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## **Mind the Gap:**

*Transitioning to Tax Reform*

Vermont's Blue Ribbon Tax Structure Commission



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*Transitioning to Tax Reform*

A White Paper Produced by  
Vermont's Blue Ribbon Tax Structure Commission

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Tax reform creates winners and losers by disrupting current economic relationships.<sup>1</sup> Tax reform disrupts economic relationships by departing fundamentally from the current system, altering and/or eliminating rates, deductions, exclusions, and credits to which individuals and businesses have grown accustomed.<sup>2</sup> These disruptions, and their administrative counterparts, can be labeled transition losses and range from simple to complex.<sup>3</sup> The questions of whether, and how, to offer relief to mitigate transition losses is the domain of tax transition policy.

Government deploys tax transition policy whenever it enacts tax reforms.<sup>4</sup> Policymakers must decide whether to offer taxpayers relief from these effects or let the losses fall where they may. If relief is offered, policymakers must make complex and costly choices regarding how best to use transition policy to traverse the gap between current policy and reform.<sup>5</sup> The Blue Ribbon Tax Structure Commission will utilize this white paper to examine the challenge to effective reform presented by tax transition effects and tax transition policy.

The Commission examined tax transitions in Vermont and other jurisdictions and found that the personal income tax changes enacted by the Legislature in 2009 illuminate many of the complexities of tax transition.<sup>6</sup> The 2009 personal income tax changes provide a compelling example of the policies, resources, and complexity deployed to fill the gap that arises between current policy and reform.<sup>7</sup> The Commission will focus on this reform as it examines tax transition policy.

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<sup>1</sup> U.S. Congress, House Committee on the Budget, “Tax Reform: Prospects and Possibilities,” Testimony of C. Eugene Steuerle. 108<sup>th</sup> Congress, 2<sup>nd</sup> sess. 4 October 2004. Available from: Tax Policy Center [http://www.taxpolicycenter.org/UploadedPDF/900749\\_Steuerle\\_100604.pdf](http://www.taxpolicycenter.org/UploadedPDF/900749_Steuerle_100604.pdf). Dr. Steuerle asserts that “the only way to create no losers in tax and budget policy is to maintain current law.”

<sup>2</sup> Richard D. Hobbet, “Transitional Mechanisms to Facilitate Tax Reform,” *Law and Contemporary Problems* 34:4, Tax Simplification and Reform (Autumn 1969) 818; Louis Kaplow, “An Economic Analysis of Legal Transitions,” *Harvard Law Review* 99:3 (January 1986) 512; Kyle Logue, “Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment,” *Michigan Law Review* 94:5 (March 1996) 1130.

<sup>3</sup> Michael Doran, “Legislative Compromise and Tax transition Policy,” *University of Chicago Law Review* 74:2 (Spring 2007) 546.

<sup>4</sup> Kaplow, 511.

<sup>5</sup> The U.S. Department of the Treasury, *Report to the President: Tax Reform for Fairness, Simplicity, and Economic Growth* (Washington, DC: GPO, 1984) for the proposition that “tax reform has often – and long – been held hostage by failure to deal with transitional issues,” and the possibility of deploying transition policies to ease transition losses. Quoted by Gordon Bale, “The Treasury’s Proposals for Tax Reform: A Canadian Perspective,” *Law and Contemporary Problems* 48:4 (Autumn 1985) 170.

<sup>6</sup> Staff examined several major tax reforms within and outside Vermont to analyze transition losses and transition policies. These included Act 60, Act 68, and Unitary Combined Reporting within Vermont, and the federal Tax Reform Act of 1986, Ohio’s 2005 Commercial Activity Tax, and the 2007 Texas Franchise Margin Tax.

<sup>7</sup> 2009 Act No. 2, sec. 16a, 16b, 17, 18, 19, 20, and 21 – Special Session H442. All references to the income tax changes of 2009 throughout this paper are to this act.

This white paper proceeds in four parts. First, the paper will discuss the potentially disruptive transition effects of tax reform. Second, the paper will present possible tax transition policies. Third, the Commission will examine the Legislature's enactment of personal income tax changes in 2009 as a case study of tax transition policy. Fourth, the Commission will make preliminary findings regarding tax transition policy.

### **THE TRANSITION EFFECTS OF COMPREHENSIVE TAX REFORM**

Comprehensive tax reform has the potential to create many disruptive transition effects, including uncertainty and complexity for individuals, businesses, tax professionals, and the government.<sup>8</sup> These effects include, but are not limited to, the following:

- A change in the value and tax treatment of investments
- Disruption in current economic relationships
- Administrative complexity for the government, taxpayers, tax preparers, and vendors
- Short-term volatility in revenue collection and revenue forecasting
- Other unintended consequences

The Commission will examine the tax transition policy responses available to policymakers considering comprehensive tax reform.

### **TAX TRANSITION POLICIES**

Tax transition policies take many forms, but they fall into six broad categories.<sup>9</sup>

- No transition relief offered
- Delayed implementation
- Phased-in implementation
- Partial implementation
- Complete grandfathering
- Full compensation

Each potential transition policy has strengths and weaknesses. The Commission will address each briefly.

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<sup>8</sup> See note 2.

<sup>9</sup> Kaplow, 582-592. See also, Michael Graetz, "Legal Transitions: The Case for Retroactivity in Income Tax Revision," *University of Pennsylvania Law Review* 126:1 (November 1977) 47-87.

### *No Transition Relief*

The threshold question in tax transition policy is whether to offer taxpayers relief from transition losses. The current view among some economists is that the government should not offer transition relief when changing tax laws.<sup>10</sup> Transition relief disrupts the market's ability to properly price risk by encouraging investors to invest with disregard to the possibility of government policy changes.<sup>11</sup> In this way, transition policies may increase moral hazard and transaction costs.<sup>12</sup> Additionally, a legislative decision not to offer transition relief limits behavioral responses to tax reform that may blunt reform's effectiveness. Instead, scholars "generally favor a transition policy of nominally prospective implementation of changes in government policy with no transitional relief."<sup>13</sup> In short, policymakers should avoid retroactivity but, otherwise, not offer transition relief.

### *Delayed Implementation*

Delayed implementation provides taxpayers relief by allowing time to reposition in response to reform.<sup>14</sup> Also, delayed implementation gives the government time to prepare for implementation. The cost of this transition relief is an extension of the status quo's costs and a deferral and reduction of reform's presumed benefits.<sup>15</sup>

### *Phased-in Implementation*

Phased-in implementation is a transition strategy that reforms the status quo in incremental steps over time.<sup>16</sup> Phased-in implementation provides taxpayers with an adjustment period to reposition themselves.<sup>17</sup> Additionally, phased-in implementation may reduce volatility in revenue collection by withdrawing the old system and implementing the new system gradually.

Phased-in implementation has several drawbacks. Just as with delayed and partial implementation, the cost of this transition relief is an extension of the status quo's costs and a

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<sup>10</sup> Daniel Shaviro, *When Rules Change: An Economic and Political Analysis of Transition Relief and Retroactivity* (Chicago, Illinois: University of Chicago Press, 2000), 3; Logue, 1131; Doran, 546.

<sup>11</sup> Kaplow, 513.

<sup>12</sup> Kaplow, 536-537.

<sup>13</sup> Kaplow 551.

<sup>14</sup> Kaplow, 590-591.

<sup>15</sup> Kaplow, 590-591.

<sup>16</sup> Kaplow, 592.

<sup>17</sup> Kaplow, 587-592.

deferral and reduction of reform's presumed benefits.<sup>18</sup> Additionally, taxpayers and the government may face additional complexity in administering and complying with shifting, and perhaps multiple, tax regimes over several years.<sup>19</sup> Last, but certainly not least, reform is susceptible to constant political pressure over the course of the phased-in period.<sup>20</sup>

### *Partial Implementation*

Partial implementation is a transition strategy that implements reform immediately but reduces that reform substantively. Essentially, partial implementation can be described as reform watered down significantly by exceptions to the reform rules. By favoring the status quo for certain taxpayers, partial implementation reduces both reform's losses and benefits.<sup>21</sup> Therefore, partial implementation may have the advantage of easing the transition but the burden of continuing part of the status quo and increased administrative complexity. Unlike a phased-in or delayed implementation, these burdens accumulate indefinitely.

### *Grandfathering*

Grandfathering "exempts pre-reform investments from newly enacted regulation."<sup>22</sup> The benefit of this transition strategy is to reduce the transition losses and opposition of taxpayers holding affected investments.<sup>23</sup> Grandfathering has numerous drawbacks.

Economists consider complete grandfathering inefficient.<sup>24</sup> First, grandfathering exempts investors from the cost of reform but does not address any underlying change in the value of an investment.<sup>25</sup> Second, grandfathering reduces the potential benefits of reform by reducing revenue.<sup>26</sup> Third, grandfathering creates complex administrative issues by creating separate tax treatment of similar assets. Fourth, grandfathering divides taxpayers arbitrarily by date. This

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<sup>18</sup> Kaplow, 592.

<sup>19</sup> Hobbet, 836. Logue, 1175.

<sup>20</sup> Ohio provides an example of this pressure. Ohio enacted a comprehensive tax reform that phased in incrementally over five years. Governor Strickland stopped implementation of the final year of the tax reform to address current budget issues. Jim Siegel, "Strickland Signs New State Budget; Tax Cuts Delayed," *Columbus Dispatch*, December 22, 2009, ([http://www.dispatch.com/live/content/local\\_news/stories/2009/12/22/strickland-signs-budget.html](http://www.dispatch.com/live/content/local_news/stories/2009/12/22/strickland-signs-budget.html)) For more information about Ohio's phased-in implementation of comprehensive tax reform, see [http://tax.ohio.gov/divisions/communications/news\\_releases/documents/Tax\\_reform\\_fact\\_sheet.pdf](http://tax.ohio.gov/divisions/communications/news_releases/documents/Tax_reform_fact_sheet.pdf)

<sup>21</sup> Doran, 584. Kaplow, 588.

<sup>22</sup> Kaplow, 584.

<sup>23</sup> J. Mark Ramseyer & Minoru Nakazato, "Tax Transitions and the Protection Racket: a Reply to Professors Graetz and Kaplow," *Virginia Law Review* 75:6 (September, 1989) 1155-1175.

<sup>24</sup> Kaplow, 585; Graetz, 47, 53; Ramseyer and Nakazato, 1155.

<sup>25</sup> Kaplow, 584.

<sup>26</sup> Kaplow, 585.

special treatment, in which the same income or asset is taxed differently based on date, is difficult to explain and defend.

### *Full compensation*

Full compensation by the government is considered rare outside eminent domain and government contracts.<sup>27</sup> Employing this transition strategy in tax reform would be highly unusual.<sup>28</sup> Furthermore, full compensation for tax losses would be quite costly, blunting reform entirely.

Every tax reform includes these six transition policy options to some degree as policymakers must choose whether and how to offer relief. While these transition policies seem straightforward in the abstract, real world examples abound with complex trade-offs and thorny policy problems. Vermont's 2009 personal income tax reform was no exception.

## **TRANSITION POLICIES IN ACTION: VERMONT'S 2009 PERSONAL INCOME TAX CHANGE**

Personal income tax changes enacted by the Legislature in 2009 provide a provocative example of the complexities of tax transition policy.<sup>29</sup> The Commission believes it is important to acknowledge at the outset that the Legislature enacted this reform at the nadir of the Great Recession.<sup>30</sup> The recession is subsiding slowly, but the pressure of that time may make the example instructive for comprehensive tax reform.

There is debate regarding whether capital gains income should be taxed at the same rate as earned income or at a preferential rate. That debate is beyond the scope of this white paper; however, the Legislature's policy choice in 2009 was to treat capital gains more like ordinary income. The tax transition effects of ending the preferential treatment of capital gains created many winners, but it created increased tax liability for a small but significant group of

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<sup>27</sup> Kaplow, 584.

<sup>28</sup> For a contrary view, *see* Logue.

<sup>29</sup> 2009 Act No. 2 secs. 16a, 16b, 17, 18, 19, 20, and 21 – Special Session H442. All references to the income tax changes of 2009 throughout this paper are to this act. For more information about this change, see the Tax Department's website.

<http://www.state.vt.us/tax/pdf.word.excel/legal/legislation/Highlights%20of%202009%20Legislation.pdf>

<sup>30</sup> State of Vermont Emergency Board, *2010 Economic Review and Revenue Forecast Update* (Montpelier, VT, January 13, 2010) for the proposition that May 2009 was likely the bottom of the Great Recession for Vermont.

taxpayers.<sup>31</sup> The Legislature, perhaps anticipating the response to these transition effects, offered multiple forms of transition relief to bridge the gap between the status quo and the proposed reform.

The personal income tax change enacted by the Legislature in 2009 ended the highly preferential treatment of capital gains by eliminating the exclusion of 40 percent of all capital gains from taxable income. Instead, beginning on July 1, 2009, the 40 percent exclusion of capital gains income was converted to a flat exclusion. For tax years 2009 and 2010, the exclusion amount is \$2,500; then it goes to \$5,000. Simultaneously, the law reduced personal income tax rates. The phased-in rate reductions are illustrated in the chart below.

2008 Marginal Rates	Phase I - 2009 Marginal Rates	Phase II - 2010 Marginal Rates
3.6%	3.55%	3.55%
7.2%	7.00%	6.80%
8.5%	8.25%	7.80%
9.0%	8.90%	8.80%
9.5%	9.40%	8.95%

Furthermore, the Legislature grandfathered sales of farms and timber and carved out a time-limited exceptions for individuals aged 70 or older. Taxpayers over 70 could choose the 40-percent exclusion or the flat exclusion until that relief phases out on January 1, 2011. Through these exceptions, the Legislature deployed all five traditional transition policies within the 2009 personal income tax changes; phased-in implementation, delayed implementation, partial implementation, grandfathering, and no transition relief.

*Phased-In Implementation*

Phased-in implementation was the most visible transition policy utilized by the 2009 personal income tax reform. Phased-in implementation provided transition relief by reducing marginal personal income tax rates incrementally as capital gains taxation rose. Structurally, the

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<sup>31</sup> Analysis by the Legislative Joint Fiscal Office indicates that taxpayers with less than \$12,500 of capital gains income will benefit from the new policy. This includes the majority of Vermonters with capital gains. <http://www.leg.state.vt.us/JFO/Tax%20Commission/Summary%20of%202009%20PIT%20Changes%20JFO.pdf>

2009 personal income tax changes broadened the personal income tax base while reducing the rate. Generally, this is considered sound public policy; however, this phased-in implementation created significant complexity as a transition strategy.

The 2009 personal income tax changes created four separate personal income tax regimes during tax years 2009, 2010, and 2011. Taxpayers saw three different personal income tax rates between 2008 through 2010. Tax treatment of capital gains changed substantially from the first half of 2009 (which replicated the 40 percent treatment) to the second half of 2009, 2010, and 2011. The shifting tax system runs contrary to the virtue of simplicity in administration and compliance espoused by most taxing authorities. Moreover, the shifting tax systems created implementation concerns, including public confusion, tax preparer frustration, and technical difficulties for the government in administering state tax collection.

#### *Delayed Implementation*

The Legislature utilized delayed implementation as a transition strategy within the capital gains tax reform. In tax year 2009, the Legislature carved out an 18-month exception that permitted taxpayers aged 70 and above to choose either the previous 40 percent exclusion for all long-term capital gains or a \$2,500 flat exclusion. This delay added cost and complexity.

It is estimated that this delayed implementation for seniors added \$6.2 million to the estimated \$15 million cost in foregone revenue created by the legislation's tax transition policies.<sup>32</sup> Beyond economic cost and complexity, the transition policy confuses the tax landscape. The Legislature allowed a specific group, seniors, to retrench when faced with a shifting tax landscape. This dispensation may affect taxpayer morale as other taxpayers make claims to similar relief.

#### *Partial Implementation*

The personal income tax law can be read to endorse the rule that capital gains are similar to ordinary income. Yet, the Legislature allowed taxpayers to shield specific amounts of capital gains from taxation. For tax years 2009 and 2010, the exclusion amount is \$2,500; then it goes to \$5,000. This exception to the rule that capital gains are ordinary income is an example of

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<sup>32</sup> Based on analysis by the Tax Department and Legislative Joint Fiscal Office. It is worth noting that the Joint Fiscal Office and Tax Department had difficulty untangling the layered effects of multiple, shifting transition policies. This difficulty demonstrates the complexity and volatility of transition policies.

partial implementation as a transition strategy. The policy choice waters down the rule and will cost Vermont's taxpayers \$6 million this year and millions of dollars in the future.<sup>33</sup>

### *Grandfathering*

The 2009 personal income tax changes grandfathered two industries, farming and logging.<sup>34</sup> The capital gains of farmers and loggers will be taxed under the old regime with a 40 percent capital gains exclusion. These taxpayers benefit potentially from the lower marginal rates and are shielded from the effects of reform; however, these carve-outs cost taxpayers \$3 million.<sup>35</sup> This cost will accrue indefinitely. Perhaps more striking, grandfather policies embolden others to seek similar relief. Currently, the Legislature is considering changes to the treatment of capital gains for other small groups of taxpayers and industries with sympathetic claims.<sup>36</sup> These potential future carve-outs would reduce revenue, add complexity, and empower more groups to demand exceptions to the current policy.

### *No Transition Relief*

A curious feature of the tax reform, inserted due to the need for revenue generation, is an instance where the Legislature did not offer transition relief. Typically, tax reforms are designed to begin at the advent of a new tax year.<sup>37</sup> The law, passed in May 2009, taxed capital gains under two different regimes during tax year 2009. Capital gains income received on June 30 was taxed differently from capital gains received on July 1 of that same year. The decision not to provide transition relief on the implementation date caused serious administrative complexity as taxpayers, the Department of Taxes, and state vendors struggled to respond effectively to those changes. Several specific examples illustrate the scope of the issues found under the banner of complexity.

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<sup>33</sup> Based on analysis by the Tax Department and Legislative Joint Fiscal Office.

<sup>34</sup> The Commission understands that Vermont, as every state, has a vested interest in using its laws to promote certain behaviors and protect certain industries. The competing virtues embedded within tax reform generally, and tax transition policy specifically, make this process highly complex and difficult.

<sup>35</sup> Based on analysis by the Tax Department and the Legislative Joint Fiscal Office.

<sup>36</sup> Hobbet, 831. Professor Hobbet notes that part of the difficulty in enacting tax reform is both the quantity of parties seeking special relief and the quality of their claims.

<sup>37</sup> Kaplow, 551; Logue, 1134.

Compliance became much more difficult in the wake of these changes.<sup>38</sup> The best visual representation of the change is in the forms required to calculate the capital gains exclusion. Taxpayers determined their 2008 capital gains exclusion using one small worksheet from Vermont's 2008 personal income tax booklet. For tax year 2009, taxpayers were required to use a new five-page capital gains form and an accompanying four-page technical bulletin to determine the amount of their exclusion. Tax department staff spent significant time and effort developing and testing these forms, and vendors struggled to patch software to facilitate online filing. Staff will need to adjust these forms and bulletins again as the rules change due to the phased-in implementation of the legislation.

Compliance issues birthed auditing issues. The new rules and forms likely led to taxpayer and preparer confusion, more errors, and questions, which slow down processing and erode compliance. The state would need to devote new, and costly, resources to determine whether compliance issues occurred. For example, the split year treatment of capital gains increases the likelihood that taxpayers, either through confusion, inattention, or evasion, claim that gains and losses occurred during the first half of the year when capital gains taxation was taxed at a more preferential rate. While the state can hire workers to check this compliance through intrusive audits, simplicity and voluntary compliance is more timely and cost-effective.

The 2009 personal income tax changes were a complex tax reform undertaken by the Legislature during an extraordinarily difficult time. The transition policies deployed, and their consequences, demonstrated the complex and costly trade-offs of tax transition policy. The Commission draws three fundamental lessons from the 2009 personal income tax reform and other examples of tax transition policy.

### *Tax Transition Policies Generally Add Complexity*

Transition policies add complexity by functioning as exceptions to the general rules of a tax system. Complexity is not an abstraction but has real consequences for taxpayers and administrators alike. Here, the simplest potential rule from a tax structure standpoint would have been a reduction of marginal personal income tax rates and an end to the preferential treatment of capital gains, beginning at the start of the next tax year. Instead, the Legislature created

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<sup>38</sup> The discussion of 2009 personal income tax change implementation issues is based on Tax Department testimony taken by the Blue Ribbon Tax Structure Commission.

exceptions regarding who would be affected, when people would be affected, and at what rates. Accordingly, the government, public, and practitioners contended with four tax regimes in three years and special carve-outs extended indefinitely. This additional complexity created serious administrative issues, reduced taxpayer morale, and made the legislation susceptible to continued political pressure. Given the costs of complexity, an effort ought to be made to determine whether the trade-offs are worth the complexity in tax transition policy.

#### *Transition Policies Can Be Expensive*

Tax transition policies generally function as tax expenditures. Similar to tax expenditures, transition policies mean that Vermont will forgo revenue due to the use of exclusions, exemptions, deductions, credits, deferrals, and preferential rates in the tax code. The tax transition policies embedded within the 2009 personal income tax change are estimated to have cost taxpayers \$15 million during tax year 2009. These costs are not trivial and will continue at some level in the future.

#### *Transition Policies may not Receive the Proper Level of Scrutiny*

The Legislature has not precommitted to any particular transition policy. Accordingly, the Legislature may address the transition effects of each tax change with some combination of six different policy responses. While this preserves maximum flexibility for the Legislature, the ad hoc deployment of tax transitions has serious implications for the policymaking process.

Assessing tax transitions ad hoc, if at all, reduces the Legislature's ability to determine the complexity and cost of transition policy options. Moreover, the Commission's examination of tax transitions in Vermont and other jurisdictions indicates that transition policy is frequently inserted into legislation late in the process as a political palliative.<sup>39</sup> Tax transition policy may seem an incidental way to overcome obstacles, but its complexity and cost mean that transition policies deserve the same level of scrutiny as the underlying bill.

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<sup>39</sup> Alan Murray, *Showdown at Gucci Gulch* (New York, NY: Random House, 1987) 146-147, 241-243. The book is a fascinating account of the federal Tax Reform Act of 1986. Chairman Rostenkowski used transition relief to secure support for the bill in committee. He made clear to the committee members that he had budgeted \$4 billion for transition relief, and supporters of the bill would be able to provide relief to constituents for special projects under the banner of mitigating transition losses.

The Commission will use this examination of tax transition policy to set forth its finding and best practices for addressing tax transitions in the future. These findings include a process-based commitment and a policy-based finding.

## **TAX TRANSITIONS: COMMISSION FINDINGS AND BEST PRACTICES**

### *1. Making Tax Transition Effects and Policies Explicit*

The Commission's goal, set by the Governor and Legislature, is to recommend a long-term vision for the revenue and tax system that provides sustainability, appropriateness, and equity.<sup>40</sup> At the outset, the Commission acknowledged that this type of tax reform will create winners and losers, given reform's economic disruptions. Tax transition losses will create a difficult gap between the status quo and reform. Tax transition policy may be a useful, although complex and costly, way to address transition losses. The Commission will seek to be formally mindful of this gap given the complex trade-offs and long-term costs of transition policies.

The Commission will identify, and make explicit, the tax transition effects and tax transition policy implications of its proposals. Each proposal will articulate a general rule and identify the transition effects of that reform. Furthermore, the Commission will recommend a tax transition policy, or policies, and, to the extent possible, determine the potential complexity and cost of each transition policy. While this process-based requirement will not end the complexity or cost of transition policy, it will make the policymaking deliberate and transparent. The goal would be to use this deliberation and transparency to craft better policies that gain public acceptance and are not unnecessarily complex. The Commission recommends that the Legislature consider making specific findings regarding tax transition effects and policy when it considers changes to the tax policy.

### *2. Choosing Among Transition Policies*

The previous section stated the Commission's commitment to a deliberate and transparent tax transition review process. This section provides the Commission's findings regarding specific tax transition policies.

The Commission views itself as a constituency for simplicity. Simplicity is an enumerated principle of a high quality revenue system and the foundation of taxpayer morale. Both taxpayers and the government would benefit from a system that favors simplicity by uniformly applying

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<sup>40</sup> 2009 Act No. 1, Sec. H.56 – Special Session

straightforward tax rules. The Commission's preference toward simplicity would indicate a potential preference for offering no transition relief; however, the Commission's potential preference for no transition relief is tempered by the likely far-reaching transition effects of comprehensive tax reform.

Taxpayers make legitimate plans based on the current tax regime. Policymakers considering fundamental reform ought to acknowledge those plans and provide some ability for taxpayers to reposition themselves. Accordingly, the Commission would likely favor some measure of transition relief within comprehensive reform.

If the Commission is going to recommend some form of tax transition policy relief, it must choose between delayed implementation, phased-in implementation, partial implementation, and grandfathering. Again, the Commission favors simplicity by preferring a delayed or phased-in tax transition policy to a partial or grandfathered implementation policy. Delayed implementation and phased-in implementation give every taxpayer the same transition relief; time to make rationale choices about their future financial plans. While both implementation strategies offer the same relief, the strategies have different drawbacks.

Phased-in implementation creates considerable complexity, but these complexities resolve after a set amount of time. Delayed implementation reduces administrative complexity but significantly extends the status quo and makes reform susceptible to political changes prior to implementation. Overall, the Commission favors delayed implementation slightly, given the simplicity of telling Vermonters that the rules will change substantially once, and only once, and every taxpayer has the same amount of time to address this comprehensive change.

Partial implementation and grandfathering are disfavored on simplicity grounds. Both transition policies set up exceptions whereby some taxpayers will bear the burden of reform while others will be exempted from it. The separate treatment of equal assets adds complexity and taxpayer dissatisfaction. Furthermore, the exceptional treatment of one group provides a podium for others to make claims for the same relief, increasing the potential that the integrity of the tax system is compromised. Furthermore, these exceptions carry costs indefinitely into the future, costs borne by other taxpayers without access to this special type of relief.

The Commission's overriding goal in addressing tax transition policy is simplicity. No transition relief is the best transition strategy in ordinary changes to the tax system; however, comprehensive reform likely requires some opportunity for taxpayers to reposition themselves, given

changed circumstances. Accordingly, the Commission will avoid giving an advantage to one group of taxpayers over another in any given tax transition. Instead, the Commission, absent a compelling reason to the contrary, will use delayed implementation or phased-in implementation to provide Vermonters with the same resource to adapt to change. That resource is the time to adjust intelligently to change.

## **CONCLUSION**

The Commission reviewed tax transitions generally and Vermont's 2009 personal income tax changes specifically. These examples demonstrated that tax transition policies add complexity, require scarce resources, and may implicate-process based notions of transparency and good governance. Yet, policymakers may feel compelled to offer transition relief. Tax reform creates a difficult gap between the status quo and reform, and relief may be deployed to honor the legitimate concerns of a taxpayer's prior plans, allow time for adjustment to comprehensive reform, and smooth the administrative and political transition to a new regime.

Whether tax policy transitions are unnecessarily complex, too expensive, or less scrutinized than desirable are questions that cannot be answered in the abstract, given the extraordinary complexity of tax reform. Instead, policymakers are encouraged to engage in a deliberate examination of tax transition policies to understand fully the complex costs and trade-offs. If the decision is made to offer transition relief, the Commission recommends that policymakers strive for simplicity and avoid transition policies that create exceptions to tax reform's rules. These exceptions erode the tax system's integrity and taxpayer morale. Rather, the Commission recommends deploying transition policies that provide taxpayers with equal relief to fill the gap between the current regime and tax reform. Most likely, this relief will be the time necessary for taxpayers to reposition themselves and their investments.