Income-Based Education Tax Study Committee

Report Prepared Pursuant to No. 175, Section 5 of the Acts and Resolves of 2022

Study Committee Members

Representative Emilie Kornheiser, Co-Chair

Representative Scott Beck

Representative Peter Conlon

Senator Ann Cummings, Co-Chair

Senator Christopher Pearson

Senator Andrew Perchlik

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Executive Summary

Act 175 of 2022, an act relating to making miscellaneous changes in education law, created the Income-Based Education Tax Study Committee. The Committee met six times to study and make recommendations on the creation and implementation of an income-based education tax to replace the homestead property tax. The Committee decided to focus on "*if* an education income tax were to be adopted, *how* would it be structured?" The Committee has no consensus recommendation regarding the policy question whether an education income tax should be adopted.

If an education income tax were to be adopted, the Committee has the following recommendations for structuring the tax. Details on each of these recommendations, and additional detailed recommendations are discussed in Section V of this report.

- An education tax should be structured with progressive tax rates and income brackets on the adjusted gross income of all Vermont taxpayers.
- The education tax rates should apply by school district and be increased or decreased according to the locally voted education spending decisions as compared to the prior year statewide average education spending.
- The current structure and timing for setting tax rates should be maintained. The Legislature should set the education tax rates and continue to set the nonhomestead tax rates to balance the Education Fund if actual revenues or expenditures are higher or lower than forecast.
- Education tax withholding and estimated payments should be maintained in the same circumstances that personal income tax is withheld or estimated payments are due.
- The existing Renter Credit program should be maintained in its current form.
- A new nonrefundable credit for all renters against the education tax should be created and structured as a percentage of gross rent paid.
- The nonhomestead property tax structure and its administration should be maintained. The nonhomestead tax base should be expanded to apply to the portion of a homestead property that exceeds the housesite.
- The amount set aside in the Stabilization Reserve should be increased due to the decreased stability that an education tax based on income will introduce into the Fund compared to the homestead property tax.
- Education payments and cash flow to school districts should continue to follow the same timeline as under current law.
- Municipalities' involvement in the State property tax system should be maintained.

I. Enabling legislation

Act 175 of 2022, an act relating to making miscellaneous changes in education law, created the Income-Based Education Tax Study Committee. Section 5 of Act 175 reads:

(a) Creation. There is created the Income-Based Education Tax Study Committee to study and make recommendations regarding the creation and implementation of an income-based education tax system to replace the homestead property tax system for education funding in this State.

(b) Membership. The Study Committee shall be composed of the following members:

(1) three current members of the House of Representatives, not all from the same political party, who shall be appointed by the Speaker of the House; and

(2) three current members of the Senate, not all from the same political party, who shall be appointed by the Committee on Committees.

(c) Powers and duties. The Study Committee shall study the creation and implementation of an income-based education tax system, including the following issues:

(1) restructuring the renter credit under 32 V.S.A. chapter 154 or creating a new credit or other mechanisms to ensure that Vermonters who rent a primary residence participate fairly in the education income tax system;

(2) transitioning from the current homestead property tax system to a new income-based education tax system;

(3) accurate modeling, given the differences between household income for homestead property tax purposes and adjusted gross income for income tax purposes;

(4) whether there should be a limit to the amount of income subject to a new income-based education tax;

(5) challenges or other considerations for administering a new proposed education income tax system;

(6) with regard to income as a tax base, the impact of a new proposed education income tax on the State's taxing capacity, including the impact on the General Fund; and

(7) any other relevant considerations.

(d) Assistance. The Study Committee shall have the administrative, technical, and legal assistance of the Agency of Education, the Department of Taxes, the Joint Fiscal Office, the Office of Legislative Counsel, and the Office of Legislative Operations and shall consult with the Vermont League of Cities and Towns and any other interested stakeholders.

(e) Report. On or before December 30, 2022, the Study Committee shall submit a written report to the House Committees on Education and on Ways and Means and the Senate Committees on Education and on Finance with its findings and recommendations for legislative action, which shall include proposed legislative language.

(f) Meetings.

(1) The Joint Fiscal Office shall call the first meeting of the Study Committee to occur on or before July 15, 2022.

(2) The Study Committee shall select a chair from among its members at the first meeting.

(3) A majority of the membership shall constitute a quorum.

(4) The Study Committee shall cease to exist on December 31, 2022.

(g) Compensation and reimbursement. For attendance at meetings during adjournment of the General Assembly, members of the Study Committee shall be entitled to per diem compensation and reimbursement of expenses pursuant to 2 V.S.A. § 23 for not more than six meetings. These payments shall be made from monies appropriated to the General Assembly.

II. Vermont's education finance system

Overview and background

Vermont's education funding formula is both unique and complex. The State's education finance system differs from those in other states, in that it is a statewide funding formula coupled with local spending decisions and primarily local property tax administration. Each school district's education spending is determined at a local level, where school boards set budgets that must be approved by voters.

The current system is a product of multiple reforms over the years that have aimed to adjust inequities in the funding system. These reforms have included Act 60 of 1997, Act 68 of 2003, and Act 127 of 2022.

Prior to Act 60, Vermont relied on a "foundation" program to fund its education system. A foundation formula relies on a base level of revenue for each school district, and State aid is provided to districts that are unable to raise the full foundation amount on their own. Fluctuations in the State's fiscal status led to underfunding of the foundation formula, which shifted the responsibility to school districts to make up the funding through local taxation. This generally meant that property-wealthy districts benefitted from low tax rates and high per-pupil spending, while property-poor districts faced high tax rates and low per-pupil spending.

In 1997, the Vermont Supreme Court found this funding system to be unconstitutional in the *Brigham* decision.[1] The Court ruled that, because a town's property wealth affected its base education tax rate, the foundation formula violated the Vermont Constitution.[2] The Court stated that the State is responsible for providing a public education to its citizens under the Education Clause of the Vermont Constitution and for ensuring substantial equality of educational opportunity under the Common Benefits Clause of the Vermont Constitution.[3] The Court further clarified that the Vermont Constitution is silent on how these constitutional rights must be financed. The Constitution does not mandate any specific system of education funding. In particular, the Constitution does not require an education funding system to be based on property taxes or designed to promote local control.[4] The Court emphasized that the specific means of discharging the State's constitutional duty to "make educational opportunity available on substantially equal terms" is left to the discretion of the General Assembly.[5]

In response to the *Brigham* decision, the Legislature passed Act 60 in 1997. This new law, and further reforms in Act 68 of 2003, adjusted the education funding formula so that a town's property wealth does not affect its base education tax rate. Act 60 is the foundation upon which the current education financing system has been built. In the current system, towns with the same per-pupil spending have the same

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[1] *Brigham v. State*, 166 Vt. 246 (1997).

[2] For a more detailed legal analysis, see, Office of Legislative Council, *Memorandum to House and Senate Committees on Education, Vermont General Assembly*, available online: https://ljfo.vermont.gov/assets/Uploads/f74892d194/WDonna-Russo-SavageBrigham-v.-State-166-Vt.-246-19972-5-2015.pdf

[3] *Brigham*, ¶ 268; Vt. Cons. Ch. I, Art. 7 and Ch. II, § 68.

[4] *Id.*, ¶ 267.

[5] *Id.*, ¶ 268.

homestead equalized tax rate regardless of their property wealth.[6] This means that if the Legislature reduces funds for education, all school districts, regardless of their property wealth, are affected.

As in most funding structures, Vermont's education expenditures and education funding are inherently linked. But unlike most funding structures, Vermont's education expenditures are *not* a function of how much money is raised for education; instead, the converse is true: property tax rates to fund education are a function of education expenditures. This unique system will be explained in the following section.

Given the complexities in Vermont's education funding formula, it is important to understand the structure of the system before analyzing potential changes to it. The following sections provide an overview of Vermont's education finance system through a lens of first exploring education expenditures, and then examining how these education expenditures are funded.

Education expenditures

Vermont's education finance system is a statewide funding formula coupled with local budget decisions and local property tax administration, and therefore it must be examined on both the local level and the State level.

On a Local Level

Every year, each school district in Vermont builds a budget that must be approved by local voters; these budgets will ultimately determine the amount of funding their school will receive. Some of the components within school districts' budgets are predetermined outside of the school districts' annual decisions. These predetermined sources, also known as "offsetting revenues," include State and federal categorical aid,[7] tuition revenues (to the school district), prior year surpluses or deficits (of the school district), and reserve funds (of the school district).

After subtracting all offsetting revenues from the locally voted education budget, the remainder of the total voted education budget is referred to as "education spending." This term describes the funds that a school district decides to spend on top of the offsetting revenues it receives.[8] A school district's education spending per pupil will ultimately influence its local education tax rates.

On a Statewide Level

All school budgets are funded through Vermont's Education Fund. The expenditures in this statewide fund are the total aggregated costs of public education in Vermont. In general, Vermont's education expenditures can be sorted into two different categories – the statewide education payment and all other expenditures.

The education payment is the aggregated amount of all school districts' education spending. Recall that education spending is the amount that each school district decides to spend in addition to the State and federal categorical aid it will receive.

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[6] Equalized tax rate refers to the tax rate *prior* to the application of the common level of appraisal (CLA). After the CLA is applied, towns with the same equalized tax rates will likely have differing "actual" tax rates. Actual tax rates are rates which have been adjusted by the CLA.

[7] Existing examples of State categorical aid includes state placed students, transportation, technical education, small school support, essential early education, flexible pathways, and special education aid.

[8] This is a simplified definition. See, 16 V.S.A. § 4001(6) [definition of "education spending"].

All other Education Fund expenditures include the State share of categorical aid, one-time appropriations, and other operating and administerial costs at the State level.

Recent Legislative Changes to Education Fund Expenses

Legislative amendments over the last five years have impacted the Education Fund by creating new funding obligations. These changes include teacher pensions, other postemployment benefits (OPEB), special education funding, universal school meals, and pupil weighting. Other reserves, studies, and reports regarding future funding options were enacted during the 2021-2022 legislative biennium, notably regarding polychlorinated biphenyls (PCBs) and career technical education (CTE). Additionally, whenever new sales tax exemptions are enacted, they decrease sales tax revenue to the Education Fund. These are called "tax expenditures," which are actual or estimated losses in tax revenue resulting from exemptions, exclusions, deductions, credits, preferential rates, or deferrals of liability applicable to a tax.[9] For a more detailed list of recent, new Education Fund expenses, see Appendix A.4.

Education Fund

Vermont's Education Fund is funded through both non-property tax sources and property tax sources. The amount generated through the property tax is the remaining amount of funds needed to support education expenditures net of non-property tax sources.

Necessity of Adjustable Tax Rates

School district budgets are determined locally, which in turn determines the total sum of funds that must be raised for the Education Fund. Due to the current system's structure, there needs to be an adjustable mechanism to respond to changing financial demands on the Education Fund. Currently, the mechanism to ensure that revenues coming into the Education Fund equal expenditures is the annual setting of the homestead yields and the nonhomestead tax rate. This mechanism is sometimes referred to as a "flexible lever". Depending on the performance of non-property revenue sources and the size of appropriations out of the Education Fund, the yields and nonhomestead tax rate can be adjusted up or down to raise sufficient revenue to fund education spending decided at the local level.

Non-Property Tax Sources

There are multiple non-property tax sources that contribute to the Education Fund. These include all of the revenues from the Sales and Use Tax, one-third of the Purchase and Use Tax revenues, one quarter of the Meals and Rooms Tax revenues, revenues from the State lotteries, Medicaid reimbursement funds, and other miscellaneous revenue sources.[10] Together, these non-property tax revenue sources generally contribute less than 30% of the revenue of the Education Fund.

The remainder of the required funds are raised through property taxes. Property tax rates are set annually by the Legislature at the level necessary to fund voter-approved school budgets and all other public education costs. More than 70% of the Education Fund is funded through property taxes. The property taxes are broken into two distinct categories, homestead and nonhomestead, each with a distinct tax rate and rate design Approximately 39% of the Education Fund is funded by the nonhomestead property tax and 34% of it is funded by the homestead education property tax. Each type of property tax is discussed in more detail below.

[9] See, 32 V.S.A. § 312.

[10] 16 V.S.A. § 4025.

Nonhomestead Education Property Taxes

Nonhomestead property taxes apply to all taxable real property that does not qualify as a "homestead". This includes everything from commercial and industrial property to second homes and rental units. The equalized nonhomestead property tax rate is uniform across all towns (although each town is subject to its own common level of appraisal to account for differences in valuation practices). The nonhomestead property tax rate is set in statute at the rate of $1.59 per $100.00 of property value.[11] Generally, however, this statutory rate is notwithstood each year in session law, and the Legislature imposes a different rate for a given fiscal year. This single rate applies across the state, although the actual rate shown on a taxpayer's property tax bill varies by town depending on the town's common level of appraisal. For example, in fiscal year 2022, the statewide nonhomestead property tax rate before adjustment by the common level of appraisal was $1.612 per $100.00 of property value.[12]

Calculation of Homestead Education Property Taxes

Vermont has a complex homestead property tax system that includes adjustments based on income and property value. Due to these complexities, this section will outline the calculation of district-level homestead property education tax rates.[13] The report will then present the household-level property tax credit for homestead owners in the next section.

Each district's homestead property tax rate is a function of two primary factors:

a) The education spending per equalized pupil of the district where the homestead is located, and
b) The statewide property yield, which is the per pupil spending amount the state can support with a $1.00 tax rate.

Together these factors are used to calculate the district level tax rate according to the following equation:

$$District's\ homestead\ property\ tax\ rate = \$1.00 * \frac{Education\ spending / Equalized\ pupils}{Statewide\ property\ yield}$$

Education spending per equalized pupil

Homestead education property tax rates depend on district education spending per equalized pupil.[14]

Vermont's education funding formula aims to address the differences in the cost of educating certain student populations through "pupil weights." Pupil weights adjust student counts according to different student needs or circumstances. Each district reports its overall student counts, and weights are applied to certain types of students to account for the potential higher costs to school districts of educating these students. After weights are applied to adjust all school districts' pupil counts, an equalization ratio is used to make the number of State equalized pupils match the overall statewide pupil count. These are referred to as "equalized pupils."[15] The equalized pupil count will vary from district to district based on its total number of students, and its share of weighted pupils in comparison to other districts.

[11] 32 V.S.A. § 5402(a)(1).
[12] See, 2021 Acts and Resolves No. 73, Sec. 17.
[13] See, 32 V.S.A. ch. 135.
[14] Recall that education spending is the total additional funds a school district includes in its budget after accounting for its offsetting revenues.
[15] Act 127 of 2022 adjusted the education funding formula and current weights. Per Act 127, starting in FY 2025, there will be no equalization ratio applied to weighed pupil counts.

Next, each district's education spending is divided by its total equalized pupils. This results in the education spending per equalized pupil, which is one of the primary factors of determining a district's homestead property education tax rate. This component of the homestead tax calculation ties the tax bills of each district's town or towns to the voter-approved per-pupil spending (and are not a function of a district's property wealth).

Statewide property yield

In addition to the education spending per equalized pupil, district homestead property tax rates are also determined by the statewide property yield, which is set annually by the Legislature and is the same across all school districts, although the actual rate shown on a taxpayer's property tax bill varies by town depending on the town's common level of appraisal. The property yield can be thought of as the per pupil amount of spending that the Education Fund can support with a uniform homestead tax rate of $1.00 on homestead value.[16] In districts that spend more per pupil than the property yield, the homestead property tax is increased proportionately.

For example, in fiscal year 2022, the property yield per equalized pupil was $11,317.00.[17] This means that districts with education spending per equalized pupil equal to or less than $11,317.00 had an equalized tax rate of $1.00. Districts that voted to spend more than $11,317.00 per equalized pupil had an equalized tax rate higher than $1.00.

Calculation of the Homestead Property Tax Credit

In Vermont, approximately 70% of households' property taxes are adjusted based on their income through an adjustment referred to as a "property tax credit" or formerly known as the "income sensitivity property tax adjustment".[18] This property tax credit is set according to an income tax percentage based on the income yield, which is also annually determined by the Legislature.[19] A district's income education tax rate has a minimum percentage of 2%, and the calculation of a district's income education tax rate is very similar to the calculation of a district's homestead property education tax rate. The equation used for calculating district rates is the following:

$$District's\ income\ education\ tax\ rate = 2\% * \frac{Education\ Spending \big/ Equalized\ Pupils}{Statewide\ property\ yield}$$

In essence, the property tax credit represents the difference between the education property taxes paid on the housesite and the education taxes that would be owed if they were paid on income. The property tax credit is calculated from the prior year's data. This means that if the education property taxes on the housesite are greater than what the tax would have been on income, the household receives a property tax credit reflecting the difference.

Not all Vermont households receive a property tax credit, primarily because of income level restrictions. In fiscal year 2022, about 70% of households received a property tax credit. Household income both determines if a household may use the credit, and, if so, the value of the home on which the credit can be used.

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[16] This means $1.00 tax rate per every $100.00 of property value. See, 32 V.S.A. § 5401(15).
[17] 2021 Acts and Resolves No. 73, Sec. 17.
[18] 32 V.S.A. ch. 154.
[19] 32 V.S.A. §§ 5401(16) and 6066(a)(2).

Household income determines the amount of housesite value that may be applied to calculate the property tax credit. Households with incomes under $90,000 may use the property tax credit on the first $400,000 of their homestead property taxes. Households with incomes over $90,000 may use the property tax credit on the first $225,000 of the homestead value. The following table outlines the different calculations of the property tax credit for different levels of household income.

Table 1: Calculation of Property Tax Credit by Income Level

Household income	Housesite value	Calculation of amount that would be paid under income	Calculation of the property tax credit
< $47,000	< $400,000	$income * income\ rate$	The property tax credit is the amount paid for property taxes minus the lesser of: • The amount that would be paid under income *OR* • The statewide education tax rate multiplied by the equalized value of the housesite in the taxable year reduced by $15,000
	≥ $400,000	$(income * income\ rate) + ((\frac{HS\ value - \$400{,}000}{100}) * HS\ rate)$	
$47,001 - $ 90,000	< $400,000	$income * income\ rate$	The property tax credit is the difference between the amount paid for property taxes and the amount that would be paid under income
	≥ $400,000	$(income * income\ rate) + ((\frac{HS\ value - \$400{,}000}{100}) * HS\ rate)$	
≥ $90,000	< $225,000	$income * income\ rate$	The property tax credit is the difference between the amount paid for property taxes and the amount that would be paid under income
	≥ $225,000	$(income * income\ rate) + ((\frac{HS\ value - \$400{,}000}{100}) * HS\ rate)$	

Recent Legislative Changes Increasing Education Fund Revenues

Legislative amendments over the last five years have impacted the Education Fund positively by adding larger percentages of existing revenue source allocations or expanding the tax base of existing revenue sources. These have included changes to funding sources and revenue stream allocations, as well as increases to the tax bases of the revenue streams dedicated in whole or in part to the Education Fund (notably to sales and use tax following the U.S. Supreme Court decision in *Wayfair*). For a more detailed explanation of recent increases to Education Fund revenues, see Appendix A.4.

III. Principles of a high-quality tax system

According to NCSL Tax Policy Handbook for State Legislators[20], there are six key principles of a high-quality tax system. These six pillars are: sustainability and reliability, economic competitiveness, tax neutrality, accountability, fairness, and simplicity. While the principles are distinct, they are inherently linked and no tax system adheres to all the principles exactly. As a result, tradeoffs are inherent and prioritization is key. The Committee explored these principles, the intersection of the principles, and reviewed the principles in the context of an education income tax.

After reviewing the principles of a high-quality tax system and its considerations for an education income tax, **the Committee decided to focus on "*if* an education income tax were to be adopted, *how* would it be structured?" The Committee has no consensus recommendation regarding "*if* an education income tax should be adopted".**

While the Committee has no consensus recommendation, Committee discussions frequently focused on the tension between the pillars of "simplicity" and "fairness". Appendix A.5 outlines the principles of a high-quality tax system, and some key takeaways when considering the principles in the context of an education income tax.

[20] https://www.ncsl.org/documents/fiscal/TaxPolicyHandbook3rdEdition.pdf

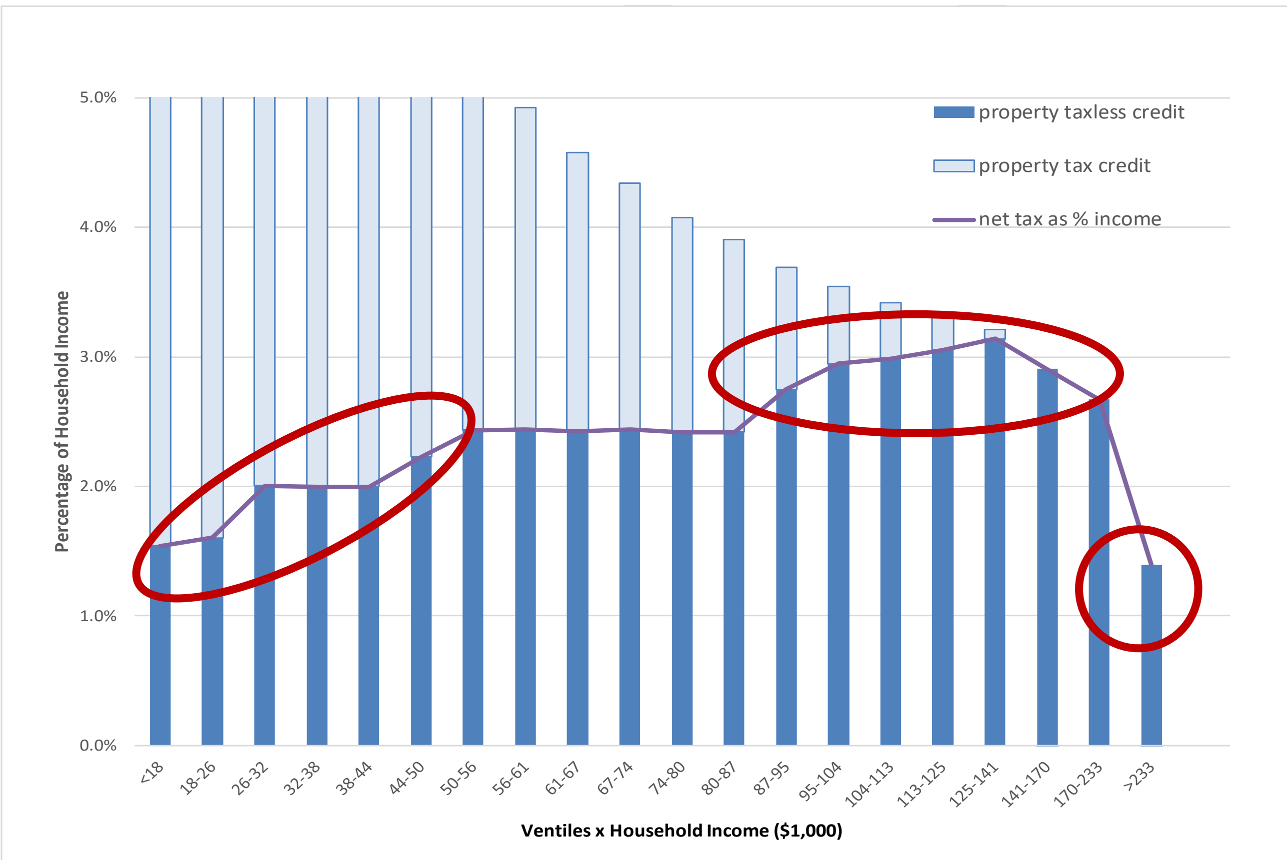
IV. Considering adjustments to the property tax credit

The Committee explored different options for adjusting or expanding the current income sensitized property tax credit in order to achieve smoother and greater progressivity in the tax paid as a share of income. Upon reviewing the modeling and the conclusions drawn from that analysis, **the Committee makes no recommendation on adjusting the income sensitized property tax credit under current law.**

In reviewing the distribution of net education tax that is paid as a share of household income under current property tax credit law, the Committee identified three areas that it wished to adjust. These areas can be seen circled in red in the *Figure 1* (below).

Figure 1:Current Law Property Tax Minus Credit Paid as a Share of Household Income

(Based upon 2019 data, mean)



Source: Adjusting the Property Tax Credit Modeling and Considerations Presentation, Graham Campbell and Deb Brighton, October 25, 2022.

As observable in this figure, the Committee identified three areas to be adjusted:

- The cliffs and bumps for people with lower household income that qualify for the circuit breaker;
- The "hump" after household income of $90,000; and
- The very low effective tax rate paid by taxpayers with the very high household income.

Following guidance from the Committee, JFO modeled adjustments to the property tax credit to:

- Smooth the relatively high effective tax rates for taxpayers with upper middle household income,
- Lift effective tax rates for taxpayers with very high household income, and
- Shield taxpayers with low and middle household income from effective tax rate increases.

Analyzing the modeling results led to the following primary conclusions, which apply across multiple sets of thresholds or cutoffs for income and housesite.[21]

1. *"Pushing on the balloon"*: Solving one issue using the property tax credit system creates new issues elsewhere in the income distribution.
    - These issues would require at least four distinct, major changes to the current credit.
    - Doing any single solution leads to undesirable outcomes:
        - Increasing the maximum credit to $10,000 leads to tax increases for taxpayers with middle and upper-middle household income.
        - Increasing the tax paid for households with the highest household income raises too much money that the system cannot absorb without making two other major changes.

2. *"The sledgehammer"*: It is difficult to achieve the desired effects in a targeted way using the property tax credit system.
    - Even if it possible to "smooth the curve" across the entire distribution, the relationship between housesite value and income means that there may be as many households paying more tax as those paying less tax, even within income groups. For instance, in the modeled proposal, 42%of households would pay more in net property tax.[22]
    - A policy to make the groups with the highest income pay a state-average effective tax rate is difficult to do without a specific surcharge or minimum tax.

Ultimately, results of the modeling suggested (imperfect) progressivity can be achieved in the system through adjusting the property tax credit. However, solving one issue creates new issues elsewhere in the distribution of tax paid as a percentage income, and it is difficult to achieve the desired effects in a targeted way. Given this analysis and the Committee's desire to simplify the property tax system, the Committee makes no recommendations for any adjustments to the property tax credit.

[21] Full modeling results are available at: https://ljfo.vermont.gov/assets/Meetings/Income-Based-Education-Tax-Study-Committee/2022-10-26/8a0fb5f4c9/Adjustments-to-the-Property-Tax-Credit-Modeling-and-Considerations-Campbell-v3.pdf

[22] Net property tax refers to the actual property tax paid, which is the property tax minus the property tax credit.

V. Recommended structure for an income-based education tax

Summary of recommendations

After deciding not to recommend adjusting the property tax credit, the Committee explored options for creating an income-based education tax. The Committee did not consider the merits of imposing an education income tax; rather, the Committee considered how an education income tax ought to be structured and administered to achieve the maximum progressivity and simplicity in the taxes used to fund education, if a tax were imposed. Based on this analysis, **the Committee recommends creating an education tax structured with progressive tax rates and income brackets on the adjusted gross income of all Vermont taxpayers. The education tax rates would apply by school district and be increased or decreased according to the locally voted education spending decisions as compared to the prior year statewide average education spending.**

Tax rates

Progressive Tax Rates and Income Brackets

While the Committee was clear that an education tax should use progressive tax rates and income brackets like the personal income tax, the Committee did not set recommended rates or brackets.[23] With multiple outstanding decision points in the form of potential expenditures, the Committee did not reach a recommendation for specific rates and brackets, as these rates will hinge on future structural decisions and associated impacts. The Committee noted that any decisions to create expenditures, credits (including the new renter credit), or caps for certain taxpayers would likely increase the rates for other taxpayers.

Given the number of outstanding decision points, the Committee did not reach consensus recommendation regarding the specific structure of the rates. Remaining decisions regarding the rates and brackets include the number of brackets and corresponding income thresholds, rates associated with each bracket, and the desired steepness of the progressive curve.

Locally Adjusted Rates

The Committee recommends a tax structure that adjusts education tax rates by school district according to locally voted education spending decisions. This structure would retain existing local control over education spending. Rates would be increased or decreased by the same percentage that locally voted education spending exceeded or fell below the prior year's statewide average education spending. The definition of education spending would be the same as under current law.[24]

For example, *Table 2* shows some of the ratios that would have been applied if this was implemented for FY23.

[23] For example rates and brackets, see Option 2, p. 12 of the JFO presentation on Nov. 10, 2022. These example rates and brackets are preliminary and do not constitute a recommendation by the Committee. The example rates do not factor in any expenditures or other adjustments.

[24] See, 16 V.S.A. § 4001(6).

Table 2: Education Spending per Equalized Pupil (ES/EP) and corresponding adjustment ratios

FY23 ES/EP	ES/EP	% of average ES/EP	Ratio to apply to tax rate	Local spending adjusted tax rate =
Average	$18,524	100%	1	= Bracket rates * 1
Minimum	$13,314	71.9%	0.719	= Bracket rates * 0.719
Median	$18,721	101.1%	1.011	= Bracket rates * 1.011
Maximum	$25,738	138.9%	1.389	= Bracket rates * 1.389
Mode	$20,771	112.1%	1.121	= Bracket rates * 1.121

Structure and Timing for Setting Rates

The Committee recommends maintaining the current structure and timing for setting tax rates and using the education tax rates and nonhomestead rates as the mechanism to accommodate actual revenues being higher or lower than forecast. Under current law, voters determine local education spending through school district budgets. The General Assembly sets the property and income yield based on local education spending decisions. To inform the General Assembly's rate-setting process, the Commissioner of Taxes, in consultation with the Secretaries of Education and Administration and the Joint Fiscal Office, is required under statute to calculate and recommend the property and income yields needed to set the homestead property tax rate and a nonhomestead property tax rate for the following fiscal year.[25] The Commissioner must submit this letter annually on or before December 1st, which is colloquially known as the December 1st letter. After the General Assembly sets the yields, then, on or before June 30th, the Commissioner of Taxes calculates the spending-adjusted homestead tax rate for each town based on its local spending decisions.[26]

The Committee recommends that an education tax rate setting process follow this existing structure and timeline. The Committee further recommends that the General Assembly's use its discretion to set rates in a way that accommodates actual Education Fund revenues that diverge from forecasted revenues. The December 1st letter statute would need amendment notably to set the rate for the education tax, rather than the homestead property tax, and to require the calculation of the rates to assume that the percentage change to the average nonhomestead tax bill would be equal to the percentage change to the average education tax bill.

Defining income

The Committee was presented with different existing legal definitions of income for different tax types.[27] Based on these presentations, **the Committee recommends using adjusted gross income (AGI) as the tax base for an education income tax.**

Income can be defined in many ways. Creating new definitions, notably for more than one tax on income as a tax base, creates complexity. More complexity in the tax code can cause confusion and challenges for compliance by taxpayers and enforcement by administrators. Existing definitions of income, especially for the personal income tax, already have a developed body of federal and state case law as well as extensive guidance that provide precedent and certainty. AGI is a definition that taxpayers and administrators already

[25] 32 V.S.A. § 5402b(a)(3); 16 V.S.A. § 4026.
[26] 32 V.S.A. § 5402(b)(1).
[27] See, infra, Appendix A.4 for the hyperlink to the Committee web page; see the meeting on September 28, 2022, where the Committee heard a presentation on definitions of income.

have experience using.

The Committee recommends applying the tax to all Vermont taxpayers, which includes residents, part-year residents, and nonresidents. For nonresidents' AGI, the Committee recommends adjusting nonresidents' AGI in order to tax only Vermont-source income in the same way that personal income tax achieves this balance. Vermont's personal income tax code subtracts "income exempted from State taxation under the laws of the United States" from adjusted gross income as part of the determination of taxable income.[28] Additionally, Vermont's personal income tax code adjusts a part-year resident or nonresident's tax liability "by a percentage equal to the portion of adjusted gross income that is not Vermont income […]."[29] In other words, taxpayers who live in Vermont a portion of the year would have their education tax liability adjusted in proportion to their time as a resident of the State, in the same that that income tax liability is proportional. This approach has been upheld to comply with federal law and the U.S. Constitution, which prohibit or preempt states from taxing certain types of income, notably income derived from sources outside the state under the Due Process Clause.[30] Nonresident education tax rates would not be adjusted by any local factor.

Cap on income subject to an education income tax

As part of its legislative charge, the Committee considered whether a cap should be set on the amount of AGI subject to an education income tax. The Committee perceived both advantages and disadvantages to creating a cap. On the one hand, a cap would limit the tax liability for earners with higher income, which, without a cap, would be infinite according to their AGI. On the other hand, setting a cap on the amount of taxable income would require other adjustments to generate the same amount of revenue. One such adjustment would likely be an increase in the tax rates paid by other taxpayers.

Administrative considerations

The Committee recommends generally applying the administrative and assessment laws that govern the personal income tax to the education tax, including the administration of the education tax by the Vermont Department of Taxes. This would include underpayment provisions for penalties and interest, as well as safe harbors from penalties and interest corresponding those allowed under personal income taxes.[31] The Committee was in favor of setting a grace period to suspend penalties and interest during the transition to a new tax. For overpayments and refunds, the education tax would also follow the current personal income tax law that authorizes overpayments to be used to offset tax liabilities.[32]

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[28] 32 V.S.A. § 5823(a)(1), (b)(4), (c). See, also, 32 V.S.A. §§ 9741(1) [Vermont sales and use tax exempts "[s]ales not within the taxing power of this State under the Constitution of the United States"] and 3802(1) [Vermont education property tax law exempts "real and personal estate owned by the United States"].

[29] 32 V.S.A. § 5822(e); *Shaffer v. Carter*, 252 US 37 (1920); *Wheeler v. State*, 127 Vt. 361 (1969); *International Shoe Co. v. Washington*, 326 US 310 (1945).

[30] *Wheeler v. State*, 127 Vt. 361 (1969). Other examples of income that states are pre-empted from taxing are railroad retirement income, federals bonds, and any discriminatory tax treatment of federal-source income in favor of state-source income. See, 4 U.S.C. § 111(a); 45 U.S.C. § 231m(a); *M'Culloch v. Maryland*, 17 U.S. 316; *Barker v. Kansas*, 503 U.S. 594; *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803; *Weston v. City Council of Charleston*, 27 U.S. 449.

[31] For estimated payments of personal income tax under current law, the underpayment penalty safe harbor to avoid is penalties or interest is if tax liability is less than $500 or taxpayer had no tax liability in the preceding taxable year. 32 V.S.A. § 5855(b).

[32] 32 V.S.A. § 3112.

The Committee also recommends following the same return filing requirements as under personal income tax law. Current law requires filing by residents, part-year residents, and nonresidents who earned Vermont income, who are required to file a federal income tax return, and who either earned or received more than $100 in Vermont income, or who earned or received gross income of more than $1,000 as a nonresident.[33] The Committee did not recommend requiring taxpayers who are not required to file personal income tax returns to be required to file for the education tax. **For taxpayers who are required to file a personal income tax return, the Committee recommended including additional mandatory information on the income tax return for the reporting and collection of the education tax.** As the homestead declaration would no longer be required, the Committee envisioned the income tax return serving as the vehicle to collect residency information for the purposes of the education tax.[34]

Withholding, Estimated Payments, and Annual Reconciliation

The Committee recommends requiring education tax withholding and estimated payments in the same circumstances that personal income tax is withheld or estimated payments are due. Taxpayers would choose the amount of education tax to be withheld based on education tax withholding tables calculated as a percentage of the prior year statewide average (mean) rate, which would be indexed annually. Taxpayers whose income is not subject to withholding would make estimated payments in the same amounts and on the same schedule required for personal income tax (quarterly or annually). Taxpayers would then reconcile annually by reporting their income and computing their education tax liability at the same time as filing their personal income tax return. Reconciliation would include a computation of the taxpayer's effective education tax rate from January 1 to December 31.

Under current personal income tax law, withholding is generally required for wage income, pensions, annuities, and other payments if the payments are subject to federal income tax withholding and the payments are made to a Vermont resident or a nonresident of Vermont for services performed in Vermont.[35] Vermont withholding is calculated in the same way as federal withholding by using Vermont withholding tables or wage bracket charts. A taxpayer (such as an employee) provides either a federal or both a federal and a Vermont W-4 form to the person withholding from their payment (such as an employer). The taxpayer tells the person withholding how much tax to withhold depending on their anticipated income tax liability. For sources of income that are not subject to withholding, Vermont law requires taxpayers to make installment payments of the taxpayer's estimated tax liability for each taxable year.[36] Estimated payments are generally required of non-wage earners, such as self-employed and members of passthrough entities, and must be the lesser of either 90% of the current year's tax liability or 100% of the preceding year's tax liability.[37] The Committee recommends following the same structure and administration

[33] 32 V.S.A. §§ 5861 [filing requirements] and 5823(b)(1)–(6) [sources of income for nonresidents].

[34] Note that, prior to Act 60 of 1997, a taxpayer was required to disclose on the taxpayer's personal income tax form the amount of real property taxes assessed by a municipality on the taxpayer's housesite (domicile dwelling and up to two acres of land surrounding the dwelling). 1995 Acts and Resolves, No. 47, Sec. 20 adding subsec. (f) to 32 V.S.A. § 5861. This requirement was repealed in 1999, during the Act 60 transition. 1999 Acts and Resolves, No. 49, Sec. 56. At that time, Vermont switched to a homestead declaration and property tax adjustment, so the housesite municipal tax was declared on a different form. Additionally, the housesite value is provided on property tax bills by the town to the taxpayer. All of this is now addressed in 32 V.S.A. chs. 135 and 154, under the housesite and homestead definitions and property tax bill information requirements.

[35] 32 V.S.A. ch. 151, subch. 4.

[36] 32 V.S.A. ch. 151, subch. 5.

[37] 32 V.S.A. § 5851(2).

as under current law.

The Committee recommended making withholding and estimated payments of the education tax mandatory for all filers except renters, who could claim exemption from withholding in anticipation of future credits that would result in de minimis or zero education tax liability. If exempt from the tax, renters would be required to self-certify on their withholding forms that they are renters and anticipate having zero education tax liability.

Furthermore, **the Committee recommended indexing the withholding rates annually prior to releasing the withholding tables or charts.** The recommended price index is the National Income and Product Accounts (NIPA) Implicit Price Deflator for State and Local Government Consumption Expenditures and Gross Investment as reported by the U.S. Department of Commerce, Bureau of Economic Analysis.

Calculating the final education tax rate at the time of reconciliation will be complicated by the different timing for education budget years versus income tax years. Education budgets run on a July 1 to June 30 fiscal year, which is the schedule that the Committee recommends the education tax rates follow to raise revenues in the budget year for which the rates will have been voted. Income tax years, however, which are used to calculate AGI, run on a January 1 to December 1 year. This means that the AGI tax base will be determined on a year that is halved between two different education tax rates. To avoid complexities and potential inconsistencies between taxpayers, **the Committee recommends applying the effective tax rate (the average of the two school year rates) against an entire income tax year's AGI when reconciling in April. The Committee further recommends that, by default, residents pay the locally adjusted education tax rate based on their residence as of on January 1.** This recommendation would address taxpayers who have a change of residence within Vermont between school districts during the taxable year.

Lastly, the Committee recognized that creating a new withholding system would place new requirements on employers that merit special consideration during the transition period.

Renters

The Committee recommends that the current Renter Credit be maintained in its current form.[38] The current Renter Credit functions more like a benefit program than a tax credit and is not funded by the Education Fund. It is funded by the General Fund.

The Committee recommends that a new nonrefundable credit for renters against the education tax be created. The credit would be structured as a percentage of gross rent paid. The Committee did not make a recommendation about the percentage that would be used to calculate the credit, but did discuss the assumption that as part of the rent paid, renters already pay the nonhomestead property tax on their dwelling.[39] The credit would result in revenue forgone from the Education Fund and would therefore be

[38] See, infra, Appendix A.4 for the hyperlink to the Committee web page; see the meeting on November 10, 2022, where the Committee heard a presentation on the Renter Credit program.

[39] Note that prior to 2020 Acts and Resolves No. 160, the former Renter Rebate was calculated based on "allocable rent," which was 21% of the gross rent. "Gross rent" was the rent actually paid during the taxable year by the individual or other members of the household during the taxable year and did not include payments for utilities or other fees. The 21% figure has been used since 1997 Acts and Resolves No. 60, Sec. 54, which used the term "rent constituting property taxes paid." See, also, 2010 Acts and Resolves No. 160, Sec. 24, which amended the term to "allocable rent."

made up elsewhere in the tax structure. The Committee did not determine how these foregone revenues would be accounted for.If a credit were enacted, the education tax and/or nonhomestead rates would need to be adjusted upward to make up the revenues foregone by crediting an amount of rent paid against renters' education tax owed.

The Committee recognized potential situations that would merit further consideration when structuring the new renter credit to avoid unintended consequences. For example, depending on the renter credit and the nonhomestead rate, in some towns it could be advantageous for a homeowner to transfer their homestead property to a separate legal entity such as a limited liability company and then rent their former homestead back to themselves. In this scenario, the property owner (the LLC-landlord) would pay the nonhomestead property tax and the renter (the former homeowner-turned-renter) would receive a renter credit against the education income tax for gross rent paid.

Nonhomestead Property Tax

The Committee recommends generally maintaining the nonhomestead property tax structure and its administration. With regard to the nonhomestead property tax base, the Committee recommends expanding the tax base to apply it to the portion of a homestead property that exceeds the housesite. The Committee also recommends using the nonhomestead property tax rate as a flexible lever to accommodate fluctuations in the Education Fund.[40]

Leaving the nonhomestead property tax as a revenue stream for the Education Fund, and increasing the nonhomestead tax base, is one way to maintain stability in the fund. The housesite, which would be defined as the dwelling and surrounding two acres of a homestead property would be exempt from the nonhomestead property tax, but the acreage exceeding two acres would become subject to the nonhomestead property tax. Municipalities would continue to administer appraisals, grand list preparation and maintenance, billing, collection, and appeals. The Common Level of Appraisal (CLA) would still apply to the nonhomestead tax rate as a means of equalizing valuation practices across municipalities to approximate fair market value. The Committee recommends robust future legislative research and deliberation on creating new, separate categories of nonhomestead properties to be appraised and taxed differently.

Education Fund, Education Payments, and Cash Flow

The Committee recommends allocating all education tax revenues to the Education Fund and using the education tax rates as flexible levers in case of underperformance or unexpectedly strong performance of education tax revenues. The Committee did not recommend adding any additional revenue streams to the Education Fund. Furthermore, additional considerations regarding cash flow would need to be addressed by future policymakers.

Additionally, the Committee recommends increasing the amount set aside in the Stabilization Reserve due to the decreased stability that an education tax based on income will introduce into the Fund compared to the homestead property tax.[41] The Committee recommends that the increased

[40] Currently the default rate is set in statute at a flat rate of $1.59/$100 of property value. 32 V.S.A. § 5402(a)(1). This rate is generally notwithstood and a different rate is set by the General Assembly each year in session law.

[41] See, 16 V.S.A. § 4026 and 32 V.S.A. § 5402b

Stabilization Reserve be filled over time, and that its size be commensurate to the unanticipated fluctuations.

Before determining the necessary size of the reserve, policymakers would need to clarify the structure of the education tax brackets and rates, as well as the structure of the reserve. Considerations for policy makers on the use of the Stabilization Reserve include:

- When and how would funds be withdrawn from the Stabilization Reserve?
    - Would there be statutory guidelines outlining the circumstances under which funds could be withdrawn?
- How would the Stabilization Reserve be filled?
    - Would there be statutory guidelines regarding a percentage of surpluses flowing to the reserve before expended elsewhere?

Would there be a minimum amount of required funding in the the reserve?

The Committee further recommends that the education payments and cash flow to school districts continue to follow the same timeline as under current law. Under current law, payments from municipalities to school districts are netted against the payments from the State Education Fund to school districts three times per year.[42] Municipalities that pay the State Education Fund directly are required to pay twice per year.[43] Any late payments are subject to an 8% late payment penalty.[44]

Repeal of Homestead Property Tax and Municipalities

Homestead Property Tax and Credit

The Committee recommends repealing all references to the homestead property tax and the corresponding income sensitized property tax credit. The existing Renter Credit which functions similar to a subsidy to renters with low incomes and is codified in same subchapter as homestead property tax credit, would be untouched and could continue to be funded by the General Fund. The homestead property tax and the property tax credit were identified by the Committee as the primary sources within the current education financing system that cause an unequal distribution of tax paid as a share of household income.

Municipalities

Although the homestead property tax and credit would be repealed, the Committee recommends maintaining municipalities' involvement in the State property tax system. Municipalities would continue to appraise and list both homesteads and nonhomesteads on the grand list, even though the State nonhomestead property tax would not apply to all homesteads. The dwelling plus two acres (the housesite) on a homestead property would be exempt from nonhomestead property tax, but any remaining acreage would become taxable under the nonhomestead property tax.[45] **Furthermore, the Committee recommends that municipalities continue to receive most of the existing statutory payments from the State relating to the administration of the State property tax.** The Committee is aware that there is currently significant stress on the appraisal system statewide. The purposes of those payments include:

- reappraisals, preparing and maintaining the grand list, billing, and collecting education property tax.[46]
- delinquent tax penalties.[47]

[42] 16 V.S.A. §§ 426, 4011(c), and 4028(a).
[43] 32 V.S.A. § 5402(c)
[44] 32 V.S.A. § 5409(1).
[45] Note that current law requires insurance replacement value of exempt properties to be listed on the grand list. 32 V.S.A. § 4152(a)(6) and (c).
[46] 32 V.S.A. §§ 5405(f), 5410(k) and (h).
[47] 32 V.S.A. § 5410(g).

- timely payment of tax collections to school districts or the State Education Fund.[48]

However, with the repeal of the property tax credit, municipalities would no longer receive payments for billing for late property tax credit claims, because there would no longer be any administration related to credit claims.[49]

Municipal "Circuit Breaker"

The Committee recommends continuing to provide a nonrefundable credit against municipal property taxes for homeowners whose income does not exceed $47,000. The credit should continue to be funded by the General Fund. The Committee further recommends that the credit use the same definition of income to determine eligibility that is used for the existing Renter Credit.

Currently, the municipal "super circuit breaker" property tax credit is available to homeowners whose household income is $47,000 or less. The municipal credit is codified in the same statutory section that computes the homestead property credit and uses the same income thresholds and household income definition as the homestead property tax credit.[50] With the repeal of homestead property tax credit, none of the income information currently collected by the State to determine eligibility for the "super circuit breaker" will be collected any longer. The Committee therefore recommends that the credit use the same definition of income to determine eligibility that is used for the purposes of the Renter Credit.[51] The "income" definition used for the Renter Credit has the added benefit of simplifying the income reporting required by claimants.

Transition

The Committee recommends implementing the new education tax and associated changes to replace the homestead property tax and credit at least one year after passage of any legislation. A staggered effective date would ensure time to stand up new administrative structures, notably at the Vermont Department of Taxes and on the municipal level, and to educate taxpayers about the changes. Additionally, if policymakers choose to make changes to the Stabilization Reserve, that will allow time to build up or pre-fund the reserves. The Committee recommends that any decision to set an effective date for the new structure take into account the pupil weighting changes effective starting in fiscal year 2025. Lastly, the Committee recommends that any transition period incorporate a grace period for tax compliance, so that penalties and interest would be waived during the transition.

Other Impacts

Given the complexities of the current education financing system, there are likely numerous other areas of policy that would be impacted by a move to an income-based education tax. The Committee did not address all of these impacts, but strongly recommends that these areas be explored before enactment of a new education tax. These include but are not limited to Tax Increment Financing (TIF) Districts and escrow accounts for mortgages.

[48] 32 V.S.A. § 5402(c).
[49] 32 V.S.A. § 5402(c).
[50] 32 V.S.A. § 6066(a)(3) and (a)(5).
[51] 32 V.S.A. § 6061(18).

Conclusion

[*To be determined based on Committee meeting on December 16, 2022*]

Appendices

A.1. Glossary of education finance terms

Average Daily Membership (ADM)
Average daily membership is "[…] [t]he full-time equivalent enrollment of students, as defined by the State Board by rule, who are legal residents of the district or municipality attending a school owned and operated by the district, attending a public school outside the district under section 822a of this title, or for whom the district pays tuition to one or more approved independent schools or public schools outside the district during the annual census period. The census period consists of the 11th day through the 30th day of the school year which is actually in session." 16 V.S.A. § 4001(1)(A). State placed students and pre-kindergarten students are counted differently. *See* 16 V.S.A. § 4001(1)(B) and (C).

Common Level of Appraisal
Common level of appraisal (CLA) means the ratio of the aggregate value of local education property tax grand list to the aggregate value of the equalized education property tax grand list. The CLA is applied to property tax rates as a measure to ensure property values reflect fair market value. A town's CLA is determined through the annual Equalization Study, which uses real estate sales data from the past 3 years. 32 V.S.A. § 5405. The Department of Taxes determines the tax rate actually seen on a property tax bill by dividing a town's school district(s) tax rate by the town's CLA. 32 V.S.A. §§ 5401(3) and 5402(b)(1).

December 1st Letter
The December 1st letter is a statutorily required letter from the Commissioner of Taxes, prepared in consultation with the Secretary of Education, the Secretary of Administration, and the Joint Fiscal Office, which calculates and recommends a property dollar equivalent yield, an income dollar equivalent yield, and a nonhomestead property tax rate for the following fiscal year. In making these calculations, the Commissioner is required to assume: (1) a homestead tax rate of $1 per $100 of property value; (2) an income percentage of 2%; and (3) that Education Fund stabilization reserves are maintained at 5% of prior year appropriations. 32 V.S.A. § 5402b(a)(3); 16 V.S.A. § 4026.

District
A town school district, union school district, interstate school district, city school district, unified union district, and incorporated school district, each of which is governed by a publicly elected board. 16 V.S.A. § 11(10).

Education Fund
The Education Fund is established under 16 V.S.A. § 4025 and receives revenue from the following sources:

- all revenue paid to the State from the statewide education tax on nonhomestead and homestead property under 32 V.S.A. chapter 135
- revenues from State lotteries under 31 V.S.A. chapter 14 and from any multijurisdictional lottery game authorized under that chapter
- 25% of the revenues from the meals and rooms taxes imposed under 32 V.S.A. chapter 225
- 30% of the revenues raised from the purchase and use tax imposed by 32 V.S.A. chapter 219, notwithstanding 19 V.S.A. § 11(1)
- all revenue raised from the sales and use tax imposed by 32 V.S.A. chapter 233
- Medicaid reimbursement funds pursuant to 32 V.S.A. § 2959a(f)
- Wind-powered electric generating facilities tax under 32 V.S.A. § 5402c
- Uniform capacity tax (on solar renewable energy) under 32 V.S.A. § 8701)

Revenues in the Education Fund are used for the following:

- Education payments to school districts and supervisory unions under 16 V.S.A. chapter 133 and 32 V.S.A. chapter 135
- Homestead property tax credit (formerly known as the income sensitivity adjustment or homestead rebate) under 32 V.S.A. § 6066
- Teachers' pensions, normal cost only under 32 V.S.A. § 1944(c)
- Special education aid under 16 V.S.A. chapter 101 and § 4028(b)
- State-placed students under 16 V.S.A. § 4012
- Transportation aid under 16 V.S.A. § 4016
- Technical education aid under 16 V.S.A. chapter 37 and § 4028(b)
- Small schools support grants under 16 V.S.A. § 4015
- Essential early education aid under 16 V.S.A. §§ 2948 and 2956
- Flexible Pathways Initiative under 16 V.S.A. § 941
- Other uses (accounting and auditing, financial systems and reporting) 16 V.S.A. § 4025(b)(2) and (b)(5)

Education Spending

Education spending is "the amount of the school district budget, any assessment for a joint contract school, career technical center payments made on behalf of the district under subsection 1561(b) of this title, and any amount added to pay a deficit pursuant to 24 V.S.A. § 1523(b) that is paid for by the school district, but excluding any portion of the school budget paid for from any other sources such as endowments, parental fundraising, federal funds, nongovernmental grants, or other State funds such as special education funds paid under chapter 101 of this title." 16 V.S.A. § 4001(6).

Education Spending Adjustment

(1) *Education income tax spending adjustment* is "[…] the greater of one or a fraction in which the numerator is the district's per pupil education spending plus excess spending for the school year, and the denominator is the income dollar equivalent yield for the school year, as defined in subdivision (16) of this section." 32 V.S.A. § 5401(13)(B).

(education spending + excess spending) (/) (income dollar yield)

(2) *Education property tax spending adjustment* is "[…] the greater of one or a fraction in which the numerator is the district's per pupil education spending plus excess spending for the school year, and the denominator is the property dollar equivalent yield for the school year, as defined in subdivision (15) of this section." 32 V.S.A. § 5401(13)(A).

(education spending + excess spending) (/) (property dollar yield)

Equalized Education Property Tax Grand List

Equalized education property tax grand list means "one percent of the aggregate fair market value of all nonhomestead and homestead property that is required to be listed at fair market value as certified during that year by the Director of Property Valuation and Review under section 5406 of this title, plus one percent of the aggregate value of property required to be listed at a value established under a stabilization agreement described under section 5404a of this title, plus one percent of the aggregate use value established under chapter 124 of this title of all nonhomestead property that is enrolled in the use value appraisal program." 32 V.S.A. § 5401(6).

Equalized Pupils

"'Equalized pupils' means the long-term weighted average daily membership multiplied by the ratio of the statewide long-term average daily membership to the statewide long-term weighted average daily membership." 16 V.S.A. § 4001(3).

Excess Spending

The per-equalized-pupil amount of the district's education spending, plus any amount required to be added from a capital construction reserve fund under 24 V.S.A. § 2804(b). Excess spending is spending in excess of 121% of the statewide average district education spending per equalized pupil increased by inflation, as determined by the Secretary of Education on or before November 15 of each year based on the budgets passed to date. 32 V.S.A. § 5401(12)(A).

Excess spending has many exclusions that do not count toward the calculation of spending, which are listed under 32 V.S.A. § 5401(12)(B).

The excess spending provisions have been inoperative since the start of fiscal year 2022 and will remain ineffective through the end of fiscal year 2029. See, 2021 Acts and Resolves, No. 59, Sec. 5; 2022 Acts and Resolves, No. 127, Sec. 8(a).

Homestead

"“Homestead” means the principal dwelling and parcel of land surrounding the dwelling, owned and occupied by a resident individual as the individual's domicile or owned and fully leased on April 1, provided the property is not leased for more than 182 days out of the calendar year or, for purposes of the renter credit under subsection 6066(b) of this title, is rented and occupied by a resident individual as the individual's domicile." 32 V.S.A. § 5401(7)(A).

The homestead tax rate is a base rate of $1.00, multiplied by the education spending adjustment, per $100.00 of equalized education property value. 32 V.S.A. § 5402(a)(2). The education spending adjustment takes into account the education spending in the particular school district.

Household Income

The property tax credit allowed against the current year's homestead property tax liability is computed based on the prior year's household income. 32 V.S.A. § 6066. Household income means modified adjusted gross income, which is federal adjusted gross income with certain additions and subtractions intended to capture the amount of income a household has available to pay property taxes. 32 V.S.A. § 6061(4) and (5). The definition of "household income" for the property tax credit is different from the definition of "income" for the renter credit. 32 V.S.A. § 6061(4), (5), and (18).

Housesite

"Housesite" means the dwelling and as much of the land owned by the claimant surrounding the dwelling as is reasonably necessary for use of the dwelling as a home, up to two acres per dwelling unit; and in the case of multiple dwelling units, no more than two acres per dwelling unit up to a maximum of 10 acres per parcel. 32 V.S.A. §6061(11). Only the property taxes imposed on the housesite are eligible for a property tax credit.

Income Percentage

Income percentage is "[…] two percent, multiplied by the education income tax spending adjustment under subdivision 5401(13)(B) of this title for the property tax year which begins in the claim year for the municipality in which the homestead residence is located." 32 V.S.A. § 6066(a)(2).

Long-Term Membership

"'Long-term membership' of a school district in any school year means the mean average of the district's average daily membership, excluding full-time equivalent enrollment of State-placed students, over two school years, plus full-time equivalent enrollment of State-placed students for the most recent of the two years." 16 V.S.A. § 4001(7).

Nonhomestead
Nonhomestead property is everything other than homestead property, exempt property, and other statutorily named properties, particularly those subject to other taxes. Nonhomestead property includes secondary residences and commercial properties. 32 V.S.A. § 5401(10). The nonhomestead tax rate is a default statutory rate $1.59 per $100.00 of equalized education property value. This rate is typically subject to a notwithstanding clause, and the General Assembly sets a different, uniform statewide rate each year.

Property Tax Credit
Prior to 2019, the property tax credit was known as the income sensitivity property tax adjustment or the homeowner rebate. *See*, 2019 Acts and Resolves No. 51, § 33. The credit is available to income-eligible taxpayers who own their homestead as of April 1, were domiciled in Vermont for the full prior calendar year, are not claimed as a dependent of another taxpayer, and timely file a homestead declaration. 32 V.S.A. chapter 154.

Tax Capacity
The ability of a group of taxpayers to pay taxes imposed on a tax base before experiencing hardship or the ability of a taxing authority to raise revenues to fund services. Also referred to as "taxable capacity" or "taxing capacity". Tax capacity is to be distinguished from "fiscal capacity," which is the government's ability and willingness to meet its financial obligations as they come due on an ongoing basis.

Weighted Long-Term Membership
"'Weighted long-term membership' of a school district in any school year means the long-term membership adjusted pursuant to section 4010 of this title". 16 V.S.A. § 4001(12). To obtain this number, student groups are broken into grade-level categories: pre-kindergarten, elementary or kindergarten, and secondary students. A long-term membership is determined for each category by using the actual average ADM over two consecutive years for each group, the latter year being the current school year. The long-term membership for each of those categories is multiplied by the statutory weights associated with each grade-level category. Those results are then added together and the final number is the weighted long-term membership. The weights are meant to reflect the additional (or lower) costs associated with educating students in each category.

Yields
There are 2 yields: one for taxpayers who pay based on property value and one for those who pay based on household income and prop erty value. The yields are the amount of spending per equalized pupil that could be supported by the statutory tax rate or income percentage and maintaining the Education Fund reserves at 5%. 32 V.S.A. § 5401(15) and (16).

> (1) *Income dollar equivalent yield* is "the amount of spending per equalized pupil that would result if the income percentage in subdivision 6066(a)(2) of this title were 2.0 percent, and the statutory reserves under 16 V.S.A. § 4026 and section 5402b of this title were maintained." 32 V.S.A. § 5401(16).
>
> (2) *Property dollar equivalent yield* is "the amount of spending per equalized pupil that would result if the income percentage in subdivision 6066(a)(2) of this title were 2.0 percent and the statutory reserves under 16 V.S.A. § 4026 and section 5402b of this title were maintained." 32 V.S.A. § 5401(15).

The yields are typically set each year by the General Assembly in session law, but if not, the prior fiscal year's yields will apply by default. 32 V.S.A. § 5402b(b).

A.2. Agenda topics and list of witnesses

All documents reviewed by the Committee are publicly available on the Joint Fiscal Office website on the page dedicated to the Committee. See, https://ljfo.vermont.gov/committees-and-studies/income-based-education-tax-study-committee

Agenda topics

September 28, 2022
https://ljfo.vermont.gov/committees-and-studies/income-based-education-tax-study-committee/meetings/2022-09-28

- Welcome, Committee Organization and Meeting Dates
- Review of Enabling Legislation
- Review of Current Education Funding Formula
- Definition of Income and Options
- Tax Study Presentation
- Tax Structure Commission Recommendation
- Stakeholder Considerations
- Committee Discussion

October 12, 2022
https://ljfo.vermont.gov/committees-and-studies/income-based-education-tax-study-committee/meetings/2022-10-12

- Follow up from Tax Report Preliminary Presentation: Non-Taxpayers
- Principles of a High-Quality Tax System and the Education Income Tax
- Committee Discussion
- Review of Education Income Tax Structural Options
- Committee Discussion

October 26, 2022
https://ljfo.vermont.gov/committees-and-studies/income-based-education-tax-study-committee/meetings/2022-10-26

- General Fund: Historical Trends and Unknowns
- Education Fund: Overview of Revenue History
- Education Fund: Historical Trends and Unknowns
- Committee Discussion
- Modeling Equity
- Expanded Property Tax Credit: Modeling and Considerations
- Committee Discussion

November 10, 2022
https://ljfo.vermont.gov/committees-and-studies/income-based-education-tax-study-committee/meetings/2022-11-10

- Modeling and Discussion of Two EIT Options
- Renter Credit Presentations
- Committee Discussion

December 2, 2022
https://ljfo.vermont.gov/committees-and-studies/income-based-education-tax-study-

committee/meetings/2022-12-02

- Committee Discussion of Remaining Questions on Option 2
- Additional Modeling of Impacts on Non-Property Tax Holders
- Committee Discussion
- Next Steps

List of Witnesses

Joint Fiscal Office

- Julia Richter, Fiscal Analyst, Joint Fiscal Office
- Graham Campbell, Senior Fiscal Analyst, Joint Fiscal Office
- Deb Brighton, Consultant, Joint Fiscal Office
- Emily Byrne, Associate Fiscal Officer, Joint Fiscal Office
- Sarah Clark, Deputy Fiscal Officer, Joint Fiscal Office

Office of Legislative Counsel

- Abby Shepard, Legislative Counsel, Office of Legislative Counsel

Department of Taxes

- Jake Feldman, Senior Fiscal Analyst, Department of Taxes

Stakeholders

- Deb Brighton, Chair, Tax Structure Commission
- Jeff Fannon, Executive Director, National Education Association
- Karen Horn, Executive Director, Vermont League of Cities and Towns
- Stephanie Yu, Deputy Director, Public Assets Institute

A.3. Potential structural options for an education income tax

The committee explored the potential structural options for an education income tax, and evaluated three general potential structural options. These three categories are:

A. Replace the homestead property tax with education income tax rates tied to a statewide yield;
B. Add an education income tax to the Education Fund as another revenue stream, keep property taxes, and remove income sensitivity; or
C. Replace the homestead property tax with education income tax not tied to statewide yield.

The structure of these options is outlined in the following sections.

Option A – Replace the homestead property tax with an education income tax tied to a statewide yield

This option would replace the homestead property tax and income sensitivity with an education income tax that is tied to local spending decisions. This option would retain the nonhomestead property tax in its current structure, and all other aspects of the Education Fund would remain the same.

This is a very similar structure to what was recommended by the Tax Structure Commission[52] and was later introduced as a bill in S.212.[53]

Option B – Add education income tax to the Education Fund as another revenue stream, keep property taxes, remove income sensitivity

This option would add an education income tax with brackets that is not tied to local spending decisions to the Education Fund. This would be an additional revenue stream, and would be forecasted like other revenues (e.g. Sales and Use tax revenues, Meals and Rooms tax revenues, etc.).

Under this option, some form of property taxes would be retained. Homestead property taxes could remain tied to local spending decisions (or not). Revenues from the education income tax could be used to buy down only the homestead property tax, or could be used to buy down all property taxes. Income sensitivity could also be removed from homestead property taxes.

This is a very similar structure to what was presented in H.911 as it passed the Vermont House of Representatives.[54]

Option C – Replace the homestead property tax with an education income tax not tied to a statewide yield

This option would replace the homestead property tax (and income sensitivity) with a progressive education income tax that is not tied to local spending decisions. This would be an additional revenue stream in the Education Fund and would be forecasted like other revenues (e.g., Sales and Use Tax revenues, Meals and Rooms Tax revenues, etc.).

This option would retain the nonhomestead property tax in its current structure, and all other aspects of the Education Fund would remain the same. Because the amount raised would likely no longer be directly tied to the amount that needs to be raised (as it currently is), a flexible lever would need to be maintained to adjust for volatile revenue performance.

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[52] Brighton, D., Trenholm S., and Kleppner, B. "Final Report of the Vermont Tax Structure Commission". February 8, 2021. https://ljfo.vermont.gov/assets/Subjects/Final-Report/10306868b9/TSC-Final-Report-2-8-2021.pdf

[53] https://legislature.vermont.gov/Documents/2022/Docs/BILLS/S-0212/S-0212%20As%20Introduced.pdf

[54] https://legislature.vermont.gov/Documents/2018/Docs/BILLS/H-0911/H-0911%20As%20passed%20by%20the%20House%20Official.pdf

A.4. Recent legislative changes to the Education Fund

Recent Education Fund Expenses

Legislative amendments over the last five years have impacted the Education Fund by creating new funding obligations. These changes include:

- Teacher pensions. The normal cost of teacher pensions was added to the statutorily allowed uses of the Education Fund.[55]
- Other postemployment benefits (OPEB). $14 million was reserved for OPEB.[56] A year later, the normal cost was spent and was added to the statutorily allowed uses of the Education Fund.[57]
- Special education funding. The State special education funding model was transitioned from a reimbursement model to a census-based model.[58]
- Universal school meals. In fiscal year 2023, $29 million was appropriated for the provision of universal school meals. Additionally, a study on potential future funding sources for school meals was required.[59]
- Pupil weighting bill. Pupil weights in Vermont's education financing system will be adjusted or added in fiscal year 2025. Categorical aid will also be provided for school districts with more than 0 but less than 26 English Learning students. Moreover, JFO was tasked with multiple reports regarding education finance.[60]

Other reserves, studies, and reports regarding future funding options were enacted during the 2021-2022 legislative biennium. These include:

- Polychlorinated biphenyls (PCBs). $32 million was set aside in reserves for PCB investigation, testing, assessment, remediation, and removal in schools.[61] Certain emergency uses are authorized, but a longer term, multi-agency plan for disbursement of funds to address PCBs in schools is due in 2023.
- Career technical education (CTE). The Legislature required study and reporting on funding and governance models, and appropriated $15 million in fiscal year 2023 to the Vermont Housing and Conservation Board to fund the CTE Construction and Rehabilitation Experiential Learning Program and Revolving Loan Fund.[62] Two studies were required on school construction, one due in 2022 providing a school facilities inventory and an additional conditions assessment is due in 2023.[63]

Any time new sales tax exemptions are enacted, they decrease sales tax revenue to the Education Fund. These are called "tax expenditures," which are actual or estimated losses in tax revenue resulting from exemptions, exclusions, deductions, credits, preferential rates, or deferrals of liability applicable to a tax.[64] For illustration, but not purporting to provide an exhaustive list, below are some recent legislative changes to the sales tax that have reduced revenues to the Education Fund:

[55] 2017 Acts and Resolves, No. 85, Sec. E.500.2; 16 V.S.A. § 4025(b)(4).
[56] 2021 Acts and Resolves, No. 74, Sec. C.101.
[57] 2022 Acts and Resolves, No. 114, Secs. 25 and 28; 16 V.S.A. § 4025(b)(4).
[58] 2018 Acts and Resolves, No. 173.
[59] 2022 Acts and Resolves, No. 151, Sec. 5.
[60] 2022 Acts and Resolves, No. 127.
[61] 2022 Acts and Resolves, No. 178, Secs. 2-3.
[62] 2022 Acts and Resolves, No. 127, Sec. 17; 2022 Acts and Resolves, No. 183, Sec. 16.
[63] 2021 Acts and Resolves, No. 72; Sec. 3; 2022 Acts and Resolves, No. 166, Sec. 9.
[64] See, 32 V.S.A. § 312.

- "Cloud" tax exemption.[65]
- Menstrual products exemption.[66]
- Wood pellets added to residential energy exemption.[67]
- Cannabis and small cannabis cultivators.[68]

Recent Increases to Education Fund Revenues

Legislative amendments over the last five years have impacted the Education Fund positively by adding larger percentages of existing revenue source allocations or expanding the tax base of existing revenue sources.

Revenue Allocations

At the time the General Fund transfer to the Education Fund was repealed in 2018, the Legislature simultaneously increased the percentage of the Sales and Use Tax revenue allocation to the Education Fund, so that all sales tax revenues were dedicated entirely to the Education Fund.[69] Previously, 64% of sales tax revenues were allocated to the General Fund and only 36% were allocated to the Education Fund. The allocation of Meals and Rooms Tax revenues was also amended in 2018, so that rather than being dedicated entirely to the General Fund, Meals and Rooms Tax revenues were split between the General Fund and the Education Fund, allocating the current 25% to the Education Fund.[70]

Tax Revenue Increases

Sales and Use Tax: *Wayfair*, Remote Sellers, and Marketplace Facilitators

In 1992, the U.S. Supreme Court in the *Quill* case limited states' ability to require all sellers to collect sales tax on sales made in the state.[71] The Court in *Quill* found that for a state's sales tax collection law to be constitutionally valid under the Commerce Clause, only sellers with a physical presence in the state could be required to collect sales tax.[72] With the advent of the Internet and the resulting increase in online sales as a proportion of all sales, sales and use tax revenues paid to states decreased and remote sellers were able to make sales into states without charging or collecting sales and use tax. In 2018, the U.S. Supreme Court decided the *Wayfair* case, which overruled the physical presence requirement from *Quill* and looked instead at whether the state collection statute at issue met the "substantial nexus" requirement under the Commerce Clause.[73] The Court found that particular statute to be constitutional, which laid the groundwork for state legislatures across the country to expand their collection requirements to remote sellers. Prior to the *Wayfair* decision, Vermont had foreseen a national development like the *Wayfair* case, and in 2016 enacted a remote seller collection requirement that only took effect when certain conditions were met, including the U.S.

[65] 2015 Acts and Resolves, No. 51, Sec. G.8.
[66] 2021 Acts and Resolves, No. 73, Secs. 11-11a; 2022 Acts and Resolves No. 179, Secs. 27a-27b; 32 V.S.A. § 9741(56).
[67] 2021 Acts and Resolves, No. 73, Sec. 11a; 2021 Acts and Resolves, No. 54, Sec. 21; 32 V.S.A. § 9741(26).
[68] 2020 Acts and Resolves No. 164, Sec. 16; 2022 Acts and Resolves No. 158, Sec. 2; 32 V.S.A. § 9741(3), (25), (50), and (55).
[69] 2018 Acts and Resolves (Spec. Sess.), No. 11, Sec. H.8; 16 V.S.A. § 4025(a)(4); 32 V.S.A. § 435(b)(7).
[70] *Id.*, Secs. H.8 and H.9. Note that since 2019, 6% of Meals and Rooms Tax revenues have been allocated to the Clean Water Fund, and the General Fund allocation was reduced to 69%. *See*, 2019 Acts and Resolves No. 76, Sec. 3a; 10 V.S.A. § 1388(a)(4). The Education Fund continues to receive 25% of Meals and Rooms Tax revenues.
[71] *Quill v. North Dakota*, 504 U.S. 298 (1992); *see*, also, *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753 (1967).
[72] *Id*.
[73] *South Dakota v. Wayfair, Inc.*, 138 S.Ct. 2080 (2018).

Supreme Court striking down the physical presence requirement in *Quill*. The *Wayfair* decision triggered Vermont's remote seller collection requirement to start in mid-2018.[74]

In the legislative session following the *Wayfair* decision, further adjustments were made to the collection requirements imposed on sellers. Vermont enacted a marketplace facilitator law to require online platforms (marketplaces) that facilitate sellers' retail sales of tangible personal property, taxable services, or digital goods to collect Vermont sales tax under the same conditions as remote sellers.[75]

Meals and Rooms Tax: Online Travel Agents and Taxable Meal Facilitators

During the 2019 and 2021 legislative sessions, Vermont expanded the meals and rooms tax collection requirements to include online travel agents ("booking agents") and to make charges by those agents for booking rooms taxable transactions.[76] Additionally, meal delivery service and other meal facilitator charges for online ordering were made taxable under the meals tax.[77]

[74] 2016 Acts and Resolves, No. 134, Secs. 27 and 41(5); 32 V.S.A. § 9701(9)(F).
[75] 2019 Acts and Resolves, No. 46, Secs. 3 and 4; 32 V.S.A. § 9701(9)(J).
[76] 2019 Acts and Resolves No. 71, Sec. 7; 32 V.S.A. § 9202(4), (8), (20).
[77] 2021 Acts and Resolves, No. 73, Sec. 1; 32 V.S.A. § 9202(4), (10), (21).

A.5. Principles of a high-quality tax system

According to NCSL Tax Policy Handbook for State Legislators, there are six key principles of a high-quality tax system. These six pillars are: sustainability and reliability, economic competitiveness, tax neutrality, accountability, fairness, and simplicity.

Sustainability and Reliability

This principle refers to the maintenance of a reliable, sustainable, and diverse revenue stream. A few considerations regarding this principle and an education income tax include:

- Income taxes are less predictable than property taxes.
- Replacing the property tax with an income tax would likely increase volatility in the Education Fund.
- Balance is important in a revenue stream, mainly for volatility and reliability. Replacing the property tax with an income tax would shift the balance of state revenues to rely on income taxes more substantially.

Fairness

Fairness refers to equality in taxes paid across similar ability to pay and circumstances. Fairness is generally evaluated through two different measures of equity: horizontal equity, and vertical equity. Horizontal equity refers to equity in which taxpayers with similar economic circumstances have similar tax burdens. Vertical equity, also known as progressivity, refers to how the distribution of tax burdens varies among taxpayers with different economic circumstances.

When considering this principle in the context of an education income tax, the Committee discussed the following considerations:

- Evaluations of fairness in a tax system should not look at one tax in isolation.
- How should fairness be evaluated? What is the committee’s desired combined tax incidence?

Simplicity

Simplicity refers to a tax system that is easy for a taxpayer to understand and comply with, and one that is easy to administer. Decisions about simplifying the tax code to achieve specific goals are often made at the expense of fairness. The Committee considered the principle of simplicity in the context of the education income tax. Committee discussions explored the principle of simplicity as applied to taxpayers’ decision-making when voting on school budgets and transparency regarding the impact of voting decisions on tax rates. These considerations included:

- With respect to taxpayer understanding, any tax system tied to local-voted school budgets and statewide yields creates complexities regardless of the financing system.
- Ease of administration for an education income tax varies drastically depending upon design.

Economic Competitiveness

The principle of economic competitiveness refers to a tax system that is responsive to interstate and international economic competition. Specifically, it refers to the provision of a level playing field devoid of unnecessarily high rates and compliance burdens, and the discouragement of tax liability-shopping and interstate migration. Considerations of this principle in the context of an education income tax include:

- Under current law, Vermont does not have the highest income taxes in the country, nor in New England.
- Vermont has comparatively high property taxes. Generally, Northeastern states have higher property

taxes.

- It is easier for individuals to move/adjust their income without major disruption to their lives, while tax shopping is more difficult with property taxes.
- An income tax system may be more responsive to a changing world.

Tax Neutrality

Tax neutrality describes a tax system that tries to minimize the unintended consequences. Unintended consequences may include encouraging or discouraging the consumption or production of goods in services, changing the allocation of resources, or impacting business decisions. Tax neutrality in the context of an education income tax leads to the following considerations:

- Income tax likely drives more individual behavior changes than property tax.
- Income tax might make people less sensitive to school spending decisions.
- Incentives may vary in terms of housing mismatches when comparing property tax credits based on income or education income taxes.

Accountability

The principle of accountability states a tax system should include taxes that are explicit, minimize credits and exemptions, and limit the amount of tax flow through. A few considerations regarding this principle and an education income tax include:

- Carve-outs in the current system are minimal.
- The income tax code contains more exemptions for individuals.