REPORT OF THE

JOINT SUBCOMMITTEE TO STUDY THE

VIRGINIA INDIVIDUAL INCOME TAX STRUCTURE

TO

THE GOVERNOR

AND

THE GENERAL ASSEMBLY OF VIRGINIA

SENATE DOCUMENT NO. 16

COMMONWEALTH OF VIRGINIA
Richmond, Virginia
1980

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Report of the
Joint Subcommittee to Study the
Virginia Individual Income Tax Structure
To
The Governor and the General Assembly of Virginia
Richmond, Virginia
December, 1979

To: Honorable John N. Dalton, Governor of Virginia
and
The General Assembly of Virginia

I. INTRODUCTION

During the 1978 Session of the General Assembly, Senate Joint Resolution No. 21 was adopted requesting that the Senate and House Finance Committees study the structure of the Virginia individual income tax and present recommendations that would improve the inequities of the tax. (Appendix I.) Particular items designated in the resolution for study were the marriage penalty, the movement away from federal conformity, the increased use of credits at the federal level, the standard deduction and personal exemptions.

The chairman of the Senate Finance Committee appointed four members from his committee and the chairman of the House Finance Committee appointed four members from his committee, the eight members to compose a Joint Subcommittee for purposes of examining Senate Joint Resolution No. 21 and making recommendations respective thereto. The Joint Subcommittee elected Omer L. Hirst its chairman. The Division of Legislative Services served as staff. The Joint Subcommittee met numerous times in 1978 and 1979, and received information from its staff, various State agencies and professional interest groups.

Although the Joint Subcommittee has assimilated an abundant amount of material relating to inequities in the Virginia income tax structure, the Joint Subcommittee concluded that it was not yet in a posture to make a final recommendation on any of the topics being considered and that further study was needed. Therefore, the Joint Subcommittee recommended that an interim informational report be made to the 1979 General Assembly which would isolate and review tax inequities and possible approaches to the correction thereof. The Joint Subcommittee further recommends that the study be extended for an additional year to permit the members sufficient time to thoroughly discuss the issues and make prudent recommendations thereon. A copy of the proposed continuation resolution is included as Appendix II.

II. "MARRIAGE PENALTY"

The "marriage penalty" refers to the difference in federal or state income taxes, as the case may be, paid by married persons and the taxes the same two joint wage earners would pay if they were not married. The marriage penalty in Virginia results from the fact that a married couple has to share a standard deduction (i.e., 15% of adjusted gross income not to exceed $2,000, or $1,300 whichever is greater) or the itemized deduction, while an unmarried couple are each allowed to take a standard deduction. If one of the partners of the unmarried couple may itemize his deductions, then that partner may itemize his deductions while the other partner takes the standard deduction. The penalty occurs only when both partners of the marital union are wage earners.

The penalty is magnified significantly at the federal level since married wage earners filing a joint return must add their salaries together, thereby pushing their tax rate upwards in the federal graduated income tax structure. This portion of the "marriage penalty" has been corrected in Virginia if the married couple files separately on a combined return. This allows each spouse to allocate his income and thereby pay only such rate of tax on that income as would apply to the income earned by taxpayer.

Even though this portion of the penalty has been corrected, a substantial tax benefit is still realized by persons "living in sin". For example, if a husband's annual adjusted gross income is $25,000 and his wife's income is $12,000, assuming itemized deductions of $4,500, the total state tax payable by this married couple equals $1,631.50. Assuming the identical factual situation, if the male and female were not married, the tax would equal only $1,325.88 or a resulting "marriage penalty"

of $305.62. (For other examples, see Appendix III.)

The number of taxpayers effected by the penalty is rising in ever increasing numbers. Nationwide from 1969 to 1974, the number of joint returns filed by all married individuals rose less than four percent. In contrast, the number of joint returns filed by married individuals each of whom had wages rose more than ten percent. Because of the substantial increase in the number of joint returns filed by married individuals both of whom were wage earners, and because of dramatic changes in the relative wages earned by these married individuals, the number of joint returns filed by husbands and wives who paid the marriage penalty increased from approximately nine million in 1969 to more than 13 million in 1974. Therefore, in 1974 approximately 70 percent of all joint returns filed by married individuals both of whom had wages were returns on which such individuals paid a marriage penalty.

Alternatives considered by the Joint Subcommittee :

The first method of correcting this embarrassing result, not caused by Virginia but by amendments at the federal level which are automatically incorporated through conformity into the Virginia income tax structure, was the approach utilized in Minnesota. Essentially the "Minnesota Plan" allows married taxpayers to file as single taxpayers. Estimates prepared by the Department of Taxation show that if Virginia were to double each of the current maximum standard deduction amounts for married taxpayers so that a couple filing jointly received a deduction not exceeding $4,000 and a spouse filing separately or a single individual each received a deduction not exceeding $2,000, the estimated revenue cost would equal approximately $55 million for fiscal year 1981 and $45 million for fiscal year 1982 and each year thereafter.

A second approach considered by the joint subcommittee was a staff proposal modifying an American Bar Association recommendation adopted in 1979. (See ABA Recommendation III, Tax Section Rcommendation No. 1978-6 in Appendix IV of this report.) This alternative would provide for an income tax credit to taxpayers based on the difference between the tax married taxpayers would pay if they were single, and the tax actually due by the taxpayers. In computing the credit, only earned income would be used. This would simplify the form used to compute the credit and ease administrative problems brought about by the credit. The credit would result, however, in an additional computation for the taxpayer.

The rationale for using only earned income in computation of the credit is that married taxpayers could find the required figures for the additional computation by referring only to their federal forms W-2 or W-2P, their Forms 1099, or annual statements of profit and loss. They would not have to split ownership and proceeds from property between them to determine a result, as would be the case if all income were included in the problem.

[For additional information on the marriage penalty and solutions thereto, see Appendix V, Issues for Individual Income Tax Reform in Virginia, pages 47 through 56.]

III. STATE CONFORMITY TO FEDERAL INCOME TAX STRUCTURE VS. NON-CONFORMITY

The 1971 extra Session of the Virginia General Assembly, after five years of consideration and study, adopted an individual income tax structure that conformed, in large part, with the federal income tax structure which existed at that time. The conformity structure which became effective for all taxable years beginning on and after January 1, 1972 contained the following basic elements:

1. $600 exemption for three classes - personal, dependent and blindness.

2. The federal maximum standard deduction of 15% of adjusted gross income not to exceed $2,000.

3. The Federal minimum standard deduction of $1,300 and existing treatment of joint returns, or no provision for a split income option.

Under the pre-conformity structure, exemptions were $1,000 for a personal exemption, $300 for a dependent exemption, $600 for age or blindness, and $700 for single head of household; the maximum standard deduction was 5% of adjusted gross income not to exceed $500. The tax rate

schedules adopted by the 1972 Session which became effective with conformity added a slightly higher marginal tax rate on incomes over $12,000. The tax on incomes above this amount was increased from 5% to 5-3/4%.

The purpose of this section of the joint subcommittee's report is twofold; first, to review the reasons Virginia adopted conformity and to note the similarity of the taxes for Virginia and the federal government in terms of the base and, secondly, to review the large number of changes that have taken place in the federal individual income tax structure while the Virginia income tax structure has remained virtually dormant. Needless to say, many of the federal changes have caused the two tax systems to conform less and less and, therefore, placed Virginia in the position of receiving fewer benefits from conformity while having to accept the modifications in federal Adjusted Gross Income (AGI) which may or may not be desirable. There also arises the problem of trying to adapt the federal system to the Commonwealth's given revenue constraints.

Pre-conformity

Pre-conformity income tax law differed from the corresponding federal law in many significant respects. Under pre-conformity, taxpayers had to simultaneously comply with two different sets of rules in preparing tax returns as well as determining tax liability. The convenience to taxpayers which might stem from conformity, and also the number of states which at that time had revised their state income tax laws to conform to the federal government, led the 1966 Virginia General Assembly under House Joint Resolution 64 to call for an independent Commission to study the matter. The Commission was known as the Virginia Income Tax Study Commission.

The recommendations of the Commission were that "Virginia income tax should be revised, with the few exceptions mentioned below, and without altering our present income tax rates, it would be brought into conformity with the federal law, particularly in the determination of net income subject to tax." The Commission recognized that there were three basic areas which led to the recommendations. The first was the advantages for taxpayers. The advantages were simplification and convenience. The Commimssion found numerous items of income which were treated differently under the then existing state and federal law including: sick-pay, pensions and annuities, dividends, alimony, life insurance payments, income of trusts and estates, capital gains and losses, child-care expenses, medical expenses, charitable contributions, education expenses, and automobile mileage allowances.

After examining both structures, the Commission stated "Even where the present Virginia income tax rule might appear more desirous than the federal, the advantages of the Virginia rule do not seem to the Commission to outweigh the simplification that would flow from having consistent provisions in the two laws." Conformity would permit shortened and simplified income tax returns.

The Commission felt there would be advantages in administration. It would ease administrative burden on the Department of Taxation and would allow use of federal income tax data to assist in auditing Virginia returns as well as verifying their accuracy. Needless to say, this is not possible without conformity. Moreover, it would increase the number of returns with the standard deduction, and this in and of itself would ease the audit and processing costs, while at the same time assisting taxpayers.

The final reason concerns the good experience in other states that have adopted conformity. The Commission did recommend some variance from conformity in the areas of government bond interest, deduction for state income taxes, dividends and bank stocks, dividends from Virginia corporations, and benefits from the Virginia government retirement system.

In general, the Commission believed that the number of adjustments to federal net income should be held to a minimum because the simplicity of the recommended new tax return form and the ease of compliance and administration are reduced to the extent adjustments are needed to determine state net income. The advantages of a conforming state law would disappear rapidly if it were to require numerous adjustments to the federal return.

As a result of the study and the recommendations, there was no action taken. There appeared to be two factors responsible for this result. T he first problem was a question regarding the possible unconstitutional imposition of a tax which would require a reference to the federal Internal Revenue

Service Code. This problem was resolved in the new Constitution. A further barrier to favorable action in the 1970 Session was the federal enactment in late December, 1969 of the Tax Reform Act of 1969 which caused some revenue shortfall problems due to increased federal personal exemptions and increased standard deductions. The federal government, over a four-year period, raised the personal exemption deduction from $600 to $700 per dependent. In addition, they raised the standard deduction from a flat 5% to 10% and, effective 1978, raised that amount to 14%.

In 1970, the General Assembly again expressed its desire to reconsider conformity by passing House Joint Resolution No. 91 and creating the Income Tax Conformity Statute Study Commission. This Commission's charge was to recommend the soundest type of conformity legislation if the General Assembly would deem it advisable to conform.

This Commission concluded the reasons for conformity were similar to those presented by the previous study commission. Because the federal government under the Tax Reform Act of 1969 raised the amounts for personal exemptions and the standard deduction, the Commission was caught in a dilemma because it wanted to recommend no change in the income tax rates. The dilemma was whether to adopt the standard deduction of the federal government or the personal exemption treatment. The Commission felt they could not afford to adopt both because of the resulting revenue loss. The Commission recommended adopting the federal standard deduction and felt that, if they didn't "the desired simplification of the reporting requirements of Virginia taxpayers would be lost."

Recent Changes in the Federal Income Tax Laws
Tax Reduction Act of 1975

The Tax Reduction Act of 1975 was primarily intended to reduce taxes and stimulate the economy. Prior to the enactment of this law, the minimum standard deduction was 15% of AGI with a minimum deduction of $1,300 and a maximum deduction of $2,000. The Act of 1975 increased this standard deduction to 16% of AGI with limits for a single taxpayer of $1,600 and a maximum of $2,300, and for a joint return, a minimum of $1,900 to $2,600. The Act also provided for a direct tax credit of $30 for each taxpayer and dependent.

The Act also enacted an earned income credit which is a refundable tax credit equal to 10% of the first $4,000 of earned income, phased out as AGI approached $8,000. This applies only to families that maintain a household for one dependent child whom the taxpayer can claim as a dependent. The Act also granted a tax credit of 5% on the purchase price of a new principle residence for purposes of stimulating the housing industry. In addition, the Act changed the minimum income tax filing levels to correspond with the increased standard deduction.

Tax Reform Act of 1976

The Tax Reform Act of 1976 served a number of purposes including simplification, fiscal stimulus and major revision of the Federal Estate and Gift Tax Law. The Act changed the treatment of capital gains and losses. It increased the holding period which defines a long-term gain and which receives preferential treatment over a two-year period, from a six-month holding period to a one-year holding period. In addition, it increased the maximum capital loss deduction from $1,000 to $3,000. The Tax Reform Act also made great strides in tax simplification. The treatment of child and dependent care expenses was converted from a straight deduction if the taxpayer could itemize his deductions into a flat 20% credit, so it would be available to all taxpayers instead of just those who itemize.

The Act permanently increased the minimum standard deduction to 16% of AGI and increased the minimum and maximum amounts. For a single individual the minimum and maximum standard deductions were increased by $100 so it was a minimum of $1,700 and a maximum of $2,400. The corresponding deductible amount for a married couple was $2,100 to a maximum of $2,800. Moreover, filing levels were increased while the number of tax tables were reduced from 12 to 4.

Another major change concerned the deduction of alimony payments. Before 1976, taxpayers could deduct alimony payments only if they itemized deductions. The Act allowed a straight deduction from gross income without having to first qualify for itemized deductions. The Act also made a number of changes in the retirement income credit. The federal act also made changes in

sick-pay benefits, military disability pensions and moving expense charges.

Tax Reduction and Simplification Act of 1977

This Act was designed to provide economic stimulus to increase consumer spending plus simplify the income tax law. In addition to providing a refund for 1976 of $50 for each taxpayer and dependent which was phased out at income levels between $25,000 and $30,000, the Act also made a substantial change in the standard deduction. As you will recall, while Virginia's standard deduction is still 15% of AGI with a minimum of $1,300 and maximum of $2,000, the federal government increased the standard deduction to a flat $2,200 for single returns and $3,200 for joint returns and heads of households. These changes in the standard deduction plus the personal exemptions and tax credits were incorporated into the tax tables so, as a result, only 4% of all taxpayers would have to make calculations and compute their taxes under tax rate schedules.

In fact, the old concept of the standard deduction is completely eliminated from the federal tax law and federal tax forms. Amounts equal to what otherwise would be the standard deduction are built into the tax tables and known as the zero rate bracket amount (ZBA). Since the standard deduction is being built into the tax rate schedules, the Act places the floor under itemized deductions equal to what otherwise would be the standard deduction so itemizers would deduct only the excess deductions over the standard deductions.

The Act also made numerous other changs in business tax credits and extended the 1977 cuts to corporations and individuals. Finally, the bill increased the filing requirements to correspond with the increased standard deduction amounts.

Conclusions

As pointed out previously, all these changes at the federal level vary sharply with the Virginia individual income tax structure, which has had very limited change. In fact, the 1978 Session of the General Assembly enacted one of the few major changes in the income tax law which changed the filing requirements to $3,000 starting in tax year 1978 which was due in 1979. As to future federal income tax changes in terms of reductions or simplification, it is purely a matter of speculation, however, the federal personal exemption has now been increased from $750 to $1,000 effective with the beginning of taxable year 1979. The Carter administration has been discussing additional income tax reduction with little result. However, the recent trend toward credits, increased standard deductions and changes in the definition of AGI clearly will impact Virginia significantly. For example, an increase in the exemption level from $600 to $1,000 effective on and after January 1, 1980 would cost approximately $122 million for fiscal year 1981 and approximately $86 million in fiscal year 1982.

For additional discussion of conformity issues and alternatives for structural reform, including adoption of federal standard deductions and zero bracket amounts, see Appendix V, Issues for Individual Income Tax Reform in Virginia, pages 5 through 37.

IV. INDEXING THE VIRGINIA INCOME TAX

This subject will only receive a cursory examination in this report as a subcommittee of the Revenue Resources and Economic Commission (RREC) was conducting an extensive examination of this same matter during 1979. In an attempt to avoid unnecessary duplication of responsibilities and labor, the Joint Subcommittee utilized the work product of the RREC, with particular attention to a publication prepared for that Commission entitled *Inflation and the Virginia Income Tax* , reprinted as Senate Document 5 of 1980 and also contained on pages 1 through 46 of the Annual Report of the Revenue Resources and Economic Commission, 1980.

Although there have been no changes in the rate structure of the income tax since 1971, it is obvious from an examination of Table 1, that something drastic has occurred and that factor is inflation. Table 1 shows that between 1971 and 1978 actual collections under the income tax rose from $365,378,374 to $854,815,907 or in excess of a 200% increase.

TABLE 1

VIRGINIA INDIVIDUAL INCOME TAX REVENUE

FISCAL YEAR	ACTUAL COLLECTIONS	PERCENTAGE CHANGE
1967-68	$222,677,673	...
1968-69	273,429,980	+ 22.8%
1969-70	282,768,933	+ 3.4%
1970-71	312,984,063	+ 10.7%
1971-72	365,378,374	+ 16.7%
1972-73	441,900,952	+ 20.9%
1973-74	468,967,445	+ 6.1%
1974-75	547,125,306	+ 16.7%
1975-76	614,575,116	+ 12.3%
1976-77	714,086,256	+ 16.2%
1977-78	854,815,907	+ 19.7%

SOURCE: Division of Legislative Services

Even though some of this increase could be attributed to the fact that Virginia has realized a modest increase in population, the overwhelming factor behind this increase is the gripping influence inflation has had on the Virginia income tax since the early 1960's. Table 2 lists the income brackets now contained in the tax and the percentage of total revenue that has shifted into upper taxable income brackets. For example, between 1972 and 1976, 6.5% of total revenue collections under the income tax moved from the lowest bracket to the next highest bracket (i.e., from the 2% bracket to the 3% bracket).

TABLE 2

INDIVIDUAL INCOME TAX REVENUE BY BRACKET AS PERCENT OF TOTAL INDIVIDUAL INCOME TAX REVENUE, Tax Years 1972 - 1976

NET INCOME BRACKET	PERCENT OF TOTAL REVENUE				
	1972	1973	1974	1975	1976
$ 0- 3,000	23.0	21.1	19.3	18.0	16.5
$ 3,001- 5,000	15.4	14.7	13.9	13.3	12.6
$ 5,001-12,000	37.5	37.7	38.2	39.2	39.4
$12,001 +	23.9	26.2	28.4	29.4	31.2

SOURCE: Division of Legislative Services

This same inflationary phenomenon also has a detrimental effect on the standard deduction and personal exemptions which have remained at their current amounts since 1971. The actual value of these deductions in inflated dollars decreases each year.

True indexing of an income tax, which has been accomplished in several states, results in an adjustment to the bracket limits and the deductions and exemptions by a figure representing the annual increase in cost of living. Some states use the Consumer Price Index–all items–Bureau of Labor Statistics of the U. S. Department of Labor. Other states only index the brackets, while others index only the exemptions and deductions. Some states have devised their own procedure for computing the annual increase in the cost of living.

The purpose of indexation is to tax only true growth in income and not income received by a taxpayer to enable him to maintain his current economic position in 'the community. Even though many Virginians boast that there has not been a general tax increase since 1966, the income tax will perpetually increase each year if left unchecked.

V. RETIREMENT INCOME TAX CREDIT

The Virginia retirement income tax credit was enacted into law as Chapter 781 of the 1976 Acts of Assembly to bring uniformity and equity to the income tax treatment of retirement income. The credit is computed by using the maximum social security benefit allowable to a single beneficiary of the taxpayer's age as the base and reducing this amount by the actual social security benefits or railroad retirement benefits, as the case may be, actually received by the taxpayer. The base is further reduced by an amount equaling twice the amount of the adjusted gross income received by the taxpayer in excess of $12,000. The remaining base is then multiplied by a factor of 5% and the resulting sum equals the retirement income tax credit.

Prior to the enactment of the retirement income tax credit, Virginia permitted certain subtractions of retirement income from federal adjusted gross income to derive Virginia taxable income. Retirees from civilian service for the federal government were given a $2,000 deduction and retirees from the armed forces who had reached sixty years of age were given the same deduction. A $1,000 deduction was also given to the retirees surviving spouse. All other retirees, 65 years of age or older, were given a deduction of the first $2,000 received by such retirees over and above their social security benefit. Retirement benefits received under the Virginia Supplemental Retirement System (VSRS) were totally excluded from Virginia taxable income.

The result of such treatment of retirement income was that many retirees were unhappy and most retirees felt they were being treated poorly when compared to other classes of government employees. The solution was the retirement income tax credit which treats all retirement income, except VSRS benefits, the same and grants tax relief not on the basis of the source of the income received by the retiree, but on the amount of total income received by the retiree. The credit also was founded on the principal that the Commonwealth should not gain financially as a result of the credit at the expense of retirees. It was estimted that in 1975, under the then existing subtractions for retirees, the program was costing approximately $12 to $14 million. The total relief granted under the retirement credit for 1976, however, equaled only $5.5 million. This figure increased to $7.3 million in 1977. The average credit given also increased from $77 per taxpayer in 1976 to $83 in 1977. As retirees become educated as to the applicability of the credit, it is anticipted that $12 million will in fact be reached or exceeded. Even though the credit formula is clearly explained on the State income tax form, there is normally a lag between the time any change is made till the time the taxpayer makes himself knowledgeable as to how the change works.

VI. DEDUCTION OF FEDERAL INCOME TAX

Another issue the Joint Subcommittee discussed was the deduction of federal income taxes from the State income tax. Of the forty-three states that levy an income tax, sixteen have allowed a full or partial deduction of the federal income tax. Ten of these sixteen states allow a deduction of all federal income tax. (See Appendix VI.)

Three aspects of allowing this deduction were discussed. The first was cost. Based on 1976 federal income tax data, the Commonwealth would have lost $138.3 million in revenue during the tax year 1976 if all State income tax filers had been allowed this deduction. Breaking this figure down, the impact of allowing the deduction for persons filing short form returns would have been $47 million and for those filing itemized returns $91.3 million.

The second aspect discussed was the relation of federal income tax liability of Virginians to personal and federal ajusted gross income. The Joint Subcommittee learned the federal income tax liability as a percentage of personal income was 10.8 percent for tax year 1976. As a percentage of federal adjusted gross income, federal tax liability was 13.7 percent for the same year. (See Appendix VII.)

The third aspect examined was a comparison with Virginia and those states allowing the deduction of federal income tax. The Joint Subcommittee learned that other states have from one to twenty-four income tax brackets with rates ranging from 0.5 percent to 17.0 ercent. (See Appendix

VIII.) Those states allowing a deduction of the federal income tax had brackets ranging in number from one to seventeen with rates ranging from 0.5 percent to 17.0 percent. (See Appendices IX and X.)

The Joint Subcommittee also looked at the effective tax rate of some states allowing a full deduction of the income tax for a more realistic comparison of those states allowing such a deduction to Virginia's rate structure. (See Appendix XI.) Those states examined were Minnesota, Iowa, and Arizona. The Virginia rates were lower than those of Minnesota and Arizona in all AGI classes. The Virginia rate exceeded the rates of Iowa only in income classes of $5,000 and less. Thus, one conclusion that may be reached is that most of those states allowing a deduction of the federal income tax have a higher rate structure.

VII. PROGRESSIVITY

The Joint Subcommittee discussed also the issue of the progressivity of the Virginia Income Tax. A progressive tax is one in which the rate increases as the tax base increases. Thus the Virginia income tax, with its nominal rates increasing as income increases, has, technically, a progressive income tax structure.

A review of Appendix VIII will show that most states levying the personal income tax have a nominal progressive structure. This same table will also show that some twenty-eight states have a more progressive structure than Virginia as their tax is spread over a greater number of income brackets with accompanying rates.

A review of Appendix XI will also show that the Virginia structure is progressive up to the incomes of greater than $100,000, at which point the rate decreases. The Minnesota rate structure also decreases at this point.

VIII. INCOME TAX WITHHOLDING

The last of the major subjects considered by the Joint Subcommittee was an examination of the income tax withholding schedules. It was evident from the fact that total individual income tax refunds for fiscal year 1979 exceeded $209 million, that a problem may exist in the current formula for income withholding. The 1979 figure exceeds the 1973 refund total of $68 million four-fold.

The issue is a simple one. Is it wiser to over-collect from taxpayers through withholding and refund the money back at a later date, thereby insuring that all monies due the Commonwealth through the income tax are collectible, or decrease the schedules so that some classes of taxpayers will receive less refunds and other taxpayers will owe the Commonwealth additional taxes? The present formula allows for withholding at a level sure of producing the tax that would be due the Commonwealth when the filing of a return is made. There are advantages and disadvantages to both positions.

The withholding schedules are developed by the State Tax Commissioner, however, it is highly unlikely that any change would be made in the current withholding tables without legislative approval. For an indepth discussion of income tax withholding, see pages 72 through 78 of *Issues for Individual Income Tax Reform in Virginia* located in Appendix V.

IX. MISCELLANEOUS CONSIDERATIONS

Child Care Deduction--

Prior to the Tax Reform Act of 1976, the deduction against federal income tax for child and other dependent care flowed through on the Virginia income tax via the conformity statute. The deduction was against adjusted gross income for only those taxpayers itemizing. The Reform Act, however, changed the dependent care relief measure from a deduction to a credit. Since there is no flow through of credits under the Virginia conformity statute, many Virginians were deprived of this relief. The federal government made the change to allow all taxpayers, regardless of whether they itemize or take the standard deduction, to benefit from this relief.

In 1976 the General Assembly attempted to correct the problem by permitting a deduction equal to five times the amount of the federal credit. The figure five was determined to be the factor

necessary to inflate the federal credit to an equivalent State deduction. The 1976 action, however, extended the relief to only those taxpayers itemizing their deductions which essentially put Virginians in status quo with prior Tax Reform Act of 1976 law.

In 1978, the General Assembly concluded that the child and dependent care deduction should apply to all taxpayers regardless of method of filing. This action placed applicable Virginia taxpayers in an equivalent position with the philosophy taken by Congress. There no longer appear to be inequities in Virginia regarding the child and dependent care issue.

Consumer Utility Tax--

Another deduction examined by the Joint Subcommittee was the local consumer utility tax, prmitted under State law and imposed on a permissive basis by counties and cities in the Commonwealth. The considerations included whether the tax could be reconstructed so as to be deducted as a tax for federal income tax purposes and if not, whether the tax should be permitted as an itemized deduction on the Virginia income tax. The Joint Subcommittee ascertained that the tax would have to be abolished and the State 4% sales tax applied to items representing the base to be considered deductible at the federal level. The Joint Subcommittee concluded that this was not the proper study to address this particular issue with the broad-reaching effects that such a change would have and that any such deduction at the State level would result in further movement away from the original concept of income tax conformity.

Respectfully submitted,

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Joseph A. Leafe, Vice-Chairman
Herbert H. Bateman
John C. Buchanan
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APPENDIX I

SENATE JOINT RESOLUTION NO. 21

Requesting that a Joint Subcommittee of the Senate and House Finance Committees be appointed to study the Virginia Individual Income Tax structure.

WHEREAS, equity in the treatment of the citizens of Virginia is of prime importance in the formulation of the Commownealth's tax structure; and

WHEREAS, the constantly changing environment of the Commonwealth, including its citizens, its economy, and its needs necessitates a constant monitoring and examination of the equity and fairness of its taxes; and

WHEREAS, the Virginia Individual Income Tax has clearly become the largest source of revenue to the Commonwealth and is the largest State tax paid by a large number of Virginians; and

WHEREAS, increasing levels of income stemming from inflation and the progressive nature of the income tax structure have increased the burden of the tax as well as magnified the inequities of the tax; and

WHEREAS, beginning with taxable year nineteen hundred seventy-two Virginia conformed with the federeal income tax structure for reasons of equity and administrative simplicity; and

WHEREAS, in the past few years, the Tax Reduction Act of 1975, the Tax Reform Act of 1976, and the Tax Reduction and Simplification Act of 1977 have caused the acceleration of the divergence of the Virginia and United States income tax structures which has caused Virginia and its taxpayers to lose a substantial portion of the benefits gained when conformity was adopted; and

WHEREAS, other major areas of the income tax structure also need to be explored and analyzed, such as, the marriage penalty, the increased use of credits rather than exemptions at the federal level; a decreasing reliance on the standard deduction, as well as the effect of anticipated future federal reforms; and

WHEREAS, the Commonwealth wishes to ensure that Virginia tax laws remain as equitable as possible; now, therefore, be it

RESOLVED by the Senate of Virginia, the House of Delegates concurring, That a Joint Subcommittee of the Senate and House Finance Committees be appointed to study the Virginia Individual Income tax structure including its conformity, rates and exemptions and to present recommendations that would improve the equity of the income tax.

The Joint Subcommittee shall be composed of eight members who shall be appointed in the following manner: four members appointed by the chairman of the Senate Finance Commitee from the membership of that committee and four members appointed by the chairman of the House Finance Committee from the membership of that committee. The Joint Subcommittee shall elect one of its members to serve as its chairman.

The legislative members of the Joint Subcommittee shall receive such compensation as is authorized by law for members of the General Assembly and be reimbursed for their expenses incurred for the work of the Joint Subcommittee. The Division of Legislative Services shall serve as staff and all officials and employees of all State agencie shall cooperate fully with the Joint Subcommittee.

The Joint Subcommittee shall make a report of its findings, deliberations, and recommendations to the Governor and the General Assembly not later than November one, nineteen hundred seventy-nine.

APPENDIX II

HOUSE JOINT RESOLUTION NO.__

Continuing the Joint Subcommittee studying the individual income tax structure.

WHEREAS, a Joint Subcommittee of the Senate and House Finance Committees was established pursuant to Senate Joint Resolution No. 21 by the nineteen hundred seventy-eight General Assembly to study the Virginia individual income tax structure; and

WHEREAS, the Joint Subcommittee met numerous times during the 1978 and 1979 interim and examined the so-called marriage penalty, complete conformity with the federal income tax system, exemptions and deductions, indexation, progressivity of the tax rate structure, and various credits provided at the state and federal level; and

WHEREAS, the Joint Subcommittee has filed with this session of the General Assembly a report, however, it did not finalize its recommendations concerning those issues before it; now, therefore, be it

RESOLVED by the House of Delegates, the Senate concurring, That the Joint Subcommittee of the Senate and House Finance Committees studying the Virginia individual income tax is hereby continued for an additional year to finalize its recommendations to the Governor and the General Assembly. The Joint Subcommittee shall complete its work on or before October one, nineteen hundred eighty.

The membership of the Joint Subcommittee shall consist of those same members serving on the Subcommittee pursuant to Senate Joint Resolution No. 21 of the nineteen hundred seventy-eight session.

Appendix III

FEDERAL

MARRIED COUPLE (zero children)

Husband	$25,000	
Wife	12,000	$4,500 in itemized deductions
	$37,000	

$37,000 - Gross Income
35,700 - Taxable Income

$ 8,100 - Tax Table Schedule B

UNMARRIED COUPLE

Male	$25,000	- Owning house and having it in his name and having deductions of $3,800
Female	$12,000	- Taking standard deductions
Male	$25,000	- Gross Income
	22,650	- Taxable Income
	$ 5,230	
	456	
	$ 5,686	- Tax for Male from Schedule X
Female	$12,000	
	1,679	- Tax from Tax Table A

Total Tax Due..... 5,213
1,679
$6,892

Difference........ $8,100
6,892
$1,208 - On Federal Taxes

VIRGINIA

MARRIED COUPLE (zero children)

Husband	$25,000	
Wife	12,000	$4,500 in itemized deductions (Reduce itemized deduction by guesstimated state withholding of: $1,500 = $3,000)

$37,000 - Gross Income

Tax = $ 470.00
1,161.50
$1,631.50

UNMARRIED COUPLE

Male	$25,000	Same facts as Federal Computation
Female	$12,000	

$25,000
3,000
$21,400
600
$20,800

Male - Gross $25,000 Tax: $470 = $506 = $976

Female- Gross $12,000
9,600 (1800 + 600)
Tax: $349.88

Total Tax: $1,325.88 of Male & Female
Difference of: $ 305.62

MARRIED - Filing Separate

Husband	$25,000
Wife	$12,000

Wife - $12,000
600
$11,400

Husband - $25,000
600
$24,400
3,600
$20,800

$439.88 - Tax from Wife ... $976 - Tax from Husband
TOTAL: $1,415.00

- $1,415.00
1,325.00
$ 90.00 - Penalty Difference

Appendix III
(continued)

FEDERAL

MARRIED COUPLE (zero children)

Husband $18,000
Wife 0

Taking standard deduction

Total Tax - $ 2,411 - From Tax Table B

UNMARRIED COUPLE

Male $18,000
Female 0

Tax Total - $ 3,363 - From Tax Table A

UNMARRIED COUPLE PAYS- $952.00 more

VIRGINIA

MARRIED COUPLE

Husband $18,000
Wife 0

Standard deduction

Total Gross $18,000
- 1,200
$16,800
2,000
$14,800

Total tax - $631.00

UNMARRIED COUPLE

Male $18,000
Female 0

Total tax - $666.00

MARRIED COUPLE - Filing separate

Total tax - $631.00

FEDERAL

Appendix III
(continued)

MARRIED COUPLE (zero children)

Husband $15,000
Wife $ 9,000 Taking standard deduction

$24,000 - Gross Income

Tax from Tax Table B.... $4,011

UNMARRIED COUPLE (zero children)

Male $15,000 Tax liability = $2,472
Female $ 9,000 1,007
$3,479

$4,011
3,479
$ 2 = Difference

VIRGINIA

MARRIED COUPLE (zero children)

Husband $15,000
9,000
$24,000
2,000 - standard deduction
$22,000
1,200 - Less personal exemptions
$20,800

TAX... $976

UNMARRIED COUPLE

		Male		Female	
Male	$15,000	$15,000		$ 9,000	
Female	$ 9,000	2,000	- standard	1,350	- standard
		$13,000		$ 7,650	
		600		600	- Personal
		$12,400		$ 7,050	exemption
	Tax Liability:	$ 493	Tax Liability:	$ 222.38	

Total Tax: $ 493.00
222.38
$ 715.38

$ 976.00
715.38
$ 260.62 - Difference

MARRIED - Filing Separate

Husband $15,000
Wife $ 9,000

Husband
$15,000
2,000 - husband takes full standard deduction
$13,000
600
$12,400
Tax = $493

Wife
$ 9,000
600 - Personal exemption
$ 8,400
Tax - $289.88

$493.00
289.88
$782.88

$782.88
715.38
$ 67.50 - Difference

RESOLVED that the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to adopt the stock-ownership attribution rules of section 318, except for the 50 percent limitation contained in section 318(a)(2)(C), for purposes of determining whether control of a corporation exists in the context of acquisitions of stock or property which are made for the principal purpose of evading or avoiding tax;

FURTHER RESOLVED that the Section of Taxation is directed to urge upon the proper committees of the Congress amendments which will achieve the foregoing results.

RECOMMENDATION II

(TAX SECTION RECOMMENDATION NO. 1978-5)

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO PERMIT THE USE OF INVESTMENT TAX CREDITS TO THE FULL EXTENT OF TAX LIABILITY, AND TO ALLOW CARRYOVER OF UNUSED CREDITS INDEFINITELY.

RESOLVED that the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to permit the refund of an overpayment of income tax attributable to carryback or carryover of losses and credits to a taxable year with respect to which a timely petition has been filed in the Tax Court;

FURTHER RESOLVED that the Section of Taxation is directed to urge on the proper committees of the Congress amendments which will achieve the foregoing results;

FURTHER RESOLVED that the American Bar Association supports such amendment whether or not the Congress determines that it should be accompanied by a reduction in investment credit rates or appropriate other changes in the Internal Revenue Code to offset any revenue loss produced by the amendment.

RECOMMENDATION III

(TAX SECTION RECOMMENDATION NO. 1978-6)

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO ALLOW A CREDIT AGAINST TAX SO THAT NO MARRIED INDIVIDUAL HAVING EARNED INCOME SHALL PAY A GREATER TAX THEREON BECAUSE OF MARITAL STATUS.

RESOLVED that the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to allow, to married individuals, a credit against the tax imposed on their income, which credit shall be equal to the taxes which married individuals pay on their earned income in excess of the sum of the taxes each would pay on his or her earned income if unmarried, so that no married individual having earned income shall pay a greater tax thereon because of marital status;

FURTHER RESOLVED that the Section of Taxation is directed to urge on the proper committees of the Congress amendments which will achieve the foregoing results.

year is worth only 58 percent of a credit realized in the first year. A credit realized at the end of a ten-year carryover period is only worth 46 percent of a credit received in the year earned. The alternative of refundable credits was rejected because granting direct cash payments to a business otherwise than as an offset against taxes owed involves broader questions of policy. A limited carryover period longer than the present seven years was also rejected because any limit on the use of earned credits tends to frustrate the purpose of the credit, and there is little difference between administering a limited but long carryover period and administering unlimited carryover period.

The Section of Taxation has no earlier recommendation that is related to this Recommendation.

No member of the originating committee or of the Council of the Section of Taxation is known to have a material interest in the Recommendation by virtue of a specific employment or engagement to obtain the result of the Recommendation. The proposed amendment would have only prospective application and [illegible] affect clients in any pending matter.

RECOMMENDATION III

(TAX SECTION RECOMMENDATION NO. 1978-6)

Under the Code, higher tax rates apply to the taxable income of married individuals when each of them contributes approximately 20 percent or more to their total income than to equivalent taxable income of an unmarried individual. Thus, a husband and wife in some cases pay higher taxes on their individual incomes than they would pay if they were not married. For earned income at least, higher tax rates should not apply because individuals are married.

It is recommended that a credit be allowed to offset the additional tax which married individuals having earned income pay on such income because of marital status.

Discussion

The amount of additional tax which a husband and wife each having income pay on such income because of marital status, the so-called "marriage penalty," depends upon the amount of the aggregate income of the husband and wife and the ratio of their incomes, one to the other. The marriage penalty is caused by the relationship between the rate schedules for married individuals filing jointly or separately and the rate schedule for an unmarried individual. This relationship, established by the Tax Reform Act of 1969, was specifically designed to alleviate the disparity between taxes paid on equal income by married individuals and an unmarried individual. The relationship assures that an unmarried individual does not pay a tax more than 20 percent greater than the tax paid by married individuals with taxable income equal to the unmarried individual's taxable income.

Congress realized that, in alleviating the disparity between tax rates for married individuals and an unmarried individual, it would cause married individuals each of whom had income to pay more tax on their aggregate income than they would on their separate incomes if they were not married. However, Congress justified this result on the grounds that married individuals' expenses were likely to be less than two unmarried individuals' expenses. Congress concluded that since married individuals had a greater ability to pay taxes than unmarried individuals, it would impose higher tax rates on the income of married individuals than on the income of an unmarried individual.

From 1969, when Congress so justified the marriage penalty, to 1974, the latest year for which Form W-2 analysis is available, the number of joint returns filed by all married individuals rose less than four percent. In contrast, the number of joint returns filed by married individuals each of whom had wages rose more than ten percent. Because of the substantial increase in the number of

joint returns filed by married individuals both of whom were wage earners, and because of dramatic changes in the relative wages earned by these married individuals, the number of joint returns filed by husbands and wives who paid the marriage penalty increased from approximately nine million in 1969 to more than 13 million in 1974. In perspective, in 1974 approximately 70 percent of all joint returns filed by married individuals both of whom had wages were returns on which such individuals paid a marriage penalty. These returns represented approximately one-third of all joint returns filed in 1974 that reported wages. (It is probable that some married individuals who filed joint returns reporting income from self-employment but no wages, and some married individuals who filed separate returns, also paid a marriage penalty in 1974. At this writing statistics on the size of these groups are not available.)

Analysis of 1974 Form W-2 data also dispels the notion that the marriage penalty is paid only by the well-to-do. These data indicate that approximately 20 percent of the married individuals who paid the marriage penalty in 1974 had combined incomes of less than $10,000; 54 percent had combined incomes between $10,000 and $20,000; 25 percent had combined incomes between $20,000 and $50,000; and less than one percent had combined incomes in excess of $50,000.

While Form W-2 data are not yet available for years after 1974, Bureau of the Census statistics on family income in 1976 indicate that, of families with earned income, 62 percent had two or more earners, up from 59 percent in 1969. These statistics also reveal an actual reduction between 1969 and 1976 in the number of one-earner families. This indicates that the trend toward the two-earner family exists not only among new young families but among established couples as well.

Thus, as the number of two-earner married couples increases, the adequacy of Congress' justification, expressed in 1969, for taxing married individuals' income at higher rates than an unmarried individual's income is called into serious question. This is borne out by recent taxpayer unrest over the marriage penalty. (In its acute stages such dissatisfaction has produced "divorce-remarriage" tax planning challenged by the Service as " 'sham-transaction[s]' designed to manipulate for federal income tax purposes an individual's marital status as of the close of a taxable year." Rev. Rul. 76-255, 1976-2 C.B. 40).

These facts prompt the present proposal that the marriage penalty on earned income be eliminated. The Recommendation would serve the ends of tax equity and neutrality without, as is shown below, adding materially to the complexity of the Code.

The Recommendation would allow a credit against the taxes imposed by chapter 1. A husband and wife, each of whom has earned income, would determine the credit by calculating the sum of the taxes each would have paid on earned income if unmarried, after reducing earned income for personal exemptions, and an amount of income equal to that which would have been offset by the general tax credit (by resorting to the Tax Tables or current Form 1040 Schedule TC), and subtracting that sum from the tax imposed on their aggregate earned income, after the same reductions, as married individuals. A married individual filing a separate return would determine the credit in the same way, but would divide the credit by two at the end of the calculation.

If the sum of the taxes married individuals would have paid if the earned income of each were taxed at the rates for an unmarried individual were to exceed the tax they would pay at the rates for married individuals, a married couple would pay no additional tax. Thus, the Recommendation would eliminate the tax penalty while retaining the tax reward of marital status. The originating committee considered and rejected methods of increasing taxes on a "penalty-free" married couple to generate revenue that would offset the revenue lost because of the credit.

All adjustments to income, deductions, and credits would operate as if there were no married earners credit.

The tax rates applicable to the income of unmarried individuals would not be affected by the married earners credit.

The following examples illustrate how the married earners credit would have been calculated for income earned in 1977 by a husband and wife filing a joint return. In the first example, each spouse has earned income of $15,000: in the second example, one spouse has earned income of $10,000 and the other spouse has earned income of $20,000. (See table on following page.)

For the following reasons, the Recommendation is confined to a credit based on earned income.

The scope of the marriage penalty problem should be limited as much as is consistent with solving the problem for the taxpayers who are affected most by it. The statistics on income mentioned above suggest that more than three-quarters of the married individuals who pay the marriage penalty probably have

	Example #1			*Example #2*		
1. Tax on earned income as married filing jointly:						
a. Earned income of husband and wife	(1a)	$30,000		(1a)	$30,000	
b. Tax on (1a) as marrieds filing jointly	(1b)	5,939	(1) $5,939	(1b)	5,939	(1) $5,939
2. Sum of taxes on individual earned income if single:						
a. Earned income of husband	(2a)	$15,000		(2a)	$10,000	
b. Earned income of wife	(2b)	15,000		(2b)	20,000	
c. Tax on 2a	(2c)	2,457		(2c)	1,216	
d. Tax on 2b	(2d)	2,457	(2) $4,914	(2d)	3,999	(2) $5,215
3. Married Earners Credit			(3) $1,025			(3) $ 714

little or no income other than their earned income. Limiting the problem to earned income, therefore, removes the burden of the marriage penalty tax from the vast majority of the individuals who pay it.

Limiting the problem to the marriage penalty on earned income facilitates its solution from an administrative point of view. Married individuals could find the figures they would use to compute the married earners credit by referring only to their Forms W-2 or W-2P, their Forms 1099, or annual statements of profit and loss. They would not have to split ownership and proceeds from property between them to determine a result, as would be the case if all income were included in the problem.

If the problem were not limited to earned income, the few married individuals paying the marriage penalty who have unearned income, the higher bracket taxpayers, would be encouraged to shift property ownership between them to achieve the best tax advantage. The results of this maneuvering would make the solution to the marriage penalty problem more costly than the married earners credit proposed in the Recommendation.

For similar reasons, if the marriage penalty problem were not limited to

earned income, a vastly more complex solution than that proposed in the Recommendation would be necessary. Provision would have to be made to allocate deductions between spouses and to minimize the effect of numerous tax-avoidance devices designed to shift income between spouses as was done under pre-1948 individual filing.

Therefore the Recommendation is limited to address the marriage penalty problem only in respect of the difference between the tax due on two individuals' taxable earned income, on the one hand when they **are married**, **and** on the other hand when they are not.

Even so limited, the marriage penalty is susceptible to a broad spectrum of solutions. One is the imputation of earned income to a one-earner married couple to reflect an amount of income equal to the value of services rendered by the nonearner spouse for the family unit or the value of the nonearner spouse's time freed from labor-force employment. Whatever one's view of such an imputation of income, one can at least point out that receipt of such valuable services by the one-earner married couple justifies a difference in tax paid by one-earner and by two-earner married couples. The originating committee rejected this solution because of the administrative difficulties in placing values on such earned income. Additional problems are raised, for example, in the case of a two-earner married couple, when one of the spouses has part-time "service value" earned income and part-time "traditional" earned income.

Another solution that the committee considered and rejected is mandatory individual filing for married individuals with earned income who pay the marriage penalty. Individual filing raises numerous tax avoidance problems (family partnerships, etc.) that the committee believed could be avoided while still reducing substantially the burden of the marriage penalty. Optional individual filing, the term used to describe the often suggested solution of allowing one-earner married couples to split income as they presently do while allowing two-earner married couples to report their income individually, raises the same tax avoidance problems and adds administrative problems. Some of the latter are educating taxpayers about who has an option and when the option can or should be exercised, and predicting the revenue impact resulting from inappropriate exercise of the option. As the approach of the Recommendation to the marriage penalty problem is limited, individual filing is not necessary to effect it.

Another solution that the originating committee considered and rejected is a new rate table for married individuals that would result in the tax paid by such individuals equaling the tax that would be paid by two unmarried individuals with equal individual taxable earned income. While a new table might be useful if all income were in issue, as the committee limited the problem, a more limited solution, in the context of the present tax rate schedules and tables, is available.

Another solution considered and rejected by the committee is the allowance of a deduction against the earned income of married individuals. Such a deduction would be calculated so that for each tax bracket married individuals each of whom had earned income would reduce their taxable earned income sufficiently to produce an effective tax rate for that bracket which would not exceed the tax rate applicable to two unmarried individuals, each of whom had an equivalent amount of taxable earned income. The deduction is not as effective in solving the problem as is the solution proposed by the Recommendation. The deduction would be more to the advantage of high-income taxpayers than it would to the majority of the taxpayers who are paying the marriage penalty. In short, taxpayers for whom the penalty represents the highest percentage of taxes due, and whose numbers are greatest, would not receive the most relief under the deduction solution.

It is believed that the proposed solution to the problem posed by the burden of the marriage penalty on married individuals each of whom has earned income, a credit, would not encourage sham employment relationships to establish earned income for both spouses. If one spouse were to compensate the

other through a corporation, partnership, or other separate entity, and either spouse were to own stock (including ownership through attribution under section 318), present rules would make a "sham salary" a constructive dividend. These rules would still obtain if there were a married earners credit. (*See* Reg. § 1.162-7). Similarly, in the case of a partnership or other entity, a "sham salary" for a partner's or owner's spouse would raise the same assignment-of-income questions with a married earners credit that such avoidance devices raise today. Moreover, section 162 provides that to be deductible compensation must be reasonable in amount, based on services actually rendered, and actually paid or incurred. These rules would continue to deter sham compensation arrangements.

If one spouse, pursuant to a contract with the other spouse, were to compensate that spouse directly without use of a separate entity, it is submitted that, with tax avoidance as its primary purpose, this arrangement would in any event be insufficient to constitute an assignment of income from the earning spouse to the non-earning spouse. Moreover, if the contract for services were to result in remuneration for most domestic services in the home, such remuneration would be excluded from "wages" and therefore would not be included in the definition of "earned income" for the married earners credit. (*See* Reg. § 31.3401(a)(3)-1). As long as a plausible arrangement (for example, the provision of traditional domestic services in the home) would not suffice to achieve married earner status, taxpayers would not resort to implausible sham arrangements to become eligible for the credit.

Under the Recommendation, married individuals in community property states would still file joint returns, as would married individuals in common law states. The only difference is that under the Recommendation the tax result for married individuals in the community property states would be calculated in respect of each individual's earned income, since that is how the credit would be calculated. Married individuals' separate earned incomes already form the basis for calculating various federal taxes in community property states, and the calculation of the credit as if individuals were subject to tax solely on their own earned income does not raise a constitutional question.

The constitutionality of the tax rate schedules that produce the marriage penalty was upheld in *Barter v. United States*, 550 F.2d 1239 (7th Cir. 1977), *aff'g* 422 F. Supp. 958 (1976), *cert. denied*, 434 U.S. 1012 (1978).

The Section of Taxation has no earlier recommendation that is related to this Recommendation.

No member of the originating committee or of the Council of the Section of Taxation is known to have a material interest in this Recommendation by virtue of a specific employment or engagement to obtain the result of the Recommendation. It is recommended that the amendment be given only prospective application, so that clients would not be affected in any pending matter.

RECOMMENDATION IV

(TAX SECTION RECOMMENDATION NO. 1978-7)

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO ELIMINATE THE IMPOSITION OF INITIAL PRIVATE FOUNDATION EXCISE OR PENALTY TAXES FOR YEARS FOLLOWING THE TAXABLE YEAR IN WHICH THE CAUSE FOR IMPOSITION OF SUCH TAXES ARISES.

Summary

In the Tax Reform Act of 1969, Congress added to the Code a series of private foundation excise or penalty tax provisions designed to induce certain patterns of activity and operation by [illegible]

ISSUES FOR INDIVIDUAL INCOME TAX REFORM IN VIRGINIA

Issue Paper No. 8
Research Division
Department of Taxation
September, 1979

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SECTION 1:

INTRODUCTION

The individual and fiduciaries income tax is the state's largest source of general fund revenue. For fiscal year 1979, individual income tax collections totalled $966.6 million and represented 43.7 percent of total general fund revenues. In addition, the importance of the individual income tax as a revenue source has increased and will continue to increase over time. For example, only six years ago individual income tax collections for fiscal year 1973 totalled $441.9 million, or about half the current annual collection level, and represented 39.2 percent of total general fund revenues. By the end of fiscal year 1982, individual income tax revenues are projected to total $1,368 million, or over 50 percent of projected total general fund revenues.[1/] Obviously, any change to the state's current income tax structure could potentially have a significant revenue impact for the state.

This study of issues for individual income tax reform in Virginia was undertaken in response to Senate Joint Resolution No. 21, which was passed at the 1978 session of the General Assembly.[2/] This resolution established a joint legislative study committee to examine such issues as the equity of the income tax structure, the interrelationship between inflation and the progressivity of the tax structure, conformity to the

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1/ Based on the Governor's long term estimates of general fund revenues developed December 15, 1978.

2/ Appendix I attached to this paper contains the text of Senate Joint Resolution No. 21.

federal income tax structure, the impact of recent and anticipated federal legislative changes on Virginia taxpayers, the marriage penalty, the use of credits in lieu of exemptions, and changes in the use of the standard deduction. The resolution requires that the joint legislative committee make a report and formulate recommendations by November 1, 1979.

This study is intended to provide the Executive Branch background on selected issues with which to respond to any legislative recommendations and/or to develop its own tax reform package. The paper is organized into three major sections. Following this introduction is an analysis of advantages and disadvantages of conformity to the federal income tax structure. Also included is a brief discussion of the option available to states for federal administration and collection of state income taxes.

The next section begins with a description of the state's current income tax structure. In this section, we examine in detail such issues as alternatives to the current personal exemptions, the current treatment of taxpayers who must claim the standard deduction and alternatives, remedies for the marriage penalty, and the treatment of retired and elderly taxpayers. For the most part, we examine each of these issues in isolation and, where applicable, the revenue and distributional impacts of alternatives. Also included in this section is a discussion of the impact of inflation on the income tax structure and the taxpayer. However, currently available data and revenue estimating technology, as well as the uncertainties surrounding the possible reform in the foregoing areas, really preclude more than general discussion of indexation as an

alternative at this time. Therefore, we have not developed estimates of revenue and distributional impacts of alternatives for indexation. In addition, there have already been several recent studies and at least one current study of the impact of inflation on the Virginia income tax structure, all of which are referenced later in this paper. In this section, we also discuss briefly and in a general way the possibility for reform of the Virginia withholding formula. Since the issues surrounding withholding and its relationship with revenues, tax administration, and taxpayer burdens are highly complex, here we also reserve analysis of specific alternatives for a more detailed study of the issue to be completed at a later date.

In the final section of this paper, we develop two alternative tax reform packages drawing on the isolated analyses of each reform issue in the previous section. The packages are developed with the objectives of maintaining conformity to the federal income tax structure, correcting provisions that currently have the most serious adverse equity effects on the taxpayer, effecting reform without requiring a tax rate increase, and minimizing as much as possible the revenue impact of any change. This is accomplished primarily by redistributing the current tax burden among the taxpayers in a way that makes the tax structure more progressive. In conclusion, we emphasize that the alternatives presented in this paper, with respect to both individual issues and to combination tax packages, are intended only to provide fundamental background information that policy makers can use to formulate their own alternatives.

SECTION 2:

CONFORMITY TO THE FEDERAL INCOME TAX STRUCTURE

The adoption of conformity in 1972 had two objectives -- (1) to simplify the state income tax for the taxpayer and (2) to provide for more effective and efficient administration of the income tax. This section will discuss the specific advantages and disadvantages of conformity as they originally related to these two objectives and will examine how they have changed since 1972. In addition, it will examine the extensiveness of conformity to the federal income tax structure among the states. Finally, it will briefly examine the related alternative of federal administration of the state income tax.

Advantages of Conformity

For the Virginia taxpayer, conformity essentially meant two things. First, under the original conformity legislation, the law provided for the same standard deduction limits for state purposes as for federal purposes and the same allowable itemized deductions (with the exception of the itemized deduction for state income taxes). In addition, conformity required taxpayers to claim the same type and amount of deduction at the state level as at the federal level. Because of the differences in the federal and state amounts and types of deductions claimed prior to conformity, many taxpayers were required to maintain separate records for federal and Virginia tax purposes. Thus, the utilization of the same deductions eliminated the need for taxpayers to maintain two dif-

ferent sets of federal and state tax records. In addition, these features of conformity offered the taxpayer greater uniformity in the method by which he computed his federal and state income taxes. Both of these advantages obviously simplified the taxpayers' encounter with the state income tax.

Second, conformity meant that federal adjusted gross income (AGI) became the starting point in the calculation of Virginia income tax liability. Prior to the adoption of conformity, adjusted gross income for Virginia purposes was defined by Virginia law. For most taxpayers with only wage and salary income, federal and Virginia AGI were equivalent before and after the adoption of conformity. However, the adoption of federal AGI as the starting point eliminated the need to delineate at the state level those sources of unearned income that were subject to state income tax. In addition, federal AGI takes into account certain expenses (subtractions) related to the earning of income (i.e., employee business expenses, moving expenses, etc.). Therefore, conformity eliminated the need for many detailed state tax laws and rulings.

Furthermore, prior to conformity existing interpretations of state laws and rulings relating to these expenses and certain other allowances and deductions were not always easily referenced. Therefore, the potential existed for different interpretations of essentially the same set of taxpayer circumstances. Under conformity the availability of Internal Revenue Service (IRS) rulings offered both state tax administrators and tax practitioners easy access to interpretations of federal laws and regulations, provided uniform treatment of taxpayers at both the federal and state levels, and insured consistency in the treatment of Virginia

taxpayers appealing similar claims. Thus, the adoption of federal AGI as the state income tax base related favorably to the objective for simplification and at the same time allowed for more effective and efficient administration.

For the state, conformity offered two primary advantages. First, it offered a framework under which a larger number of more revenue productive audits could be performed and under which the degree of taxpayer compliance could be evaluated. Specifically, state tax authorities can enter into an agreement with the IRS to obtain federal tax return data on computer tape for taxpayers from their state. The data on these tapes can then be compared to equivalent tax return data items on state tapes to identify discrepancies in federal AGI, itemized deductions, number of dependents claimed, and other data and also to identify those taxpayers who filed federal returns but did not file state returns. Second, the IRS notifies state tax authorities when taxpayers have been assessed additional taxes as the result of a federal audit. In many cases, a federal audit resulting in a larger federal tax would also result in a larger state tax. These two advantages corresponded favorably to the objective for more effective and efficient administration.

In addition, as noted above, many state taxpayers who formerly claimed the standard deduction at the federal level but who found it more advantageous to itemize at the state level were under conformity required to claim the standard deduction for state purposes as well. Moreover, the federal standard deduction that Virginia automatically conformed to was significantly larger than the state's preconformity standard deduction. Therefore, the impact of the limitation that only taxpayers who

are eligible to itemize at the federal level may do so at the state level along with the larger federal standard deduction amounts was a substantial decline in the number of state tax returns with itemized deductions to be processed. Since returns with standard deductions require less review, they are less costly to process. Thus, conformity reduced the overall time and expense of processing state tax returns, thereby allowing more time to be devoted to auditing returns with a high potential for error and additional tax. Obviously, this feature also promoted administrative effectiveness and efficiency.

Disadvantages of Conformity

When policy makers were studying the concept of conformity, they recognized that there were two choices that could be made relating to the desired degree of conformity.[1/] One option was to conform to the federal income tax structure as it existed at a given point in time (i.e., a fixed base). The other option was to conform to the existing federal structure as well as all subsequent adjustments made to the structure by the Congress (i.e., a moving base). The disadvantages of conformity emanate from whichever base is chosen. The major disadvantage of the fixed base concept is that unless continuing adjustments are made at the state level to coincide with federal changes the state income tax structure gradually deconforms. Consequently, many of the advantages initially gained are lost. The major disadvantage of the moving base concept is that state tax liability and income tax revenue are automatically tied to many changes in the federal tax structure adopted by the Congress.

1/ D. French Slaughter, Jr., et. al., Toward a Simplified Income Tax System for Virginia Taxpayers (Richmond: Department of Purchases and Supply, 1967), p. 26.

Proponents of the moving base concept argue that any federal change that has an adverse impact on either the taxpayer or state revenues can be offset by compensatory adjustments to the state income tax laws. However, such amendments at the state level would also potentially deconform the tax structure. Apparently, policy makers believed that the disadvantages of conformity to a moving base were not serious enough to outweigh the numerous advantages of conformity as they related to the two objectives for simplification and greater administrative effectiveness and efficiency, since the original conformity legislation utilized the moving base concept.

Since 1972 the Congress has enacted several major changes to the federal income tax structure. Under the Tax Reduction Act of 1975 the federal standard deduction amounts were temporarily increased. Since the original conformity legislation provided that the Virginia income tax structure would automatically adhere to all such changes, federal tax reduction accomplished through larger standard deductions would have also reduced Virginia income tax revenues. Estimates developed during the consideration of the 1975 Act indicated that the larger standard deductions would have reduced state income tax revenues by $11 million during fiscal year 1976.[1/] The magnitude of this revenue loss during a period of slow economic growth was unacceptable to state policy makers, and consequently the 1975 General Assembly voted to freeze the Virginia standard deduction at its 1974 level for 1975. Under the Tax Reform Act of 1976, the Congress permanently extended and further increased the larger federal

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[1/] Barry E. Lipman, Richard D. Brown, et. al., Fiscal Prospects and Alternatives: 1976 (Richmond: June, 1975), p. 161.

standard deduction limits, and to again preclude a substantial state revenue loss the 1976 General Assembly voted to permanently freeze the Virginia standard deduction at its 1974 level. After temporarily and then permanently increasing the standard deduction amounts, under the Tax Reduction and Simplification Act of 1977 the Congress finally replaced them with zero bracket amounts. These zero bracket amounts were increased under the Revenue Act of 1978. The table below summarizes the changes that have occurred at the federal level since the adoption of conformity and compares the federal provisions with the Virginia provisions:

	Maximum Virginia Standard Deduction	Equivalent Federal Maximum			
		Standard Deduction		Zero Bracket Amount	
		1975 Act	1976 Act	1977 Act	1978 Act
Single Persons	$2,000	$2,300	$2,400	$2,200	$2,300
Married Couples	2,000	2,600	2,800	3,200	3,400
Married Separate	1,000	1,300	1,400	1,600	1,700

With the increases in the federal standard deduction amounts and the subsequent adoption of zero bracket amounts and with Virginia's standard deduction frozen at 1974 levels, the Virginia income tax structure has increasingly moved out of alignment with the federal structure. Obviously, the original moving base concept of conformity no longer applies, and Virginia now conforms partially to a fixed base (e.g., the 1974 federal standard deduction amounts) and partially to a moving base (e.g., any federal changes affecting federal AGI or allowable subtractions or itemized deductions). Therefore, some of the initial advantages of conformity have been lost, mostly those affecting the individual taxpayer. The conforming requirement that taxpayers may only itemize for Virginia purposes if they may itemize for federal purposes has impacted the state

income tax liability of many taxpayers. Specifically, taxpayers whose itemized deductions exceed their allowable Virginia standard deduction but are less than the current federal zero bracket amount have been subject to an increase in their state liability, because they are limited to a smaller Virginia standard deduction. This requirement does not impose a direct administrative burden on the state, but it could potentially encourage these taxpayers into noncompliance if they continue to claim (either intentionally or inadvertantly) itemized deductions for state purposes. For the state, the federal changes in the maximum standard deduction amounts and now the use of zero bracket amounts coupled with the limitation against itemizing unless permitted at the federal level have substantially reduced the number of state tax returns with itemized deductions, thereby further reducing processing costs. In addition, the frozen standard deduction has not only precluded a revenue loss, but coupled with the requirement for like federal and state deductions it has generated unintended additional revenue for the state.

In summary, Virginia currently conforms only partially to the moving federal base. Most of the broad advantages to the state gained initially remain intact. As the federal government has adopted changes to its standard deduction provisions and later adopted zero bracket amounts and as Virginia has remained frozen to the 1974 amounts, the simplicity of tax structure as it confronts the taxpayer has deteriorated. In addition, the effect has been an unintentional tax increase for those taxpayers with itemized deductions less than the federal zero bracket amount but greater than the Virginia standard deduction.

Conformity in Other States

There are essentially three different ways that a state can conform to the federal income tax structure. One way is to conform to federal AGI, as Virginia does, and to leave to state legislative discretion additions, subtractions, exemptions, deductions, and tax rates. A second way is to conform to federal taxable income and to leave to state discretion only applicable state income tax rates. This alternative is obviously more limiting to states, since it provides for complete adherence to a moving federal base. The final way that states can conform is by levying a state income tax that is some percentage of federal income tax (i.e., a piggyback tax). This alternative is even more limiting, because not only is the state income tax tied to a moving federal base but it is also tied to any changes in the federal income tax rate schedule.

Conformity began to gain popularity among the states beginning in the 1950's and 1960's, a period when the federal income tax structure was relatively stable.[1/] The advantages of conformity coupled with a stable tax base encouraged many states to adopt conformity legislation. Currently there are 41 states with broad based income taxes. Of these 41 states, 34 have opted for one of the three types of conformity. Conformity to federal AGI is the most widely used method, with 22 states (including Virginia) defining it as the starting point in the calculation of their state income taxes. Eight states reference federal taxable income as the starting point, and four states have piggyback taxes as a percentage of the federal tax.

1/ Leon Rothenberg, "The Impact of Federal Tax Changes on State Taxation", Revenue Administration 1978: Proceedings of the Forty-Sixth Annual Meeting of the National Association of Tax Administrators, (Federation of Tax Administrators: Washington, D.C.), p. 39.

As noted above, those states that conform to either federal taxable income or that use a piggyback tax have less flexibility and are more affected by federal income tax changes. Specifically, as the federal government has effected tax cuts by reducing taxable income and/or tax rates, these states have automatically experienced state income tax cuts. Some states, in order to avoid a serious revenue loss, have had to enact higher state tax rates. Although these states may have enacted higher tax rates merely to offset the effect of federal tax reductions, many taxpayers have unhappily perceived the state action as a tax increase.

On the other hand, states that are tied to federal taxable income have experienced problems in both directions. After various federal changes that reduced taxable income (i.e., increases in the old standard deduction, new itemized deductions, and increases in exemptions), the federal government repealed the standard deduction and replaced it with zero bracket amounts. These zero bracket amounts are built into the federal rate tables and essentially represent a bracket amount of income on which a zero tax rate applies. Since the zero bracket amount is part of the tax rate schedule and since standard deductions are no longer subtracted from federal AGI to arrive at federal taxable income, the effect is a significantly larger federal taxable income amount. For states that start with federal taxable income, the result has been an unintended but automatic tax increase. Taxpayers in some of these states have pressed for offsetting tax relief, while other states have received a revenue windfall.

The recent problems that conformity states have experienced relative to the numerous federal tax cuts can and have been handled in several ways. First, states can, as Virginia has done, freeze their state income tax

structure or parts of it at a given point in time. This, however, complicates both state tax administration and taxpayer understanding and thereby diminishes some of the broad advantages of conformity. Second, states can revert from conformity to a state defined income tax. This alternative has not been exercised by any state, presumably because the advantages to be gained by at least some degree of conformity are viewed to exceed the disadvantages. Some states have, however, considered amending the degree to which they conform to the federal tax structure. Specifically, at least two states with piggyback taxes have recently considered switching to federal AGI as their starting point.[1] The final alternative is for the conforming states to be more vocal and influential when federal income tax changes are being considered. Traditionally, the states have had the responsibility for tracking federal tax changes and reacting as necessary after the changes become law. However, if the states as a group recognize that a given federal tax proposal potentially has an adverse effect on state tax administration and state revenues, state governments should make the Congress aware of these effects. It is possible that the proposed federal legislation could be amended to avoid the potential problems. In addition, since the federal income tax is an instrument of national fiscal policy, it can be argued that a federal tax cut or tax hike that is not offset by unknown counter or complimentary effects at the state income tax level will be more effective in achieving the desired stimulatory or contractionary goal.

1/ Leon Rothenberg, "The Impact of Federal Tax Changes on State Taxation," p. 38.

Federal Administration of State Income Taxes

In 1972, when federal general revenue sharing was adopted, the federal government also enacted legislation allowing for federal administration and collection of state income taxes. This provision was an offshoot of the relative importance of state income tax revenues in the revenue sharing allocation formula. Since some states did not have income taxes, the federal government made available to the states its own collection and administration framework so that these states could if they wished quickly adopt and implement an income tax. Essentially, the federal law allows all states, including those with income taxes already in place, to elect federal administration. However, none of the states has exercised the option to have the Internal Revenue Service administer and collect the tax.

Briefly, any state that would opt for federal administration must adopt a state income tax whose base is either federal taxable income or federal tax liability.[1/] The state could enact a single tax rate or a graduated tax rate schedule for application to federal taxable income, or it could enact a flat state tax rate that is essentially a percentage of federal income tax (i.e., a piggyback tax). Employer withholding would take into account both federal and state income tax liability and would be paid to the federal government, which would then return state income tax revenues to the state government. The taxpayer would file one tax return with the federal government.

Proponents of federal administration cite various advantages to the concept. First, federal administration would eliminate duplication of

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1/ As noted earlier, states that conform their income tax to the federal structure but administer their own tax can also use either of these bases.

effort between federal and state government with respect to collection, administration, and processing. Second, it would simplify tax compliance for the taxpayer, since only one tax return would be filed. Third, it could potentially accelerate state income tax collections, which could generate a one-time revenue windfall for the state. However, any windfall would depend upon the frequency of the federal withholding payment schedule relative to the state's current withholding payment schedule, the amount of overwithholding built into the federal withholding tables relative to the state tables, and the frequency that the federal government returned revenues to the state. Finally, state tax administrative costs would be reduced, since the federal government would assume all collection, compliance, processing, and other administrative responsibilities at no charge to the state.

Critics of federal administration cite three primary disadvantages. Since states must elect either federal taxable income or federal tax liability as the state income tax base and since both of these tax bases can change significantly whenever the Congress enacts tax cuts, state revenues are at the mercy of federal discretion. As noted in the previous section, the states could respond by enacting higher state tax rates to offset any potential loss, but the perception among taxpayers would in all likelihood still be that the state had increased taxes. Moreover, it is unclear whether a state could react quickly enough in amending its tax rates to avoid a potential state revenue problem caused by Congressional action. Obviously, then, the biggest disadvantage of federal administration is the potential reduction in control that states would have over their financial affairs.

Second, federal administration, with its requirement that either federal taxable income or federal tax liability be used as the tax base, confines state tax policy to accepting federal definitions of income, subtractions, deductions, and exemptions with very little opportunity for any deviation. In other words, a state that currently accepts either of these two bases but administers its own tax can still enact whatever modifications its policy makers believe to be appropriate. However, this flexibility would be lost if federal administration were elected. Third, federal distributions of state income tax revenues would be made based on estimates of annual state income tax collections developed by the U.S. Treasury's Office of Tax Analysis (OTA). These estimates could be revised, if necessary, at any time by the OTA, but states could potentially be faced with receiving less revenues (based on a low estimate) than are actually flowing to the federal government or more revenues (based on a high estimate). Obviously, states would rather receive all of the revenues to which they are entitled as taxes are paid and could find it difficult to return any overpayment.

Most of the advantages of federal administration can be considered appealing to states that do not have an income tax in place. However, for Virginia the apparent advantages should be carefully weighed with the benefits already available through conformity. While it is true that federal administration would remove duplication of effort and reduce state tax administration and collection costs, it would also reduce compliance efforts. Currently, the state with its own compliance program can not only audit those taxpayers selected for audit for the IRS but can also focus its attention on other taxpayers it has identified through its own efforts. Thus, federal administration could actually

reduce compliance activities. Also, unless the IRS increased its manpower substantially, enforcement activities would quickly decrease. With respect to simplicity for the taxpayer as the result of the need to file only one tax return, the current state income tax using federal AGI as the starting point requires little, if any, additional bookkeeping for most taxpayers. In addition, it would be necessary for taxpayers from states electing federal administration to attach a supplementary schedule to their federal tax return to calculate their state income tax. Thus, the taxpayer would still be required to complete a state tax form. Moreover, the current state income tax return allows for deviations from federal tax policy with respect to tax relief (e.g., for elderly persons and low income filers) and to the collection of additional special taxes (e.g., the litter control tax on businesses). Finally, Virginia already has one of the most rapid withholding payment systems among the states, with many large employers filing payments on a quarter-monthly basis. (The majority of states require payments only on a monthly basis.) In fact, Virginia's quarter-monthly withholding payment schedule closely parallels the federal payment schedule. Thus, it is unlikely that federal administration could further accelerate the collection of withholding taxes. In addition, when coupled with the disadvantages associated with distributions of revenues based on estimates rather than actual collections and other potential cash/flow problems associated with any differences in overwithholding and refunds, federal administration for Virginia could actually be a step backward.

SECTION 3:

CURRENT ISSUES FOR STRUCTURAL REFORM

The Current Virginia Income Tax Structure

Under current law federal AGI is the starting point in the calculation of Virginia income tax. Federal AGI essentially includes income from wages and salaries, rents, royalties, and commissions, alimony received, annuities and retirement benefits (except social security), interest (except on state and local securities), dividends and other investment income, proprietorship and partnership business income, and certain other less common income items. Federal AGI excludes moving expenses, employee business expenses, alimony paid, a certain portion of disability payments, and certain contributions to retirement plans (i.e., Individual Retirement Accounts and Keogh plans). Virginia AGI is determined by adding certain income items to federal AGI that are constitutionally or statutorily nontaxable by the federal government and by subtracting certain other income items that are similarly nontaxable by Virginia. Specifically, Virginia AGI is derived from federal AGI by adding interest from obligations of other states and certain other income or loss items and by subtracting state income tax refunds (for taxpayers who itemize), a $400 exclusion for aged taxpayers, interest on U.S. obligations, state retirement benefits, and certain other income or loss items. For most taxpayers with only wage and salary income, federal and Virginia AGI are identical.

Married taxpayers who file joint returns at the federal level must either file a joint state return or a married combined return.[1/] Married taxpayers who filed separate federal returns must either file a separate or a married combined Virginia return. Virginia currently allows a $600 exemption for each personal, dependent, age and blindness exemption allowable at the federal level.[2/] (The federal exemption amounts for 1979 are $1,000.) Itemized deductions for Virginia purposes are with one exception equivalent to allowable federal itemized deductions. These include the broad groupings of medical expenses, various state and local taxes, most interest expenses, charitable contributions, casualty and theft losses, and various other miscellaneous expenses. (Virginia does not allow the itemized deduction for state income taxes that is allowable at the federal level.) Only taxpayers who itemize for federal purposes are permitted to itemize for state purposes. The Virginia standard deduction for single taxpayers and married taxpayers filing jointly or on a combined return is the greater of 15 percent of federal AGI or $1,300 but is limited to no more than $2,000. For married taxpayers who file separately the Virginia standard deduction is the greater

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[1/] The married combined return is filed by couples who each have income and who, in essence, file as separate taxpayers on one return. The advantage of filing in this manner is that deductions and dependent exemptions can be allocated between spouses as mutually agreeable in order to minimize total tax liability.

[2/] Virginia also allows a $400 exclusion for taxpayers age 65 and over, which in effect provides a $1,000 age exemption. This additional $400 exclusion was adopted in 1973 as a measure intended to restore the $1,000 preconformity age exemption.

of 15 percent of federal AGI or $650 but no more than $1,000.[1] After reducing Virginia AGI by the appropriate exemption and deduction amounts state income tax is calculated according to the following progressive tax rate schedule, which applies to all taxpayers regardless of marital status:[2]

Taxable Income	Tax Rate
$ 0 - 3,000	2%
3,001 - 5,000	3%
5,001 - 12,000	5%
12,001 and over	5.75%

Appendix II attached to this paper contains comparative information on the income tax structures of other states.

This section will analyze various issues that suggest reform to the current income tax structure. To estimate the aggregate and distributional effects of most of the alternatives presented, we utilize the Virginia income tax sampling model. This model is constructed from data taken from a sample of tax returns for taxable year 1977, the most recent year for which actual data are available. In short, this model allows us to

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1/ An additional deduction for child and dependent care expenses is also allowable for taxpayers who are eligible for the federal tax credit for these expenses. This child and dependent care deduction is available to all taxpayers, regardless of whether or not they itemize their deductions.

2/ A progressive income tax structure is one that exhibits an increasing ratio of tax to income as the level of income rises.

analyze the impact of various changes to exemptions, deductions, and rate schedules by income class.[1/]

Potential Modifications to the Current Structure

Personal, Dependent, Age, and Blindness Exemptions

Conceptual Background

Most experts agree that an equitable income tax structure is one that accounts for each taxpayer's ability to pay taxes.[2/] This "ability to pay" theory of taxation states that the income tax structure should demonstrate both horizontal and vertical equity. If persons with equivalent amounts of income pay equal amounts of tax, the tax structure displays horizontal equity. If persons are required to pay an equal or higher rate of tax as their level of income increases, the tax structure exhibits vertical equity.

An income tax structure should contain those tax provisions that are necessary to promote both horizontal and vertical equity by adjusting tax burdens to account for different circumstances that may affect one individual's ability to pay income taxes relative to the ability of another individual. For example, two persons may have equivalent incomes, but one individual may have several persons dependent upon him

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[1/] For a more lengthy discussion of the features of this model, see Robert T. Benton and Philip M. Gabel, "Uses of a State Income Tax Sampling Model" Revenue Administration 1977: Proceedings of the Forty-Fifth Annual Meeting of the National Association of Tax Administrators (Washington, D. C.: Federation of Tax Administrators), p. 160.

[2/] See, for example, Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice, Second Edition, (New York: McGraw-Hill Book Company, 1976), pp. 215-216.

for financial support while the other individual is responsible only for himself. Obviously, the first individual has less ability to pay taxes and should be required to pay less income tax than the second individual.

Also, two persons may have different amounts of income, but the person with the larger amount of income may actually have less ability to pay taxes if he has a larger family than the person with the smaller amount of income. The tax structure should also account for the impact of such factors on the relative taxpaying ability of these two individuals. Thus, one function of personal and dependent exemptions is to adjust tax liabilities for the effects of family size according to the "ability to pay" theory of taxation.

Another function of personal and dependent exemptions relates to the notion that there should be some minimum amount of tax-free income that is roughly equivalent to the amount of income required for minimum subsistence. This basic allowance should be granted to all taxpayers regardless of their level of income.[1/] Thus, the second function of personal and dependent exemptions is to remove from the tax rolls persons who only earn enough to provide themselves basic living essentials and who cannot really afford to pay tax.[2/] Obviously, the minimum subsistence level for larger families will be greater than for smaller families. Thus, the second function of personal and dependent exemptions relates favorably to the first function.

1/ Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice, p. 271.

2/ George F. Break and Joseph A. Pechman, Federal Tax Reform, The Impossible Dream?, (Washington, D.C.: The Brookings Institution, 1975), p. 27.

As far as the exemptions for age and blindness are concerned, there is really no theoretical justification for these provisions. Goode characterizes both of these provisions as simply makeshift welfare legislation and points out that they are unrelated to need and indiscriminately allowed to all taxpayers.[1/] Presumably, these exemptions were granted on the basis that both the aged and the blind have special living expenses. However, Goode suggests that these presumptions are questionable, with the elderly actually requiring less income to attain the same level of living as younger persons and the blind facing circumstances no different than other handicapped persons who do not receive an exemption. Goode further suggests that the repeal of both of these special exemptions would be justifiable, although probably not a high priority item.[2/]

Ironically, critics of the exemption mechanism also cite the "ability to pay" theory of taxation in pointing out the inequity of these provisions. Since the tax reduction value of any exemption is dependent upon the taxpayer's marginal tax rate, the exemption is worth more to higher income taxpayers than lower income taxpayers. Under the current state income tax structure, each $600 exemption is worth $12 to a taxpayer subject only to the lowest marginal tax rate, while each $600 exemption is worth $34.50 to a taxpayer in the highest tax bracket. Clearly, these values violate the concept of vertical equity by reducing taxes to a much greater extent for upper income persons than for lower income persons. While there is justification for differentiating tax liabilities

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1/ Richard Goode, The Individual Income Tax, Revised Edition, (Washington, D.C., The Brookings Institution, 1976), pp. 222-223.

2/ Richard Goode, The Individual Income Tax, Revised Edition, p. 223.

for different family sizes, there is really no justification for differentiating to a greater extent for higher income taxpayers than for lower income taxpayers. Additionally, if we assume that the first dollars of income received must be committed to subsistence expenses regardless of the family's total income, then the case can be made for a tax-free slice of income only at the bottom of the income scale. In other words, why should a taxpayer in an upper income level be permitted to subtract his tax-free income off the top at a higher marginal tax rate than a person subject to the lowest marginal tax rate?

Alternatives to the Current Provisions

Table 1 provides detailed data on the numbers of the various exemptions claimed by AGI class for taxable year 1977. Table 2 provides further data on the numbers of returns and numbers of personal and dependent exemptions cross-classified by AGI class and by total number of personal and dependent exemptions claimed per return. These distributions would, of course, not change under any alternative to the current law.

There are essentially two reform options relating to the current personal, dependent, age, and blindness exemptions. The first option would be to increase the personal, dependent, and blindness exemptions from their current $600 level to $1,000. Since the current $600 age exemption along with the $400 exclusion (subtracted from federal AGI) already provides the equivalent of a $1,000 exemption, no further increase to the $1,000 available to persons age 65 and over is considered. This alternative would bring into uniformity each of the four classes of exemptions, and it would also equate the Virginia exemptions with the federal exemptions. However, neither of these accomplishments would in

TABLE 1--NUMBER OF EXEMPTIONS BY TYPE
AND ADJUSTED GROSS INCOME (AGI) CLASSIFICATION--TAXABLE YEAR 1977

AGI Classification	Numbers of Exemptions by Type				Totals
	Personal	Dependent	Age	Blindness	
$ 0 - 999	105,901	17,437	11,170	136	134,644
$ 1,000 - 1,999	127,057	19,006	9,637	151	155,851
$ 2,000 - 2,999	123,857	26,185	14,329	160	164,531
$ 3,000 - 3,999	115,811	32,569	15,181	236	163,797
$ 4,000 - 4,999	117,225	40,465	15,649	293	173,632
$ 5,000 - 5,999	127,580	50,226	14,378	290	192,474
$ 6,000 - 6,999	123,952	54,417	12,731	295	191,395
$ 7,000 - 7,999	118,295	56,938	10,694	260	186,187
$ 8,000 - 8,999	114,412	57,753	9,402	200	181,767
$ 9,000 - 9,999	111,627	58,804	7,956	198	178,585
$10,000 - 10,999	107,974	59,943	6,829	199	174,945
$11,000 - 11,999	104,458	60,793	5,916	152	171,319
$12,000 - 12,999	101,850	60,613	5,411	141	168,015
$13,000 - 13,999	99,762	61,815	4,690	123	166,390
$14,000 - 14,999	99,561	63,125	4,145	133	166,964
$15,000 - 19,999	442,688	291,877	15,005	443	750,013
$20,000 - 24,999	309,379	210,205	9,260	250	529,094
$25,000 - 29,999	191,478	134,391	6,086	167	332,122
$30,000 - 34,999	112,197	81,114	3,930	95	197,336
$35,000 - 35,999	66,231	49,236	2,929	78	118,474
$40,000 - 44,999	41,746	31,123	1,891	39	74,799
$45,000 - 49,999	26,105	19,299	1,406	21	46,831
$50,000 - 74,999	42,774	32,129	3,184	51	78,138
$75,000 - 99,999	10,442	8,785	1,134	14	20,375
$100,000 - over	10,434	8,330	1,491	19	20,274
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All AGI Classes	2,952,796	1,586,578	194,434	4,144	4,737,952

SOURCE: Department of Taxation printout.

TABLE 2 -- NUMBER OF RETURNS AND NUMBER OF EXEMPTIONS CLASSIFIED BY ADJUSTED GROSS INCOME (AGI) CLASS AND BY NUMBER OF EXEMPTIONS DECLARED OTHER THAN AGE OR BLINDNESS -- TAXABLE YEAR 1977

	Number of Exemptions Declared Other Than Age or Blindness						
AGI Classification	1	2	3	4	5	6/over	Total
$ 0-999							
Number of returns	74,048	10,761	3,155	2,188	1,034	665	91,851
Number of exemptions	74,048	21,522	9,465	8,752	5,170	4,381	123,338
$1,000-1,999							
Number of returns	97,155	11,404	3,450	1,940	863	555	115,367
Number of exemptions	97,155	22,808	10,350	7,760	4,315	3,675	146,063
$2,000-2,999							
Number of returns	82,439	15,176	5,016	2,743	1,207	791	107,372
Number of exemptions	82,439	30,352	15,048	10,972	6,035	5,196	150,042
$3,000-3,999							
Number of returns	67,446	16,958	6,148	3,506	1,522	1,057	96,637
Number of exemptions	67,446	33,916	18,444	14,024	7,610	6,940	148,380
$4,000-4,999							
Number of returns	58,844	20,202	7,722	4,248	1,880	1,332	94,228
Number of exemptions	58,844	40,404	23,166	16,992	9,400	8,884	157,690
$5,000-5,999							
Number of returns	58,506	22,609	9,878	5,295	2,452	1,672	100,412
Number of exemptions	58,506	45,218	29,634	21,180	12,260	11,008	177,806
$6,000-6,999							
Number of returns	50,775	22,258	10,597	6,205	2,758	1,921	94,514
Number of exemptions	50,775	44,516	31,791	24,820	13,790	12,677	178,369

Continued on next page.

TABLE 2 -- NUMBER OF RETURNS AND NUMBER OF EXEMPTIONS CLASSIFIED BY ADJUSTED GROSS INCOME (AGI) CLASS AND BY NUMBER OF EXEMPTIONS DECLARED OTHER THAN AGE OR BLINDNESS -- TAXABLE YEAR 1977 (Continued)

AGI Classification	Number of Exemptions Declared Other Than Age or Blindness						Total
	1	2	3	4	5	6/over	
$7,000-7,999							
Number of returns	42,729	21,368	10,845	6,906	3,087	2,138	87,073
Number of exemptions	42,729	42,736	32,535	27,624	15,435	14,174	175,233
$8,000-8,999							
Number of returns	37,534	20,447	10,850	7,243	3,367	2,345	81,786
Number of exemptions	37,534	40,894	32,550	28,972	16,835	15,380	172,165
$9,000-9,999							
Number of returns	33,101	19,463	10,949	7,737	3,629	2,501	77,380
Number of exemptions	33,101	38,926	32,847	30,948	18,145	16,464	170,431
$10,000-10,999							
Number of returns	27,932	18,669	11,086	8,165	3,916	2,578	72,346
Number of exemptions	27,932	37,338	33,258	32,660	19,580	17,149	167,917
$11,000-11,999							
Number of returns	23,157	18,205	11,003	8,644	3,935	2,782	67,726
Number of exemptions	23,157	36,410	33,009	34,576	19,675	18,424	165,251
$12,000-12,999							
Number of returns	19,141	17,775	11,264	8,878	3,993	2,789	63,840
Number of exemptions	19,141	35,550	33,792	35,512	19,965	18,503	162,463
$13,000-13,999							
Number of returns	15,817	17,024	11,507	9,306	4,304	2,784	60,742
Number of exemptions	15,817	34,048	34,521	37,224	21,520	18,447	161,577
$14,000-14,999							
Number of returns	13,327	16,739	11,445	10,138	4,397	2,858	58,904
Number of exemptions	13,327	33,478	34,335	40,552	21,985	19,009	162,686
$15,000-19,999							
Number of returns	37,547	71,753	53,202	50,580	21,798	12,600	247,480
Number of exemptions	37,547	143,506	159,606	202,320	108,990	82,596	734,565
$20,000-24,999							
Number of returns	14,389	48,679	37,352	38,707	16,949	8,665	164,741
Number of exemptions	14,389	97,358	112,056	154,828	84,745	56,208	519,584
$25,000-29,999							
Number of returns	6,547	29,393	22,234	25,142	11,304	5,706	100,326
Number of exemptions	6,547	58,786	66,702	100,568	56,520	36,746	325,869
$30,000-34,999							
Number of returns	3,039	17,232	12,499	14,778	7,045	3,705	58,298
Number of exemptions	3,039	34,464	37,497	59,112	35,225	23,974	193,311

TABLE 2 -- NUMBER OF RETURNS AND NUMBER OF EXEMPTIONS CLASSIFIED BY ADJUSTED GROSS INCOME (AGI) CLASS AND BY NUMBER OF EXEMPTIONS DECLARED OTHER THAN AGE OR BLINDNESS -- TAXABLE YEAR 1977 (Continued)

AGI Classification	Number of Exemptions Declared Other Than Age or Blindness						Total
	1	2	3	4	5	6/over	
$35,000-39,999							
Number of returns	1,653	10,265	7,015	8,428	4,513	2,457	34,331
Number of exemptions	1,653	20,530	21,045	33,712	22,565	15,962	115,467
$40,000-44,999							
Number of returns	925	6,485	4,520	5,171	2,808	1,641	21,550
Number of exemptions	925	12,970	13,650	20,684	14,040	10,690	72,869
$45,000-49,999							
Number of returns	577	4,140	2,781	3,181	1,762	1,028	13,469
Number of exemptions	577	8,280	8,343	12,724	8,810	6,670	45,404
$50,000-74,999							
Number of returns	1,110	6,770	4,326	5,144	3,030	1,784	22,164
Number of exemptions	1,110	13,540	12,978	20,576	15,150	11,549	74,903
$75,000-99,999							
Number of returns	368	1,494	926	1,245	877	568	5,478
Number of exemptions	368	2,988	2,778	4,980	4,385	3,728	19,227
$100,000-over							
Number of returns	507	1,760	899	1,029	786	607	5,588
Number of exemptions	507	3,520	2,697	4,116	3,930	3,994	18,764
*****							
All AGI Classes							
Number of returns	768,613	467,029	280,669	246,547	113,216	67,529	1,943,603
Number of exemptions	768,613	934,058	842,007	986,188	566,080	442,428	4,539,374

SOURCE: Department of Taxation printout.

general be viewed as important policy goals, since the most important conformity factor with respect to exemptions is that the number and type of exemptions claimed at the state level matches the number and type claimed at the federal level. In addition, any increase in the exemption amounts would do nothing to correct for the vertical equity problems associated with the use of exemptions. In fact, an increase in the exemption level from $600 to $1,000 would widen the gap in the value of the exemptions between the highest and lowest marginal tax rates from the current $34.50 and $12, respectively, to $57.50 and $20. If we assume that the higher exemption levels would become effective for taxable years beginning on and after January 1, 1980, we estimate that this option would cost approximately $122 million for fiscal year 1981 and approximately $86 million for fiscal year 1982. (The first year cost is somewhat greater because it actually reflects more than a 12 month revenue impact. In other words, if the General Assembly enacted the change at the 1980 session, withholding would in all likelihood not change until fiscal year 1981, and additionally taxpayers would claim larger refunds during fiscal year 1981 on their 1980 tax returns for any overpayment.)

Some states provide tax credits in lieu of the various exemptions.[1/] Thus, a second option would be to substitute tax credits in lieu of the current exemptions (and the additional $400 exclusion for age). For example, in lieu of the current exemptions the state could provide a $12 tax credit for each federal exemption claimed. The credit would be

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1/ The reader is referred to Appendix II for a description of the credits in the states of Arkansas, California, Iowa, Kentucky, Minnesota, and Wisconsin.

equivalent in value to the current $600 exemption at the lowest marginal tax rate. Alternatively, the state could provide a $20 tax credit for each federal exemption claimed, which would be equivalent in value to the $1,000 exemption at the lowest marginal tax rate. Each of these alternatives would still enable easy comparison with the number and type of exemptions claimed at the federal level, and each would allow uniformity in the value for the four exemption categories. More importantly, however, either credit alternative would correct for the vertical equity problems associated with exemptions. In other words, each allowable tax credit would be worth the same amount to all taxpayers regardless of their level of income.

Table 3 provides distributional data on the tax impact of each of these credits based on 1977 tax return data. Under each alternative additional revenues would have been generated. Obviously, the reason that the substitution of tax credits for exemptions generates revenues is that the value of both of these credits is less than the value of the current $600 (and $1,000) exemption at the state's highest marginal tax rates. The result is a tax increase for taxpayers falling in these highest marginal tax brackets and a modest tax decrease for taxpayers who receive a credit larger than the value of the current exemption at the lowest marginal tax rates. Under the $12 tax credit, taxpayers with AGI under $4,000 actually experience a decline in tax of approximately $0.7 million, while higher income taxpayers would pay additional tax totalling approximately $68.4 million, for a net increase of $67.7 million. However, of the total increase for taxpayers with incomes over $4,000, approximately two-thirds of the increase would be borne by taxpayers with incomes greater than $14,000. Under the $20 tax credit, taxpayers with AGI

TABLE 3 -- THE IMPACT OF SUBSTITUTION OF TAX CREDITS FOR PERSONAL EXEMPTIONS ON TAX LIABILITY AND EFFECTIVE TAX RATES

	Tax Liability Under Current Structure ($600 Exemptions)			Tax Liability With $12 Tax Credits					Tax Liability With $20 Tax Credits				
					Change from Current Structure					Change from Current Structure			
Virginia AGI Class	Amount	Average Per Tax Return	Effective Tax Rate	Amount	Amount	Percent of Total Increase (Decrease)	Average Tax Per Return	Effective Tax Rate	Amount	Amount	Percent of Total Increase (Decrease)	Average Tax Per Return	Effective Tax Rate
$ 0- 999	$ 74,191	$ 1	0.15%	$ 0	$- 74,191	11.3[a/]	$ 0	0.00%	$ 0	$- 74,191	1.7[a/]	$ 0	0.00%
1,000- 1,999	270,501	2	0.15	0	- 270,501	41.1[a/]	0	0.00	0	- 270,501	6.1[a/]	0	0.00
2,000- 2,999	1,264,096	12	0.46	952,426	- 311,670	47.3[a/]	9	0.35	0	- 1,264,096	28.6[a/]	0	0.00
3,000- 3,999	2,564,856	27	0.76	2,562,478	- 2,378	0.4[a/]	27	0.77	1,374,657	- 1,190,199	26.9[a/]	14	0.41
4,000- 4,999	4,189,413	43	0.96	4,569,790	+ 380,377	0.6	47	1.05	3,259,004	- 930,409	21.0[a/]	34	0.75
5,000- 5,999	6,492,399	64	1.16	7,456,400	+ 964,001	1.4	73	1.33	6,006,862	- 485,537	11.0[a/]	59	1.08
6,000- 6,999	8,474,174	46	1.36	10,065,285	+ 1,591,111	2.3	106	1.63	8,268,017	- 206,157	4.7[a/]	91	1.34
7,000- 7,999	10,473,195	119	1.58	12,946,435	+ 2,473,240	3.6	147	1.96	11,493,318	+ 1,020,123	2.7	130	1.74
8,000- 8,999	12,676,128	156	1.83	15,327,735	+ 2,651,607	3.9	189	2.22	13,911,434	+ 1,235,306	3.3	171	2.02
9,000- 9,999	14,512,515	190	2.00	17,227,234	+ 2,714,719	4.0	226	2.38	15,829,641	+ 1,317,126	3.5	207	2.19
10,000-10,999	15,979,869	222	2.12	18,671,594	+ 2,691,725	4.0	260	2.48	17,283,644	+ 1,303,775	3.5	241	2.30
11,000-11,999	16,994,473	255	2.21	19,650,578	+ 2,656,105	3.9	294	2.56	18,302,090	+ 1,307,617	3.5	274	2.38
12,000-12,999	17,880,223	285	2.27	20,524,531	+ 2,644,308	3.9	327	2.62	19,192,499	+ 1,312,276	3.5	306	2.45
13,000-13,999	19,303,326	316	2.34	22,063,148	+ 2,759,822	4.0	361	2.68	20,701,206	+ 1,397,880	3.7	339	2.51
14,000-14,999	20,897,678	354	2.43	23,812,022	+ 2,914,344	4.3	403	2.78	22,465,782	+ 1,568,104	4.2	380	2.62
15,000-15,999	21,819,522	392	2.53	24,767,875	+ 2,948,353	4.4	445	2.87	23,482,130	+ 1,662,608	4.4	422	2.72
16,000-16,999	22,316,255	429	2.60	25,214,147	+ 2,897,892	4.2	485	2.94	23,972,523	+ 1,656,268	4.4	461	2.80
17,000-17,999	22,521,169	465	2.66	25,356,671	+ 2,835,502	4.2	524	3.00	24,174,004	+ 1,652,835	4.4	500	2.86
18,000-18,999	23,364,180	509	2.75	26,173,592	+ 2,809,412	4.1	570	3.08	25,035,314	+ 1,671,134	4.5	545	2.95
19,000-19,999	23,954,321	551	2.82	26,640,771	+ 2,686,450	4.0	613	3.14	25,550,556	+ 1,596,235	4.3	588	3.01
20,000-20,999	22,899,624	589	2.87	25,360,597	+ 2,460,973	3.6	652	3.18	24,377,955	+ 1,478,331	4.0	627	3.06
21,000-21,999	22,436,777	630	2.92	24,724,909	+ 2,288,132	3.3	693	3.23	23,827,053	+ 1,390,276	3.7	668	3.11
22,000-22,999	21,913,415	673	2.99	24,030,899	+ 2,117,484	3.1	739	3.28	23,198,902	+ 1,285,487	3.4	713	3.17
23,000-23,999	21,174,654	717	3.05	23,107,641	+ 1,932,987	2.8	783	3.33	22,354,454	+ 1,179,800	3.2	758	3.27
24,000-24,999	20,079,289	760	3.10	21,856,173	+ 1,776,884	2.6	827	3.38	21,180,595	+ 1,101,306	2.9	801	3.27
25,000-29,999	88,237,169	886	3.24	95,166,325	+ 6,929,156	10.1	955	3.50	92,557,406	+ 4,320,237	11.6	929	3.41
30,000-34,999	65,336,948	1,124	3.48	69,593,519	+ 4,256,571	6.2	1,198	3.71	68,053,355	+ 2,716,407	7.3	1,172	3.63
35,000-39,999	47,012,455	1,381	3.70	49,636,193	+ 2,623,738	3.9	1,458	3.91	48,712,418	+ 1,699,963	4.5	1,431	3.84
40,000-44,999	35,486,632	1,637	3.87	37,181,847	+ 1,695,215	2.5	1,716	4.06	36,590,333	+ 1,103,701	3.0	1,688	3.99
45,000-49,999	25,659,070	1,903	4.02	26,686,226	+ 1,027,156	1.5	1,980	4.19	26,325,609	+ 666,539	1.8	1,953	4.13
50,000-74,999	53,734,718	2,472	4.20	55,490,686	+ 1,755,968	2.6	2,552	4.34	54,900,116	+ 1,165,398	3.1	2,525	4.29
75,000-99,999	19,925,252	3,821	4.48	20,352,626	+ 427,314	0.6	3,907	4.58	20,204,011	+ 278,759	0.7	3,879	4.55
100,000 & over	42,111,641	8,212	4.71	42,556,095	+ 444,454	0.7	8,300	4.76	42,415,950	+ 304,309	0.8	8,273	4.75
TOTALS	$752,030,127	$ 384	2.84%	$819,726,448	$+67,696,321	100.0	$ 419	3.10%	$785,000,838	$+32,970,711	100.0	$ 400	2.97%

NOTE: Details may not add to totals due to rounding.

SOURCE: Department of Taxation income tax sampling model, taxable year 1977 data. (Reference Structures 02, 48, and 49.)

a/ Percentages calculated for income classes that experience a decline in tax liability reflect the relative share of the total tax reduction. All other percentages reflect the relative share of the total tax increase, which is greater than the net increase in tax liability across all income

under $7,000 experience a decline in tax of approximately $4.4 million, while higher income taxpayers would pay additional tax totalling approximately $37.4 million, for a net increase of $33.0 million. Of the total increase for taxpayers with incomes over $7,000, approximately two-thirds would be borne by taxpayers with incomes greater than $16,000.

These changes also effect an increase in the progressivity of the tax structure as exhibited by the changes in the effective tax rates. Obviously, those taxpayers who experience a tax reduction also experience a decline in their effective tax rate, while those who experience an increase would be subject to higher effective tax rates. In the aggregate, the effective tax rate under the $12 tax credit would increase from 2.8 percent to 3.1 percent, while the effective tax rate under the $20 tax credit would only increase to 3.0 percent. Again, the reason for these increases relates to the provision of a credit whose value is less than the value of the current exemptions for taxpayers subject to the highest marginal tax rates.

If we again assume a January 1, 1980, effective date, we estimate that eliminating exemptions and replacing them with a $12 tax credit would actually generate approximately $149 million in additional revenues for fiscal year 1981 and $122 million for fiscal year 1982. A $20 tax credit would generate approximately $69 million for fiscal year 1981 and $56 million for fiscal year 1982.[1/]

1/ The first year gains are larger for the same reasons as noted earlier. In other words, if the tax credits were enacted in 1980 and became effective January 1, 1980, new withholding tables could probably not be implemented until fiscal year 1981. Any underpayment of taxes for 1980 would be made up when returns are filed in fiscal year 1981, thus generating more than 12 months worth of additional revenue.

Conceptual Background

The various personal deductions that are provided at both the federal and state levels have several purposes, some of which are related to the overall equity of the income tax and some of which are not. Like personal and dependent exemptions, personal deductions also adjust for unusual circumstances that affect the individual's ability to pay taxes relative to other taxpayers. Relating again to the concepts of horizontal and vertical equity, we can, for example, justify an adjustment to tax liability for hardships caused by extreme medical expenses or casualty losses. An individual with little or no medical expenses is clearly more able to pay income tax than an individual with equal income but with large medical expenses. Similarly, two individuals may have different amounts of income, but the individual with the lower income may actually be better able to pay tax if he has no medical expenses than the higher income person.

Second, personal deductions allow individuals to deduct certain items that are actually costs associated with earning income and therefore should theoretically be excluded from economic income. Deductions for union dues, professional association fees, required educational expenses, and child care expenses fall into this category.[1/]

Third, some deductions, such as the deductions for real and personal property taxes and the general sales tax (and at the federal level the state income tax), are really measures to aid in fiscal coordination

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1/ As noted earlier the Virginia child and dependent care expense deduction is a special deduction that is available to all taxpayers, regardless of whether or not they itemize.

under our federal system.[1/] For example, with the federal, state, and local governments all levying various taxes independent of one another, there is a risk, in the extreme sense, that the combined effects of taxation could become confiscatory. Therefore, the federal government, with its extensive financial strength relative to state and local governments, has ensured against confiscation through personal deductions of various state and local taxes. In addition, the federal deductions for state and local taxes permit these governments somewhat more financial flexibility in that any state or local tax increases are offset to some extent (i.e., for taxpayers who itemize) by reductions in federal income tax. At the state level this also holds, since, for example, any local real or personal property tax increase or any increase in either the state or local option sales tax would be partially offset by a further reduction in state income tax.

Fourth, some personal deductions have no real theoretical basis but are instead provisions to promote certain socially, politically, or economically desirable objectives. Such provisions are commonly referred to as "tax expenditures," since they reduce revenues just the same as an explicit government program providing direct financial assistance to individuals engaged in the desireable activity. One example of a deduction that falls into this category is philanthropic contributions.

Finally, some deductions cut across two or more categories. According to Goode, for example, the mortgage interest deduction (the single largest personal deduction) recognizes real differences in income and taxpaying capacity for homeowners who are debtors versus those who are

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1/ Richard Goode, The Individual Income Tax, Revised Edition, p. 170.

nondebtors.[1] In addition, the mortgage interest deduction also takes into account the investment costs associated with the imputed return on owner occupied homes, even though the deduction of such "costs" is not really warranted since imputed rental income is not part of the current tax base. Finally, the mortgage interest deduction is a powerful government incentive for homeownership, which policy makers in general view to be a desirable social and economic objective.

Conceptually the case can generally be made for permitting deductions falling in the first three categories, but it is unclear whether "tax expenditures" are more or less appropriate than direct budgetary outlays. In any event, many taxpayers would only have very modest expenditure amounts that would qualify for deduction. In order to limit the itemization of the various allowable personal deductions for taxpayers who would otherwise have very small amounts to deduct, the federal government until 1977 granted a standard deduction. To digress briefly, the standard deduction was a percentage of AGI with minimum and maximum constraints. In 1977, the federal standard deduction was replaced with zero bracket amounts, which are essentially flat amounts of income subject to a zero tax rate. Any income in excess of the zero bracket amount is then subject to the tax rate schedule, so in essence the zero bracket amount is a flat standard deduction subtracted from AGI at the bottom rather than at the top. Taxpayers whose personal deductions are less than the applicable zero bracket amount may not itemize and must use the zero bracket amount. Taxpayers whose personal deductions exceed their applicable zero bracket amount may only deduct the excess.

1/ Richard Goode, The Individual Income Tax, Revised Edition, p. 149.

The primary reason for limiting the use of personal (itemized) deductions is more related to administrative simplification than to either theoretical or other considerations. Obviously, taxpayers who claim some fixed or percentage deduction amount or a zero bracket amount, instead of maintaining detailed records on their various qualifying expenditures, will have a much easier time completing their tax return. Similarly, if the government does not have to verify and/or audit large numbers of returns with itemized deductions, the administration process will be greatly simplified and less costly.

Issues Surrounding the Current Law and Alternatives

One potential area of reform to Virginia's current provisions relating to personal deductions is the standard deduction. As noted in an earlier section, the Virginia standard deduction is currently frozen to the 1974 federal standard deduction, even though the federal government has twice increased its standard deduction beyond the 1974 levels and has substituted a zero bracket amount that has already been increased once. In addition, the federal government has replaced certain itemized deductions over the last several years with other provisions (e.g., the itemized deduction for child care expenses has been replaced by a credit and the alimony payments deduction has been replaced by an exclusion). Since Virginia law requires that taxpayers may only itemize at the state level if they may itemize for federal purposes, the effect of these various federal changes has been that fewer state taxpayers have been able to itemize their deductions each year. For 1977, approximately 7 of every 10 returns claimed the Virginia standard deduction, while in 1974 (prior to the freeze) only 6 of every 10 returns claimed the standard deduction.

Table 4 provides more detailed data for 1977 on the split between itemized and standard deductions by income class as well as distributional data on tax liability under the current structure.

The majority of taxpayers who have been forced to revert from the itemized deduction are limited to a Virginia standard deduction that is significantly less than either the federal equivalent or the amount they could claim if they were permitted to itemize. For example, consider a married couple with federal AGI of $12,000 who files a joint return and has federal itemized deductions totalling $3,000 (including state income tax of $400). Since the couple's itemized deductions are less than the current $3,400 federal zero bracket amount for married couples, they are not permitted to itemize for either federal or state purposes. For Virginia purposes, if they could itemize they could deduct $2,600 (federal itemized deductions less state income tax), but under the current law requiring like deductions at both the federal and state level they must take the Virginia standard deduction. Their Virginia standard deduction is only $1,800 (15 percent of federal AGI). Thus, the couple loses the benefit of $800 worth of deductions, and assuming the couple is subject to the state's 5 percent marginal tax rate they must as the result pay $40 in additional state income tax. (Assuming the state had continued to conform completely to the federal structure and had automatically adopted the zero bracket amount, the couple would have gained the equivalent of a $1,600 deduction that would result in a decrease of $80 in state income tax.)

The effect of the federal changes have therefore been an unintended tax increase for taxpayers with itemized deductions greater than the allow-

TABLE 4 -- THE CURRENT VIRGINIA INCOME TAX STRUCTURE AND THE DISTRIBUTION OF TAX RETURNS BY TYPE OF DEDUCTION, TAX LIABILITY, AND EFFECTIVE TAX RATE

Virginia AGI Class	Total No. of Returns	Distribution of Returns By Type of Deduction: No. of Standard Deductions (Percent of Returns)	Distribution of Returns By Type of Deduction: No. of Itemized Deductions (Percent of Returns)	Tax Liability: Amount	Tax Liability: Average Tax Per Return	Tax Liability: Effective Tax Rate
$ 0 - 999	101,820	81,460 (80.0%)[a]	2,372 (2.3%)[a]	$ 74,191	$ 1	0.1%
1,000 - 1,999	123,304	119,334 (96.8%)[a]	2,771 (2.2%)[a]	270,501	2	0.1
2,000 - 2,999	108,593	104,781 (96.5%)[a]	2,734 (2.5%)[a]	1,264,096	12	0.5
3,000 - 3,999	95,654	91,158 (95.3%)[a]	4,196 (4.4%)[a]	2,564,856	27	0.8
4,000 - 4,999	96,637	92,006 (95.2%)	4,381 (4.5%)	4,189,413	43	1.0
5,000 - 5,999	101,452	95,448 (94.1%)	5,861 (5.8%)	6,492,399	64	1.2
6,000 - 6,999	95,217	89,132 (93.6%)	5,868 (6.2%)	8,474,174	46	1.4
7,000 - 7,999	87,894	80,363 (91.4%)	7,339 (8.3%)	10,473,195	119	1.6
8,000 - 8,999	81,331	72,556 (89.2%)	8,655 (10.6%)	12,676,128	156	1.8
9,000 - 9,999	76,272	67,006 (87.9%)	9,218 (12.1%)	14,512,515	190	2.0
10,000 - 10,999	71,827	60,980 (84.9%)	10,687 (14.9%)	15,979,869	222	2.1
11,000 - 11,999	66,767	54,607 (81.8%)	12,032 (18.0%)	16,994,473	255	2.2
12,000 - 12,999	62,816	49,142 (78.2%)	13,642 (21.7%)	17,880,223	285	2.3
13,000 - 13,999	61,054	45,905 (75.2%)	15,054 (24.7%)	19,303,326	316	2.3
14,000 - 14,999	59,104	42,236 (71.5%)	16,852 (28.5%)	20,897,678	354	2.4
15,000 - 15,999	55,630	37,900 (68.1%)	17,718 (31.8%)	21,819,522	392	2.5
16,000 - 16,999	52,043	32,510 (62.5%)	19,509 (37.5%)	22,316,255	429	2.6
17,000 - 17,999	48,381	27,846 (57.6%)	20,499 (42.4%)	22,521,169	465	2.7
18,000 - 18,999	45,863	24,209 (52.8%)	21,654 (47.2%)	23,364,180	509	2.7
19,000 - 19,999	43,510	21,105 (48.5%)	22,393 (51.5%)	23,954,321	551	2.8
20,000 - 20,999	38,865	17,279 (44.5%)	21,562 (55.5%)	22,899,624	589	2.9
21,000 - 21,999	35,636	14,169 (39.8%)	21,451 (60.1%)	22,436,777	630	2.9
22,000 - 22,999	32,543	12,104 (37.2%)	20,431 (62.8%)	21,913,415	673	3.0
23,000 - 23,999	29,530	9,995 (33.8%)	19,519 (66.1%)	21,174,654	717	3.0
24,000 - 24,999	26,421	8,075 (30.6%)	18,338 (69.4%)	20,079,289	760	3.1
25,000 - 29,999	99,639	22,072 (22.2%)	77,511 (77.8%)	88,237,169	886	3.2
30,000 - 34,999	58,108	7,915 (13.6%)	50,153 (86.3%)	65,336,948	1,124	3.5
35,000 - 39,999	34,041	3,127 (9.2%)	30,906 (90.8%)	47,012,455	1,381	3.7
40,000 - 44,999	21,672	1,586 (7.3%)	20,078 (92.6%)	35,486,632	1,637	3.9
45,000 - 49,999	13,482	810 (6.0%)	12,640 (93.8%)	25,659,070	1,903	4.0
50,000 - 74,999	21,736	1,221 (5.6%)	20,482 (94.2%)	53,734,718	2,472	4.2
75,000 - 99,999	5,214	237 (4.5%)	4,969 (95.3%)	19,925,252	3,821	4.5
100,000 - 999,999	5,218	176 (3.4%)	4,938 (96.3%)	42,111,641	8,212	4.7
TOTALS	1,957,183	1,388,450 (70.9%)	546,412 (27.9%)	$752,030,127	$ 384	2.8%

NOTE: Details may not add to totals due to rounding.

SOURCE: Department of Taxation income tax sampling model, taxable year 1977. (Reference Structure 02)

[a] Percentages do not add to 100, because for some returns at low income levels personal, dependent, age, and blindness are sufficiently large to reduce AGI to zero without deductions.

able Virginia standard deduction but less than the federal zero bracket amount. Consequently, the state has experienced an unintended revenue gain. Moreover, the current law encourages taxpayers with itemized deductions less than the federal zero bracket amount but greater than the Virginia standard deduction into noncompliance. Even though taxpayers who wrongly claim itemized deductions would eventually be detected, such noncompliance would divert the time of auditors from normal enforcement activities.

There are several ways that the state could remedy the adverse effects of the current law. One alternative would be to allow Virginia taxpayers to claim their more advantageous deduction, regardless of whether or not they claim the federal zero bracket amount. This alternative would not only assist those taxpayers with itemized deductions falling between the zero bracket amount and the maximum Virginia standard deduction who have suffered from the unintentional tax increase, but it would also benefit some taxpayers whose itemized deductions are less than the current Virginia maximum standard deduction. For example, a taxpayer with $10,000 of federal AGI and $1,900 of itemized deductions (excluding state income tax) is currently limited to a standard deduction of $1,500. This alternative would therefore allow this taxpayer as well as the couple in the previous example to itemize and receive a larger deduction. However, this alternative has the disadvantages of moving the income tax structure even further out of alignment with the federal structure, encouraging larger numbers of itemized deductions, and requiring increased state audits not currently needed because of the federal-state exchange program. We estimate that the current cost of this alternative could be as much as $23 million annually.

Another alternative would be to allow only persons whose itemized deductions fall between the federal zero bracket amount and the maximum allowable Virginia standard deduction to itemize their deductions for Virginia purposes. (Taxpayers such as the one in the example above would continue to claim the percentage standard deduction.) This alternative essentially has all of the same disadvantages as the first alternative, except that by selectively limiting the availability of the itemized deduction to only those taxpayers caught between the federal zero bracket amount and the Virginia maximum the deconformity and audit problems could possibly be more complex for taxpayers. Since this alternative would allow fewer taxpayers to revert to itemized deductions than the first alternative (i.e., only those caught between the federal zero bracket amount and the Virginia standard deduction), its cost is somewhat less. We estimate that this alternative would cost from $13 million to $18 million per year, which is the estimated equivalent of the annual gain currently associated with the cumulative impact of the various federal changes since the Virginia standard deduction was frozen. In other words, the unintended state revenue gain (tax increase) from the increases in the federal standard deduction and the adoption of zero bracket amounts along with the state requirement for like deductions is estimated between $13 million and $18 million annually.

If policy makers wish to preserve the benefits of conformity and also correct for the problems associated with the current law, then there are two other options that could be considered. Obviously, one alternative is to once again bring Virginia into complete conformity with respect to the federal zero bracket amounts. Adoption by Virginia of the zero bracket amounts would again provide all taxpayers who do not itemize the

same nontaxable income allowance at the federal level as at the state level. It would therefore in effect restore the deductions lost to taxpayers whose itemized deductions are less than the federal zero bracket amount but greater than the current Virginia standard deduction. As a result, this alternative would remove the temptation to the taxpayer to wrongly claim itemized deductions. In addition, this alternative would also preserve the current distribution of returns with and without itemized deductions. Therefore, no additional audit activity would become necessary.

While this alternative does have many advantages, it would have a significant revenue cost. Obviously, adoption of the federal zero bracket amounts will cause revenues to decline because it restores a larger nontaxable income allowance to taxpayers caught between the federal zero bracket amount and the Virginia maximum standard deduction. However, since it goes further and eliminates the current percentage allowance with its range of $1,300 to $2,000, it also increases significantly the nontaxable allowance for all other taxpayers currently claiming the standard deduction who have been unaffected by the various federal changes. In other words, even low income married couples who currently claim only the $1,300 minimum standard deduction would receive the $3,400 zero bracket amount.

In addition, it is important to note that even if the state were to adopt the current federal zero bracket amounts, any further increases adopted by the federal government would again move the Virginia income tax structure out of alignment with the federal structure. Of course, Virginia could always provide for complete conformity to federal zero bracket amounts, which would remove this problem. However, it would

also reduce state income tax revenues as federal tax cuts were enacted. With a recession currently underway, already some federal legislators and Presidential advisors are calling for federal tax cuts, which, if recent patterns are any indicator, may well be implemented through higher zero bracket amounts.

Table 5 provides various data by AGI class on the mix of returns with and without itemized deductions and on the change in tax liability under this alternative based on returns filed for 1977. Comparing these data to the data in Table 4 for the current tax structure we see that on an aggregate basis the number of returns claiming itemized deductions declines slightly from 28 percent to 22 percent, with returns that would claim the zero bracket amount increasing by a similar percentage. In 1977, this alternative would have cost approximately $51 million in revenues with approximately two-thirds of this tax relief accruing to taxpayers with incomes under $15,000. While the effective tax rate declines for all income levels and in the aggregate declines from 2.8 percent to 2.6 percent, again taxpayers with under $15,000 of income would experience the largest relative declines. We estimate that adoption of the federal zero bracket amounts effective for taxable years beginning on and after January 1, 1980, would cost approximately $112 million during fiscal year 1981 and $92 million during fiscal year 1982, with the first year costs larger for the same reasons as noted earlier.

A second related alternative that would have all of the same advantages as complete conformity to the federal zero bracket amounts would be to maintain the current percentage allowance and simply increase the current maximum standard deduction amounts to the applicable zero bracket amounts. Under this alternative, Virginia would allow a standard deduction equi-

TABLE 5 -- THE IMPACT OF FEDERAL ZERO BRACKET AMOUNTS APPLIED TO VIRGINIA ON THE DISTRIBUTION OF TAX RETURNS BY TYPE OF DEDUCTION, TAX LIABILITY, AND EFFECTIVE TAX RATE

Virginia AGI Class	Total No. of Returns	Distribution of Returns By Type of Deduction: No. of Standard Deductions[a] (Percent of Returns)	Distribution of Returns By Type of Deduction: No. of Itemized Deductions (Percent of Returns)	Tax Liability: Amount	Tax Liability: Change From Current Structure: Amount	Tax Liability: Change From Current Structure: Percent of Total	Average Tax Per Return	Effective Tax Rate
$ 0 - 999	100,820	81,661 (80.2%)[b]	2,171 (2.1%)[b]	$ 61,328	$- 12,863	0.03	$ 1	0.12%
1,000 - 1,999	123,304	119,735 (97.1%)[b]	2,369 (1.9%)[b]	182,190	- 88,311	0.2	1	0.10
2,000 - 2,999	108,593	105,262 (96.9%)[b]	2,253 (2.1%)[b]	339,732	- 924,364	1.8	3	0.13
3,000 - 3,999	95,654	92,170 (96.4%)	3,184 (3.3%)	1,080,977	- 1,483,879	2.9	11	0.3
4,000 - 4,999	96,637	92,995 (96.2%)	3,393 (3.5%)	2,366,915	- 1,822,498	3.6	24	0.5
5,000 - 5,999	101,452	96,675 (95.3%)	4,633 (4.6%)	3,963,671	- 2,528,728	5.0	39	0.7
6,000 - 6,999	95,217	90,069 (94.6%)	4,932 (5.2%)	5,595,881	- 2,878,293	5.7	59	0.9
7,000 - 7,999	87,894	81,470 (92.7%)	6,232 (7.1%)	7,112,752	- 3,360,443	6.6	81	1.1
8,000 - 8,999	81,331	74,218 (91.2%)	6,993 (8.6%)	8,940,136	- 3,735,992	7.4	110	1.3
9,000 - 9,999	76,272	69,008 (90.5%)	7,216 (9.5%)	10,869,295	- 3,643,220	7.2	143	1.5
10,000 - 10,999	71,827	63,266 (88.1%)	8,401 (11.7%)	12,643,641	- 3,336,228	6.6	176	1.7
11,000 - 11,999	66,767	57,228 (85.7%)	9,411 (14.1%)	14,152,771	- 2,841,702	5.6	212	1.8
12,000 - 12,999	62,816	52,156 (83.0%)	10,628 (16.9%)	15,442,811	- 2,437,412	4.8	246	2.0
13,000 - 13,999	61,054	49,258 (80.7%)	11,700 (19.2%)	17,134,890	- 2,168,436	4.3	281	2.1
14,000 - 14,999	59,104	46,282 (78.3%)	12,805 (21.7%)	18,733,521	- 2,164,157	4.3	317	2.2
15,000 - 15,999	55,630	42,151 (75.8%)	13,467 (24.2%)	19,708,670	- 2,110,852	4.1	354	2.3
16,000 - 16,999	52,043	37,425 (72.0%)	14,594 (28.0%)	20,349,710	- 1,966,545	3.9	391	2.4
17,000 - 17,999	48,381	33,093 (68.4%)	15,252 (31.5%)	20,721,993	- 1,799,176	3.5	428	2.5
18,000 - 18,999	45,863	29,416 (64.1%)	16,447 (35.8%)	21,718,940	- 1,645,240	3.2	474	2.6
19,000 - 19,999	43,510	26,853 (61.7%)	16,645 (38.3%)	22,456,444	- 1,497,877	2.9	516	2.7
20,000 - 20,999	38,865	22,333 (57.5%)	16,508 (42.5%)	21,646,907	- 1,252,717	2.5	557	2.7
21,000 - 21,999	35,636	19,095 (53.6%)	16,525 (46.4%)	21,373,265	- 1,063,512	2.1	600	2.8
22,000 - 22,999	32,543	16,445 (50.5%)	16,090 (49.4%)	20,991,433	- 921,982	1.8	645	2.9
23,000 - 23,999	29,530	14,382 (48.7%)	15,132 (51.2%)	20,377,265	- 797,389	1.6	690	2.9
24,000 - 24,999	26,421	12,056 (45.6%)	14,357 (54.3%)	19,415,540	- 663,749	1.3	735	3.0
25,000 - 29,999	99,639	37,148 (37.3%)	62,435 (62.6%)	86,244,212	- 1,992,957	3.9	866	3.2
30,000 - 34,999	58,108	16,655 (28.6%)	41,413 (71.3%)	64,498,064	- 838,884	1.6	1,110	3.4
35,000 - 39,999	34,041	7,393 (21.7%)	26,640 (78.2%)	46,656,854	- 355,601	0.7	1,371	3.7
40,000 - 44,999	21,672	4,040 (18.6%)	17,624 (81.3%)	35,297,066	- 189,566	0.4	1,629	3.9
45,000 - 49,999	13,482	2,046 (15.1%)	11,404 (84.6%)	25,562,183	- 96,887	0.2	1,896	4.0
50,000 - 74,999	21,736	2,937 (13.5%)	18,766 (86.3%)	53,593,105	- 141,613	0.3	2,466	4.2
75,000 - 99,999	5,214	553 (10.6%)	4,653 (89.2%)	19,898,530	- 26,722	0.1	3,816	4.5
100,000 & Over	5,128	405 (7.9%)	4,709 (91.8%)	42,092,336	- 19,305	0.04	8,208	4.7%
TOTALS	1,957,183	1,495,880 (76.4%)	438,982 (22.4%)	$ 701,223,029	$-50,807,098	100.0	$ 358	2.6%

NOTE: Details may not add to totals due to rounding.

SOURCE: Department of Taxation income sampling model, taxable year 1977 data. (Reference Structure 46)

a/ Actually reflects returns claiming a zero bracket amount and not a standard deduction in the current sense.

b/ Percentages do not add to 100, because for some returns at low income levels personal, dependent, age and blindness exceptions are sufficiently large to reduce AGI to zero without deductions.

valent to 15 percent of federal AGI with the same minimum of $1,300 but with a higher maximum of $3,400. (For married taxpayers filing separately, the minimum would be $650 and the maximum would be $1,700, and for single taxpayers the minimum would be $1,300 and the maximum would be $2,300.)

This alternative would restore a larger nontaxable income allowance to taxpayers caught between the federal zero bracket amount and the current Virginia maximum, but only to the extent that their federal AGI is sufficiently large enough to entitle them to more than the current maximum. For example, a married couple with federal AGI of $13,333 or greater is currently limited to a $2,000 Virginia standard deduction. Under this alternative, a couple could only receive a larger standard deduction amount if their federal AGI was greater than $13,333, and only couples with federal AGI of $22,667 or greater would receive the $3,400 maximum. Thus, any couple who is caught between the federal zero bracket amount and the current Virginia maximum would still receive no relief if their federal AGI is under $13,333, and married taxpayers might receive only partial relief if their federal AGI is between $13,333 and $22,667. In addition, this alternative, like the previous one, would also not keep pace with any increases in the federal zero bracket amounts, unless Virginia were to tie its upper bounds to the prevailing zero bracket amount. Of course, tying the maximum standard deduction to whatever increases are adopted by the Congress would also potentially reduce state income tax revenues.

Table 6 contains the same detailed data as presented in the previous two tables on the distributional effects of this alternative. Under this alternative the number of returns with itemized deductions also declines

TABLE 6 -- THE IMPACT OF FEDERAL ZERO BRACKET AMOUNTS AS UPPER STANDARD DEDUCTION BOUNDS ON THE DISTRIBUTION OF TAX RETURNS BY TYPE OF DEDUCTION, TAX LIABILITY, AND EFFECTIVE TAX RATE

Virginia AGI Class	Total No. of Returns	Distribution of Returns By Type of Deduction: No. of Standard Deductions (Percent of Returns)	Distribution of Returns By Type of Deduction: No. of Itemized Deductions (Percent of Returns)	Tax Liability: Amount	Tax Liability: Change From Current Structure: Amount	Tax Liability: Change From Current Structure: Percent of Total	Tax Liability: Average Tax Per Return	Effective Tax Rate
$ 0 - 999	101,820	81,581 (80.1%)[a]	2,252 (2.2%)[a]	$ 71,364	$- 2,827	0.02	$ 1	0.14%
1,000 - 1,999	123,304	119,454 (96.9%)[a]	2,650 (2.2%)[a]	241,760	- 28,741	0.2	2	0.13
2,000 - 2,999	108,593	105,141 (96.8%)[a]	2,374 (2.2%)[a]	1,191,706	- 72,390	0.5	11	0.4
3,000 - 3,999	95,654	91,758 (95.9%)	3,596 (3.8%)	2,488,298	- 76,558	0.6	26	0.7
4,000 - 4,999	96,637	92,106 (95.3%)	4,281 (4.4%)	4,114,648	- 74,765	0.6	43	0.9
5,000 - 5,999	101,452	95,713 (94.3%)	5,596 (5.5%)	6,419,650	- 72,749	0.5	63	1.2
6,000 - 6,999	95,217	89,277 (93.8%)	5,724 (6.0%)	8,415,116	- 59,058	0.4	88	1.4
7,000 - 7,999	87,894	80,435 (91.5%)	7,267 (8.3%)	10,412,797	- 60,398	0.5	118	1.6
8,000 - 8,999	81,331	72,676 (89.4%)	8,535 (10.5%)	12,616,284	- 59,844	0.4	155	1.8
9,000 - 9,999	76,272	67,150 (88.0%)	9,074 (11.9%)	14,438,402	- 74,113	0.6	189	2.0
10,000 - 10,999	71,827	61,133 (85.1%)	10,534 (14.7%)	15,907,778	- 72,091	0.5	221	2.1
11,000 - 11,999	66,767	54,691 (81.9%)	11,948 (17.9%)	16,923,345	- 71,128	0.5	253	2.2
12,000 - 12,999	62,816	49,278 (78.5%)	13,506 (21.5%)	17,813,315	- 66,908	0.5	284	2.3
13,000 - 13,999	61,054	46,145 (75.6%)	14,814 (24.3%)	19,177,520	- 125,806	0.9	314	2.3
14,000 - 14,999	59,104	42,764 (72.4%)	16,324 (27.6%)	20,489,467	- 408,211	3.1	347	2.4
15,000 - 15,999	55,630	38,505 (69.2%)	17,113 (30.8%)	21,174,156	- 1,645,366	12.3	381	2.5
16,000 - 16,999	52,043	33,013 (63.4%)	19,006 (36.5%)	21,552,617	- 763,638	5.7	414	2.5
17,000 - 17,999	48,381	28,507 (58.9%)	19,838 (41.0%)	21,680,263	- 840,906	6.3	448	2.6
18,000 - 18,999	45,863	25,899 (56.5%)	19,964 (43.5%)	22,446,470	- 917,710	6.9	489	2.7
19,000 - 19,999	43,510	23,599 (54.2%)	19,899 (45.7%)	22,984,776	- 969,545	7.3	528	2.7
20,000 - 20,999	38,865	20,454 (52.6%)	18,387 (47.3%)	21,962,044	- 937,580	7.0	565	2.8
21,000 - 21,999	35,636	18,231 (51.2%)	17,389 (48.8%)	21,523,234	- 913,543	6.9	604	2.8
22,000 - 22,999	32,543	16,313 (50.1%)	16,222 (49.9%)	21,019,126	- 894,289	6.7	646	2.9
23,000 - 23,999	29,530	14,374 (48.7%)	15,140 (51.3%)	20,378,520	- 796,134	6.0	690	2.9
24,000 - 24,999	26,421	12,048 (45.6%)	14,365 (54.4%)	19,417,406	- 661,883	5.0	735	3.0
25,000 - 29,999	99,639	37,143 (37.3%)	62,440 (62.7%)	86,246,395	- 1,990,774	14.9	866	3.1
30,000 - 34,999	58,108	16,651 (28.7%)	41,417 (71.3%)	64,498,513	- 838,435	6.3	1,100	3.4
35,000 - 39,999	34,041	7,389 (21.7%)	26,644 (78.3%)	46,657,121	- 355,334	2.7	1,371	3.7
40,000 - 44,999	21,672	4,040 (18.6%)	17,624 (81.3%)	35,297,528	- 189,104	1.4	1,629	3.9
45,000 - 49,999	13,482	2,042 (15.5%)	11,408 (84.6%)	25,562,570	- 96,500	0.7	1,896	4.0
50,000 - 74,999	21,736	2,937 (13.5%)	18,766 (86.3%)	53,593,363	- 141,355	1.1	2,466	4.2
75,000 - 99,999	5,214	553 (10.6%)	4,653 (89.2%)	19,898,530	- 26,722	0.2	3,816	4.5
100,000 & Over	5,128	405 (07.9%)	4,709 (91.8%)	42,092,336	- 19,305	0.1	8,208	4.7
TOTALS	1,957,183	1,451,406 (74.2%)	483,457 (24.7%)	$738,706,419	$-13,323,208	100.0	$ 377	2.8%

NOTE: Details may not add to totals due to rounding.

SOURCE: Department of Taxation income sampling model, taxable year 1977 data. (Reference Structure 47)

[a] Percentages do not add to 100, because for some returns at low income levels personal, dependent, age and blindness exemptions are sufficiently large to reduce AGI to zero without deductions.

slightly. Since this alternative only increases the upper bound on the current standard deduction and essentially maintains the same treatment for Virginia taxpayers who have been unaffected by the various federal changes, it is significantly less costly than the previous alternative. For 1977, the estimated cost would have been approximately $13 million. For this alternative, however, a greater relative share of tax relief flows to higher income taxpayers. Only about 10 percent of the total tax relief accrues to taxpayers with under $15,000 in income and about 60 percent of the total goes to taxpayers with income between $15,000 and $25,000. This shift in the distribution of tax relief is consistent with the above example showing that taxpayers would receive a larger standard deduction only to the extent that their federal AGI is greater than $13,333 and that only taxpayers with federal AGI in excess of $22,667 would receive the new maximum standard deduction. Under this alternative there is relatively no change in both the aggregate effective tax rate and the effective tax rates for the various income classes. We estimate that if this alternative were to become effective for taxable years beginning on and after January 1, 1980, it would cost approximately $28 million in fiscal year 1981 and $23 million in fiscal year 1982.

Tax Treatment of One Earner Versus Two Earner Couples

The Nature of the Federal Marriage Penalty

The tax penalty on marriage is a phenomenon that has achieved notoriety at the federal level as the result of the federal requirement that single taxpayers and married taxpayers who file separate returns use different tax rate schedules in computing their tax liability. The federal rate schedule used by married persons who file separately is somewhat more progressive than the schedule used by single persons, and

therefore two persons who both continue to work after marriage and file separate tax returns pay more tax on the same amount of taxable income after marriage than the total amount paid by the two of them before marriage.

The federal tax penalty on marriage of the result of 1969 legislation that attempted to reduce the differential in the tax treatment of single persons and married couples who filed jointly. Prior to the enactment of this legislation married couples who filed separately and singles were both subject to the same tax rate schedules, but married couples who filed jointly were permitted to split their joint income.[1] Income splitting for joint taxpayers enabled a couple with one earner to allocate 50 percent of total earnings to each spouse, and the couple's tax was essentially computed on each spouse's share using the basic rate for single and married separate returns. In other words, income splitting had the effect of doubling the basic width of each of the taxable income classes for joint taxpayers, and it consequently reduced for them the progressivity of the rate schedule. Income splitting thus granted a "tax benefit" to persons who married, provided one spouse did not have income. Prior to enactment of the 1969 law two single persons who married and both continued to work paid the same total tax on the same amount of taxable income before and after marriage.

However, while income splitting generated a tax benefit for one earner couples after marriage, it created a differential in the tax liabilities

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1/ Income splitting was adopted in 1948 as a measure to correct for differences in the federal tax treatment of couples residing in community property states and couples living in other states. States with community property laws treated a couple's income as if it were owned equally by a husband and wife. Thus, couples from these states were filing separate returns and paying at lower marginal rates on the split amounts, while couples in other states paid at higher marginal rates on the unsplit total.

of single persons whose taxable income was equivalent to a married couple with one earner. In other words, a single individual paid more tax than a married couple with equivalent income. It is generally agreed that married couples with one earner should pay less tax than single persons when both taxpayers have the same income, because the couple has less ability to pay taxes than the single individual.[1/] However, the tax advantage for joint taxpayers created by income splitting relative to single persons was apparently viewed to be excessive. Thus, pressures to ease the federal tax burden on singles resulted in the adoption of a special tax rate schedule for them, despite arguments that it was more appropriate to adjust the relative tax burden of singles through modifications to deductions and exemptions than through the rate schedule.

Under the provisions of the Tax Reform Act of 1969, married taxpayers who file separately still compute their federal tax liability using the old rate schedule that they and single persons both previously used. The new rate schedule adopted for single taxpayers is less progressive than the old rate schedule (i.e., current rate schedule for married separate taxpayers) but still somewhat more progressive than the rates applicable to married joint taxpayers. However, under the current federal law the tax liability of a single person is never more than 20 percent greater than the tax liability of a married couple with equivalent taxable income who files jointly. There is still a moderate tax benefit in marriage for couples with one earner, but the new, less progressive rate schedule for singles has resulted in a "marriage penalty" for two earner couples.

1/ See, for example, Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and in Practice, Second Edition, (New York: McGraw-Hill Book Company, 1976), p. 276.

While the technical definition of the marriage penalty relates to the different federal tax rate schedules for single persons and for married couples who file separately, some critics also refer to the impact of the different federal zero bracket amounts for single persons and married couples as a further disadvantage to marriage. Under the provisions of the current federal law, taxpayers who do not claim itemized deductions are granted a zero bracket amount of nontaxable income. For single persons, the zero bracket amount is $2,300, and for married couples the zero bracket amount is $3,400, or $1,700 per spouse if the couple files separately. Thus, prior to marriage two single persons receive a total of $4,600 as their zero bracket amount, but after marriage the couple receives $3,400, or $1,200 less. These different zero bracket amounts have the impact of increasing taxable income for two earner couples after marriage and serve to compound the federal marriage penalty problem, since, as noted above, two earner couples who file separately are subject to a more progressive tax rate schedule.

In addition, there is a further disadvantage for two earner couples who file separately in favor of one earner couples who file jointly. Even though the federal tax rate schedules for married separate taxpayers and married joint taxpayers are designed so that if each of the two married couples has the same total taxable income they pay the same tax, some experts believe that the couple with one earner has a greater ability to pay taxes. This is because the spouse who does not earn money income still generates income in the form of services to the family.[1/] Such

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1/ George F. Break and Joseph A. Pechman, Federal Tax Reform: The Impossible Dream?, (Washington, D.C.: The Brookings Institution, 1975), p. 34.

income is not easily measurable, and for this reason it is not practical to make it taxable. However, according to this view, the tax paid by the two earner couple is proportionately greater than the tax paid by the one earner couple.

Virginia's Treatment of Married Couples and Alternatives

Virginia law provides for the use of one rate schedule for single persons, one or two earner married couples who file jointly, and two earner couples who file separately. Thus, there is no marriage penalty in the Virginia tax rate schedule, since persons who marry and both continue to work pay according to the same tax rate schedules before and after marriage. However, there is a "tax disadvantage" in marriage for two earner couples if they elect to file a married joint return rather than a married separate return, since it is likely that a couple's joint taxable income falls in a higher marginal tax bracket than if they compute their tax liabilities separately. However, married taxpayers who both have income are alerted to this disadvantage in the income tax instruction packet and are encouraged to file separately on the combined return.

While there is no marriage penalty in the Virginia tax rate schedule, the current Virginia standard deduction does impact single persons who marry similarly to the federal zero bracket amounts. Current law provides a standard deduction of 15 percent of federal AGI, with a minimum of $1,300 and a maximum of $2,000. These limits apply to both single persons and married couples. Thus, two earner married couples receive a standard deduction that is as much as $2,000 less than the total of the standard deductions that they received as single persons. For example,

assume two single persons with federal AGI's of $6,000 and $10,000, respectively. Before marriage the first individual receives a standard deduction of $1,300, and the second individual receives a standard deduction of $1,500, with the two taxpayers receiving a total of $2,800. If the two persons marry and both continue to work, and if we assume that they file separately on a combined return, their standard deduction is then based on $16,000 of federal AGI and is $2,000, or $800 less than the total amount that they received as singles. This $2,000 may be allocated between the husband and wife as they mutually agree in order to minimize their combined tax bill, but the optimal allocation does not offset the tax increase that occurs as the result of a decrease in the permissible standard deduction.

If Virginia wished to eliminate the disadvantage in marriage created by the current standard deduction, an alternative would be to provide the same standard deduction to all individuals. For example, instead of granting a current standard deduction at 15 percent of federal AGI ranging from $1,300 to $2,000 to both single persons and married couples, a new Virginia standard deduction for married couples could be provided still based on the same percentage of federal AGI but with a range from $2,600 to $4,000. This alternative would relate favorably to the notion that married couples with one earner should pay less tax than single persons when both taxpayers have the same income, and obviously it would equate the treatment of two single individuals to a two earner couple. In addition, this alternative would also move the upper bounds on the Virginia standard deduction closer to the current federal zero bracket amounts, although the Virginia maximum and the federal zero brackets would still not be brought into uniformity. For example, the federal

zero bracket amount for singles would still be $300 greater than the maximum Virginia standard deduction, but the federal zero bracket amount for couples would be $600 less than the maximum Virginia standard deduction.[1/] On the other hand, there is, as noted earlier, a moderate federal tax disadvantage in marriage associated with the federal zero bracket amounts. Clearly, if state policy makers elect to either conform fully to the federal zero bracket amounts or adopt them as new Virginia upper bounds (as outlined in an earlier section), the Virginia marriage disadvantage cannot be removed. However, if state policy makers elect to solve the Virginia marriage disadvantage, then there will have to be a tradeoff between its solution and complete conformity to the federal structure.

Table 7 presents the same distributional data for this alternative as presented earlier. When compared to the current structure (see Table 4), the number of tax returns with itemized deductions declines slightly from about 28 percent to 24 percent. In 1977, this alternative would have cost approximately $26 million, with about three-fourths of total tax relief accruing to taxpayers with incomes less than $25,000. Again,

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1/ However, it is interesting to note that the alternative outlined here could provide partial relief to taxpayers who are caught between the Virginia maximum standard deduction and the federal zero bracket amount. That is, for married taxpayers whose itemized deductions are only slightly under the $3,400 federal zero bracket amount and who are limited to a $2,000 Virginia standard deduction, this alternative could enable them to receive a larger Virginia standard deduction to the extent that 15 percent of their federal AGI is greater than $2,000. Single taxpayers, on the other hand, who are similarly caught between the federal zero bracket amount of $2,300 and the $2,000 Virginia standard deduction would not benefit. However, even if such a taxpayer had $2,299 of itemized deductions, it is likely that at least $299 of these deductions are state income taxes, which are not allowable as an itemized deduction for Virginia purposes anyway.

TABLE 7 -- THE IMPACT OF DOUBLING THE UPPER AND LOWER STANDARD DEDUCTION BOUNDS FOR MARRIED TAXPAYERS ON THE DISTRIBUTION OF TAX RETURNS BY TYPE OF DEDUCTION, TAX LIABILITY, AND EFFECTIVE TAX RATE

Virginia AGI Class	Total No. of Returns	Distribution of Returns By Type of Deduction: No. of Standard Deductions (Percent of Returns)	Distribution of Returns By Type of Deduction: No. of Itemized Deductions (Percent of Returns)	Tax Liability: Amount	Tax Liability: Change From Current Structure: Amount	Tax Liability: Change From Current Structure: Percent of Total	Average Tax Per Return	Effective Tax Rate
$ 0 - 999	100,820	81,702 (80.2%)[a]	2,131 (2.1%)[a]	$ 70,122	$- 4,069	0.01	$ 1	0.1%
1,000 - 1,999	123,304	119,454 (96.9%)[a]	2,650 (2.1%)[a]	233,638	- 36,863	0.1	2	0.1
2,000 - 2,999	108,593	105,221 (96.9%)[a]	2,294 (2.1%)[a]	1,169,777	- 94,319	0.4	11	0.4
3,000 - 3,999	95,654	91,758 (95.9%)	3,596 (3.8%)	2,362,417	- 202,439	0.8	25	0.7
4,000 - 4,999	96,637	92,234 (95.4%)	4,153 (4.3%)	3,757,293	- 432,120	1.7	39	0.9
5,000 - 5,999	101,452	95,882 (94.5%)	5,426 (5.3%)	5,831,716	- 660,683	2.6	57	1.0
6,000 - 6,999	95,217	89,301 (93.8%)	5,700 (6.0%)	7,685,363	- 788,811	3.1	81	1.2
7,000 - 7,999	87,894	80,556 (91.7%)	7,146 (8.1%)	9,498,051	- 975,144	3.8	108	1.4
8,000 - 8,999	81,331	72,848 (89.6%)	8,363 (10.3%)	11,484,446	- 1,191,682	4.7	141	1.7
9,000 - 9,999	76,272	67,488 (88.5%)	8,736 (11.5%)	13,141,314	- 1,371,201	5.4	172	1.8
10,000 - 10,999	71,827	61,327 (85.4%)	10,340 (14.4%)	14,616,474	- 1,363,393	5.3	203	1.9
11,000 - 11,999	66,767	54,847 (82.1%)	11,791 (17.7%)	15,817,811	- 1,176,662	4.6	237	2.1
12,000 - 12,999	62,816	49,507 (78.8%)	13,277 (21.1%)	16,868,666	- 1,011,557	4.0	269	2.2
13,000 - 13,999	61,054	46,401 (76.0%)	14,558 (23.8%)	18,433,891	- 869,435	3.4	302	2.2
14,000 - 14,999	59,104	42,701 (72.2%)	16,387 (27.7%)	20,020,936	- 876,742	3.4	339	2.3
15,000 - 15,999	55,630	38,261 (68.8%)	17,357 (31.2%)	20,971,176	- 848,346	3.3	377	2.4
16,000 - 16,999	52,043	32,861 (63.1%)	19,158 (36.8%)	21,516,723	- 799,532	3.1	413	2.5
17,000 - 17,999	48,381	28,255 (58.4%)	20,090 (41.5%)	21,761,483	- 759,586	3.0	450	2.5
18,000 - 18,999	45,863	25,648 (55.9%)	20,215 (44.1%)	22,514,257	- 849,923	3.3	491	2.6
19,000 - 19,999	43,510	23,371 (53.7%)	20,127 (46.3%)	23,038,961	- 915,360	3.6	530	2.7
20,000 - 20,999	38,865	20,354 (52.4%)	18,487 (47.6%)	22,001,748	- 897,876	3.5	566	2.8
21,000 - 21,999	35,636	18,115 (50.8%)	17,505 (49.1%)	21,556,015	- 880,762	3.4	605	2.8
22,000 - 22,999	32,543	16,286 (50.0%)	16,249 (49.9%)	21,034,131	- 879,284	3.4	646	2.9
23,000 - 23,999	29,530	14,899 (50.4%)	14,615 (49.5%)	20,307,633	- 867,021	3.4	688	2.9
24,000 - 24,999	26,421	13,129 (49.7%)	13,284 (50.3%)	19,260,968	- 818,321	3.2	729	3.0
25,000 - 29,999	99,639	45,474 (45.6%)	54,109 (54.3%)	85,146,940	- 3,090,229	12.1	855	3.1
30,000 - 34,999	58,108	21,485 (37.0%)	36,583 (63.0%)	63,915,958	- 1,420,990	5.6	1,100	3.4
35,000 - 39,999	34,041	9,997 (29.4%)	24,036 (70.6%)	46,394,542	- 617,913	2.4	1,363	3.6
40,000 - 44,999	21,672	5,368 (24.8%)	16,296 (75.2%)	35,152,908	- 333,724	1.3	1,622	3.8
45,000 - 49,999	13,482	2,807 (20.8%)	10,643 (78.9%)	25,489,166	- 169,904	0.7	1,891	4.0
50,000 - 74,999	21,736	3,937 (18.1%)	17,766 (81.7%)	53,488,735	- 245,983	1.0	2,461	4.2
75,000 - 99,999	5,214	751 (14.4%)	4,455 (85.4%)	19,879,367	- 45,885	0.2	3,831	4.5
100,000 & Over	5,128	515 (10.0%)	4,599 (89.7%)	42,079,094	- 32,547	0.1	8,206	4.7
TOTALS	1,957,183	1,472,740 (75.2%)	462,122 (23.6%)	$726,501,817	$-25,528,310	100.0	$ 371	2.7%

NOTE: Details may not add to totals due to rounding.

SOURCE: Department of Taxation income sampling model, taxable year 1977 data. (Reference Structure 50)

a/ Percentages do not add to 100, because for some returns at low income levels personal, dependent, age and blindness exemptions are sufficiently large to reduce AGI to zero without deductions.

married taxpayers with total incomes greater than $13,333 (who are currently limited to a standard deduction of $2,000) receive the most tax relief, since most taxpayers with incomes under this amount would be unaffected by this alternative. Only married taxpayers with incomes totalling $26,667 or more would receive the $4,000 maximum standard deduction. When we examine the effective tax rates presented in Table 7 we see a very insignificant decline both in the aggregate and for the various income levels. If the standard deduction for married couples were doubled effective January 1, 1980, we estimate that it would result in a $55 million revenue loss during fiscal year 1981 and a $45 million revenue loss during fiscal year 1982.

In addition, there is a second disadvantage to marriage under the current Virginia income tax structure that is caused by the minimum filing requirement. Under the provisions of a law enacted at the 1978 session of the General Assembly that became effective for taxable year 1979, no income tax is imposed and no tax return must be filed by an individual with less than $3,000 in Virginia AGI or by a married couple with less than $3,000 in Virginia AGI. Thus, it is likely that the tax and filing exemption enjoyed by two low income single persons would be lost after marriage.

If Virginia wished to remove this relatively insignificant marriage disadvantage, then the income constraint for married couples should be twice the income constraint for singles. The revenue cost of the current law is estimated to be approximately $1.2 million per year. If the current income constraint for married couples were doubled, we estimate that the revenue cost would increase by $2.8 million per year. On the

other hand, if the current income constraint for singles were halved, we estimate that the revenue cost would decline by $0.4 million per year.

Treatment of Retired and Elderly Persons

Prior to 1976, Virginia extended income tax relief to the elderly in the form of retirement income exclusions.[1/] These exclusions were available only to certain sectors of retirees and their survivors, and the amount of tax relief to the favored sectors was not uniform. Under the old law, elderly persons who received no formal pension income but who had limited earnings or investment income received no exclusion. Also, the old law did not explicity recognize the different amounts of nontaxable social security retirement benefits received by elderly persons.

Since the amounts of the retirement income exclusions varied between retirement sectors, between retirees and survivors, and between the age classes, and since the old law did not take into account differences in the amounts of social security benefits received by elderly persons, it enabled certain taxpayers to receive substantially different amounts of tax-exempt income. Therefore, the old law violated the concept of horizontal equity with respect to retired and other elderly taxpayers. Also, the amount of tax relief provided by the exclusions increased with the level of taxable income. The exclusions, therefore, also violated the concept of vertical equity. After several years of study of the equity implications of retirement income tax relief the old exclusions were therefore repealed, and the current Virginia tax credit for persons age 62 and over was adopted at the 1976 session of the General Assembly.[2/]

1/ An exclusion reduces the level of taxable income.

2/ A credit is a direct reduction in tax liability.

The Virginia credit was patterned after the federal retirement income credit concept. This concept attempts to provide comparable tax relief for recipients of nontaxable social security benefits and for recipients of income from other taxable sources. To achieve this comparibility, the Virginia credit is structured so that the excludable amount of income is equivalent to the maximum social security benefit payable by age. This base is adjusted annually for any changes in the maximum social security benefit level. This base amount is, however, subject to reduction for actual social security benefits received by the individual. This reduction ensures that compensatory tax relief declines as the amount of nontaxable benefits actually received increases, thereby advancing horizontal equity. A second reduction in the base amount is required when federal AGI exceeds $12,000, in order to limit tax relief to the low and middle income elderly. The amount of this reduction is $2 for each $1 in excess of $12,000. The credit is then calculated by applying 5 percent to the credit base after these adjustments and is limited to no more than the individual's tax liability. By allowing all taxpayers to calculate their credit at the 5 percent marginal rate, the current law also promotes vertical equity. Table 8 traces changes in the Virginia credit base for the 1976 through 1979 taxable years as the result of increases in social security benefits, and it demonstrates the general manner in which computations are made. For 1979, the structure of the credit will enable all taxpayers age 65 and over to receive up to $6,640 in nontaxable income.

In addition to the features noted above, the current credit is structured such that the same amount of tax relief is available to all low and

TABLE 8 -- THE VIRGINIA CREDIT FOR PERSONS AGE 62 AND OVER, 1976 THROUGH 1979 TAXABLE YEARS[a]

	1976	1977	1978	1979
Credit Base:				
Taxpayers Age 62	$3,427	$3,833	$4,255	$5,147
Taxpayers Age 63	3,786	4,212	4,666	5,634
Taxpayers Age 64	4,078	4,622	5,094	6,133
Taxpayers Age 65 and Over	4,368	4,952	5,518	6,640

Less:

1. Actual Social Security or Railroad Retirement Benefits Received; and/or

2. $2 for each $1 for Federal AGI in Excess of $12,000

Equals:
Adjusted Credit Base

Times:
5 percent

Equals:
Calculated Credit

Actual Credit:
Lesser of Calculated Credit or Income Tax Liability

a/ A credit is a direct reduction in tax liability.

NOTE: The full exclusion for Virginia Supplemental Retirement System (VSRS) pensions granted under the old law was retained on an elective basis. VSRS retirees may opt for either the credit or for the full exclusion of their VSRS benefits, but they may not claim both forms of tax relief.

middle income elderly taxpayers when social security payments are equivalent. Also, elderly persons with earned income and/or investment income are eligible for the same tax relief under the current law as persons with pensions, annuities, or other forms of retirement income. Therefore, elderly persons with any type or combination of types of income are treated equally.[1] Each of these features further advances the concept of horizontal equity.

Because the current law advances both the concepts of horizontal and vertical equity with respect to persons age 62 and over, there is very little to suggest the need for any reform. However, one alternative that has been suggested by various retired taxpayer groups is to either increase the income constraint on federal AGI or to abolish it. Obviously, either alternative would redirect tax relief to larger numbers of elderly persons with larger incomes, when the original intent of the law was to limit relief to the low and middle income elderly. On the other hand, the selection of the $12,000 income constraint really has no special merit relative to other possible income constraints, and it might be suggested by some that there is a case for increasing the current income constraint simply to adjust for the impact of inflation.

However, one could also argue that the federal AGI of most elderly and retired persons probably consists primarily of pension income, which does not usually rise with inflation and consequently would not tend to

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1/ For a more detailed evaluation of the current law and its equity implications see: Nancy D. Beistel, "Virginia's Reform of Income Tax Treatment of Elderly Persons," Revenue Administration 1978: Proceedings of the Forty-Sixth Annual Meeting of the National Association of Tax Administrators, June, 1978), pp. 176-189.

render greater numbers of tax credit recipients ineligible over time. For elderly persons who are not retired and who do depend on earnings, a stronger case can probably be made for increasing the income contraint, since some of these persons would be rendered ineligible for the tax credit to the extent that their federal AGI increased solely as the result of inflation. However, it is unlikely that such persons are highly representative of typical tax credit recipients. In addition, the current tax credit base (or equivalently the amount of excludable income) is automatically adjusted annually for increases in social security benefits, since these are tied to changes in the consumer price index by federal law. Therefore, the current credit structure already ameliorates for the effects of inflation.

For taxable year 1977, approximately 88,000 taxpayers age 62 and over claimed credits totalling $7.3 million.[1/] We estimate that if the current income constraint were increased to $18,000, as has been suggested by at least one group of retirees, that the revenue cost would increase by approximately $1.4 million per year. If the income contraint were abolished, we estimate that the revenue cost would increase by $5.2 million annually.

Another possible although not critical area for reform also relates to the income constraint and its application to married couples. Under the current law, tax relief for single persons does not completely disappear until federal AGI exceeds approximately $14,500. For married couples who each have income, tax relief for each spouse also does not disappear

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1/ For a more lengthy discussion of the characteristics of these tax credit recipients, see Virginia Department of Taxation, A Summary of the 1977 Age Credit Statistics, Issue Paper No. 7, June, 1979.

until his or her federal AGI exceeds $14,500, but there is essentially no upper limit on the combined income of the couple. For example, consider a married couple both over age 65 whose joint income is $40,000, of which $30,000 is attributable to one spouse and $10,000 is attributable to the other spouse. Assuming the spouse with $10,000 does not receive the maximum social security benefit, that spouse is still entitled to a Virginia tax credit even though total family income places the couple in an upper income level.

If policy makers wish to better limit tax relief to the low and middle income elderly, one alternative might be to require that the income constraint utilize in some way the combined federal AGI of married couples. For example, if the current federal AGI constraint on individual income were replaced with a constraint on the combined federal AGI of a husband and wife, many taxpayers with relatively high family incomes would no longer receive tax relief. Alternatively, the current law could be modified to include as a secondary constraint to the individual constraint a limit on the couple's combined income. The use of such a twin constraint would also eliminate the provision of a credit to taxpayers with relatively high family incomes. However, if the income constraint applicable to married persons was reduced relative to the constraint for single persons, this would introduce an element of marriage penalty into the tax structure with respect to elderly persons. In other words, two single individuals who are eligible for a tax credit would possibly be eligible for only a much smaller credit or even no credit if they chose to marry.

Thus, a tradeoff exists between limiting tax relief to low and middle income elderly households and avoiding discriminatory treatment of

taxpayers based on marital status. The revenue impact of either of these alternatives is probably minimal but it is unknown. However, by disallowing the credit for individuals who are members of upper income households, obviously the effect would be to generate some additional revenues.

The Impact of Inflation on the Income Tax

A great deal has already been written on the interaction of inflation with income taxes.[1/] In addition, there have been several studies of the impacts that various indexation packages would have had on Virginia income tax revenues and individual tax burdens had the original 1972 conformity structure been indexed beginning in 1973.[2/] These studies provide much insight into what indexation might have meant for past years, but the real issue for the purposes of tax reform is what indexation would mean in future years. However, unlike the tax reform alternatives that we have heretofore analyzed in this paper and for which we have estimated revenue and distributional impacts, it is more difficult to estimate the possible future effect of any indexation proposals. For

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1/ See, for example, George M. VonFurstenburg, "Individual Income Taxation and Inflation," National Tax Journal, Vol. 28, No. 1, (March, 1975), pp. 117-125; Henry J. Aaron, editor, Inflation and the Income Tax (Washington, D.C.: The Brookings Institution, 1976); and Advisory Commission on Intergovernmental Relations, Inflation and Federal and State Income Taxes, A-63, (Washington, D.C.: November, 1976).

2/ See, for example, ACIR, "Indexation of the Virginia Personal Income Tax: A Case Study," Inflation and Federal and State Income Taxes, A-63, (Washington, D.C.: November, 1976), pp. 77-82; Robert T. Benton and Philip M. Gabel, "Uses of a State Income Tax Sampling Model in Virginia: With Applications to Credits and Indexation," Revenue Administration 1977: Proceedings of the Forty-Fifth Annual Meeting of the National Association of Tax Administrators (Washington, D.C.: Federation of Tax Administrators), pp. 159-171; and a forthcoming report of the Revenue Resources and Economic Commission.

one thing, we must select a base period to which the tax structure would be indexed for following years. For example, should the base period be 1972 and should we adjust the tax structure beginning in 1980 for the relative differences in prices between 1972 and 1980, or should the base period be 1979 with the current tax structure indexed in 1980 to reflect only the change in prices from 1979 to 1980? Alternatively, should we consider indexation only after we have corrected for the problems associated with the difference between the federal zero bracket amounts and the Virginia standard deduction?

In any event, in order to estimate the impact of any indexation alternative for future years, we must be able to project increases in nominal income (i.e., money income actually received) and real income (i.e., purchasing power of the income) and the relative distribution of these increases for various income and tax levels. At best, such projections would be crude, but more importantly, even if such distributional estimates could be generated, they could not be used in conjunction with the income tax simulation model. Therefore, current revenue estimating technology precludes the estimation of the revenue and distributional effects of indexation for future years at this time. For all of these reasons, this section will focus only on the major economic effects of inflation on income taxes for individuals and government and will not specifically analyze alternatives.

To set the following discussion in broad perspective, Table 9 presents various historical data on the growth in Virginia personal income in both nominal and real terms and the rate of inflation. We also present data on the increases in tax returns, Virginia AGI, and aggregate and

TABLE 9 -- A COMPARISON OF THE STATE INCOME TAX TO REAL AND INFLATIONARY GROWTH IN THE ECONOMY

	Economic Indicators			State Income Tax Data				
	Virginia Personal Income							
Calendar (Taxable) Year	Current $ (Millions)	Constant $ (Millions)	Consumer Price Index (1972=100)	Total No. of Tax Returns	Virginia Adjusted Gross Income (Millions)	Ratio VAGI to Current $ Personal Income	Total Tax Liability (Millions)	Average Tax Per Return
1972	$20,942.0	$20,940.5	125.3	1,636,741	$15,882.4	.758	$364.7	$228
	...	...	...	...	...	...	...	...
1973	23,531.5	22,240.0	133.1	1,731,949	18,158.0	.772	436.8	257
	+12.4%	+6.2%	+6.2%	+5.8%	+14.3%	...	+19.8%	+12.7%
1974	26,205.5	22,578.9	147.8	1,807,198	20,248.1	.772	510.5	284
	+11.4%	+1.5%	+11.1%	+4.3%	+11.5%	...	+16.9%	+10.5%
1975	28,719.8	22,589.4	161.2	1,799,755	21,573.1	.751	560.2	311
	+ 9.6%	+0.04%	+ 9.1%	-0.4%	+ 6.5%	...	+ 9.7	+ 9.5%
1976	31,904.5	23,859.5	170.5	1,877,585	24,302.0	.762	657.8	346
	+11.1%	+5.6%	+ 5.8%	+4.3%	+12.6%	...	+17.4%	+11.2%
1977	35,125.8	24,788.1	181.5	1,943,603	27,459.7	.782	748.5	394
	+10.1%	+3.9%	+ 6.5%	+3.5%	+13.0%	...	+13.8%	+13.9%

SOURCES: Historical economic data: Chase Econometrics, Inc. data base.
State income tax data: Department of Taxation Annual Reports.

average tax liabilities. The more than proportionate rate of growth in income tax liability relative to any measure of income clearly indicates the aggregate impact of inflation coupled with progressivity, which we shall now discuss in greater detail.

There are three broad categories of effects that inflation can have. The first category of effects is typically viewed to be undesirable when placed under the "ability to pay" theoretical framework. The "ability to pay" theory of taxation was discussed in greater detail earlier in this paper. Essentially, this theory calls for persons with equal incomes (ability) to pay equal taxes and for persons with higher incomes (ability) to pay more tax than persons with lower incomes (ability). While the theory does not explicitly reference real income, the concept of "ability" suggests consideration of real income as opposed to nominal income.

To illustrate the first category of effects of inflation and progressivity, consider the example in Table 10 of three individuals who in some base year period have equal incomes of $10,000. In the base year nominal income is equivalent to real income. If we assume that the annual rate of inflation is 10 percent, the money income level of person A increases at the same rate as the rate of inflation but real income is constant. However, under the state's progressive income tax structure an individual's tax bill is determined by money income and not real income. Therefore, even though person A has not experienced an increase in purchasing power, his tax bill has increased. Moreover, inflation and the progressive tax rate schedule together have generated a rate of increase in tax that actually exceeds the rate of increase in money

TABLE 10 -- AN ILLUSTRATION OF THE IMPACT OF A 10 PERCENT INFLATION RATE ON THREE INDIVIDUALS INITIALLY AT EQUAL POSITIONS

	Before Tax Income Level			Tax Liability[a]		After Tax Real Income		Effective Tax Rate On:		
	Base Year	Following Year							Income Following Year	
	(Nominal $ = Real $)	Nominal $	Real $	Base Year	Following Year	Base Year	Following Year	Base Year Income (Nominal $ = Real $)	Nominal $	Real $
Person A	$10,000	$11,000 (+10.0%)	$10,000 (0.0%)	$265	$308 (+16.2%)	$9,735	$ 9,692 (-0.4%)	2.65%	2.80%	3.08%
Person B	10,000	11,500 (+15.0%)	10,455 (+4.5%)	265	329 (+24.1%)	9,735	10,126 (+4.0%)	2.65%	2.86%	3.15%
Person C	10,000	10,000 (0.0%)	9,091 (-9.1%)	265	265 (0.0%)	9,735	8,826 (-9.3%)	2.65%	2.65%	2.91%

a/ Assumes a single individual claiming one personal exemption and the current standard deduction.

income. In addition, the effective tax rate both as a percentage of nominal and real income has increased. The significance of these increases is that the effect of inflation and progressivity for a person with constant real income is to erode after tax real income. In other words, after tax real income in the base year was $9,735, but in the following year it declines to $9,692. The higher tax bill and its eroding effect on constant real income is therefore at odds with the "ability to pay" theory.

For person B who experiences an increase in both nominal and real income, again the rate of increase in tax liability exceeds the rate of increase in income measured either nominally or in real terms. Again, the effective tax rate against both nominal and real income increases. In addition, since under a progressive income tax the tax bill for the individual responds to the total income increase, and not just the real increase, the increase in income tax will also erode the gain in purchasing power. Person B experiences a before tax gain in real income of $455. In the base year, after tax real income was $9,735 and in the following year it increases to $10,126. Therefore inflation coupled with progressivity erodes the real income increase from $455 to $391. The "ability to pay" theory of taxation does suggest that higher taxes correspond with gains in real income, but inflation causes the tax bill to be higher than it would otherwise be.

Person C is a fixed income individual. Obviously, such persons experience a decline in purchasing power as prices increase. However, with income tax computed against money income, and not real income, taxes remain the same even though purchasing power declines. Put differently,

even though the effective tax rate on money income remains the same, the effective tax rate on real income increases. In the base year after tax real income is $9,735, but in the following year after tax real income declines to $8,826. For such individuals the decline in real income is not offset by decrease in tax, an undesirable effect when placed under the "ability to pay" framework.[1/]

To summarize, the important effects of inflation and progressivity are as follow:

1. Persons whose nominal incomes increase with the rate of inflation but experience no increase in real income encounter higher effective tax rates on both nominal and real incomes. The effect is to erode fixed real income, which violates the "ability to pay" theory of taxation.

2. Persons whose nominal incomes increase more rapidly than the rate of inflation also encounter higher effective tax rates on both nominal and real income. The effect is to erode the real income gain to a greater extent than called for under the "ability to pay" theoretical framework.

3. Persons living on fixed nominal incomes who experience a decline in real income encounter no increase in the effective tax rate on nominal dollars but do encounter an increase in their effective tax rate on real income. The constant level of tax causes further erosion to real income, an adverse effect relative to the "ability to pay" theory.

A carefully structured plan for indexation could correct for each of these adverse equity effects.

Second, inflation interacts with the income tax structure to reduce the real dollar value of exemptions, deductions, credits, and taxable income brackets. For example, between 1972 and 1978 inflation increased by

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[1/] The foregoing example draws on analysis by ACIR, Inflation and Federal and State Income Taxes, pp. 2-8.

approximately 56 percent. If we calculate the difference between the 1972 value of the Virginia exemption, deduction, and rate bracket amounts and the 1978 real value of these provisions, we see that inflation has had the following effect:

	Taxable Year 1972 (Base Year)	Real Value Taxable Year 1978
Exemptions:		
Personal, dependent, and blindness	$ 600	$ 384
Age	1,000	641
Standard Deduction:		
Minimum	$ 1,300	$ 833
Maximum	2,000	1,282
Rate Brackets:		
Lowest tax bracket, 2%	$ 0 - 3,000	$ 0 - 1,923
Second tax bracket, 3%	3,001 - 5,000	1,924 - 3,205
Third tax bracket, 5%	5,001 - 12,000	3,206 - 7,692
Highest tax bracket, 5.75%	12,001 and over	7,693 and over

Thus, during inflationary periods when incomes are rising in nominal dollars and real incomes may or may not be rising, if these various provisions remain fixed their real value to the taxpayer declines. As the result, the effect is to increase the income tax burden for the taxpayer in the same manner as if there were a zero rate of inflation and the legislature reduced the personal exemption and deduction amounts and increased the progressivity of the tax rate schedule. However, taxpayers are less cognizant of such inflation induced change than they would be of a legislative change. Indexation could also remove these continual unintended tax increases caused by inflation.

Third, under a progressive income tax structure revenues increase more than proportionately to increases in income, since the tax rate schedule provides for ever higher rates of tax at higher income levels. When the

inflation rate is zero and and the level of income increases as the result of an expanding economy, this progressivity is generally desirable from the government's point of view since taxpayers may demand proportionately more public services. For example, if taxpayers feel relatively more wealthy as the result of expanding real income, they may desire to increase their consumption of such public services as higher education for their children or recreational facilities. If revenues increase more than proportionately to increases in real income, the government then has sufficient resources to accommodate increased demand for such public services.

However, as shown previously when inflation accompanies increases in real income, some taxpayers may actually experience a decline in after tax real income. Since tax liability and hence tax revenues are based on nominal income, the more than proportionate increase in revenues under a progressive income tax is even larger as the result of inflation. Consequently, the government collects more revenues even though the taxpayer's demand for public services may remain constant or may be declining as the result of a decline in after tax real income. The potential result is a larger public sector than taxpayers actually desire. Indexation can also prevent a larger than desired public sector. In addition, it would mandate a higher degree of fiscal accountability among policy makers.[1/]

On the other hand, it can also be argued that during inflationary periods the cost of operating government for a given level of services is also

1/ It is worthwhile to note that this feature of indexation makes it a viable alternative to other concepts of tax and/or expenditure limitation.

increasing, and therefore the tax structure should provide sufficient additional revenues to accommodate price level increases. It is unclear whether or not the "normal" progressivity of the tax structure (i.e., indexed for the effects of inflation) that would accompany expanding economic activity (increasing levels of real income) would be sufficient to accommodate such increases in the cost of providing a given level of government services. In other words, even if the tax structure could be fully indexed to offset for the taxpayer the impact of inflation, it is unclear whether the progressivity relative to real income increases would be sufficient to operate a government acquiring goods and services at higher price levels. Of course, if there were no increases in real income for any taxpayer and if the income tax were fully indexed, income tax revenues would be held constant while costs of operating government would be increasing. Thus, some service cuts might become necessary. Finally, if real incomes were falling as the result of an economic slowdown or recession but inflation was still advancing, full indexation again would remove the adverse inflationary impact for the taxpayer but income tax revenues would decline. This decline would be accompanied by higher governmental costs brought on by inflation and possibly increased demand for such public services as welfare or other public assistance programs. Thus, while indexation has many advantages for the taxpayer and would provide for a higher degree of fiscal accountability, it could potentially tie the hands of policy makers in responding to increasing costs of operating government.[1/]

[1/] The foregoing discussion of the effects of inflation on revenues, fiscal accountability, demand for public services, and relative size of the public sector is also drawn from ACIR, Inflation and Federal and State Income Taxes, pp. 3, 43-50.

Individual Income Tax Withholding

Under current law the State Tax Commissioner is authorized to develop individual income tax withholding tables. (See Section 58-151.3, Code of Virginia.) The law provides that withholding tables reflect "...the number of exemptions allowed under the laws of the United States relating to federal income taxes..." as well as the current state standard deduction. The law also mandates that "...the amount withheld for any individual during his taxable year shall approximate in the aggregate as closely as practiceable..." his tax liability for the year.

The current withholding formula and tables were constructed following the adoption of conformity legislation and the enactment of the 5.75 percent rate for taxable incomes over $12,000. Although the authority granted the State Tax Commissioner is quite broad and the law clearly specifies that withholding reflect as closely as possible the taxpayer's actual tax bill, the current withholding formula takes into account several other important administrative and policy considerations. First, the current formula was structured so that the cash/flow impact of converting from the previous formula would be minimized. In other words, any change to the withholding formula that either increases or decreases the level of withholding could have a one-time impact on revenues during the first fiscal year for which the change were to become effective, depending upon when the new table is implemented. Second, the current table was intentionally structured to include a certain degree of overwithholding. Some overwithholding is desirable from a tax administrative viewpoint, since taxpayers who are due a refund have an incentive to file a tax return. On the other hand, if the formula were not designed to overwithhold, taxpayers who owe no tax

or underpay conceivably would have no incentive to file a tax return. Of course, these taxpayers would eventually be detected when the state tax file is compared to the federal file, but overwithholding encourages voluntary rather than enforced compliance.

Table 11 shows the current withholding formula based on an estimate of annual income adjusted for personal and dependent exemptions and a standard deduction allowance. In order to effect the desired rate of overwithholding relative to the old withholding formula, the current formula essentially assumed for each taxpayer a standard deduction of only $650. Of course, only married taxpayers who file separate tax returns and each of whom has under $4,333 in income are limited to a $650 standard deduction. The majority of taxpayers have significantly larger standard deductions. For example, the average standard deduction for 1977 was $1,472. In addition this $650 allowance applies to taxpayers who itemize, most of whom have deductions of $3,400 or greater. At the federal level, taxpayers who have substantial amounts of itemized deductions can avoid large refunds and instead receive withholding relief by claiming additional withholding allowances. For example, a taxpayer who anticipates large itemized deductions can for withholding purposes be treated as if he had larger family and as if he were entitled to more dependent exemptions. However, the current Virginia withholding formula only allows such taxpayers to claim additional exemptions if they request and receive permission from the State Tax Commissioner. Unless these taxpayers make such a request they have income tax withheld as if they had only a $650 standard deduction. As the result, the majority of taxpayers receive refunds when they file their tax returns.

TABLE 11 -- THE CURRENT FORMULA FOR COMPUTING VIRGINIA INCOME TAX WITHHOLDING

Legend

G = Gross pay for pay period

P = Pay periods per year

A = Annualized gross pay

E = Total personal and dependent exemptions

T = Annualized taxable income

W/H = Tax to be withheld for pay period

W = Annualized tax to be withheld

Formula

(1). (G) P - [$650 + (600) E] = T

(2). If T is: W is:

Not over $3,000 .... 2% of T

Over . . .	But not over . . .		of excess over . . .
$3,000	$5,000	$60 + 3%	3,000
5,000	12,000	120 + 5%	5,000
12,000	......	470 + 5 3/4%	12,000

(3). W ÷ P = W/H

Table 12 demonstrates the historical relationship between taxable year withholding and refunds. Since it is reasonable to assume that taxpayers who file declarations and pay estimated tax installments are rational and do not overpay their tax, the ratio of refunds to withholding indicates the approximate percentage of overwithholding built into the current withholding formula. This table indicates that the current withholding formula actually overwithholds to a slightly greater extent than did the pre-1972 formula. However, while the overwithholding percentage has remained relatively constant over time, it has demonstrated a mild downward movement. This can be explained in part by the impact of the federal changes to the standard deduction and the adoption of zero bracket amounts (discussed earlier), which has resulted in an unintentional state tax increase for taxpayers who have lost the benefit of itemized deductions. Since these taxpayers are limited to a smaller Virginia standard deduction, their state tax bills have increased and consequently their refunds have diminished over the past several years.

While the overwithholding factor has remained relatively constant at approximately 21 to 23 percent, obviously as the level of withholding increases so does the level of refunds. For fiscal year 1979, individual income tax refunds totalled almost $210 million. This is approximately four times the $68 million volume of refunds issued during fiscal year 1973. This reflects a $210 million float for the state that taxpayers might otherwise have had at their disposal. Thus, one alternative for tax relief (and reform) would be to restructure the income tax withholding formula to reduce the degree of overwithholding. One advantage to reduction in overwithholding is that taxpayers would perceive such a move as a tax cut, since they would realize an increase in their

TABLE 12 -- TAX REFUNDS AS A PERCENTAGE OF TOTAL WITHHOLDING FOR CALENDAR YEARS

Taxable Year	Total Withholding	Total Refunds[a/] Dollar Amount	Total Refunds[a/] Calendar Year Paid	Refunds as % of Total Withholding
1965	$124,094,893	$ 24,998,374	1966	20.14%
1966	143,493,688	27,652,309	1967	19.27%
1967	161,562,095	31,245,162	1968	19.34%
1968	191,087,467	39,944,145	1969	20.90%
1969	231,105,577[b/]	49,474,495	1970	21.41%
1970	269,029,065	57,130,322	1971	21.24%
1971	313,038,778	65,973,100	1972	21.08%
1972	372,517,885	86,142,574	1973	23.12%
1973	445,184,116	106,604,345	1974	23.95%
1974	521,625,537	122,036,956	1975	23.40%
1975	584,005,638	133,422,726	1976	22.85%
1976	669,053,126	150,522,771	1977	22.50%
1977	790,318,465	173,551,553	1978	21.96%
1978	912,015,363	197,164,788[c/]	1979	21.62%

a/ Total refunds are paid in the year following total withholding. Therefore, refunds for taxable year 1965 are actually paid in calendar year 1966, and so forth.

b/ Adjusted to exclude a windfall of $29.709 million, which occurred as a result of the beginning of monthly withholding deposits.

c/ Preliminary figure.

net take home pay. Second, a reduction in overwithholding could potentially reduce the administrative burden of generating large yearend refunds. We emphasize that this is a potential advantage, since a proportionate reduction in overwithholding might only reduce the amount being refunded but not the number of refund items. Thus, any attempt to reduce the rate of overwithholding should also attempt to reduce the number of refund items and hence refund processing costs. Third, a reduction in overwithholding, while likely to be perceived as an ongoing tax cut and thus welcomed by the taxpayer, might have only a one-time cost for the state or even no cost.

With respect to disadvantages, the potential one-time revenue cost to the state is the primary drawback. Of course, any revenue loss caused by a reduction in the level of withholding would be offset to some extent by a reduced level of refunds. However, it is possible that the timing of a reduction in withholding could be planned to occur in the same fiscal year for which refunds would be lower, thus minimizing the revenue impact. In addition, some taxpayers view overwithholding as a means of forced saving and prefer to receive large tax refunds. Thus, even if the state alters its witholding formula to cause a reduction in withholding, some taxpayers may change their withholding back to its previous level. Finally, the reduction in overwithholding would reduce the float that the state has available to it.

As noted earlier, the State Tax Commissioner has the authority to develop appropriate withholding tables and could effect a change without legislative action. However, the potentially significant revenue (budget) impact of any change suggests that policy makers should endorse any

proposed change. Because the implications of overwithholding on revenues, tax administration, and individual tax burdens and their interrelationships are highly complex, we only raise the issue as an area for potential reform and do not offer specific alternatives here. Instead, the Department of Taxation intends to conduct a separate, more lengthy study of this issue to be completed at a later date.

SECTION 4:

ALTERNATIVE INCOME TAX REFORM PACKAGES

Objectives

In this section we present two income tax reform packages whose components are drawn from the alternatives analyzed in detail in the previous section. These two alternative packages were developed with the following objectives:

1. To maintain a high degree of conformity to the federal income tax structure;
2. To correct those provisions that currently have the most serious adverse equity effects on taxpayers;
3. To effect reform without requiring a tax rate increase but rather through increasing the progressivity of the overall tax structure; and
4. To minimize the revenue impact of tax reform on individual income tax revenues.

We must note that countless alternative tax packages exist and can be developed following these objectives and/or other reform criteria. The two alternatives presented here are only intended to be illustrative of options available to policy makers.

A Tax Package To Restore Conformity to the Federal Structure

In order to correct for the adverse equity effects for taxpayers currently caught between the federal zero bracket amounts and the maximum

Virginia standard deduction, one alternative that would satisfy the four objectives above would be to adopt the federal zero bracket amounts. As a further measure to enhance the equity and progressivity of the state income tax structure, the package could provide for the substitution of flat $12 tax credits for the four exemption categories.[1/]

This alternative would once again bring Virginia into complete conformity with respect to nontaxable allowances for taxpayers who do not itemize their deductions. As indicated earlier, such a move would also restore the deductions lost to those taxpayers whose itemized deductions are less than the federal zero bracket amount but greater than the current Virginia standard deduction. As the result of losing the benefit of itemized deductions in excess of the Virginia standard deduction these taxpayers have been subjected to an unintended tax increase, and the state has realized additional revenues. This alternative therefore would remove the incentive for such taxpayers to wrongly claim itemized deductions. Also, no additional state audit activity would be required under this alternative, since the current mix of returns with and without itemized deductions would essentially be preserved. Finally, the inclusion of $12 tax credits in this package would also improve the equity of the tax structure by providing the same tax benefits to each taxpayer and dependent and for each age and blindness characteristic of the taxpayer, regardless of income level. As noted in the previous section, there are no theoretical or equity grounds for providing greater tax benefits per person as the level of income rises.

1/ This alternative assumes that the current $400 additional exclusion for age, which essentially translates to a $1,000 exemption, would also be repealed. Persons who are age 65 and over would, however, receive two $12 tax credits.

Obviously, the provision of zero bracket amounts increases significantly the nontaxable income allowance not only for taxpayers caught between the federal zero bracket amount and the current maximum standard deduction but also for taxpayers who receive less than the maximum and who largely have been unaffected by various federal changes. These are primarily low and lower-middle income taxpayers. This increase in the nontaxable income allowance for all taxpayers who do not itemize is the reason that adoption of the federal zero bracket amounts with no other change is so costly. However, the substitution of $12 tax credits, which are in essence the same as the $600 exemption fixed in value at the lowest marginal tax rate (2 percent), has significant power to generate revenues. Since the effect of credits in lieu of exemptions is to make the tax structure more progressive, the combined effect of adoption of federal zero bracket amounts and substitution of $12 tax credits in general terms is to reduce taxes for lower income taxpayers and to increase taxes for upper income taxpayers.

This pattern is demonstrated in Table 13, which presents detailed data by AGI class on the impact of this alternative based on 1977 data. Taxpayers whose AGI is less than $12,000 would experience a decline in tax liability, and higher income taxpayers would experience a tax increase. For taxpayers with under $12,000 of AGI the total tax decrease would have been approximately $17.0 million, while for higher income taxpayers the total tax increase would have been approximately $27.1 million, for a net increase of $10.1 million. It is also important to note that under this alternative taxpayers with less than $3,000 would have had their

TABLE 13 -- THE IMPACT OF FEDERAL ZERO BRACKET AMOUNTS AND SUBSTITUTING $12 TAX CREDITS ON THE DISTRIBUTION OF TAX RETURNS BY TYPE OF DEDUCTION, TAX LIABILITY, AND EFFECTIVE TAX RATE

		Distribution of Returns By Type of Deduction		Tax Liability				
					Change From Current Structure			
Virginia AGI Class	Total No. of Returns	No. of Standard Deductions[a/] (Percent of Returns)	No. of Itemized Deductions (Percent of Returns)	Amount	Amount	Percent of Total Increase (Decrease)[b/]	Average Tax Per Return	Effective Tax Rate
$ 0 - 999	100,820	81,755 (81.1%)[c/]	2,050 (2.0%)[c/]	$ 0	$- 74,191	0.4	$ 0	0.00%
1,000 - 1,999	123,304	120,056 (97.4%)	2,008 (1.6%)	0	- 270,501	1.6	0	0.00
2,000 - 2,999	108,593	105,229 (96.9%)	2,251 (2.1%)	0	- 1,264,096	7.4	0	0.00
3,000 - 3,999	95,654	92,269 (96.5%)	3,183 (3.3%)	685,602	- 1,879,254	11.0	7	0.2
4,000 - 4,999	96,637	92,943 (96.2%)	3,392 (3.5%)	2,098,075	- 2,091,338	12.3	22	0.5
5,000 - 5,999	101,452	96,769 (95.4%)	4,608 (4.5%)	4,147,994	- 2,344,405	13.8	41	0.7
6,000 - 6,999	95,217	90,116 (94.6%)	4,884 (5.1%)	6,267,945	- 2,206,229	12.9	66	1.0
7,000 - 7,999	87,894	81,589 (92.8%)	6,256 (7.1%)	8,300,348	- 2,172,847	12.7	94	1.3
8,000 - 8,999	81,331	74,050 (91.0%)	6,969 (8.6%)	10,688,576	- 1,987,552	11.7	132	1.5
9,000 - 9,999	76,272	69,007 (90.5%)	7,192 (9.4%)	13,043,774	- 1,468,741	8.6	171	1.8
10,000 - 10,999	71,827	63,103 (87.9%)	8,328 (11.6%)	15,047,407	- 932,462	5.5	210	2.0
11,000 - 11,999	66,767	57,134 (85.6%)	9,384 (14.1%)	16,643,304	- 351,169	2.1	249	2.2
12,000 - 12,999	62,816	51,994 (82.8%)	10,581 (16.8%)	17,945,707	+ 65,484	0.2	286	2.3
13,000 - 13,999	61,054	49,153 (80.5%)	11,659 (19.1%)	19,752,297	+ 448,971	1.7	324	2.4
14,000 - 14,999	59,104	46,151 (78.1%)	12,746 (21.6%)	21,470,031	+ 572,353	2.1	363	2.5
15,000 - 15,999	55,630	42,045 (75.6%)	13,452 (24.2%)	22,470,686	+ 651,164	2.4	404	2.6
16,000 - 16,999	52,043	37,329 (71.7%)	14,526 (27.9%)	23,137,472	+ 821,217	3.0	445	2.7
17,000 - 17,999	48,381	33,029 (68.3%)	15,208 (31.4%)	23,506,574	+ 985,405	3.6	486	2.8
18,000 - 18,999	45,863	29,377 (64.1%)	16,444 (35.9%)	24,503,059	+ 1,138,879	4.2	533	2.9
19,000 - 19,999	43,510	26,777 (61.5%)	16,596 (38.1%)	25,124,467	+ 1,170,146	4.3	578	3.0
20,000 - 20,999	38,865	22,145 (57.0%)	16,327 (42.0%)	24,091,583	+ 1,191,959	4.4	620	3.0
21,000 - 21,999	35,636	18,923 (53.1%)	16,381 (46.0%)	23,646,959	+ 1,210,182	4.5	663	3.1
22,000 - 22,999	32,543	16,289 (50.0%)	15,929 (48.9%)	23,097,036	+ 1,183,621	4.4	710	3.2
23,000 - 23,999	29,530	14,235 (48.2%)	14,968 (50.7%)	22,299,985	+ 1,125,331	4.1	756	3.2
24,000 - 24,999	26,421	11,967 (45.3%)	14,215 (53.8%)	21,181,983	+ 1,102,694	4.1	801	3.3
25,000 - 29,999	99,639	36,777 (36.9%)	61,847 (62.1%)	93,150,611	+ 4,913,442	18.1	935	3.4
30,000 - 34,999	58,108	16,511 (28.4%)	40,987 (70.5%)	68,752,923	+ 3,415,975	12.6	1,184	3.7
35,000 - 39,999	34,041	7,333 (21.6%)	26,380 (77.5%)	49,280,164	+ 2,267,709	8.4	1,448	3.9
40,000 - 44,999	21,672	4,010 (18.5%)	17,452 (80.5%)	36,992,011	+ 1,505,379	5.5	1,707	4.0
45,000 - 49,999	13,482	2,023 (15.0%)	11,297 (83.8%)	26,589,519	+ 930,449	3.4	1,973	4.2
50,000 - 74,999	21,736	2,942 (13.5%)	18,750 (86.3%)	55,348,807	+ 1,614,089	5.9	2,546	4.3
75,000 - 99,999	5,214	548 (10.5%)	4,647 (89.1%)	20,326.120	+ 400,868	1.5	3,903	4.6
100,000 & Over	5,128	405 (7.9%)	4,701 (91.7%)	42,536,790	+ 425,149	1.6	8,297	4.8%
TOTALS	1,957,183	1,494,000 (76.3%)	435,611 (22.2%)	$ 762,127,809	$+10,097,682	100.0	$ 389	2.9%

NOTE: Details may not add to totals due to rounding.

SOURCE: Department of Taxation income sampling model, taxable year 1977 data. (Reference Structure 51)

a/ Actually reflects returns claiming a zero bracket amount and not a standard deduction in the current sense.

b/ Percentages calculated for income classes that experience a tax reduction reflect the relative share of the total tax reduction. Percentages calculated for income classes that experience a tax increase reflect the relative share of the total tax increase, which is greater than the net increase for all income classes.

tax liabilities reduced to zero.[1/] Even with the complete elimination of taxes for these taxpayers, their share of the total tax reduction represents only approximately 10 percent of the total decrease of $17.0 million, with taxpayers whose incomes are between $3,000 and $9,000 receiving almost three-fourths of the $17.0 million tax reduction. Of the $27 million increase for taxpayers with incomes greater than $12,000, approximately 80 percent of the increase would actually be borne by taxpayers with incomes greater than $20,000.

With respect to the overall progressivity of the tax structure, we can also see from Table 13 that under this alternative the effective tax rate for taxpayers with incomes under $12,000 would decline slightly and for higher income taxpayers it would increase slightly. (The reader is referred back to Table 4 for effective tax rates under the current structure.) In the aggregate, the effective tax rate increases from 2.8 percent to only 2.9 percent.

We estimate that adoption of this alternative effective for taxable years beginning on and after January 1, 1980, would generate approximately $22 million during fiscal year 1981 and $18 million during fiscal year 1982. These estimates assume the current federal zero bracket amounts. These estimates would, of course, remain intact only if Virginia adopted the current federal zero bracket amounts and did not tie the Virginia structure to any further increases at the federal level. Obviously, complete conformity to prevailing federal zero bracket amounts could

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1/ This elimination of taxes for taxpayers with less than $3,000 of AGI also relates favorably to the state's current provisions that state that no tax must be paid and no tax return must be filed if the taxpayer has under $3,000 of income.

reduce the estimated revenue gain or even cause a revenue decline. As noted earlier, with a recession currently underway and with the increasing likelihood of federal tax cuts to stimulate the economy, the possibility of tax reduction through higher federal zero bracket amounts cannot be overlooked. On the other hand, if Virginia elects to adopt fixed zero bracket amounts in order to avoid any potential decline in state revenues, the state would again be faced with unintentional tax increases for some taxpayers (i.e., those caught between the federal and state zero bracket amounts) and with all the associated problems of gradual deconformity to the federal tax structure discussed earlier.

A Tax Package to Remove the Disadvantage in Marriage

In order to remove the disadvantage in marriage associated with the current standard deduction and at the same time satisfy the four objectives initially set forth, one alternative would be to double the current standard deduction bounds for married taxpayers. As part of the same package, the state could also substitute $20 tax credits for the four exemption categories.[1/] Taxpayers would receive a standard deduction equivalent to 15 percent of federal AGI with a minimum of $1,300 and a maximum of $2,000 for singles, but the standard deduction for married couples would be nc less than $2,600 and no greater than $4,000. Thus, two single persons who marry and who both have income would be treated the same before and after marriage. In addition, this alternative would also move the upper bounds on the Virginia standard deduction closer to the federal zero bracket amounts, although the Virginia maximum and the

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1/ This alternative also assumes that the current $400 additional exclusion for age would be repealed. Taxpayers age 65 and over would, however, receive two $20 tax credits.

federal zero bracket amounts would still be uniform. Single taxpayers would receive a federal zero bracket amount that is $300 greater than the maximum Virginia standard deduction and married couples would receive a zero bracket amount that is $600 less than the maximum Virginia standard deduction.[1/] As noted earlier, there is, however, a moderate federal tax disadvantage in marriage associated with the federal zero bracket amounts. Thus, if state policy makers elect to either conform fully to the federal zero bracket amounts (as proposed in the first package), the Virginia marriage disadvantage cannot be removed. However, if state policy makers elect to solve the Virginia marriage disadvantage, then there will have to be a tradeoff between its solution and complete conformity to the federal structure. Finally, as in the previous tax package, the substitution of $20 tax credits for exemptions would improve the equity of the overall tax structure by eliminating relatively greater tax benefits per person as the level of income increases.

Table 14 again presents key distributional data for this alternative based on 1977 data. This alternative in general also preserves the

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[1/] The reader should, however, recall that this tax package, like the same alternative presented earlier but without tax credits, could provide partial relief to taxpayers who are caught between the Virginia maximum standard deduction and the federal zero bracket amount. That is, for married taxpayers whose itemized deductions are slightly under the $3,400 federal zero bracket amount and who are limited to a $2,000 Virginia standard deduction, this alternative could enable them to receive a larger Virginia standard deduction to the extent that 15 percent of their federal AGI is greater than $2,000. Single taxpayers, on the other hand, who are similarly caught between the federal zero bracket amount of $2,300 and the $2,000 Virginia standard deduction would not benefit. However, even if such a taxpayer had $2,299 of itemized deductions, it is likely that at least $299 of these deductions are state income taxes, which are not allowable as an itemized deduction for Virginia purposes anyway.

TABLE 14 -- THE IMPACT OF DOUBLING THE UPPER AND LOWER STANDARD DEDUCTION BOUNDS FOR MARRIED TAXPAYERS AND SUBSTITUTING $20 TAX CREDITS ON THE DISTRIBUTION OF TAX RETURNS BY TYPE OF DEDUCTION, TAX LIABILITY, AND EFFECTIVE TAX RATE

Virginia AGI Class	Total No. of Returns	Distribution of Returns By Type of Deduction: No. of Standard Deductions (Percent of Returns)	Distribution of Returns By Type of Deduction: No. of Itemized Deductions (Percent of Returns)	Tax Liability: Amount	Tax Liability: Change From Current Structure: Amount	Tax Liability: Change From Current Structure: Percent of Total Increase (Decrease)[a]	Tax Liability: Average Tax Per Return	Effective Tax Rate
$ 0 - 999	100,820	81,876 (81.2%)[b]	1,929 (1.9%)[b]	$ 0	$- 74,191	1.2	$ 0	0.00%
1,000 - 1,999	123,304	119,896 (97.2%)	2,169 (1.8%)	33,768	- 236,733	3.8	0	0.02
2,000 - 2,999	108,593	105,188 (96.9%)	2,293 (2.1%)	476,886	- 787,210	12.6	4	0.2
3,000 - 3,999	95,654	92,057 (96.2%)	3,396 (3.5%)	1,639,632	- 925,224	14.8	17	0.5
4,000 - 4,999	96,637	92,389 (95.6%)	3,946 (4.1%)	3,073,723	- 1,115,690	17.8	32	0.7
5,000 - 5,999	101,452	96,023 (94.6%)	5,354 (5.3%)	5,350,811	- 1,141,588	18.2	53	1.0
6,000 - 6,999	95,217	89,445 (93.9%)	5,555 (5.8%)	7,613,685	- 860,489	13.7	80	1.2
7,000 - 7,999	87,894	80,723 (91.8%)	7,122 (8.1%)	10,031,431	- 441,764	7.0	114	1.5
8,000 - 8,999	81,331	72,656 (89.3%)	8,363 (10.3%)	12,336,427	- 339,701	5.4	152	1.8
9,000 - 9,999	76,272	67,511 (88.5%)	8,687 (11.4%)	14,293,945	- 218,570	3.5	187	2.0
10,000 - 10,999	71,827	61,186 (85.2%)	10,246 (14.3%)	15,860,206	- 119,663	1.9	221	2.1
11,000 - 11,999	66,767	54,777 (82.0%)	11,741 (17.6%)	17,118,043	+ 123,570	0.9	256	2.2
12,000 - 12,999	62,816	49,354 (78.6%)	13,221 (21.0%)	18,177,038	+ 296,815	2.1	289	2.3
13,000 - 13,999	61,054	46,335 (75.9%)	14,477 (23.7%)	19,823,867	+ 520,541	3.7	325	2.4
14,000 - 14,999	59,104	42,587 (72.0%)	16,310 (27.6%)	21,557,773	+ 660,095	4.7	365	2.5
15,000 - 15,999	55,630	38,163 (68.6%)	17,333 (31.2%)	22,595,438	+ 775,916	5.5	406	2.6
16,000 - 16,999	52,043	32,800 (63.0%)	19,055 (36.6%)	23,166,803	+ 850,548	6.1	445	2.7
17,000 - 17,999	48,381	28,189 (58.3%)	20,047 (41.4%)	23,420,062	+ 898,893	6.4	484	2.8
18,000 - 18,999	45,863	25,621 (55.9%)	20,199 (44.0%)	24,197,084	+ 832,904	6.0	527	2.8
19,000 - 19,999	43,510	23,326 (53.6%)	20,047 (46.1%)	24,638,103	+ 683,782	4.9	567	2.9
20,000 - 20,999	38,865	20,177 (51.9%)	18,295 (47.1%)	23,478,579	+ 578,955	4.1	604	3.0
21,000 - 21,999	35,636	17,964 (50.4%)	17,339 (48.7%)	22,940,547	+ 503,770	3.6	643	3.0
22,000 - 22,999	32,543	16,132 (49.6%)	16,087 (49.4%)	22,316,353	+ 402,938	2.9	686	3.0
23,000 - 23,999	29,530	14,759 (50.0%)	14,444 (48.9%)	21,479,931	+ 305,277	2.2	728	3.1
24,000 - 24,999	26,421	13,030 (49.3%)	13,152 (49.8%)	20,351,611	+ 272,322	1.9	770	3.1
25,000 - 29,999	99,639	45,044 (45.2%)	53,580 (53.8%)	89,441,246	+ 1,204,077	8.6	898	3.3
30,000 - 34,999	58,108	21,312 (36.7%)	36,187 (62.3%)	66,633,148	+ 1,296,200	9.3	1,147	3.6
35,000 - 39,999	34,041	9,904 (29.1%)	23,808 (69.9%)	48,095,595	+ 1,083,140	7.7	1,413	3.8
40,000 - 44,999	21,672	5,330 (24.6%)	16,132 (74.4%)	36,257,359	+ 770,727	5.5	1,673	4.0
45,000 - 49,999	13,482	2,777 (20.6%)	10,543 (78.2%)	26,157,417	+ 498,347	3.6	1,941	4.1
50,000 - 74,999	21,736	3,940 (18.1%)	17,752 (81.7%)	54,654,717	+ 919,999	6.6	2,514	4.3
75,000 - 99,999	5,214	746 (14.3%)	4,449 (85.3%)	20,158,747	+ 233,495	1.7	3,870	4.5
100,000 & Over	5,128	515 (10.0%)	4,592 (89.5%)	42,384,245	+ 272,604	1.9	8,266	4.7
TOTALS	1,957,183	1,471,748 (75.2%)	457,864 (23.4%)	$ 759,754,220	$+ 7,224,091	100.0	$ 388	2.9%

NOTE: Details may not add to totals due to rounding.

SOURCE: Department of Taxation income sampling model, taxable year 1977 data. (Reference Structure 57)

a/ Percentages calculated for income classes that experience a tax reduction reflect the relative share of the total tax reduction. Percentages calculated for income classes that experience a tax increase reflect [illegible] which is greater than the [illegible] increase for all income classes.

aggregate mix of returns with and without itemized deductions and would thus require no additional audit activity. As indicated previously, doubling the upper and lower standard deduction bounds with no other structural change reduces taxes for taxpayers at all income levels. However, the tax increase and the additional progressivity caused by the substitution of a $20 tax credit, whose value is somewhat less than the value of the current exemptions at the state's highest marginal tax rates, more than offsets the tax reduction for taxpayers with more than $11,000 of AGI. Specifically, taxpayers with incomes under $11,000 would have experienced a tax decrease totalling approximately $6.3 million while higher income taxpayers would have experienced a tax increase totalling approximately $14.0 million, for a net increase for all taxpayers of approximately $7.7 million.

Relative to total tax payments for each of the two groups (i.e., those that experience a tax decrease and those that experience a tax increase), these changes are quite insignificant shifts in the distribution of total income tax liability. Relative to the broad conformity related advantages of this alternative, these shifts and the total tax change are also a quite inexpensive solution to the inequities that have been brought about by the various federal changes. Specifically, under this alternative partial relief would be accorded married couples caught between the federal zero amounts and the Virginia maximum standard deduction, to the extent that 15 percent of federal AGI is greater than $2,000. In addition, under this alternative any further increases in the federal zero bracket amounts (at least in the short run) would not substantially affect either taxpayers or revenues in an adverse manner,

as might be the case with any alternative to tie the Virginia standard deduction to the federal zero bracket amounts. In other words, since the maximum Virginia standard deduction for married couples under this alternative is greater than the federal zero bracket amounts, it is unlikely that any federal increases would soon exceed the Virginia maximum. Eventually, however, it would again become necessary to review any divergences between the federal and state equivalents. We estimate that if this alternative were to become effective for taxable years beginning on and after January 1, 1980, that revenues would increase by approximately $17 million during fiscal year 1981 and $14 million during fiscal year 1982.

APPENDIX I

SENATE JOINT RESOLUTION NO. 21

Requesting that a Joint Subcommittee of the Senate and House Finance Committees be appointed to study the Virginia Individual Income Tax structure.

WHEREAS, equity in the treatment of the citizens of Virginia is of prime importance in the formulation of the Commonwealth's tax structure; and

WHEREAS, the constantly changing environment of the Commonwealth, including its citizens, its economy, and its needs necessitates a constant monitoring and examination of the equity and fairness of its taxes; and

WHEREAS, the Virginia Individual Income Tax has clearly become the largest source of revenue to the Commonwealth and is the largest State tax paid by a large number of Virginians; and

WHEREAS, increasing levels of income stemming from inflation and the progressive nature of the income tax structure have increased the burden of the tax as well as magnified the inequities of the tax; and

WHEREAS, beginning with taxable year nineteen hundred seventy-two Virginia conformed with the federal income tax structure for reasons of equity and administrative simplicity; and

WHEREAS, in the past few years, the Tax Reduction Act of 1975, the Tax Reform Act of 1976, and the Tax Reduction and Simplification Act of 1977 have caused the acceleration of the divergence of the Virginia and United States income tax structures which has caused Virginia and its taxpayers to lose a substantial portion of the benefits gained when conformity was adopted; and

(more)

WHEREAS, other major areas of the income tax structure also need to be explored and analyzed, such as, the marriage penalty, the increased use of credits rather than exemptions at the federal level, a decreasing reliance on the standard deduction, as well as the effect of anticipated future federal reforms; and

WHEREAS, the Commonwealth wishes to ensure that Virginia tax laws remain as equitable as possible; now, therefore, be it

RESOLVED by the Senate of Virginia, the House of Delegates concurring, That a Joint Subcommittee of the Senate and House Finance Committees be appointed to study the Virginia Individual Income tax structure including its conformity, rates and exemptions and to present recommendations that would improve the equity of the income tax.

The Joint Subcommittee shall be composed of eight members who shall be appointed in the following manner: four members appointed by the chairman of the Senate Finance Committee from the membership of that committee and four members appointed by the chairman of the House Finance Committee from the membership of that committee. The Joint Subcommittee shall elect one of its members to serve as its chairman.

The legislative members of the Joint Subcommittee shall receive such compensation as is authorized by law for members of the General Assembly and be reimbursed for their expenses incurred for the work of the Joint Subcommittee. The Division of Legislative Services shall serve as staff and all officials and employees of all State agencies shall cooperate fully with the Joint Subcommittee.

(more)

The Joint Subcommittee shall make a report of its findings, deliberations, and recommendations to the Governor and the General Assembly not later than November one, nineteen hundred seventy-nine.

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APPENDIX II

INCOME TAX RATES AND EXEMPTIONS ON 1978 CALENDAR YEAR INCOME

State	Personal Exemptions *	Individual Rates	Corporation, Bank Rates
Ala.	Single .... $1,500 Married .... 3,000 Head of a family .... 3,000 Dependent 300	1st $1,000........ 1.5% Next 2,000........ 3 Next $2,000........ 4.5% Over 5,000........ 5	5% of Alabama net income. Financial institutions, 6% of net income.
Alas.	Single .... $ 750 Married .... 1,500 Dependent 750	Married Persons Filing Jointly and Surviving Spouses 1st $4,000....... 3 % Next 4,000....... 3.5 Next 4,000....... 4 Next 4,000....... 5 Next 4,000....... 5.5 Next 4,000....... 6 Next 4,000....... 7 Next 4,000....... 7.5 Next 4,000....... 8 Next 4,000....... 8.5 Next 4,000....... 9 Next $ 8,000...... 9.5% Next 12,000......10 Next 12,000......10.5 Next 12,000......11 Next 12,000......11.5 Next 20,000......12 Next 20,000......12.5 Next 20,000......13 Next 20,000......13.5 Next 120,000......14 Over 300,000......14.5 Rates for single taxpayers range from 3% on first $2,000 of taxable income to 14.5% on taxable income over $150,000. Rates for heads of households range from 3% on the first $2,000 of taxable income to 14.5% on taxable income over $200,000.	Corporations: 5.4% of federal taxable income, apportioned to Alaska, plus 4% surtax. Financial institutions, 7% of federal net income with modifications.
Ariz.	Single .... $1,000 Married .... 2,000 Head of household .... 2,000 Dependent ..... 600 (For 1978, these exemptions are adjusted to reflect the difference in the Arizona Consumer price index between the second quarter of 1978 and the second quarter of 1977.)	1st $1,000........ 2% 2nd 1,000........ 3 3rd 1,000........ 4 4th 1,000........ 5 5th 1,000........ 6 6th 1,000........ 7 Over 6,000........ 8 Joint returns must split their income.	1st $1,000........ 2.5% 2nd 1,000........ 4 3rd 1,000........ 5 4th 1,000........ 6.5 5th 1,000........ 8 6th 1,000........ 9 Over 6,000........ 10.5 Financial institutions are subject to the corporate income tax.
Ark.	From tax: Single .... $17.50 Married .... 35.00 Head of a family .... 35.00 Dependent 6.00	1st $2,999....... 1% Next 3,000....... 2.5 Next 3,000....... 3.5 Next $6,000....... 4.5% Next 10,000....... 6 $25,000 or over...... 7 (Special reduced rates apply to low-income taxpayers.)	1st $ 3,000 ..... 1% 2nd 3,000 ..... 2 Next 5,000 ..... 3 Next 14,000 ..... 5 Over 25,000 ..... 6 Financial institutions are subject to the tax.
Calif.	From tax: Single .... $100 Married .... 200 Head of household .... 200 Dependent 8.00	Resident and Nonresident Individuals [2] 1st $2,000........ 1% Next 1,500........ 2 Next 1,500........ 3 Next 1,500........ 4 Next 1,500........ 5 Next $1,500........ 6% Next 1,500........ 7 Next 1,500........ 8 Next 1,500........ 9 Next 1,500........10 Over 15,500........11 Joint returns must split their income. Rates [2] for heads of households range from 1% on the first $4,000 of taxable income to 11% of taxable income over $18,000.	Corporations 9% of California net income; minimum, $200. Financial Institutions Minimum, 9%; maximum, 13%. Minimum tax, banks, none; financial institutions, $200. Rate set in December of each year (for 1978 tax year the rate was 12.425%).
Colo.[1]	Single .... $ 850 Married .... 1,700 Dependent 850	1st $1,000........ 3 % 2nd 1,000........ 3.5 3rd 1,000........ 4 4th 1,000........ 4.5 5th 1,000........ 5 6th $1,000........ 5.5% 7th 1,000........ 6 8th 1,000........ 6.5 9th 1,000........ 7 10th 1,000........ 7.5 Over 10,000........ 8 A credit is allowed on Colorado taxable income not over $9,000 determined by dividing taxable income by 200. 2% surtax on resident's intangibles income over $5,000.	5% of federal taxable income with adjustments. Financial institutions are subject to the corporate income tax.
Conn.	Exemption from net gains: Single .... $100 Married, filing jointly .... 200 Married, filing separately ..... 100 Dependents 0	No personal income tax. However, a tax computed at the following rates is levied on all dividends received if the taxpayer's federal adjusted gross income equals or exceeds $20,000: $ 20,000 to $ 21,999 ...1% 22,000 to 23,999 ...2% 24,000 to 27,999 ...3% 28,000 to 29,999 ...4% $ 30,000 to $ 34,999 ...6% 35,000 to 39,999 ...7% 40,000 to 49,999 ...7.5% 50,000 to 99,999 ...8% 100,000 and over .....9% Net gains from the sale or exchange of capital assets if earned, received, etc. by the taxpayer during his taxable year are taxed at 7%.	10% of net income plus, to the extent it exceeds the tax on net income, 31/100 of 1 mill per dollar of asset value; minimum, $50, maximum, $100,000. Certain financial institutions pay, to the extent it exceeds the tax on net income, 4% on interest credited to savings deposits.

* Additional exemptions for aged, mentally retarded and/or blind not included.

[1] Personal income tax rates (excluding the surtax), personal exemptions and the $9,000 taxable income credit ceiling are multiplied by an annual inflation factor (106% for 1978) when computing taxes.

[2] The Franchise Tax Board will recompute the tax brackets annually by multiplying the prior year's figures by an annual inflation adjustment factor, rounded off to the nearest $10. For 1978, the inflation adjustment factor is 1.05[illegible]

State	Personal Exemptions *	Individual Rates		Corporation Rates
Del.	Single ....$ 600 Married .... 1,200 Dependent 600	1st $1,000....... 1.6% 2nd 1,000....... 2.2 3rd 1,000....... 3.3 4th 1,000....... 4.4 5th 1,000....... 5.5 6th 1,000....... 6.6 Next 2,000....... 7.7	Next $12,000....... 8.8% Next 5,000....... 9.3 Next 5,000....... 9.9 Next 10,000.......12.1 Next 10,000.......13.2 Next 25,000.......15.4 Next 25,000.......16.5 Over 100,000 ....19.8	8.7% of federal taxable income with modifications. Banks and trust companies, 8.7% of net income; building and loan associations, 8.7% of annual net earnings (after federal income taxes).
D. of C.	Single ....$ 750 Married .... 1,500 Head of a family .... 1,500 Dependent 750	1st $1,000........ 2% 2nd 1,000........ 3 3rd 1,000........ 4 4th 1,000........ 5 5th 1,000........ 6	Next 5,000........ 7% Next 3,000........ 8 Next 4,000........ 9 Next 8,000........10 Over 25,000........11	9% of District of Columbia taxable income, plus 10% surtax. Minimum tax, $25. Banks and trust companies, 6%; building and loan associations, 2%.
Fla.	None	None		5% of federal taxable income, with adjustments, of corporations and financial institutions.
Ga.[2]	Single ....$1,500 Married .... 3,000 Head of household .... 3,000 Dependent 700	1st $1,000........ 1% Next 2,000........ 2 Next 2,000........ 3	Next $ 2,000....... 4% Next 3,000....... 5 Over 10,000....... 6	6% of federal taxable income with adjustments.
Hawaii	Single ....$ 750 Married .... 1,500 Dependent 750	1st $ 500........ 2.25% 2nd 500........ 3.25 3rd 500........ 4.5 4th 500........ 5 Next 1,000........ 6.5 Next 2,000........ 7.5 A special table of rates is provided for heads of households. Joint returns must split their income.	Next $ 5,000........ 8.5% Next 4,000........ 9.5 Next 6,000........ 10 Next 10,000........ 10.5 Over 30,000........ 11	First $25,000.... 5.85% Over 25,000.... 6.435 Capital gains.... 3.08 Financial institutions 11.7
Ida.	Single ....$ 750 Married .... 1,500 Dependent ..... 750 Credit against tax....$15 ($30 if 65 or older) per taxpayer, spouse and each dependent.	1st $1,000........ 2 % 2nd 1,000........ 4 3rd 1,000........ 4.5 An additional $10 tax is due from every taxpayer required to file an income tax return except blind persons and persons receiving public assistance. Joint returns must split their income.	4th $1,000........ 5.5% 5th 1,000........ 6.5 Over 5,000........ 7.5	6.5% of federal taxable income, with adjustments, of corporations and financial institutions. Additional tax, $10.
Ill.	Single ....$1,000 Married .... 2,000 Dependent 1,000	2.5% of federal adjusted gross income with modifications.		4% of federal taxable income with adjustments.
Ind.	Single ....$1,000 Married ..1,000—2,000 Dependent 500	2% of federal adjusted gross income with modifications.		Adjusted gross income tax—3% of federal taxable income with adjustments. A 3% supplemental net income tax is also imposed. (Or applicable rate of gross income tax if tax liability is greater under the gross income tax.)
Iowa	From tax: Single ....$15.00 Married ..... 30.00 Head of household .... 30.00 Dependent ... 10.00	1st $1,000.......... 0.5 % 2nd 1,000.......... 1.25 3rd 1,000.......... 2.75 4th 1,000.......... 3.5 5th, 6th and 7th 1,000 .... 5 8th and 9th 1,000 .... 6 10th through 15th 1,000 .... 7 No tax is imposed on taxpayers whose net income is $4,000 or less including income of spouse.	16th through 20th $1,000 .... 8% 21st through 25th 1,000 .... 9 26th through 30th 1,000 ....10 31st through 40th 1,000 ....11 41st through 75th 1,000 ....12 Over $75,000 13	First $25,000..... 6% $25,000-$100,000 .. 8 Over $100,000.... 10 Financial institutions: 1st $ 25,000.... 5% Next 50,000.... 6 Next 25,000.... 7 Over 100,000.... 8

* Additional exemptions for aged, mentally retarded and/or blind not included.

[illegible] jointly and heads of households. Rates for single persons range from 1% on tax-

INCOME TAX RATES AND EXEMPTIONS—Continued

State	Personal Exemptions *	Individual Rates	Corporation, Bank Rates
Kan.	Single $ 750 Married 1,500 Dependent 750 Head of household additional 750	1st $2,000 2% Next 1,000 3.5 Next 2,000 4 Next 2,000 5 Next $ 3,000 6.5% Next 10,000 7.5 Next 5,000 8.5 Over 25,000 9	4.5% of federal taxable income with adjustments, plus a 2.25% surtax on taxable income over $25,000. Banks and development credit corporations, 5%; trust companies and savings and loan associations, 4½%. Surtax of 2¼% of net income over $25,000 applies to financial institutions.
Ky.	From tax: Single $ 20 Married 40 Dependent 20	1st $3,000 2% Next 1,000 3 Next 1,000 4 Next $ 3,000 5% Over 8,000 6	1st $25,000 4 % Over 25,000 5.8
La.	Single $2,500 Married 5,000 Head of family 5,000 Dependent 400 (Exemptions are incorporated into Louisiana tax tables.)	1st $10,000 2% Next 40,000 4 Over 50,000 6 (The amount of tax due is determined from tax tables.)	1st $ 25,000 4% Next 25,000 5 Next 50,000 6 Next 100,000 7 Over 200,000 8
Maine	Single $1,000[1] Married 2,000[1] Dependent 1,000[1]	1st $ 2,000 1% Next 2,000 2 Next 2,000 3[2] (for calendar 1978 3.5%) Next 2,000 6 Next $ 2,000 7% Next 5,000 8 Next 10,000 9.2[2] (for calendar 1978 9.1%) Over 25,000 10 Joint returns must split their income.	4.95% of federal taxable income not over $25,000 plus 6.93% of taxable income over $25,000. Financial institutions are subject to the tax.
Md.	Single $ 800 Married 1,600 Dependent 800	1st $1,000 2% Next 1,000 3 Next $1,000 4% Over 3,000 5	7% of federal taxable income with adjustments. Savings banks and associations, ¾ of 1% of net earnings over $100,000. Other financial institutions, 7% of net earnings.
Mass.	From earned income: Single $2,000 Married, up to 4,600 Dependent 600 Married, filing separately 1,000	Interest, dividends, net capital gains 10% Earned income, annuities 5% A 7.5% surtax is imposed.	$2.60 (including the 14% surtax) per $1,000 of tangible property not subject to local tax or of net worth plus 9.5% of net income (including the 14% surtax), or $228 (including the 14% surtax), whichever is greater. Banks and financial institutions, 12.54%.
Mich.	Single $1,500 Married 3,000 Dependent 1,500	4.6% of federal adjusted gross income with modifications. Persons with business activity allocated or apportioned to Michigan are also subject to a single business tax of 2.35% on an adjusted tax base. The first $40,000 of the tax base is exempt.	Individuals, firms, financial institutions, partnerships, joint ventures, associations, corporations, estates, trusts, etc., having business activity in Michigan are subject to a single business tax of 2.35% of their adjusted tax base (federal taxable income with adjustments). The first $40,000 of the tax base is exempt.
Minn.	From tax: Single $ 40 Married 80 Dependent 40	1st $ 500 1.6% 2nd 500 2.2 Next 1,000 3.5 Next 1,000 5.8 Next 1,000 7.3 Next 1,000 8.8 Next 2,000 10.2 Next 2,000 11.5% Next 3,500 12.8 Next 7,500 14 Next 7,500 15 Next 12,500 16 Over 40,000 17	12% of Minnesota net income. Minimum, $100. Banks, 12% of Minnesota net income.
Miss.	Single $4,500 Married 6,500 Head of family 6,500 Dependent 750	1st $5,000 3% Over 5,000 4	Same as individual.

* Additional exemptions for aged, mentally retarded and/or blind, not included.
[1] For the taxable year ending in 1978, $1,200 for each federal exemption.
[2] Effective July 1, 1978.

State	Personal Exemptions*	Individual Rates	Corporation Rates
Mo.	Single ....$1,200 Married ...... 2,400 Head of household or surviving spouse .... additional 800 Dependent ... 400	1st $1,000........ 1.5% Next 1,000........ 2 Next 1,000........ 2.5 Next 1,000........ 3 Next 1,000........ 3.5 Next $1,000........ 4% Next 1,000........ 4.5 Next 1,000........ 5 Next 1,000........ 5.5 Over 9,000........ 6	5% of federal taxable income with adjustments. Banks, trust companies and credit institutions, 7% of Missouri net income. (The tax is in addition to the corporate income tax but a credit is allowed for any corporate income tax paid).
Mont.	Single ....$ 650 Married ..... 1,300 Dependent ... 650	1st $1,000........ 2% Next 1,000........ 3 Next 2,000........ 4 Next 2,000........ 5 Next $2,000........ 6% Next 2,000........ 7 Next 4,000........ 8 Next 6,000........ 9 Next 15,000........10 Over 35,000........11 After computing tax liability, taxpayers must add 10% surtax.	6.75% of federal gross income with state deductions and adjustments; minimum, $50. State and national banks are subject to the tax.
Neb.	Single ....$ 750 Married ...... 1,500 Dependent ... 750	The personal income tax rate for 1978 is 16% of the taxpayer's adjusted federal income tax liability.	25% of individual rate on first $25,000 of taxable income and 27.5% of such rate on taxable income over $25,000 (4% on first $25,000 and 4.4% on income over $25,000).
N.H.	Taxpayer ......$600 Spouse......... 600	5% on income from interest and dividends.	8% of taxable business profits (federal taxable income before net operating loss deduction and special deductions).
N.J.	Single ....$1,000 Married ..... 2,000 Dependent ... 1,000	Resident and nonresident individuals, estates and trusts are subject to a 2% tax on the first $20,000 of New Jersey taxable income, and a 2.5% tax on taxable income over $20,000. Taxpayers are liable only for the greater of this tax or the N. Y.-N. J. tax. New Jersey imposes commuter income taxes on N. J. to N. Y. and N. Y. to N. J. commuters. Commuter tax rates are identical to those imposed under the N. Y. personal income tax.	7½% of allocated net income plus additional mill levy on allocated net worth. A 7¼% direct income tax is imposed on entire net income of corporations not subject to the business (income) tax. Savings institutions and banks, 5% of federal taxable income with adjustments.
N. M.[2]	Single ....$ 750 Married ...... 1,500 Dependent ... 750	1st $2,000...... 0.8% Next 2,000...... 1 Next 2,000...... 1.4 Next 2,000...... 1.8 Next 2,000...... 2.2 Next 2,000...... 2.6 Next 2,000...... 3.0 Next 2,000...... 3.5 Next 4,000...... 4 Next 4,000...... 4.5 Next $4,000...... 5% Next 4,000...... 5.5 Next 4,000...... 6 Next 4,000...... 6.5 Next 10,000...... 7 Next 20,000...... 7.5 Next 30,000...... 8 Next 100,000...... 8.5 Over 200,000...... 9	5% of federal taxable income with adjustments. Banks and financial institutions, 6% of federal taxable income with adjustments; minimum, $100.
N. Y.	Single ....$ 650[4] Married ...... 1,300[4] Dependent ... 650[4]	1st $1,000......... 2% Next 2,000......... 3 Next 2,000......... 4 Next 2,000......... 5 Next 2,000......... 6 Next 2,000......... 7 Next 2,000......... 8 Next $ 2,000........ 9% Next 2,000........10 Next 2,000........11 Next 2,000........12 Next 2,000........13 Next 7,000........14[3] Over 30,000........15[3]	Greatest of 10% of federal net income with adjustments, or 10% of 30% of net income and salaries, or 1-78/100 mills per dollar of capital, or $250, plus 9/10 mill per dollar of subsidiary capital. Banks and financial institutions, 12% of federal taxable income with adjustment. In addition, a 30% surcharge is imposed for tax years beginning on and after January 1, 1975, and ending before December 31, 1978.

* Additional exemptions for aged, mentally retarded and/or blind not included.

[2] Rates reproduced above are for married persons filing jointly and heads of households. Rates for single persons range from 0.8% on taxable income not over $2,000 to $7,203 plus 9% on taxable income over $100,000. Married persons filing separately are taxed at rates ranging from 0.8% on taxable income not over $1,000 to $7,343 plus 9% on taxable income over $100,000.

[3] For tax years ending after Dec. 31, 1978, the tax rate for taxable income over $23,000 is 14%. Proration is provided for fiscal years beginning in 1978 and ending in 1979.

[4] For 1979, $700 per exemption; for 1980, $750.

State	Personal Exemptions *	Individual Rates	Corporation, Bank Rates
N. C.	Single ....$1,000 Married ...... 2,000 Head of household .... 2,000 Dependent ... 600	1st $2,000......... 3% 2nd 2,000......... 4 3rd 2,000......... 5 Next $ 4,000........ 6% Over 10,000........ 7	6% of federal taxable income with adjustments (banks are subject to this tax). Bank privilege tax, $30 per $1,000,000 or fraction of taxable assets. Business development corporations, 4½% of North Carolina net income (minimum tax, $10); building and savings and loan associations, 7½% of North Carolina net income and 7½¢ per $100 of liability on shares of outstanding stock.
N. D.	Single ....$ 750 Married .... 1,500 (If filing joint return .... 1,800) Unmarried head of household or surviving spouse .... 1,050 Dependent 750	1st $3,000...... 1 % Next 2,000...... 2 % Next 3,000...... 3 % Next $ 4,000..... 4 % Next 18,000..... 5 % Over 30,000..... 7½% Individuals, estates and trusts required to file a personal income tax return, and partnerships required to file information returns, who derive income from operating a business, trade, or other profession, other than as an employee, must pay an additional tax of 1% of net income over $2,000 as a business privilege tax.	1st $ 3,000.... 3 % Next 5,000.... 4 % Next 7,000.... 5 % Next 10,000 ... 6 % Over 25,000.... 8½% Additional 1% tax on corporate net income over $2,000 if personal property is not assessed, if they are not subject to a special tax in lieu of personal property taxes and if they are required to file a return. Banks, trust companies and building or savings and loan associations, 5% of North Dakota net income. Minimum, $50. Additional 2% tax on such financial institutions.
Ohio	Single ....$ 650 Married ..... 1,300 Dependent ... 650	1st $5,000.........½% Next 5,000......... 1 Next 5,000......... 2 Next $5,000 ....2½% Next 20,000 .... 3 Over 40,000 ....3½	Greater of: 4% of first $25,000 of value of stock determined by net income, and 8% of the value over $25,000; or 5 mills times the value of stock determined by total value of capital, surplus, undivided profits and reserves; minimum, $50.
Okla.	Single ....$ 750 Married ...... 1,500 Dependent ... 750	Married individuals filing jointly and surviving spouse: 1st $2,000........ ½% Next 3,000........ 1 Next 2,500........ 2 Next $2,500........ 3% Next 2,500........ 4 Next 2,500........ 5 Over 15,000........ 6 For single individuals, married individuals filing separately and estates and trusts the same rates apply to half the amounts of income. For heads of households the rates range from ½% on the first $1,500 to 6% on income in excess of $11,250. (Beginning in 1979, heads of households are taxed at rates applicable to married persons filing jointly and surviving spouses).	4% of federal taxable income with adjustments. Banks and credit unions, 4% of federal taxable income with adjustments.
Ore.	Single ....$ 750 Married ..... 1,500 Dependent ... 750	1st $ 500......... 4% Next 500......... 5 Next 1,000......... 6 Next 1,000......... 7 Next $1,000......... 8% Next 1,000......... 9 Over 5,000.........10 For persons filing jointly, heads of household or a qualifying widow(er) with dependent child, the tax rates apply to twice the amount of income shown above.	7½ of Oregon net income. Minimum, $10. Banks, national banking associations, financial institutions and production credit associations are subject to the corporation income tax.
Pa.	None	2.2% of taxable compensation, net profits, net gains or income, dividends, interest and winnings. Only dividends other than stock dividends which are not considered personal income for federal purposes are to be included in taxable income.	10½% of adjusted, apportioned federal taxable income plus Pa. tax.
R. I.	Single ....$ 750 Married ...... 1,500 Dependent .. 750	19% of federal tax liability with modifications.	Greater of 8% of federal gross income with adjustments, or 40¢ per $100 of net worth. State banking and financial institutions, greater of 8% of net income or $2.50 per $10,000 of authorized capital stock. National banks, 8% of net income. Minimum bank tax, $100.

* Additional exemptions for aged, mentally retarded and/or blind not included.

INCOME TAX RATES AND EXEMPTIONS—Continued

State	Personal Exemptions *	Individual Rates	Corporation, Bank Rates
S. C.	Single .... $ 800 Married ...... 1,600 Head of household .. 1,600 Dependent ... 800	1st $2,000 .... 2% 2nd 2,000 .... 3 3rd 2,000 .... 4 4th $ 2,000 .... 5% 5th 2,000 .... 6 Over 10,000 7	6% of South Carolina net income. Banks, 4.5% of South Carolina net income. Savings and loan ass'ns, 8% of South Carolina net income.
S. D.	None	None	Banks and financial institutions, 5½% of South Dakota net income, minimum, $200 per authorized business location.
Tenn.	None	6% on dividends and interest; 4% on dividends from corporations who have 75% of their property taxable in Tennessee.	Corporate excise (net earnings) tax—6% of federal taxable income. Bank excise (net earnings) tax—3% of federal taxable income less 10% of ad valorem taxes paid. Building and savings and loan association excise (net earnings) tax—3% of federal taxable income less 10% of ad valorem taxes paid plus surtax of 1½% of gross profits.
Utah	Single .... $ 750 Married ...... 1,500 Dependent ... 750	1st $1,500 .... 2.75% 2nd 1,500 .... 3.75% 3rd 1,500 .... 4.75% 4th $1,500 .... 5.75% 5th 1,500 .... 6.75% Over 7,500 .... 7.75% Rates shown are for married persons filing jointly. Rates for single taxpayers and estates and trusts range from 2.25% of federal taxable income not over $750 to $214 plus 7.75% of federal taxable income over $4,500. Rates for married couples filing separately range from 2.75% of federal taxable income not over $750 to $178 plus 7.75% of federal taxable income over $3,750.	4% of Utah net income of corporations and banks. Minimum, $25.
Vt.	Single ...... $ 750 Married ...... 1,500 Dependent ... 750	25% of federal income tax liability.	Corporations and financial institutions, 5% on first $10,000 of federal taxable income, 6% on the next $15,000, 7% on the next $225,000 and 7.5% on federal taxable income over $250,000. Minimum tax, $50.
Va.	Single .... $ 600 Married ...... 1,200 Dependent ... 600	1st $3,000 .... 2% Next 2,000 .... 3 Next $ 7,000 .... 5% Over 12,000 .... 5.75	6% of federal taxable income with adjustments for corporations and savings and loan associations.
W. Va.	Single .... $ 600 Married ...... 1,200 Dependent ... 600	1st $2,000 .... 2.1% 2nd 2,000 .... 2.3 3rd 2,000 .... 2.8 4th 2,000 .... 3.2 5th 2,000 .... 3.5 6th 2,000 .... 4 7th 2,000 .... 4.6 8th 2,000 .... 4.9 9th 2,000 .... 5.3 10th 2,000 .... 5.4 11th 2,000 .... 6 Next 4,000 .... 6.1 Next $ 6,000 .... 6.5% Next 6,000 .... 6.8 Next 6,000 .... 7.2 Next 6,000 .... 7.5 Next 10,000 .... 7.9 Next 10,000 .... 8.2 Next 10,000 .... 8.6 Next 10,000 .... 8.8 Next 10,000 .... 9.1 Next 50,000 .... 9.3 Next 50,000 .... 9.5 Over 200,000 .... 9.6 Rates are for individuals and heads of household. For joint returns or returns of surviving spouse, the tax rate in each bracket is the same but it is applied to twice the taxable income.	6% of federal taxable income with adjustments for corporations.
Wis.	From tax: Single .... $20 Head of family 20 Married ..... 40 Dependent ... 20	1st $1,000 .... 3.1% 2nd 1,000 .... 3.4 3rd 1,000 .... 3.6 4th 1,000 .... 4.8 5th 1,000 .... 5.4 6th 1,000 .... 5.9 7th 1,000 .... 6.5 8th 1,000 .... 7.6 9th $1,000 .... 8.2% 10th 1,000 .... 8.8 11th 1,000 .... 9.3 12th 1,000 .... 9.9 13th 1,000 .... 10.5 14th 1,000 .... 11.1 Over 14,000 .... 11.4	Corporations, Banks and Trust Companies 1st $1,000 .... 2.3% 2nd 1,000 .... 2.8 3rd 1,000 .... 3.4 4th 1,000 .... 4.5 5th 1,000 .... 5.6 6th 1,000 .... 6.8 Over 6,000 .... 7.9

* Additional exemptions for aged, mentally retarded and/or blind not included.

SOURCE: Commerce Clearing House, Inc. State Tax Review, (Chicago, Illinois: December 19, 1978), pp. 8-19.

Appendix VI

STATES ALLOWING FULL OR PARTIAL DEDUCTION OF FEDERAL INCOME TAX ON INDIVIDUAL INCOME TAX

STATE	AMOUNT OF DEDUCTION
Alabama	All
Arizona	All
Colorado	All
Delaware	$300 ($600 for joint return)
Iowa	All
Kansas	Federal tax less certain credits
Kentucky	Federal tax less credits used
Louisiana	All
Minnesota	All
Missouri	All
Montana	All
North Dakota	All
Oklahoma	First $500 + 5%, $1,700 maximum
Oregon	$5,000 maximum
Tennessee	$500 maximum
Vermont	All

APPENDIX VII

RELATION OF FEDERAL INCOME TAX LIABILITY OF VIRGINIANS TO PERSONAL AND FEDERAL ADJUSTED GROSS INCOMES, TAX YEAR 1976

Federal income tax paid by Virginians: $3,458,900,000

PERSONAL INCOME	FEDERAL INCOME TAX LIABILITY AS A PERCENTAGE OF PERSONAL INCOME	VIRGINIA INCOME TAX LIABILITY AS A PERCENTAGE OF PERSONAL INCOME
$31,954,000,000	10.8	2.06

FEDERAL ADJUSTED GROSS INCOME ON VIRGINIA TAX RETURNS	FEDERAL INCOME TAX LIABILITY AS A PERCENTAGE OF FEDERAL ADJUSTED GROSS INCOME	VIRGINIA INCOME TAX LIABILITY AS A PERCENTAGE OF FEDERAL ADJUSTED GROSS INCOME
$25,169,900,000	13.7	2.61

SOURCE: Department of Taxation

Appendix VIII

INDIVIDUAL INCOME TAX BRACKETS

AND RATE RANGES

STATE	BRACKET RANGE	NUMBER OF BRACKETS	RATE RANGE
ALABAMA	$0– 1,000 to $ 5,000 +	4	1.5 - 5.0
ALASKA [1]	0– 4,000 to 800,000 +	24	3.0 - $50,100 + 14.5
ARIZONA	0– 1,000 to 12,000 +	7	2.0 - 8.0
ARKANSAS	0– 2,999 to 25,000 +	6	1.0 - 7.0
CALIFORNIA	0– 2,000 to 15,500 +	11	1.0 - 11.0
COLORADO	0– 1,000 to 10,000	11	3.0 - 8.0
DELAWARE	0– 1,000 to 100,000 +	17	1.5 - 16.65
GEORGIA	0– 1,000 to 10,000 +	6	1.0 - 6.0
HAWAII	0– 500 to 30,000 +	11	2.25 - 11.0
IDAHO	0– 1,000 to 5,000 +	6	2.0 - 7.5
ILLINOIS		1	2.5
INDIANA		1	1.9
IOWA	0– 1,000 to 75,000 +	13	0.5 - 13.0
KANSAS	0– 2,000 to 25,000 +	8	2.0 - 9.0
KENTUCKY	0– 3,000 to 8,000 +	5	2.0 - 6.0
LOUISIANA	0–10,000 to 50,000 +	3	2.0 - 6.0
MAINE	0– 2,000 to 25,000 +	8	1.0 - 10.0
MARYLAND	0– 1,000 to 3,000 +	4	2.0 - 5.0
MASSACHUSETTS	Interest, dividends, net capital gains earned income, annuities		10.0 + 7.5 5.0 + 7.5
MICHIGAN		1	4.6
MINNESOTA	0– 500 to 40,000 +	13	1.6 - 17.0
MISSISSIPPI	0– 5,000 to 5,000 +	2	3.0 - 4.0
MISSOURI	0– 1,000 to 9,000 +	10	1.5 - $315 + 6.0
MONTANA	0– 1,000 to 35,000 +	10	2.0 - 11.0
NEBRASKA		1	18.0
NEW HAMPSHIRE	Interest + Dividends only	1	5.0

Appendix VIII
(continued)

STATE	BRACKET RANGE	# BRACKETS	RATE RANGE
NEW JERSEY [2]	$0-20,000 to $ 20,000 +	2	2.0 - 2.5
commuter tax	0- 1,000 to 23,000 +	13	2.0 - 14.0
NEW MEXICO	0- 2,000 to 100,000 +	18	0.8 - 9.0
NEW YORK	0- 1,000 to 23,000 +	13	2.0 - 14.0
NORTH CAROLINA	0- 2,000 to 10,000 +	5	3.0 - 7.0
NORTH DAKOTA	0- 3,000 to 30,000 +	6	1.0 - 7.5
OHIO	0- 5,000 to 40,000 +	6	0.5 - 3.5
OKLAHOMA [3]	0- 2,000 to 15,000 +	7	0.5 - 6.0
OREGON	0- 500 to 5,000 +	7	4.0 - 10.0
PENNSYLVANIA		1	2.2
RHODE ISLAND	Modified federal income tax liability		19.0
SOUTH CAROLINA	0- 2,000 to 10,000 +	6	2.0 - 7.0
TENNESSEE [4]		1	6.0
UTAH	0- 750 to 4,500 +	7	2.25 - $214 + 7.75
VERMONT	Federal income tax	1	25.0
VIRGINIA	0- 3,000 to 12,000 +	4	2.0 - 5.75
WEST VIRGINIA	0- 2,000 to 200,000 +	24	2.1 - 16,466 + 9.6
WISCONSIN	0- 3,000 to 40,000 +	8	3.4 - 10.0

[1] Rates shown are for married persons filing jointly and surviving spouses.

[2] New Jersey taxpayers pay only the larger of the personal income tax or the New York - New Jersey or the Pennsylvania - New Jersey commuter tax.

[3] Rates shown are for heads of households, married persons filing jointly, and a surviving spouse not deducting federal income taxes.

SOURCE: Division of Legislative Services

Appendix IX

COMPARISON OF VIRGINIA INDIVIDUAL INCOME TAX RATES TO RATES OF STATES ALLOWING ALL FEDERAL INCOME TAX TO BE DEDUCTED

BRACKET	Ala.	Ariz	Col[1,2]	Iowa	La.	Minn.[1]	Missouri	Mont.[3]	N. D.[4]	Vermont	Va.	High Rate	Low Rate
0 - 500	1.5	2.0	3.0	0.5	2.0	1.6	1.5	2.0	1.0	25%	2.0	3.0	0.5
501- 1,000						2.2						3.0	0.5
1,001 - 1,500	3.0	3.0	3.5	1.25		3.5	$ 15 + 2.0%	3.0		of		3.5	1.0
1,501 - 2,000												3.5	1.0
2,001 - 2,500		4.0	4.0	2.75		5.8	$ 35 + 2.5%	4.0		federal		5.8	1.0
2,501 - 3,000												5.8	1.0
3,001 - 3,500	4.5	5.0	4.5	3.5		7.3	$ 60 + 3.0%		2.0	income	3.0	7.0	2.0
3,501 - 4,000												7.0	2.0
4,001 - 4,500		6.0	5.0	5.0		8.8	$ 90 + 3.5%	5.0		tax		8.8	2.0
4,501 - 5,000												8.8	2.0
5,001 - 5,500	5.0	7.0	5.5			10.2	$125 + 4.0%		3.0		5.0	10.2	2.0
5,501 - 6,000												10.2	2.0
6,001 - 6,500		8.0	6.0				$165 + 4.5%	6.0				10.2	2.0
6,501 - 7,000												10.2	2.0
7,001 - 7,500			6.5			11.5	$210 + 5.0%					11.5	2.0
7,501 - 8,000												11.5	2.0
8,001 - 8,500			7.0	6.0			$260 + 5.5%	7.0	4.0			11.5	2.0
8,501 - 9,000												11.5	2.0
9,001 - 9,500			7.5			12.8	$315 + 6.0%					12.8	2.0
9,501 - 10,000												12.8	2.0
10,001 - 10,500			8.0	7.0	4.0			8.0				12.8	4.0
10,501 - 11,000												12.8	4.0
11,001 - 11,500												12.8	4.0
11,501 - 12,000												12.8	4.0
12,001 - 12,500									5.0		5.75	12.8	4.0
12,501 - 13,000						14.0						14.0	4.0
13,001 - 13,500												14.0	4.0
13,501 - 14,000												14.0	4.0
14,001 - 14,500								9.0				14.0	4.0
14,501 - 15,000												14.0	4.0
15,001 - 20,000				8.0								14.0	4.0
20,001 - 25,000				9.0		15.0		10.0				15.0	4.0
25,001 - 27,500				10.0								15.0	4.0
27,501 - 30,000						16.0						16.0	4.0
30,001 - 35,000				11.0					7.5			16.0	4.0

Appendix IX
(continued)

BRACKET	Ala.	Ariz	Col[1,2]	Iowa	La.	Minn.[1]	Missouri	Mont.[3]	N. D.[4]	Vermont	Va.	High Rate	Low Rate
35,001 - 40,000								11.0				16.0	4.0
40,001 - 45,000				12.0		17.0						17.0	4.0
45,001 - 50,000												17.0	4.0
50,001 - 55,000					6.0							17.0	5.0
55,001 - 60,000												17.0	5.0
60,001 - 65,000												17.0	5.0
65,001 - 70,000												17.0	5.0
70,001 - 75,000												17.0	5.0
75,001 +				13.0								17.0	5.0

SOURCE: Division of Legislative Services

[1]Allows for indexing

[2]Surtax on intangible income over $15,000 is 2%

[3]10% surtax

[4]Additional 1% tax on net incomes over $2,000 derived from a business, trade or profession other than as employee

Appendix X

COMPARISON OF VIRGINIA INDIVIDUAL INCOME TAX RATES TO RATES OF STATES ALLOWING A PARTIAL DEDUCTION OF FEDERAL INCOME TAX

Bracket	Virginia	Delaware[1]	Kansas	Oklahoma[2]	Oregon	Tennessee[3]	Kentucky
0 - 500	2.0	1.5	2.0		4.0	6.0	2.0
501 - 1,000					5.0		
1,001 - 1,500		2.1			6.0		
1,501 - 2,000							
2,001 - 2,500		3.15	3.5		7.0		
2,501 - 3,000							
3,001 - 3,500	3.0	4.3	4.0		8.0		3.0
3,501 - 4,000							
4,001 - 4,500		5.35			9.0		4.0
4,501 - 5,000							
5,001 - 5,500	5.0	6.4	5.0		10.0		5.0
5,501 - 6,000							
6,001 - 6,500		7.45					
6,501 - 7,000							
7,001 - 7,500			6.5				
7,501 - 8,000							
8,001 - 8,500		8.4					6.0
8,501 - 9,000							
9,001 - 9,500							
9,501 - 10,000							
10,001 - 10,500		8.5	7.5				
10,501 - 11,000							
11,001 - 11,500							
11,501 - 12,000							
12,001 - 12,500	5.75						
12,501 - 15,000							
15,001 - 20,000		8.6					
20,001 - 25,000		9.05	8.5				

Appendix X
(continued)

Bracket	Virginia	Delaware[1]	Kansas	Oklahoma[2]	Oregon	Tennessee[3]
25,001 - 30,000		9.65	9.0			
30,001 - 40,000		11.55				
40,001 - 50,000		12.8				
50,001 - 75,000		14.45				
75,001 -100,000		15.0				
100,001 +		16.65				

SOURCE: Division of Legislative Services

[1]For tax years beginning after 1979, rates range from 1.4% to 13.5%

[2]Optional rate schedules for single and married returns deducting federal income tax. Optional rates may terminate in 1979 after referendum.

[3]Individuals are taxed only on interest and dividends; tax on dividends from corporations 75% of whose property is taxable in Tennessee is 4%.

Appendix XI

COMPARISON OF EFFECTIVE TAX RATES OF VIRGINIA TO CERTAIN STATES ALLOWING DEDUCTION OF FEDERAL INCOME TAX FROM INDIVIDUAL INCOME TAX, TAX YEAR 1977

AGI CLASS	VIRGINIA	IOWA	MINNESOTA	ARIZONA
$ 0- 499	0.05	0.00	1.50	1.37
500- 999			1.50	
1,000- 1,999	0.11	0.00	1.30	
2,000- 2,999	0.45	0.14	1.70	3.56
3,000- 3,999	0.76	0.37	2.20	
4,000- 4,999	0.97	0.92	2.60	3.23
5,000- 5,999	1.18	1.31	3.00	
6,000- 6,999	1.37	1.64	3.30	3.38
7,000- 7,999	1.59	1.88	3.60	
8,000- 8,999	1.83	2.09	3.80	3.58
9,000- 9,999	1.99	2.28	4.00	
10,000-10,999	2.10	2.98	4.10	3.76
11,000-11,999	2.19		4.30	
12,000-12,999	2.25		4.50	3.84
13,000-13,999	2.32		4.80	
14,000-14,999	2.42		5.00	3.89-5.23
15,000-19,999	2.65		5.40	
20,000-24,999	2.96	3.66	6.40	
25,000-29,999	3.22	4.02		
30,000-34,999	3.45	4.44	7.10	5.61
35,000-39,999	3.65			
40,000-44,999	3.82	4.84	7.40	6.24
45,000-49,999	3.94			
50,000-74,999	4.10	5.14	7.50	6.59-7.17
75,000-99,999	4.29	5.22		
100,000 +	3.91	5.30	6.90	7.52
TOTAL	2.80	2.97	4.50	5.06

SOURCE: Division of Legislative Services