# THE JEFFERSON JOURNAL

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**THE THOMAS JEFFERSON INSTITUTE FOR PUBLIC POLICY**

## Bring Tax Reform Debate Back for Round Two

By Stephen D. Haner

12/10/2019 -- Sometimes you have to start the victory lap, even if you only get halfway around the track. A year ago, the Thomas Jefferson Institute for Public Policy was beating the drum for a proposal to double the state's standard deduction, the amount of family income exempt from income tax. It was part of a broader tax reform package introduced by several legislators who liked it.

When the smoke cleared the legislature had gone halfway, increasing the standard deduction for a married couple from the ridiculously greedy (on the Tax Man's part) $6,000 to a slightly less ludicrous $9,000. The change, now in effect, will save Virginians $360 million this year and $236 million on next year's taxes. That is a fresh estimate released November 21 as the Senate Finance Committee heard an after-action report on the 2019 tax conformity issue.

This modest improvement came as the federal standard deduction was shooting up to $24,000, meaning the state now taxes substantially more of a Virginia middle-income family's earnings than does Uncle Sam. To add insult to injury, the legislature delayed the impact of the change until the 2019 tax year, even though it could easily have made it effective for the 2018 tax year that was settled with last spring's returns and refunds.

Few if any were talking about the standard deduction before it was raised here, and a number of legislators – including the Democrat who will now chair the House Finance Committee – reported they had seen and modeled the Jefferson Institute proposal. Saving taxpayers $600 million over two years is certainly not a bad outcome. It is time to do more.

The legislature agreed to one other major provision proposed by the Jefferson Institute, creating a Taxpayer Relief Fund to hold in abeyance any and all "windfall" revenue not returned by the changes made in that 2019 bill. Remember that as you read on, because it is key. The same Senate Finance Committee report demonstrates how that promised Taxpayer Relief Fund is being whittled down in future value.

This all came about because Virginia was going to reap a major revenue windfall by conforming to new federal rules on taxes, while continuing to use Virginia's existing tax rates and low standard deduction amount. Other states had used that opportunity to raise their standard deductions, which helps all taxpayers going that route but helps the lower income taxpayers proportionally more.

What was happening to individuals was also happening to corporate taxpayers, who lost several major deductions and preferences in the federal legislation and thus at the state level. At the federal level the tax rate dropped in compensation, but not at the state level. That was predicted to produce a large windfall of corporate income tax revenue, as well, and it will.

The Senate Finance Committee report counts as windfall only those funds produced from individual taxpayers, not corporate taxpayers. Checking back to the language on this year's bill, the fine print does specify only the windfall from "individual" tax provisions flows into the fund. The state made no promises after all to return excess corporate income tax revenue through future tax reform.

The committee's accounting reveals something else which was not in the fine print of the legislation. In calculating the deposit to the Taxpayer Relief Fund, it estimates the windfall revenue then deducts the value of the tax policy changes already made, mainly the impact of that higher standard deduction. But it then also deducts the revenue the state lost when it made two changes to corporate income tax rules in the bill.

*Wait a minute!* What the Senate Finance Committee slide shows is the state is deducting two *corporate* tax changes from the *individual* income tax windfall, thereby shrinking the Taxpayer Relief Fund. It shows zero revenue from higher corporate collections on the top line but uses those corporate subtractions to reduce the bottom line. Only the *individual* tax changes should be counted against the individual income tax windfall.

Even with the legerdemain on display in the chart, the Taxpayer Relief Fund is expected to hold $378 million after the first four tax years of "conformity," which by itself is a good basis for additional tax reform. But if the value of the corporate tax changes are not counted against the individual windfall, at least another $90 million is available for individual tax relief over those four years, and more going forward.

The first recommendation to the 2020 General Assembly on using those funds would be to further increase the standard deduction, looking to get closer and closer to the federal level of $24,000 (already matched by many surrounding states.) A second idea, also from last year's bill, is to index all tax provisions for inflation. Over time that is a major tax reduction.

Another step it might take is to follow the path initially proposed by Governor Ralph Northam, to make the existing Earned Income Tax Credit a "refundable" credit, meaning some of the low-income recipients would actually get checks from the state if their credit exceeded their tax liability. The policy goal is commendable, but the method inferior to a major increase in the standard deduction. That shows up immediately as more money in every paycheck.

When the state first estimated the potential conformity windfall in 2018, the fastest growth was to be in corporate taxes. Despite those two corporate tax amendments which did pass in compensation, that corporate tax windfall is still coming largely intact. And for that portion of this discussion, the predictions that the state would seek to pocket and spend the money are proving correct. The decision to conform there without reform produced a major state corporate tax increase, with no evident complaints from business taxpayers.

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*An earlier version of this commentary originally appeared in the Thomas Jefferson Institute's Jefferson Policy Journal, but several numbers have been further revised. Stephen D. Haner is Senior Fellow for State and Local Tax Policy for the Thomas Jefferson Institute for Public Policy. He may be reached at blackwalnut140@live.com.*

# Taxpayer Relief Fund: Estimated Deposits

| ($ in millions) | FY 2019 | | FY 2020 | FY 2021 | FY 2022 |
|---|---|---|---|---|---|
| | Original | Year-end | | | |
| Conform with TCJA Individual Provisions | $532.1 | $466.0 | $443.8 | $466.7 | $492.5 |
| *Tax Relief:* | | | | | |
| Refund of up to $110 (single) / $220 (married/joint) | ($419.4) | ($431)* | - | - | - |
| Deconform from GILTI | (7.1) | (0.6) | (5.4) | (5.5) | (5.8) |
| Subtraction for 20% of disallowed net interest deduction | (24.6) | (10.0) | (18.0) | (18.7) | (19.7) |
| Deconform from SALT deduction limitation | - | - | (55.6) | (41.7) | (46.7) |
| Increase the standard deduction to $4,500 / $9,000 | - | - | (359.7) | (235.7) | (236.9) |
| Limitation on itemized deductions ("Pease Limitation") | - | - | 107.5 | 73.3 | 76.2 |
| **Subtotal Tax Relief** | **($451.1)** | **($441.6)** | **($331.2)** | **($228.3)** | **($233.0)** |
| | | | | | |
| Net GF Impact, TCJA Individual Provisions | $81.1 | $24.4* | $112.6 | $238.5 | $259.5 |
| Exclude Pease Limitation from Taxpayer Relief Fund | - | - | (107.5) | (73.3) | (76.2) |
| **Net Deposit to Taxpayer Relief Fund** | **$81.1** | **$24.4*** | **$5.1** | **$165.2** | **$183.3** |

**Estimate. Actual impact of refunds and resulting deposit to the Taxpayer Relief Fund may be more or less.*



Senate Finance Committee projection on the Taxpayer Relief Fund, showing the expected windfall revenue at the top and the various adjustments which leave a remainder for future tax reform on the bottom line. The GILTI (Global Income) and net interest deductions are the corporate tax reform provisions being counted against potential future tax relief for families.