What Happened to Taxpayers Under Utah's New Individual Income Tax?

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HIGHLIGHTS

- Over a period of several years, the Legislature changed Utah's individual income tax system.
- The actual distributional effects of the income tax changes are similar to those projected at the time the changes were enacted. Analysis of actual tax year 2008 tax returns filed with the State Tax Commission shows that about 97% of tax returns paid the same or less under the new system (tax year 2008) compared to the old system (tax year 2005).
- Although the new system has a single statutory rate of 5.0%, it is not a proportional or "flat" income tax system. Rather, Utah's new income tax system remains progressive through tax credits.
- Even though most taxpayers paid the same or less under the new system, changes in withholding and payments due or refunds issued with the annual tax return may have affected taxpayer perception of the change in tax liability.

Changes to Utah's Income Tax System

Over a period of several years, the Legislature changed Utah's individual income tax system. This briefing paper follows up on the initial estimates of the distributional effects of the enacted changes and shows that the actual distributional effects were similar to those projected at the time the changes were enacted.

ENACTED CHANGES

Over several years, the Legislature changed Utah's individual income tax system. This section summarizes the major changes that took place in recent years.

2005 Tax Year

Prior to enactment of the recent changes, Utah's individual income tax had (a) a tax base structure that allowed various deductions and (b) a graduated tax rate structure. Because of the starting point of federal taxable income, along with other adjustments, the tax system allowed a number of sizable deductions from income, including federal standard or itemized deductions, 75% of federal personal exemptions, a retirement income deduction, and a deduction for one half of a taxpayer's federal income tax liability. The system applied a graduated tax rate structure to state taxable income, with a top bracket tax rate of 7.0%. However, the rate structure was only mildly graduated because the 7.0% tax rate took effect at relatively low taxable income levels ($4,313 single and $8,626 married).

2006 Tax Year

The changes enacted for tax year 2006 reduced taxes by expanding tax brackets and by slightly reducing the top bracket tax rate from 7.00% to 6.98%. The new top tax bracket began at taxable income levels of $5,500 single and $11,000 married.

2007 Tax Year

The dual track system, in place only for tax year 2007, allowed a taxpayer to pay the lower of the tax calculated under the old system (with the expanded tax brackets and a top tax rate of 6.98%), or a 5.35% single rate tax with nearly all deductions eliminated.

2008 Tax Year

In tax year 2008, the state returned to a single track system with a tax rate of 5.0% applied to a broader income base resulting from the elimination of many deductions allowed under the previous system. However, many of the largest deductions (itemized or standard deductions, 75% of personal exemptions, and retirement deduction) were replaced with tax credits that phase out as income increases.

The remainder of this briefing paper examines the effects of these income tax changes on taxpayers.

DISTRIBUTIONAL EFFECTS

Methodology

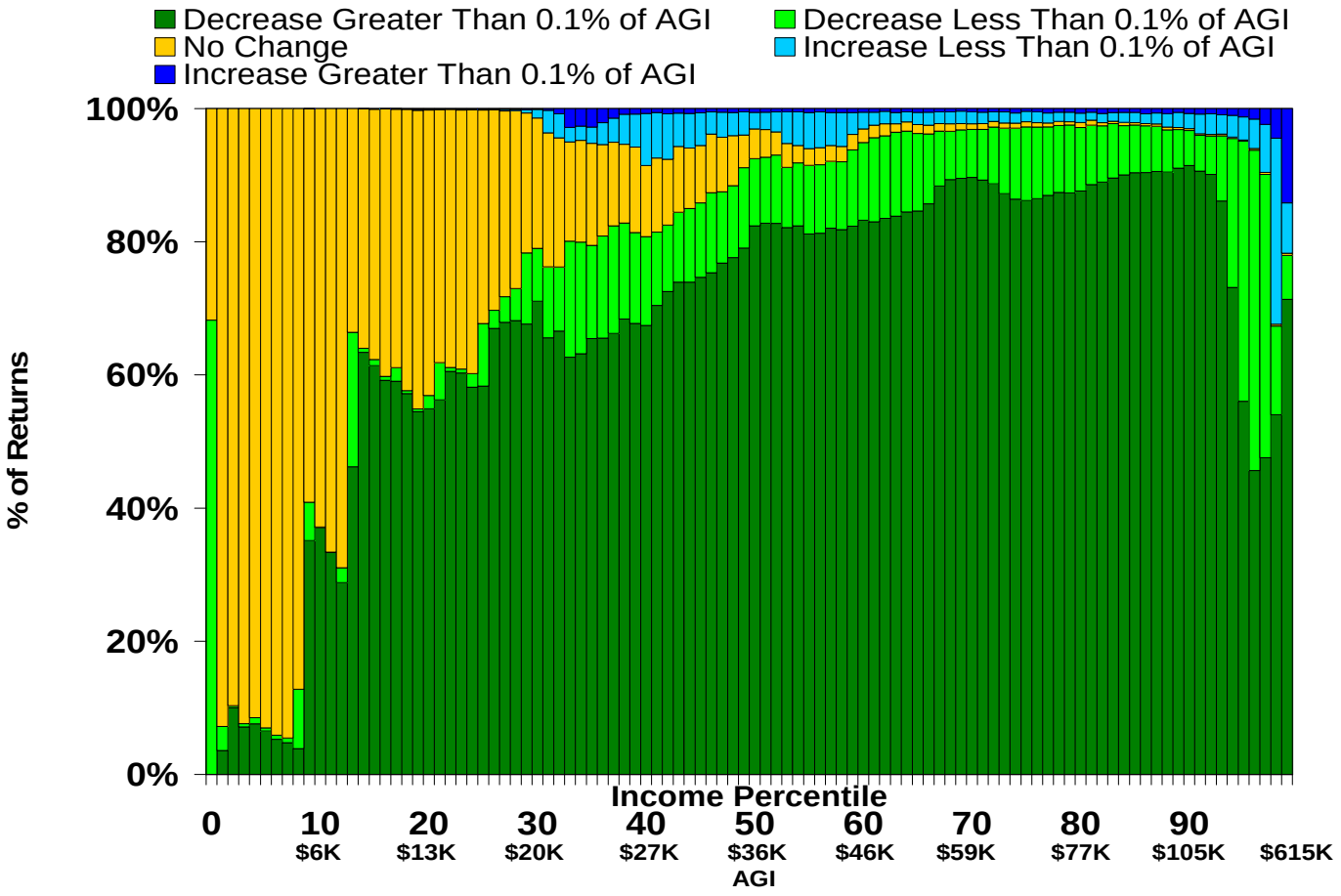
The analysis in this paper uses actual tax year 2008 individual income tax returns filed with the Utah State Tax Commission to examine the distributional effects of the tax changes enacted between tax years 2005 and 2008.[1] To perform the analysis, tax law in place in tax years 2005, 2006, and 2007 was applied to and compared to tax year 2008 return data.[2]

The actual distributional effects of the income tax changes are similar to those projected at the time the changes were enacted. Approximately 97% of tax returns paid the same or less under the new system in place in 2008 relative to the old system in place in 2005 (similar to the initial estimate of 95%). About 91% of tax returns paid the same or less under the new system in 2008 relative to the systems in place in 2006 and 2007 (similar to the initial estimate of 90%).

Tax Change Effects

Chart 1 shows the change in tax by income percentile. As the chart illustrates, most taxpayers received a tax decrease (shown in green in the chart). Many returns at lower income levels had no tax change – mostly returns that had no tax liability under either the old or new systems (shown in yellow in the chart). The highest three percentiles had the largest number of tax returns with tax increases (shown in blue in the chart).

Chart 1
Tax Change, Tax Year 2005 to 2008, by Income Percentile



To further illustrate the impact of the tax changes, Charts 2 and 3 show the change in effective tax rates between tax years 2005 and 2008. An effective tax rate is simply the tax divided by the measure of income – in this case, federal adjusted gross income (AGI). So the change in effective tax rate provides a sense of the tax change relative to income.

In Chart 2, taxpayers are sorted by AGI and each taxpayer is represented by a dot on the chart. Dots below the bold line represent taxpayers who saw an effective tax rate decrease – or in other words, a tax reduction. The opposite is true for dots above the bold line. Chart 3 analyzes the changes by income percentile and within each income percentile. Within each percentile, tax changes are shown at the 5th, 25th, 50th (median), 75th, and 95th percentiles. In other words, within each percentile, 90% of taxpayers fall between the gray and orange lines (5th and 95th percentile) and 50% of taxpayers fall between the blue and green lines (25th and 75th percentile). The median taxpayer is shown by the red line.

As Charts 2 and 3 illustrate, the median taxpayer between the 20th and 90th percentiles generally received an effective tax rate reduction of a little more than a 0.2%. Median taxpayers in income percentiles below the 20th percentile generally either received a larger effective tax rate reduction or no change. Median taxpayers between the 90th and 98th percentile generally received a lesser effective tax rate reduction of between about 0.1% and 0.2%, while the median taxpayer in the top income percentile received an effective tax rate reduction of nearly 0.4%. Interestingly, the highest income percentiles show both some of the largest taxpayer increases and decreases in effective tax rates.

Chart 4 shows the change in effective tax rate by income and by filing status. At lower and higher income levels, single filers, who typically had fewer deductions under the old system, tended to receive somewhat larger effective tax rate decreases, whereas at most middle income levels, married taxpayers had greater decreases. Head of household filers received a smaller effective tax rate reduction at most income levels.

Charts 5, 6, and 7 illustrate the change between tax years 2005 and 2008, by dollar amount. In Chart 5, taxpayers are sorted by income and each taxpayer is represented by a dot on the chart. Charts 6 and 7 show the changes both between and within each income percentile, with different scaling. As the charts illustrate, in terms of dollar amounts, most taxpayers had a tax change between $0 and a $300 reduction. Many taxpayers at lower income levels had no tax change because they paid no tax under either system. At higher income levels, some taxpayers experienced tax increases, while others experienced large decreases.

Chart 2
Effective Tax Rate Change, Tax Year 2005 to 2008, by Taxpayer & Income

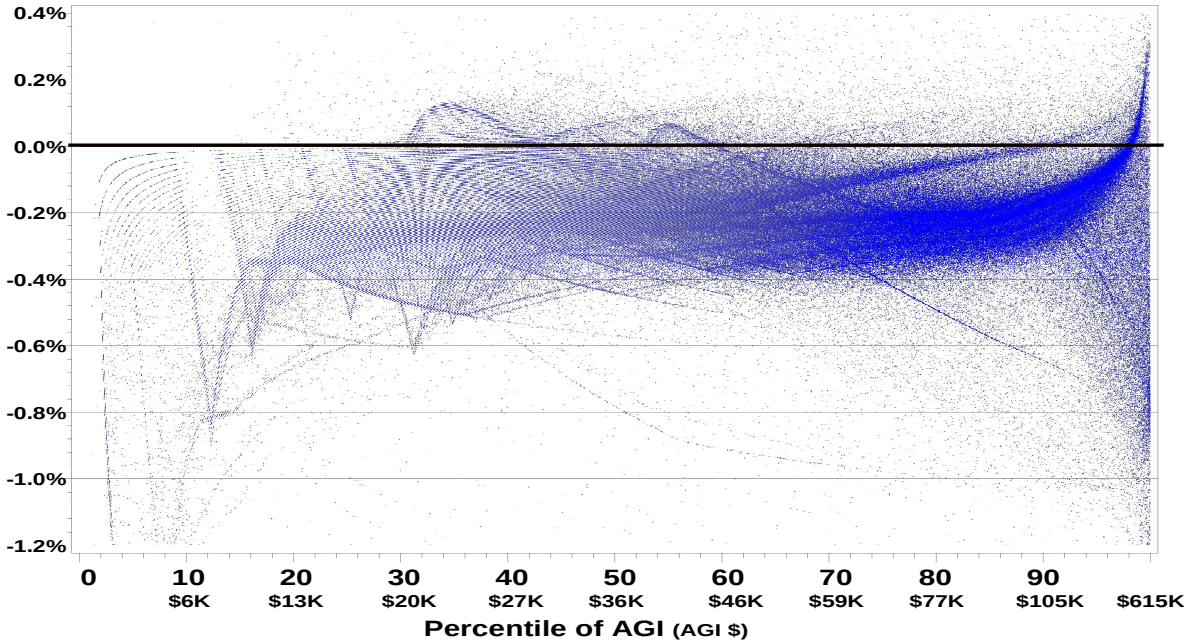


Chart 3
Effective Tax Rate Change, Tax Year 2005 to 2008, by Income

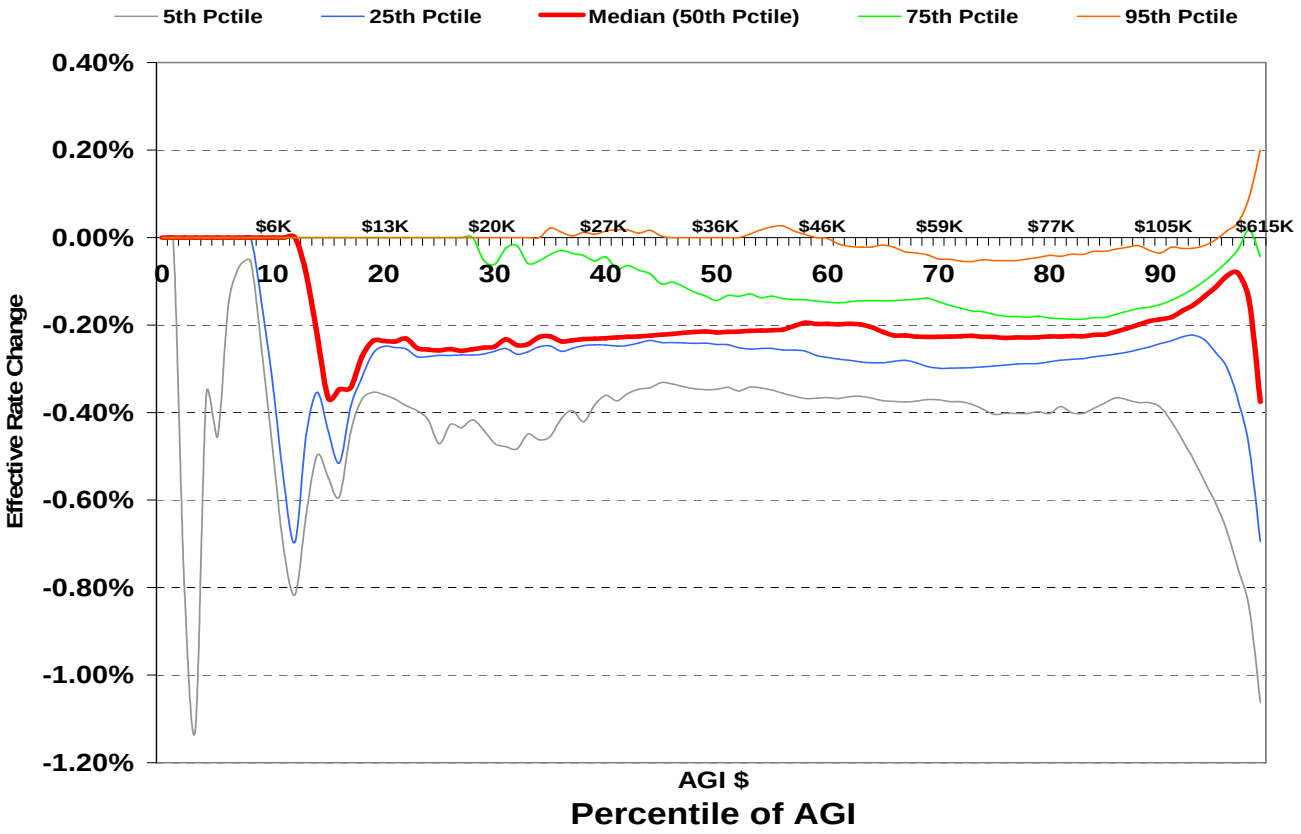


Chart 4
Median Effective Tax Rate Change, Tax Year 2005 to Tax Year 2008, by Filing Status & Income

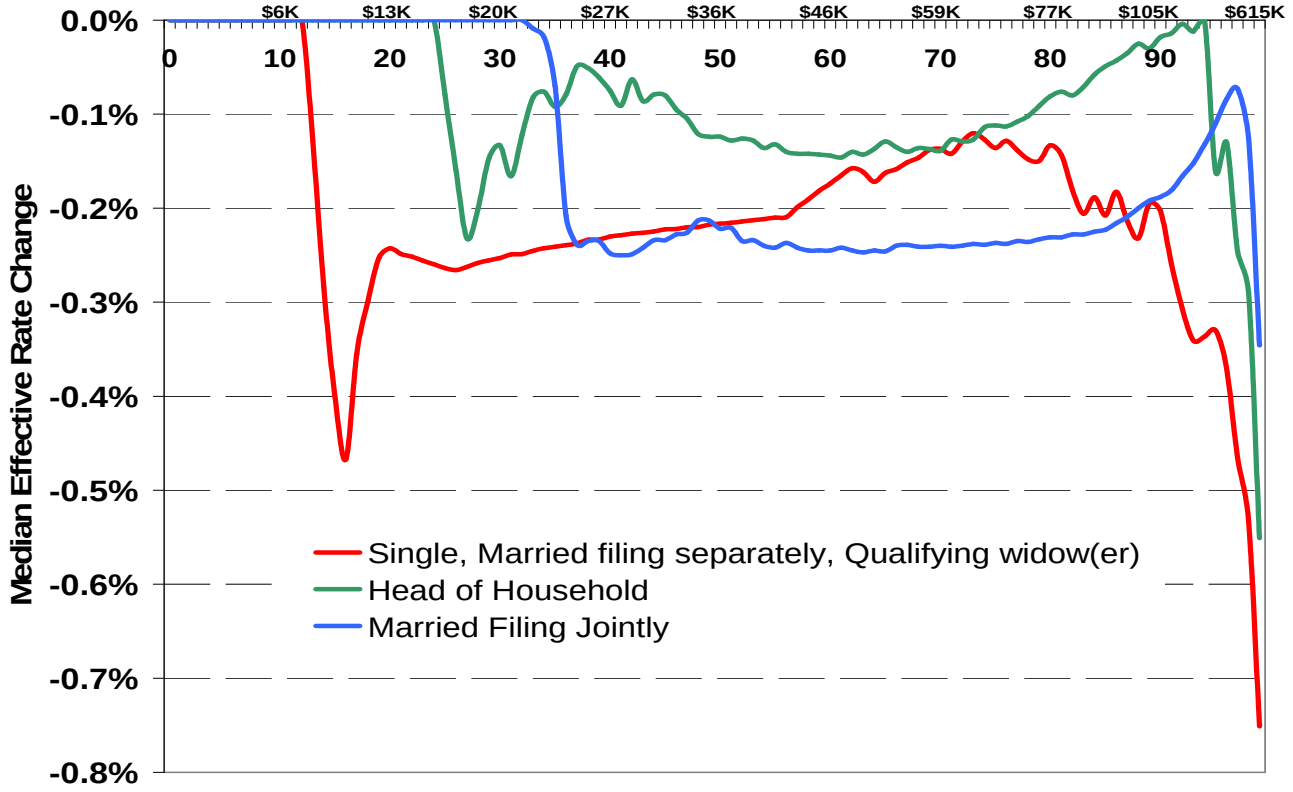


Chart 5
Dollar Amount of Change, Tax Year 2005 to 2008, by Taxpayer & Income

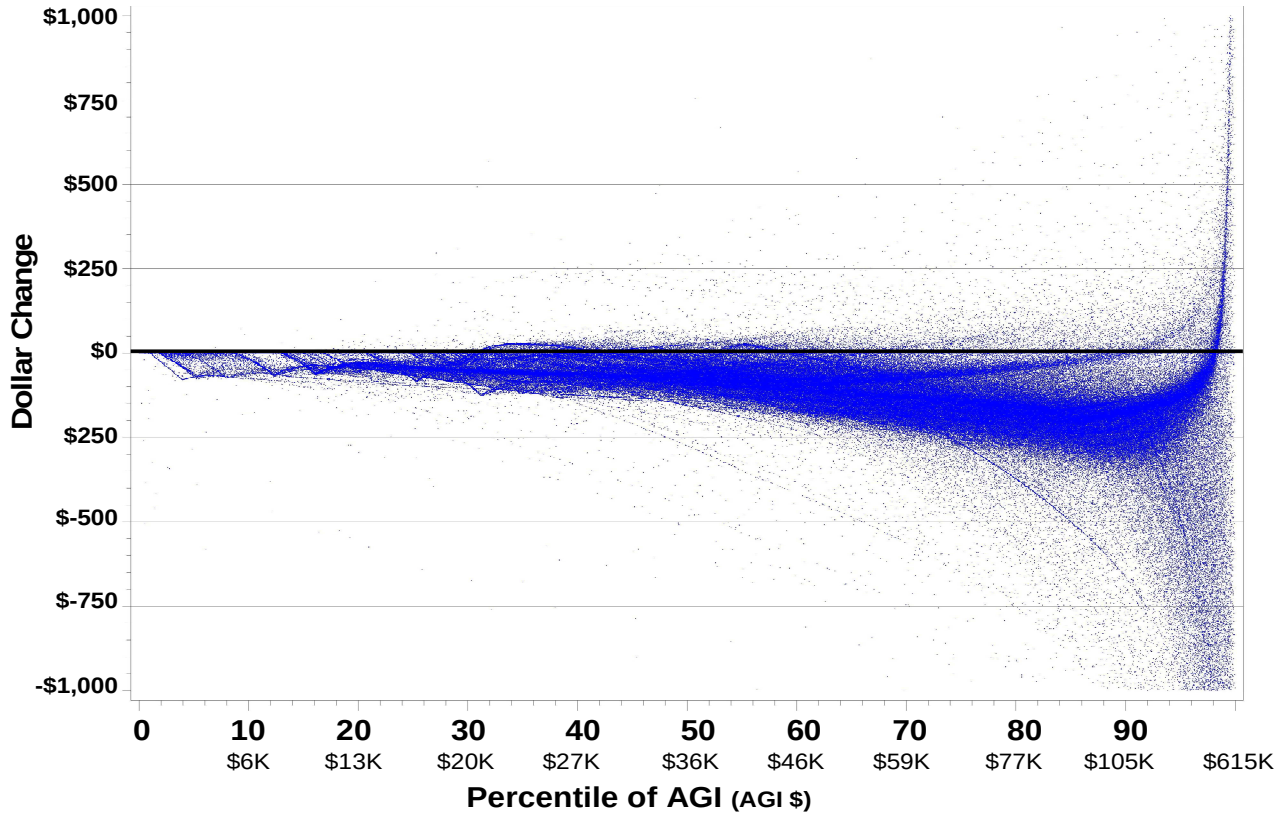


Chart 6
Dollar Amount of Change, Tax Year 2005 to 2008, by Income

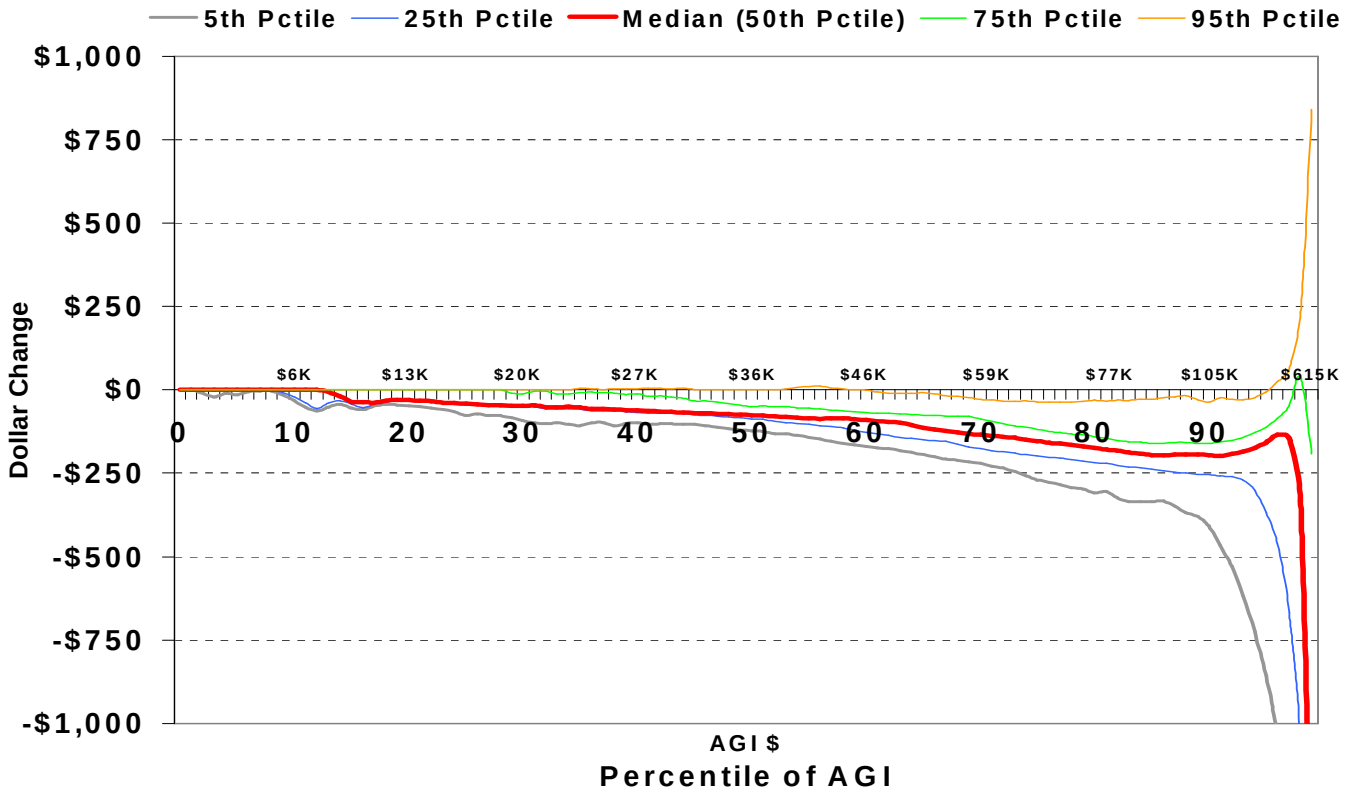
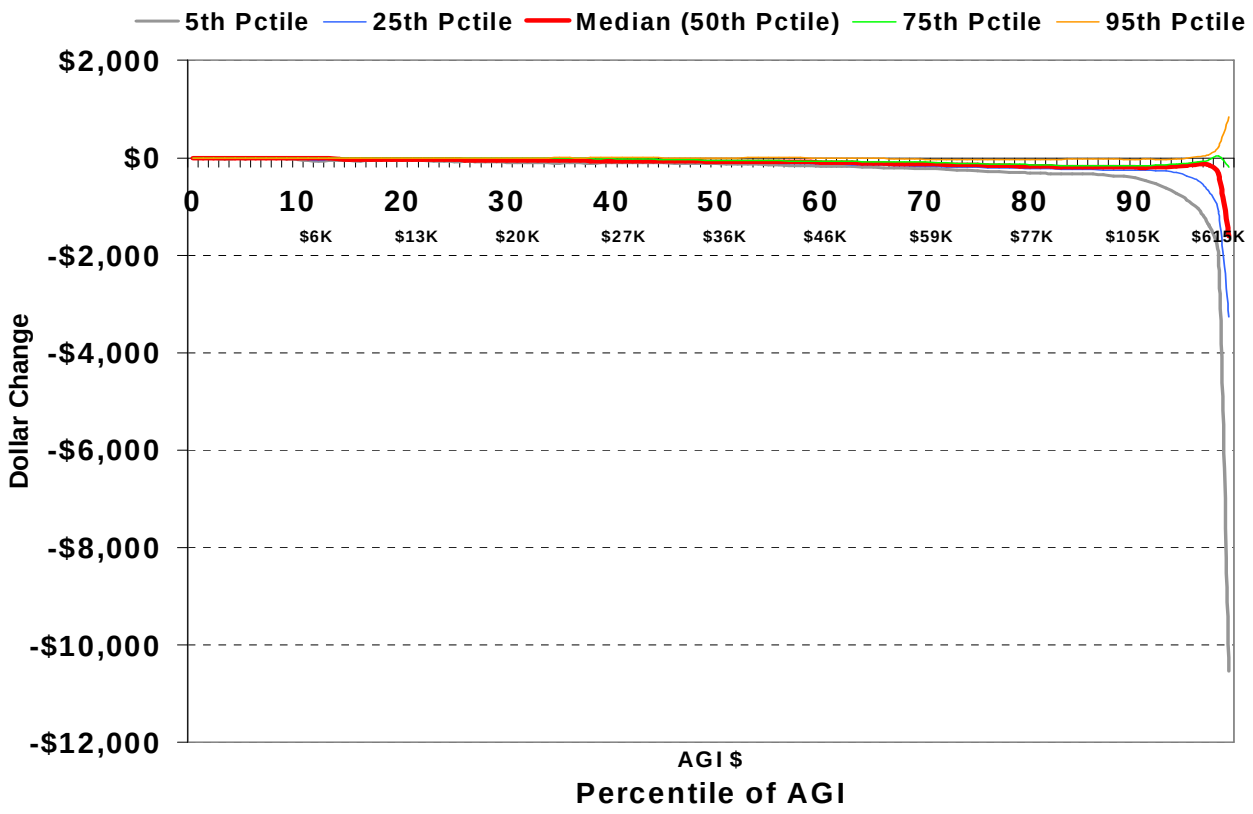


Chart 7
Dollar Amount of Change, Tax Year 2005 to 2008, by Income



Tax Burden Distribution by Income

The calculation of a tax can be summarized with the following basic tax formula:

(Base x Rate) – Credits = Tax Amount

Any of the factors on the left hand side of the formula will affect the initial distribution of the tax.

A tax is ***proportional*** if all taxpayers pay the same percentage of income in tax. A tax is ***progressive*** if high-income households pay a higher percentage of income in tax than low-income households. A tax is ***regressive*** if high-income households pay a lower percentage of income in tax than low-income households.

Utah's individual income tax system prior to enactment of the recent changes was progressive through both the tax base (deductions) and through tax rates (moderately graduated tax rate structure).

The tax changes enacted over the past several years changed the tax structure by broadening the tax base through the elimination of many deductions, reducing the top statutory tax rate from 7.0% to 5.0%, and enacting new tax credits. However, even though the new system has a single statutory tax rate of 5.0% imposed on a broader tax base, the new income tax system is not a proportional or "flat" system.

Rather, as Charts 8 and 9 illustrate, Utah's individual income tax is progressive overall because as income rises, effective tax rates increase. This progressivity is due primarily to the fact that the taxpayer credit phases out as income increases.

Chart 8
Effective Tax Rate, Tax Year 2005 and Tax Year 2008, by Taxpayer & Income

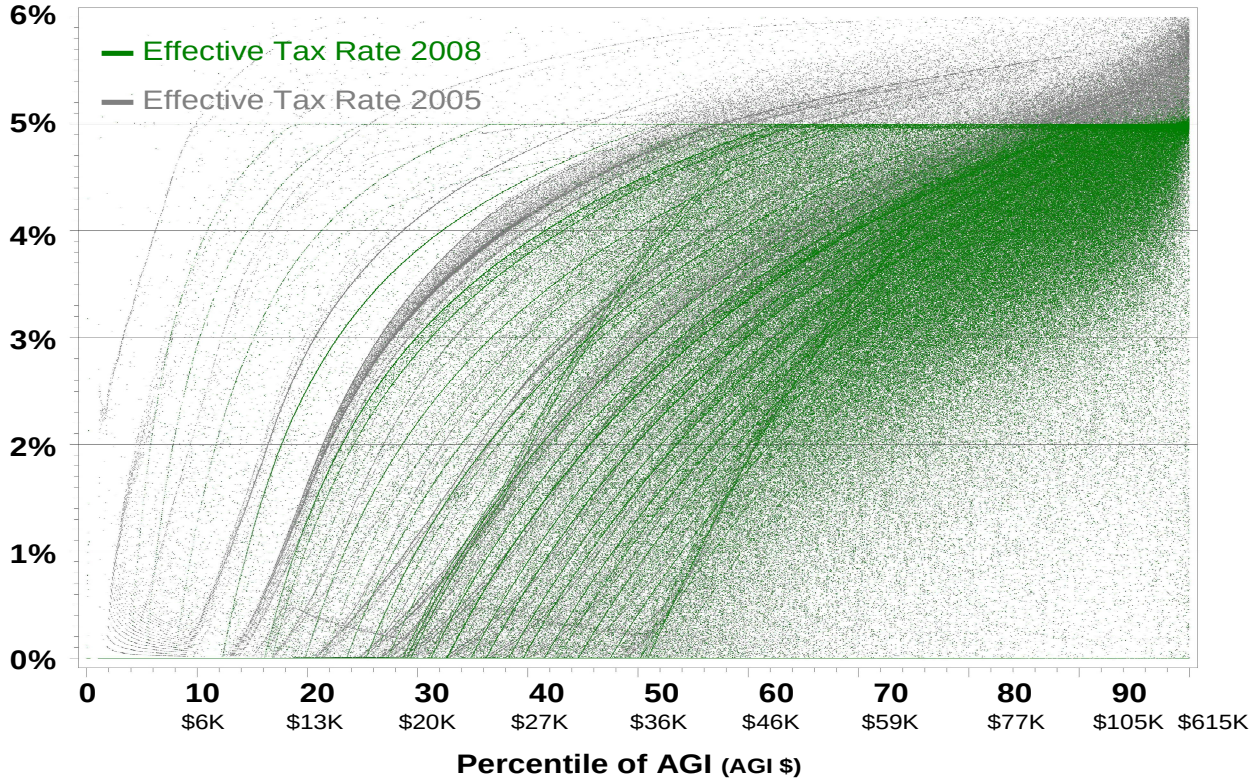
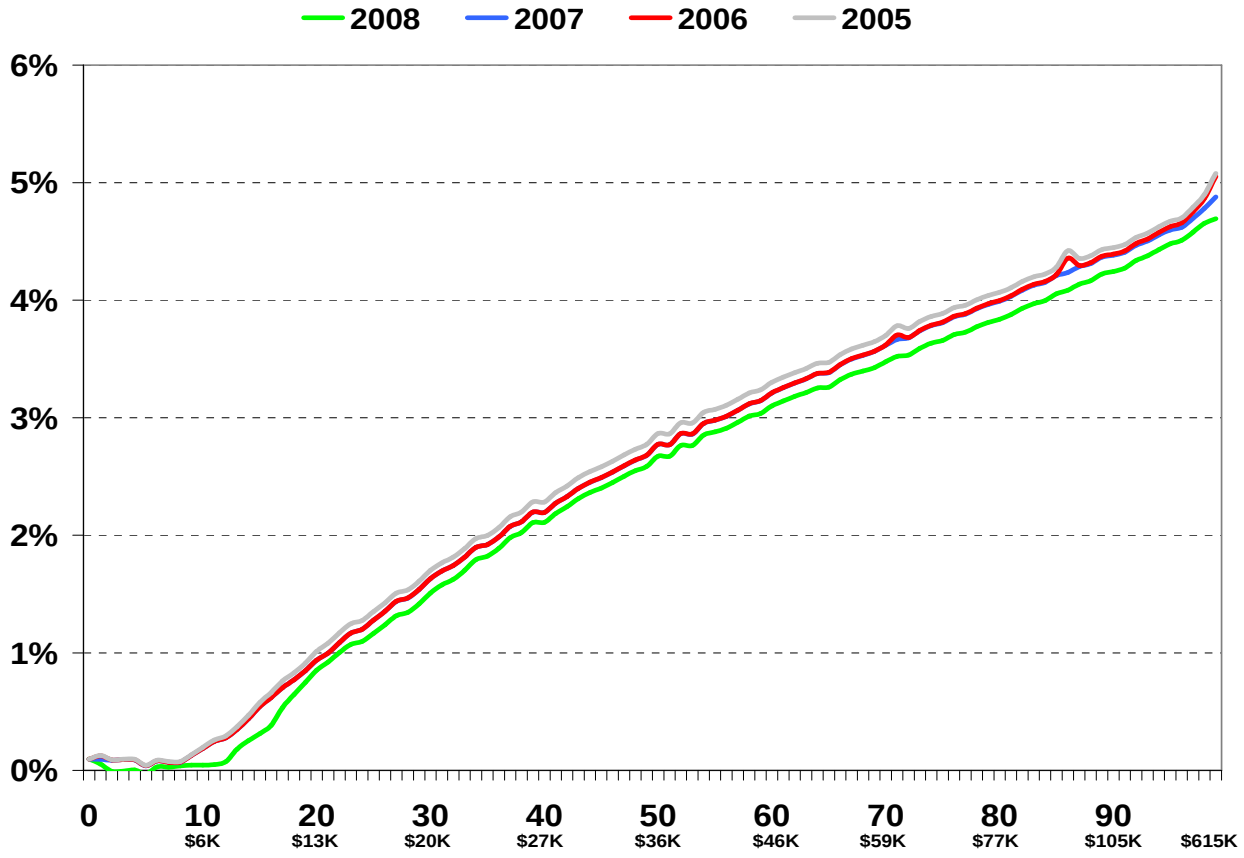


Chart 9
Effective Tax Rate, Tax Year 2005 through Tax Year 2008, by Income



WITHHOLDING CHANGES

In conjunction with the structural changes to the state's income tax system, the withholding tables changed for taxpayers with wage income subject to withholding. Under the old withholding framework, most taxpayers had a statutory marginal tax rate of 7.0%. However, due to the previous deduction for one half of the federal tax, effective marginal tax rates were normally between 5.0% and 6.0% and the withholding tables provided for withholding of 6.5% of the marginal dollar of wage earned.

This excess withholding created sizable tax refunds for many taxpayers. For many taxpayers with non-wage income not subject to withholding, this excess withholding on wage income covered some or all of the tax owed on non-wage income not subject to withholding.

Under the new withholding framework required with enactment of the new tax system, most taxpayers had smaller amounts withheld from each paycheck and excess withholding amounts tended to be reduced. As a result of this withholding change, many taxpayers received a smaller tax refund because their withholding was closer to their actual tax liability. Taxpayers with both wage and non-wage income may have received withholding reductions exceeding the tax due on their non-wage income, resulting in these taxpayers having to remit funds with their tax returns.

Thus, even though 97% of tax returns actually paid the same or less tax under the new income tax system, changes in withholding and payments due or refunds issued with the annual tax return may have affected taxpayer perception of the actual change in tax liability for the entire year.

CONCLUSION

Over a period of several years, the Legislature has changed Utah's individual income tax system. The major changes included reducing the top statutory rate from 7.0% to 5.0%, eliminating some tax deductions, and replacing other tax deductions with tax credits that phase out as income increases. The new income tax system remains progressive, primarily through tax credits.

The actual distributional effects of the tax changes are similar to those estimated at the time the changes were enacted. Analysis of the actual tax year 2008 tax returns filed show that 97% of tax returns paid either the same amount or less in tax year 2008 than would have been paid under the tax system in place in 2005. Although most taxpayers paid the same or less under the new system, changes in withholding and payments due or refunds issued with the annual tax return may have affected taxpayer perception of the change in tax liability.

1. This analysis summarizes the initial impact of the individual income tax changes and does not examine the ultimate economic incidence, which may differ from the initial tax impact to the extent that tax shifting occurs. However, most incidence studies assume that the individual income tax is borne by the taxpayer.

2. Because one half of the federal tax is no longer allowable as a deduction on the state individual income tax return, state income tax return data does not provide the data elements necessary for OLRGC to independently run the analysis comparing the old and new tax system. Rather, this analysis relies on data provided by the Tax Commission, which used state and federal returns to perform the tax calculations. However, the results are similar to OLRGC analysis performed on returns for tax years 2005, 2006, and 2007, when the data required to compare the old and new systems was available on state tax returns.