Chart 2**



**Chart 3**

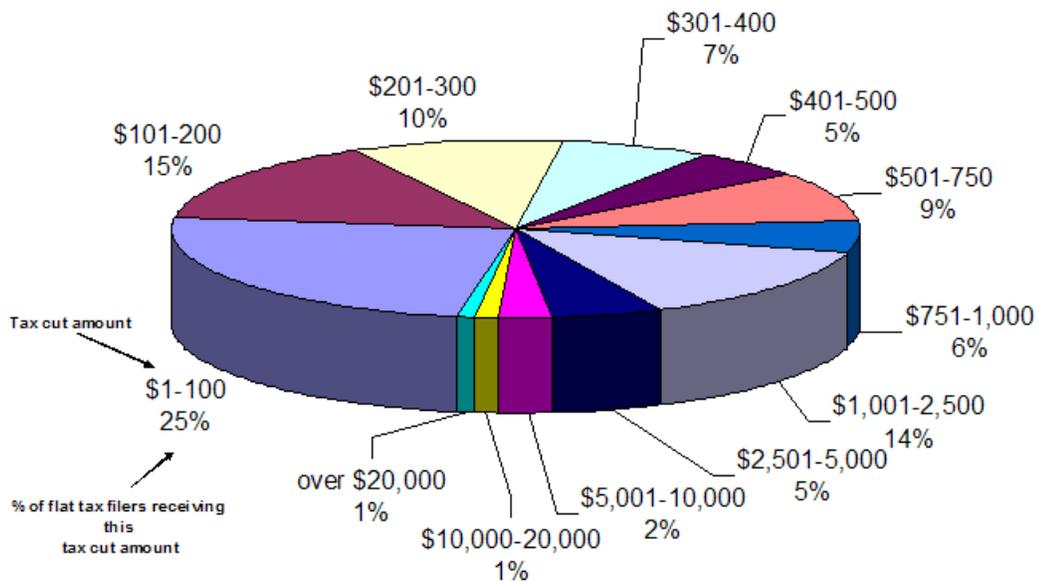


**Chart 4**

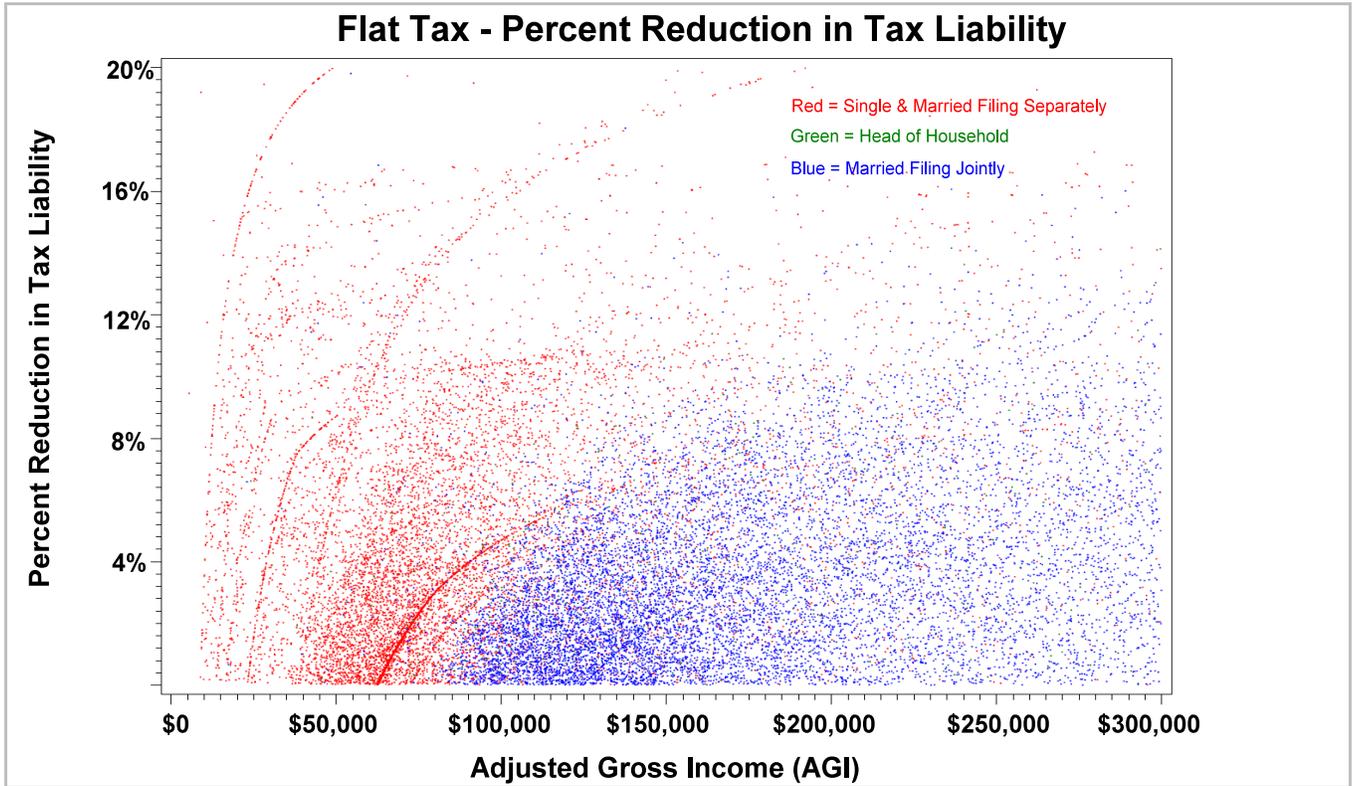


**Chart 5**

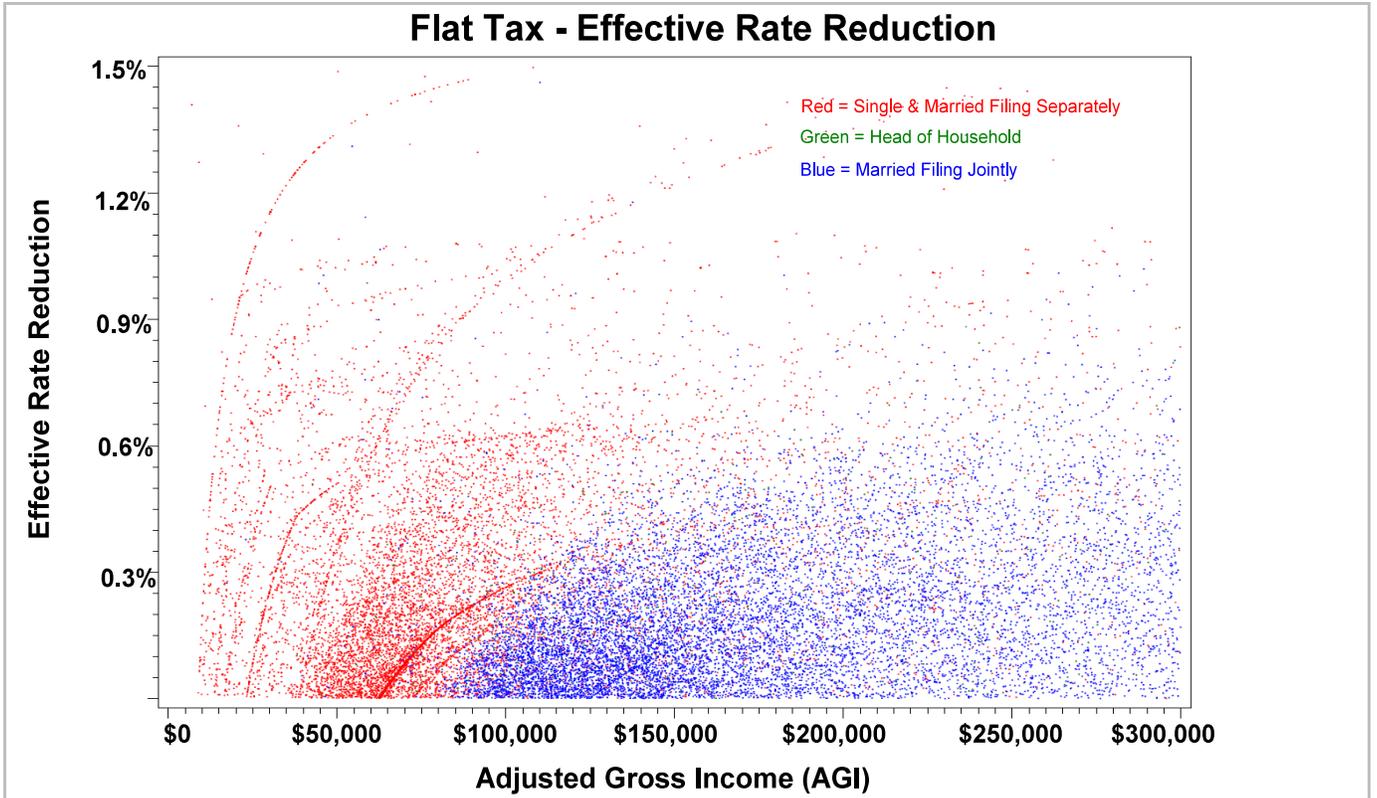
### Flat Tax Filers Distribution in Amount of Flat Tax Reduction



**Chart 6**



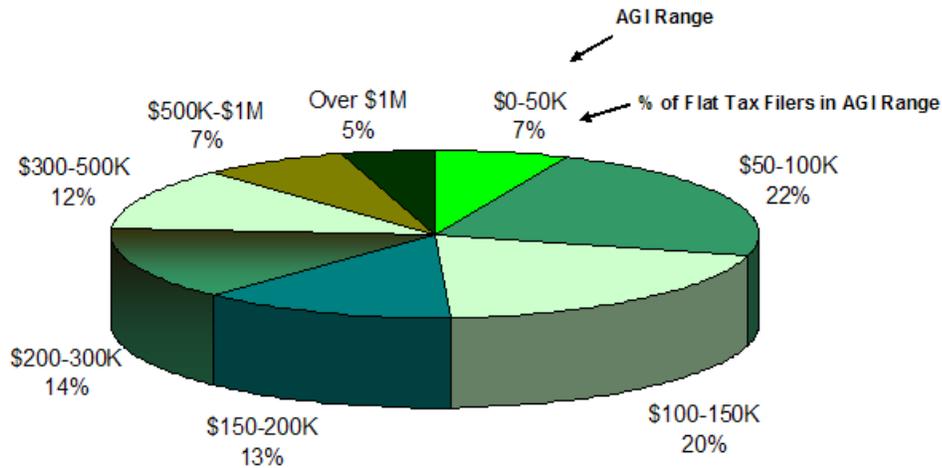
**Chart 7**



**Flat Tax Filers by Income Range.** Chart 8 and Chart 9 show the distribution of flat tax and multiple rate system filers by AGI range. The flat tax system has a greater proportion of higher income filers than the multiple rate system.

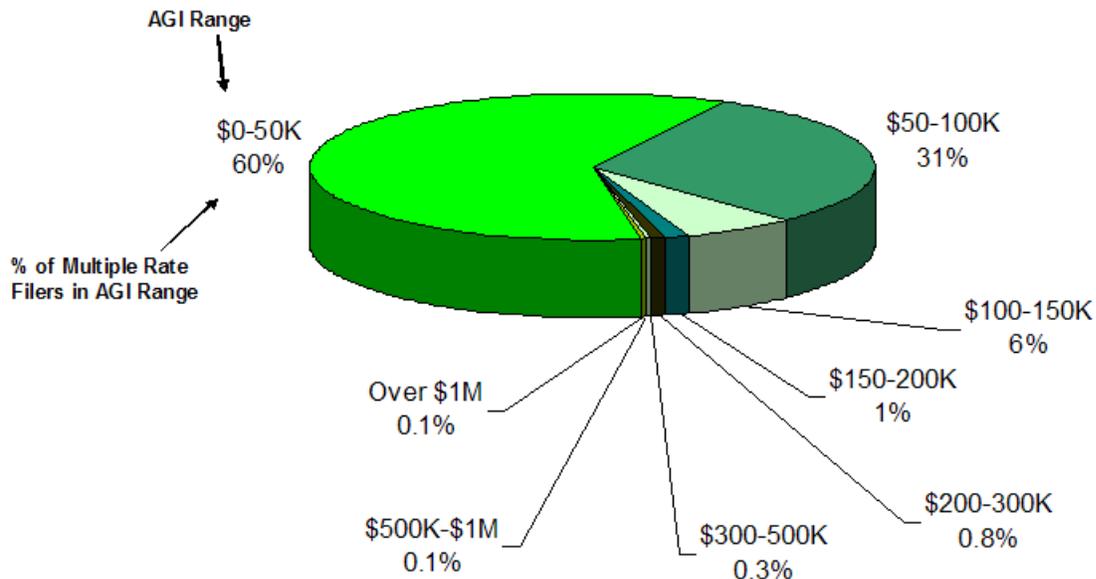
### Chart 8

## Flat Tax Filers by AGI



### Chart 9

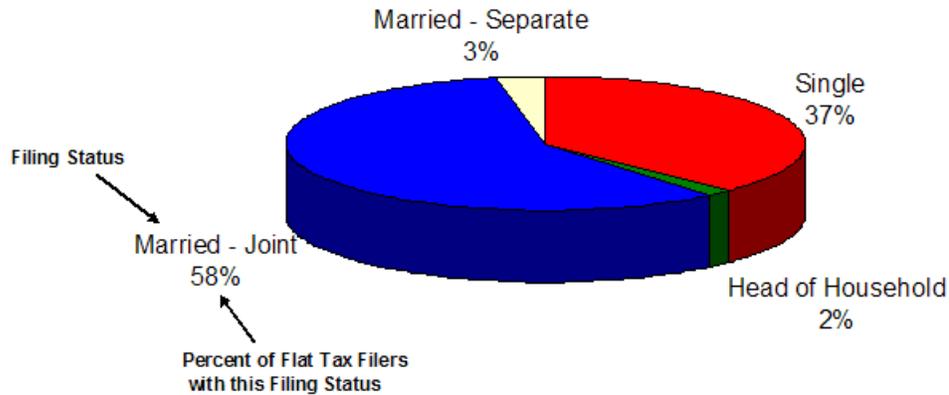
## Multiple Rate Filers by AGI



**Flat Tax Filers by Filing Status.** Chart 10 and Chart 11 show the distribution of flat tax and multiple rate system filers by filing status. The flat tax system has a slightly greater proportion of filers who are single or married filing jointly.

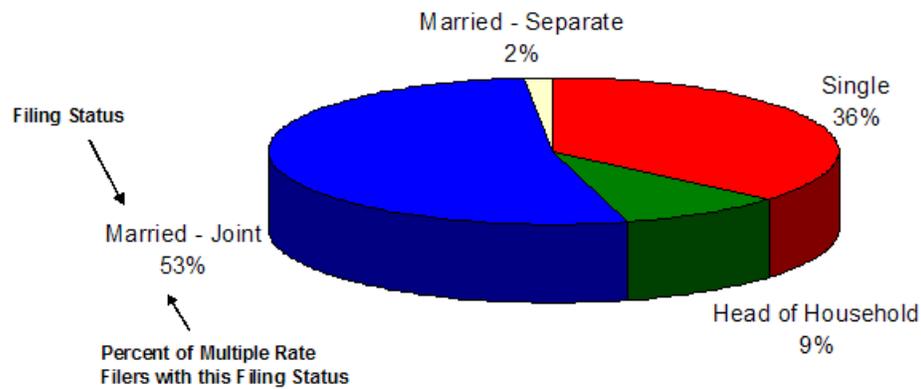
### Chart 10

## Flat Tax Filers by Filing Status



### Chart 11

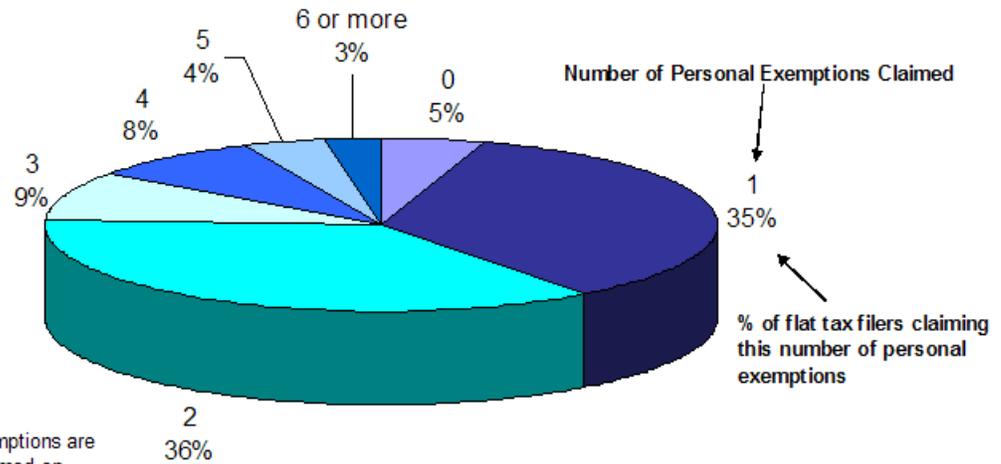
## Multiple Rate Filers by Filing Status



**Flat Tax Filers by Family Size (# of Personal Exemptions).** Chart 12 and Chart 13 show the distribution of flat tax and multiple rate system filers by the number of personal exemptions claimed, a general approximation for family size. The flat tax system has a somewhat higher proportion of returns with one or two exemptions.

### Chart 12

## Flat Tax Filers by Number of Personal Exemptions Claimed



Note: Returns with zero exemptions are returns where the filer is claimed on someone else's return

### Chart 13

## Multiple Rate Filers by Number of Personal Exemptions Claimed

