Occasional Studies

Estimating the Effects of the Tax Cuts and Jobs Act (TCJA) on the City's 2018 Income Tax Burdens

A Tax Policy Simulation and Distributional Analysis

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Introduction

The federal Tax Cuts and Jobs Act (TCJA) is the most extensive tax overhaul since the Tax Reform Act of 1986. Among other things, the TCJA lowered individual and corporate income tax rates, almost doubled the standard deduction levels for the individual income tax, suspended the personal exemptions, added a child tax credit, raised the exemption level and phaseout threshold for the alternative minimum tax, and raised the exemption level for the estate tax. (See **here** for a more complete analysis of the TCJA.)

This analysis focuses on the effects of the TCJA on individual income tax liabilities of District of Columbia residents. We estimate that under the new legislation, and in the aggregate, income taxes paid to the federal government for 2018 will be lower but income taxes paid to the District of Columbia government will be higher with the onus of the increased local income tax burden being borne largely by the city's low to middle-income tax payers.

Federal/District Individual Income Tax Conformity

District of Columbia income earning residents are subject to both federal and District income taxes. The TCJA was signed into law in December 2017 and makes extensive changes to the federal individual income tax structure. The interplay between the federal and local individual income tax structures can have significant implications for each resident's tax liability because some features of the District's tax structure are coupled to federal income tax structure while others are not. Because of the coupling between the District and federal income tax structures, the TCJA changes to the federal income tax structure will change not just District residents' federal income tax liabilities, but also their District income tax liability.

The TCJA Lowered District Resident's Federal Income Tax Liability, but Raised their District Tax Liability

The TCJA will affect the income tax liability of different District residents in various ways, depending on a tax filers circumstances, such as income, marital status, number of children, etc. Using the Office of Revenue Analysis Income Tax Microsimulation Model, we estimate that for tax year 2018 (for which taxes are due April 15, 2019) the TCJA will cause city residents to pay $617.3 million less in federal income taxes but $56.4 million more in city income taxes. Figure 1 shows an estimated 76 percent of city filers will see a decrease in their federal tax liability, and figure 2 shows that 45 percent of the same city filers will see an increase in their District income tax liability.

Figure 1

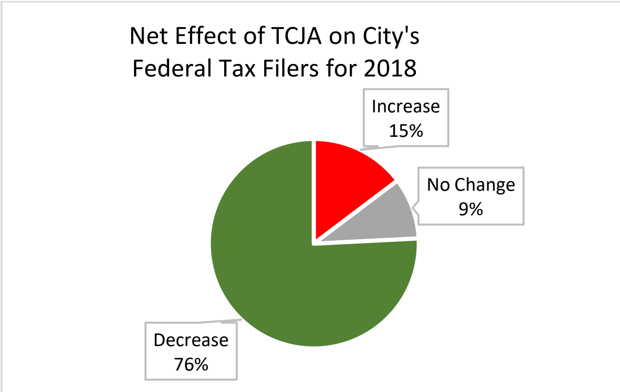
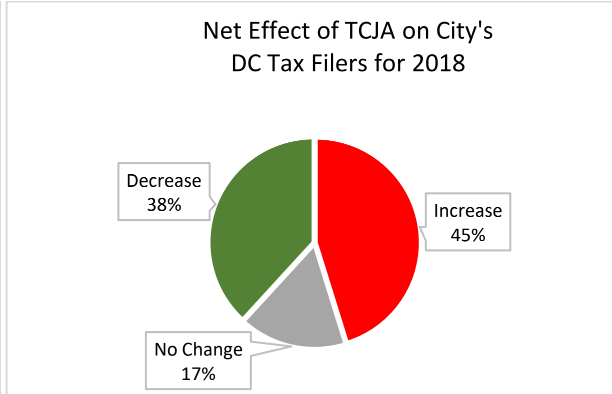


Figure 2



Distributional Effects of the TCJA

Of the estimated 76 percent that are likely to see reduced federal taxes in 2018, an estimated 40 percent of the reduced tax liability will go to residents of Wards 2 and 3. The remaining 60 percent of the reduced tax liability will go to residents of the remaining 6 wards (figure 3). This 60 percent is estimated to be further distributed in dollar terms as follows: 14 percent to filers with income less than $50,000, 19 percent to filers with income between $50,000 and $100,000 and 27 percent to those with income greater than $100,000.

Of the estimated 15 percent that will likely see higher federal taxes (from figure 1), 64 percent of the higher tax burden will be paid by residents of Wards 2 and 3, and an additional 22 percent will be paid by residents of the remaining 6 wards whose income is greater than $100,000 (figure 4).

Figure 3

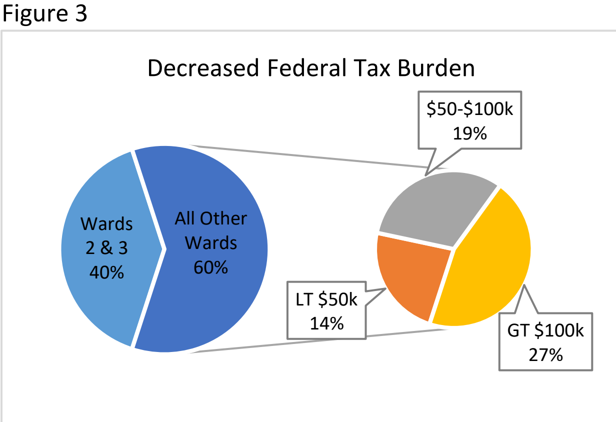
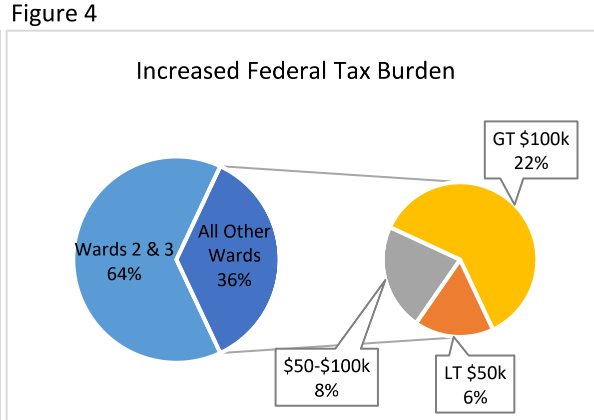
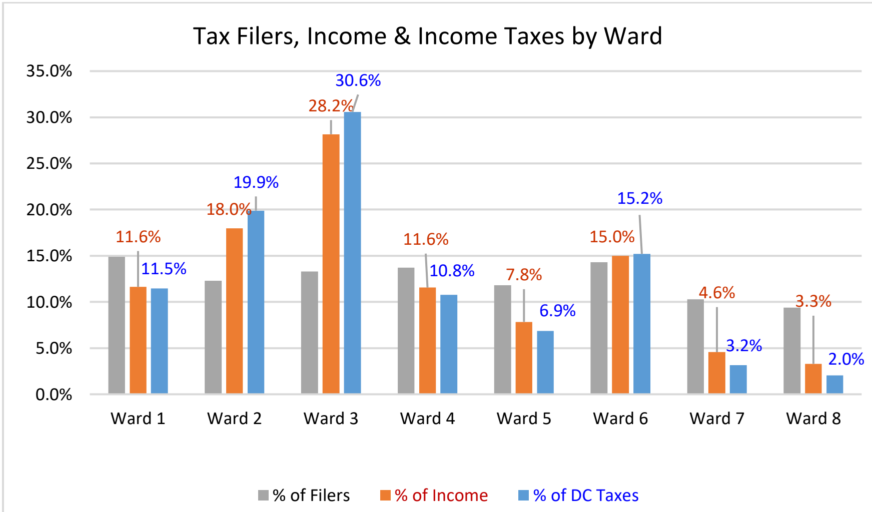


Figure 4



The above figures indicate that, in the aggregate, residents of Wards 2 and 3 will be significantly impacted. But the ward distribution of the impact of the TCJA on the city's federal income tax liability largely reflects the District's distribution of income by wards. Though each ward has an average of about 13 percent of the city's income tax filers, Wards 2 and 3 account for 46 percent of the city's annual income and 51 percent of income tax liability (as shown in figure 5).

Figure 5



Turning to the distributional impact of the TCJA changes on the District's income tax liability, of the 38 percent tax filers (figure 2) with decreased District income tax liability, 56 percent are in Wards 2 and 3 (figure 6). Of the tax filers outside of Wards 2 and 3 with lower tax liability, an estimated 14 percent have income less than $50,000 (figure 6). On the other hand, Wards 2 and 3 will only shoulder 29 percent of the increased District income tax liability and residents in the other wards and with income less than $50,000 will shoulder 18 percent of the increased local tax burden.

Figure 6

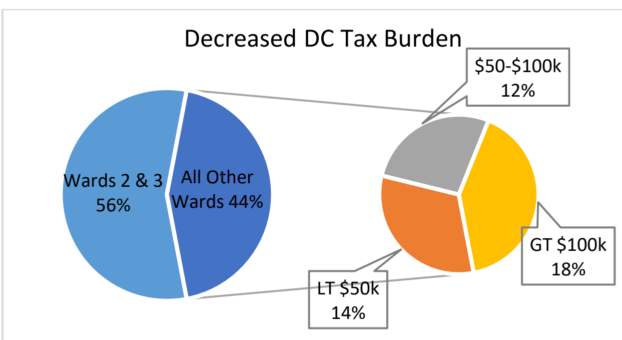
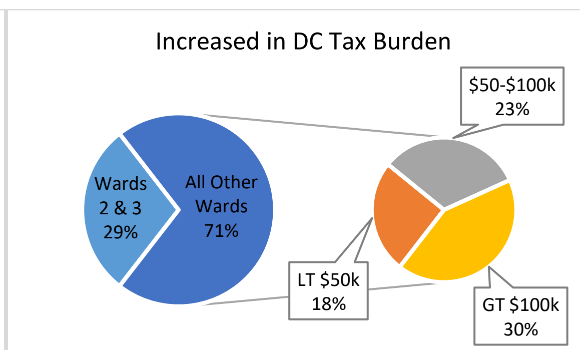


Figure 7



Why did TCJA lower District resident's federal tax liability, but raise their District income tax liability?

The main reason for differential impact of TCJA on federal versus the District income tax liability is the TCJA's suspension of the personal exemption (for tax years 2018-2025). Starting in tax year 2018 the District personal exemption was coupled to the federal personal exemption. So, when the TCJA suspended the personal exemption on December 22, 2017, it was suspended for the District individual income tax as well. Prior to the TCJA the federal personal exemption was scheduled to be $4,150 for 2018. Generally, a tax filer deducts from gross income, the personal exemption amount for herself, her spouse, and for each dependent claimed on the tax return. This can add up to a sizable amount, significantly lowering the taxable income for low-income tax filers.

As figure 8 shows, Wards 2 and 3 only accounted for 19 percent of all personal exemptions in tax year 2015, while filers with income less than $50,000 who lived in wards outside Wards 2 and 3, accounted for nearly 50 percent of all District personal exemptions. On average, head of household tax filers (unmarried tax filers with dependents) claimed 3.62 exemptions on their tax returns in tax year 2015 (figure 9). Figure 10 shows that Wards 4, 7 and 8, have the highest share of dependents, accounting for 53 percent of the District's dependents. As such, tax filers in these wards will likely be most negatively impacted by the loss of the personal exemption with overall higher District income tax liability because of the TCJA changes, even with the almost doubling of the standard deduction.

Figure 8

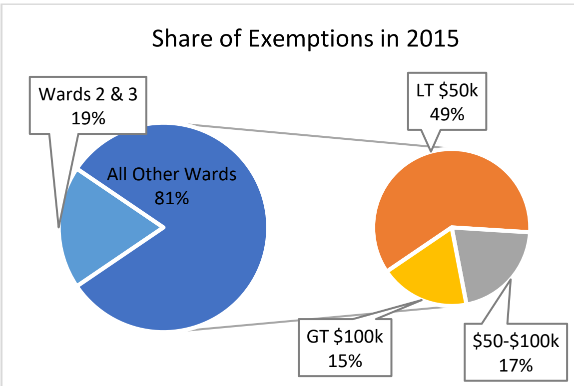


Figure 9

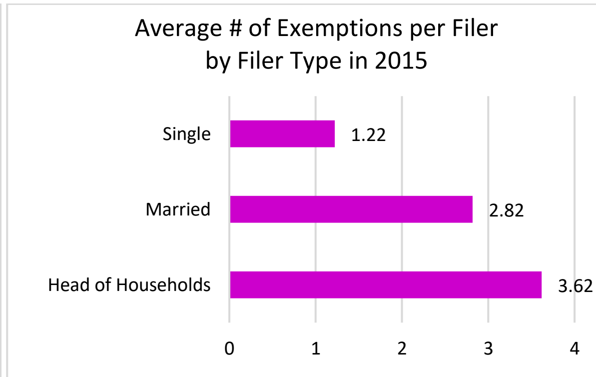
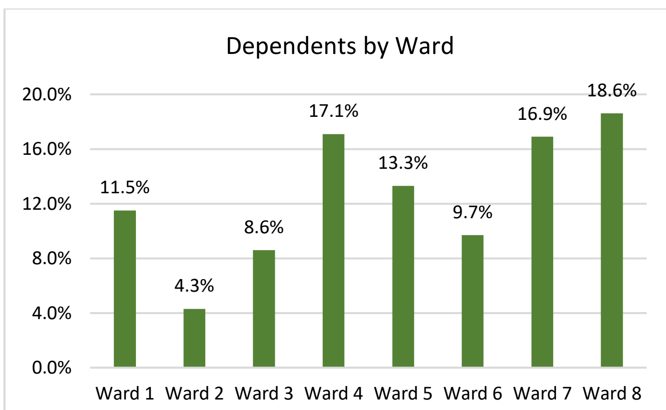


Figure 10



At the federal level, the TCJA helps to offset the projected increased tax burden for lower income filers with dependents by increasing the child tax credit (doubling from $1,000 to $2,000 per child in some cases) and creating a new $500 tax credit for dependents not eligible for the child tax credits. Unfortunately, the District of Columbia income tax structure is neither coupled to these federal child tax credit provisions nor does the District have a comparable credit specifically targeted to lower income filers with dependents. Our analysis suggests that the lack of a comparable child tax credit as part of the city's income tax structure is one of the major causes for expected higher District income tax burdens for lower income filers with dependents.

Combined Federal and DC Effects of the TCJA

Our analysis estimates that tax filers with income between $25,000 and $75,000 will experience an average increase between $155 and $173 in their 2018 District of Columbia income taxes. This translates into about a 0.2 percentage point increase in their average effective tax rate. In contrast, it is anticipated that filers with income greater than $500,000 will experience a decrease in their District of Columbia income taxes of roughly $1,000, and this translates into practically no change in their average effective tax rate.

When we consider the effect of the TCJA on the combined federal and local income taxes on District residents' tax liability, it is estimated that only 17 percent of filers will see a net increase in their combined income tax liability and 64 percent of filers will see a net decrease in their combined income taxes. (Nineteen percent of filers are expected to see no change in their combined income taxes for 2018.) This suggests that for many filers the expected decrease in their federal income taxes is likely to offset the expected increase in their city income taxes for 2018.

Conclusion

Conformity between the federal and District of Columbia income tax structures has significant implications for District residents' tax liability. Even though the TCJA suspended the personal exemption, the federal law also increased the standard deduction amounts (to which the District of Columbia income tax structure is coupled), increased the child tax credit, and created a new $500 tax credit for dependents not eligible for the child tax credits (both of which the District of Columbia income tax structure is not coupled to). At the federal level, it appears that a combination of the higher standard deduction and the higher child credit allows eligible low-income earners with dependents to lower their federal income liability despite the elimination of personal exemptions. The absence of such a credit at the District level appears to be a principle reason why many low -income earners with dependents will pay more income taxes to the District of Columbia government in 2018 under the new TCJA.

Because of the conformity of only key elements of the District tax structure to the federal tax structure, the District's income tax structure will be less progressive than it otherwise would have been in 2018. That is, beginning in 2018 the District of Columbia effective income tax rates for many low income filers with dependents are estimated to increase slightly more, on average, than the effective income tax rates for city's highest income filers.