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Tax Conformity Alone Is Not Enough

By Stephen D. Haner

10/4/2018 -- When the General Assembly meets in January 2019, it should fully conform Virginia's tax system to the new federal Tax Cuts and Jobs Act, but it should not stop there. It should also take immediate steps to reduce the tax increases that conforming the tax code will automatically create for many Virginia families and businesses.

The easiest step to help families would be to double Virginia's standard deduction, which has been stalled at $3,000 for an individual and $6,000 for a couple filing jointly for decades. Congress doubled the federal standard deduction to $24,000 for a couple and the state could double its deduction to $6,000 for an individual and $12,000 for a couple.

This could be done as part of the emergency legislation that adopts conformity. If passed in a timely manner, the increased deductions could be applied retroactively to this current tax year. It would counteract much of the expected $532 million in higher individual taxes estimated to result if conformity is adopted without tax changes.

The standard deduction coupled with today's personal exemptions create the portion of individual income that is tax free -- the threshold above which taxes are due. Under current Virginia tax law, a couple can take a $6,000 standard deduction and add their $1,860 in personal exemptions ($930 each) for a total of $7,860 tax free. Each additional dependent qualifies for another $930 personal exemption. Only income greater than the threshold is taxed.

Both federal and state law also allow for taxpayers to itemize deductions, and they continue to have this option under the new rules. However, the higher federal standard deduction is expected to cause more than 600,000 Virginians to switch to the simpler, standard deduction route. As many as 88 percent of federal taxpayers are projected to take the standard deduction.

Many of the 40 other states that tax personal income have higher thresholds than does Virginia before state taxes kick in. Compare Virginia's $8,790 tax free for a couple with one child to $13,600 in Maryland, $17,500 in North Carolina and $24,000 in South Carolina or Washington, D.C. Tennessee has no personal income tax. West Virginia, which starts to impose income taxes after $6,000, is the only near neighbor which hits its people with tax on lower levels of income than Virginia.

By doubling Virginia's standard deduction, joint filers with one child would be allowed $14,790 in tax free income.

Taxable Income Threshold	
Couple Plus One Child	
Standard Deduction + Personal Exemptions	
Virginia	**$8,790**
VA Proposed	*$14,790*
Maryland	$13,600
District of Columbia	$24,000
North Carolina	$17,500
South Carolina	$24,000
West Virginia	$6,000
Tennessee	No Income Tax
Federal Taxes	$24,000

Doubling the standard deductions in Virginia is preferable to doing nothing.

The Virginia Society of Certified Public Accountants has encouraged the Virginia General Assembly to make no rapid policy decisions, to allow the 2018 tax increase to happen and to segregate and hold the funds for future tax reform. That does nothing to prevent or compensate for the tax increase in 2018 and will require faith that the legislators do not spend the money while waiting for future tax decisions. This is a risky proposition at best.

This is also preferable to the idea proposed by Governor Ralph Northam, which is to keep all the higher tax revenue and reduce the impact on lower-income working families by giving them annual grants through the Earned Income Tax Credit process. The EITC is complicated and not everybody who is eligible files for it. The higher standard deduction would be easy to implement and could immediately be reflected in the payroll withholding tables. It puts more cash in every paycheck instead of giving someone a once-per-year refund for which they must apply.

This is preferable to deviating from the rules of tax conformity. Some have proposed allowing Virginians to take itemized deductions on the state level while using the standard deduction on the federal level. This would focus the benefits of reform a bit more closely on those impacted by the federal changes, but it still isn't a perfect return of the money and the process remains overly complicated.

How much money does doubling the personal exemptions save taxpayers? It would save an individual taxpayer $172.50 and a couple $345. The Virginia Department of Taxation has estimated it would return $440 million, which tracks very closely to the additional revenue expected from individual (but not corporate) tax returns.

At the low end of the economic scale, most have always taken the standard deduction, and this provides a tax break for everyone who continues this. At the high end of the scale, many wealthy families will still have plenty of deductions to itemize and will continue to do so in their tax filings. This proposed change does not impact them.

The debate is over whether and how best to help the lower and middle-class family with two incomes and some level of deductions between the state and federal standard deductions. Skip the paperwork required by the Governor's idea and the complicated steps in the itemized deduction approach and just give them another $3,000 for an individual and $6,000 for a couple free from tax. This is better policy, simpler to implement, and impacts everyone.

There are other ideas for tax reform that will be outlined by the Thomas Jefferson Institute over the next few weeks, and business taxes need attention as well. With the windfall coming into the state treasury from federal tax reform growing to $950 million in future years and hundreds of millions more being generated by a growing economy, comprehensive tax reform would improve Virginia's competitive position. In the short term we need to bring our tax code into the 21st century with a reasonable standard deduction.

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