

# Tax Reform & Tax Relief Package

## The New Credit System

### Summary

The new tax reform plan (LD 1495) uses new household credits in place of personal exemptions and standard and itemized deductions. These credits are a centerpiece of the new tax code, allowing Maine to maintain the progressivity of the former tax brackets, while directing the benefits of lowering income taxes to Maine residents.

In many ways, the new credits mirror the benefits provided by current exemptions and deductions. A special itemized credit is available to taxpayers who itemize on their federal form, retaining the ability to see tax savings from mortgages expenses, property taxes, charitable donations, and medical costs. There is also a new credit for elderly persons.

The new credits phase out slowly as incomes rise, so that—for instance—couples making over \$275,000 receive no credits. But taxpayers with incomes at this level will see such tax savings from the lower tax rate that they will still see an overall income tax reduction. In fact, over 95% of all Mainers will see their income taxes drop.

Another feature of the credits is that a portion is refundable. That means that even if a taxpayer does not currently pay much or any income tax, he/she could still receive money back. In addition to the household credit being refundable, the bill also allows a portion of the current Earned Income Tax Credit to be refunded.

The new credit system does NOT affect business deductions or other modifications that lower a taxpayer's adjusted gross income (AIG).

### What is a Tax Credit?

- **A tax credit is an alternative way to provide tax relief than using exemptions and deductions.**

Like exemptions and deductions, tax credits lower the amount paid in taxes. But they work differently. With an exemption or deduction, the amount of income on which a taxpayer pays taxes is reduced. Conversely with a credit, the tax itself is directly reduced. As a result, **a small credit can provide greater benefit than a much larger exemption or deduction.**

Consider, as an example, how the household credit replaces the current personal exemption. At present, a personal exemption of \$2,850 is deducted from taxable income for each person claimed on the tax return. If a taxpayer is paying tax on at least \$2,850 worth of income at the top tax rate (of 8.5%), then the value of each exemption is \$242.50 (or  $\$2,850 \times .085$ ). *NOTE: \$242.50 is the maximum value of the exemption. Some taxpayers will—for varying reasons—not*

*see as large a benefit.* Under the new system, the household credit is increased by \$250 per person to provide a benefit very similar to the personal exemption.

### **Why Use Credits?**

- **Credits are smart way to replace exemptions and deductions, providing similar benefits, all while reducing burden for Maine residents.**

There are many good reasons to switch to a credit system.

A primary reason is this: in removing the tax brackets, we still want a system where people of ALL income groups see a reduction in their tax burden. For low and moderate income persons, the credit is necessary to do this. It ensures that the effective tax rate for these Mainers is not 6.5%, but something MUCH lower.

Another reason to use credits is because we want the new tax system to be fair even AFTER any new sales taxes are included. The credit can be used to provide money back to low income persons who currently pay little or no income tax. The best way to provide this kind of benefit is through a refundable credit.

A third reason is that we want to maximize the benefits that flow to Maine residents. If we just changed the income tax in some other way, it would need to apply uniformly to all Maine income taxpayers, both residents and non-residents. But the new household credit flows back only to Maine residents.

Some people may think the new credit system is confusing, but that is only because they are looking at it in isolation, rather than as part of the overall package. With tax reform, we've simplified many parts of the tax code (removing brackets, repealing the alternative minimum tax, etc.) but added other parts that are new and (at present) a little confusing to some. But overall, the tax code will be simpler.

In the past, completing a tax return has often involved going through many calculations to find your taxable income, then turning to the tax tables or otherwise calculating what you pay. Under the new system, the process will be reversed. Over 98% of Maine taxpayers will simply multiply their adjusted gross income by 6.5%, then subtract the credits and get the tax. Under the old system, the difficult part was calculating taxable income and the resulting tax. Under the new system those parts will be easier; but as with the current system, some taxpayers will need to do some calculations.

### **New Household Credit**

- **Whether a taxpayer takes the standard deduction (as about 75% of Mainers do) or an itemized deduction, the value of both will be retained and overall tax burden will be reduced for the vast majority of Mainers.**

A taxpayer who generally takes the standard deduction on his/her income taxes will likely take the Standard Household Credit. In 2011, the credit amounts are as follows:

Filing Status	Value
Single	\$ 700
Head of Household	\$1,050
Married filing Jointly	\$1,200

In addition, the credit is increased by \$250 for each person claimed on the taxpayers tax form. (In other words, a married couple with two dependent children would receive an additional \$1,000 credit.)

A taxpayer who generally takes an itemized deduction on his/her income taxes will likely take the Alternative (Itemized) Household Credit. In 2011, this credit amounts to the following:

Filing Status	Value
Single	\$ 400 + 5.5% of itemized deductions up to maximum of \$1,150
Head of Household	\$ 600 + 5.5% of itemized deductions up to maximum of \$1,750
Married filing Jointly	\$ 800 + 5.5% of itemized deductions up to maximum of \$2,300

*NOTE: The amount of itemized deductions used above would be the amount recorded on your federal return, plus adjustments needed for Maine, as required under current law. For most taxpayers, the only adjustment is backing out the amount paid in state income taxes, which is deductible under federal law, but not under state law.*

As with the standard credit, this amount is then increased by \$250 for each person claimed on the taxpayers tax form.

### **Household Credit Phaseout**

- **The credits phase out as incomes rise, because higher income persons realize enough benefit from a lower top rate and don't need as much benefit from the credit.**

Both forms of Household Credit phase out as incomes increase. The phaseouts all begin at the same income level (for everyone in the same filing status), but may end at different income levels (because the amount of the base credit will at times be different, depending on the number of exemptions and whether someone used the standard credit or alternative credit).

The phaseouts begin as shown below:

Filing Status	Phaseout Begins
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Single	\$27,500
Head of Household	\$41,250
Married filing Jointly	\$55,000

The credits phase out incredibly slowly, falling off at a slope of only 3 over 200 (or 1.5%). This means, for instance, that many married couples will see some benefit from the credit until their taxable income has exceeded \$275,000.

### **Refundability**

- **To ensure that every income group wins, the plan allows those who pay no income tax to receive money back, in order to offset any new sales taxes.**

At times, the amount of the household credit will exceed the amount of taxes a taxpayer would otherwise be paying. In such instances, the new tax plan will allow the taxpayer to be refunded a portion of the credit. The household credit is refundable up to \$70 for taxpayers filing joint and \$50 for other filers.

**EXAMPLE:** A couple (without children) making \$25,000 would have taxes (before the credit) of \$1,625 and a credit of \$1,700. Under the tax reform plan, this couple would get back \$70. (Incidentally, this is a savings of \$266 over the income taxes that would be paid under the current system, where this couple would be paying \$196.)

By making the household credit refundable in this manner, it means that a taxpayer who pays no income tax will be able to get a small amount of cash back (\$70 or \$50). This is NOT much money, but it will help. It is expected to roughly equal the amount of additional sales taxes that would be paid by an average consumer with this level of income. To put it another way, this will help ensure that people who do not pay income taxes will not be hurt by changes to the sales tax.

*NOTE: This is not the only place in the new tax code where credits are refundable. See also "Earned Income Tax Credit" below.*

### **Elderly Credit**

- **The new elderly tax credit helps seniors and increases the overall progressivity of the tax code.**

Each taxpayers who is 65 years or older is also eligible for a special elderly credit. This credit is added on top of the household credit. The credit is \$60 for a single elderly person and \$120 for a married elderly couple filing jointly.

Like the household credit, the elderly credit phases out slowly as incomes rise. But the rate is different, falling off at a slope of 1 over 50 (or 2%).

The phaseouts begin as shown below:

Filing Status	Phaseout Begins
Single	\$32,000
Head of Household	\$48,000
Married filing Jointly	\$52,000

### **Earned Income Tax Credit**

- **The “refundability” of the Earned Income Tax Credit helps working families and increases the overall progressivity of the tax code.**

Current Maine law provides low-income working families with a special tax credit that builds off the federal Earned Income Tax Credit (EITC). Some of the taxpayers who are eligible for this credit are not able to take full advantage of it, because the credit is greater than the amount of taxes they pay. That will change under the tax reform plan, which makes Maine’s EITC “refundable” up to \$150 for married couples filing jointly and up to \$125 for other tax filers.

### **Adjustments to Credits**

The credits are indexed for inflation in 2014 and automatically each year thereafter. Indexing could not be written into the new law because of the current economic climate. However, the law contains a provision that allows for upward adjustments to the credits before 2014 if economic conditions allow. *NOTE: Even if credits are not adjusted upwards until 2014, 93% of Mainers will still see an income tax cut in 2013.*

### **What this all means**

- **Over 95% of Mainers will see their income taxes drop in 2011, while nearly 90% of Mainers will see their overall tax burden drop. And ALL Mainers will benefit in other ways.**

Many people look at all this and naturally wonder what it means to them.

If you are used to doing your own taxes and are good with math, you can calculate the impact with the information provided above.

But if you are not “running the numbers” for yourself, the analysis done by Maine Revenue Services will give you a good idea of how this will impact you.

Maine Revenue Service's sophisticated computer model contains a copy of the tax return for every Maine taxpayer, and they know (to the dollar) what the impact of these changes will be on you and everyone else. Their results are very promising.

Overall, Mainers will see their income tax burden drop by \$107 million in 2011 (and more as the economy rebounds). Over 95% of Mainers will see a reduction in their income taxes. About the only people who will not see their taxes drop are those who BOTH itemize and have a very high percentage of itemized deductions relative to their income level. If you are not in that category, you have nothing to worry about. And even if you are a high itemizer, there is still a good chance that you will not experience any negative impact, since the overall percentage of people who will see a tax benefit is so high.

Maine Revenues Services has also calculated the overall impact of the tax reform package, which not only lowers income taxes, but increases some sales taxes. There, too, the numbers look good. The overall tax burden on Maine residents will drop by \$54 million per year. About 88% of Mainers will see an overall drop in their tax burden, even AFTER all additional sales taxes are paid.

But remember, even the small percentage of Mainers who may not see a direct tax reduction still benefit in other ways. LD 1495 will also spur economic growth and stabilize state revenue—this helps the state as a whole, and every one of us who lives in it.