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# Increasing the District's Personal Exemption and Standard Deduction Would Help Provide Greater Tax Relief to Low- and Moderate-Income DC Residents

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The District's personal exemption and standard deduction are parts of the DC income tax that are available to all residents, but they provide the greatest benefits to families and individuals with low-and-moderate incomes. Despite the importance of these tax provisions, the DC deductions are far lower than the federal personal exemption and standard deductions and similar deductions in many states. The low value of these deductions means that the DC income tax does not do as much to shield lower-income families from taxes as the federal income tax or the income tax in many states.

For example, the combined standard deduction and personal exemption for a single parent family of three reduces taxable income by $10,700 in DC, compared with $15,300 in the average state and $19,600 at the federal level.

Raising the DC standard deduction and personal exemption to match the federal deduction would exempt all working poor families from owing DC income tax, increase the effectiveness of DC's earned income tax credit for lower-income working residents, and provide substantial tax benefits to low- and moderate-income working families with incomes above poverty. This also would make DC's tax system more progressive.

## Background

The personal exemption and standard deduction are part of the federal and DC income tax codes, as well as the tax codes in many states. They serve to exempt a certain amount of income from tax. The personal exemption, which generally is available to all families and individuals, provides a flat deduction for every person in a tax filing unit. (DC allows an extra exemption for families filing as a single head of household.) The DC personal exemption is currently $1,675. The standard deduction also is available to all tax filers, but taxpayers with certain eligible expenses — such mortgage interest, property taxes, and charitable contributions — can choose to take an itemized deduction over the standard deduction.[1] The DC standard deduction, which is currently set at $4,000, is

[1] For more information on itemized deductions, see: http://www.taxpolicycenter.org/taxtopics/encyclopedia/Itemized-Deductions.cfm

especially important to renters and to lower-income residents because they typically do not have sufficient deductions to itemize. In DC, for example, some 75 percent of filers with incomes below $75,000 claim the standard deduction. The vast majority of filers above that threshold, 88 percent, itemize deductions.

These deductions help make the income tax progressive. For some very low income families, the personal exemption and standard deduction eliminate taxable income and tax liability entirely. Among other families, the personal exemption and standard deduction offset a higher share of income for moderate-income families than for others. For example, the combined personal exemption and standard deduction at the federal level is $26,400 for a married couple with two children. That offsets more than half the income for a family earning $50,000, but only about a quarter of the income for a family earning $100,000.

A small number of states and the District have another mechanism to shield lower-income residents from income tax, in addition to their personal exemption and standard deduction. It is typically known as a no-tax floor or a no-filing floor, meaning that income must meet a certain level before a unit starts owing income tax. In five states and DC, the no-filing floor is greater than the combination of the personal exemption and standard deduction, which means that some families owe no income tax even though they have taxable income (income minus personal exemptions and the standard deduction.).[2]

The District has a tax credit, the Low-Income Credit, which acts like a no-tax floor. If a household's income exceeds the combination of the District personal exemptions and standard deductions but is less than the combination of its *federal* exemptions and deductions, the household can claim a Low-Income Credit. In most cases, the credit eliminates the entirety of an eligible family's tax liability.

Nevertheless, the personal exemption and standard deduction are more effective ways to limit tax liabilities for lower income families, especially in DC. All no-tax floors create a "cliff" effect. If a household's income exceeds the no-tax floor by a dollar, it is disqualified entirely from claiming the no-tax benefit. While all families can benefit from the personal exemption and standard deduction, only households below the income limit of the no-tax floor benefit from it. Instead of a gradual phasing-out, a dollar of income above the no-tax floor is a "cliff" that can result in a significant increase in in tax liability. In DC, for example, an increase in income for a married couple and two children from just below the Low-Income Credit limit to $1 above it moves the family from having no tax liability to owing $742.

DC's Low-Income Credit has an additional shortcoming that a household cannot claim both the Low-Income Credit and the refundable DC Earned Income Credit. This results in very few families with children claiming the Low-Income Credit. Overall, only a small fraction of low-income residents in DC use the Low-Income Credit.

For these reasons, strengthening DC's personal exemption and standard deduction are important to reducing income taxes for low- and moderate-income households and for making the income tax more progressive.

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[2] Filing Year 2011 Income Tax Forms and Instructions for 41 states and District of Columbia

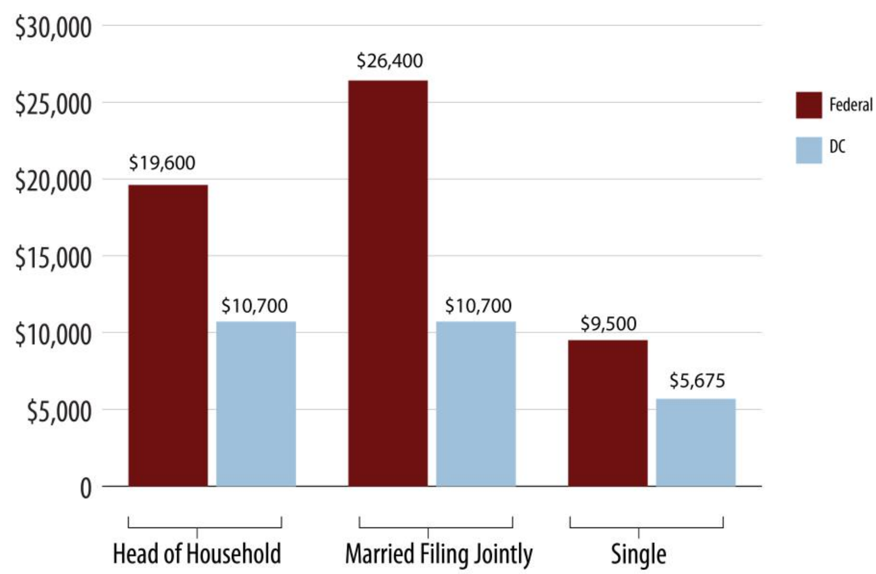
## DC's Personal Exemption and Standard Deduction Are Smaller than at the Federal Level and in Many States

The District's personal exemption and standard deduction are low when compared to the exemptions and deduction for the federal income tax. In 2011, the District's personal exemption was $1,675 per family member, plus an extra $1,675 if the taxpayer was filing as head of household.[3] The standard deduction was $4,000 for all filing units, regardless of composition. The federal exemption amounts to $3,700 per family member, and the standard deduction ranges from $5,800 to $11,600, depending on filing status.[4]

The gap is large between the combined value of these deductions in District and the similar deductions in the federal income tax. For example, the federal personal exemption and standard deduction for a single mother with two dependents would reduce their taxable income by $19,600. The same family's taxable income would be reduced by only $10,700 under DC's tax structure. The gap between the federal deductions and DC's deductions also is wide for other family types (See **Figure 1**.).

Figure 1

**The Federal Personal Exemption(s) and Standard Deduction Provide Significantly More Relief to Low- Moderate-Income Taxpayers than DC's Measures**




Source: Filing Year 2011 District of Columbia Individual Income Tax Forms and Instructions (DC); Internal Revenue Service Form 1040 Instructions for Filing Year 2011 (Federal). Head of Household is a single parent with two dependents.

The DC personal exemption and standard deduction also are low relative to the 41 other states that have an income tax. This analysis uses three different filing units -- a single head of household with two dependents, a married couple filing jointly with two dependents, and a single person with no dependents — each with an adjusted gross income of $20,000 to compare the personal exemptions and standard deduction across states. The income level of $20,000 was chosen because

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[3] Head of household means that the taxpayer is not married and provides a home for qualified dependents (such as an eligible child).

[4] Family member refers to filer, spouse, and qualified dependents. All family members in this paper are assumed to be without blindness and younger than 65.

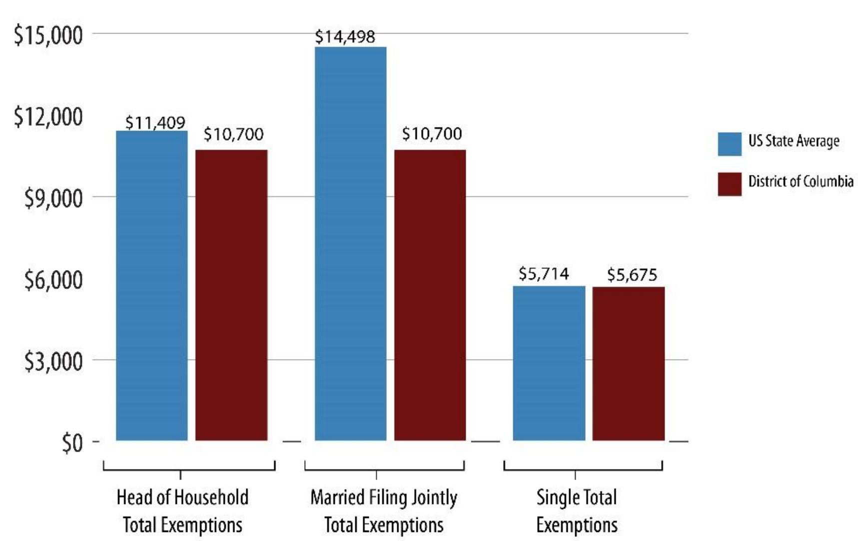
five states[5] vary either their exemptions or standard deductions based on income[6], and because $20,000 was the point where exemptions tended to be most generous.

The District's personal exemption and standard deduction are nearly all below the national average of state exemptions (see **Figure 2**).

- A District couple filing jointly with two dependents can exempt only $10,700, compared to the national average of $14,498. DC's combined deductions are lower than in 26 of the 41 states with an income tax.
- A DC head of household with two dependents can also claim $10,700 in combined deductions, compared to the national average of $11,400 and a federal combination of $19,600.
- District singles can claim $5,675 in combined deductions, which is near the national average of $5,714.

Figure 2

DC's Personal Exemption and Standard Deduction Fall Below the National Average of States Exemptions




Source: Filing Year 2011 Income Tax Forms and Instructions for 41 states and District of Columbia

The District's deductions are smaller than in neighboring states. A married couple with two kids in Maryland is eligible for up to $15,800 in income deductions, with most of Maryland's tax relief driven by its large personal exemptions of $3,200 per person – almost twice the amount in DC. While a similar couple in Virginia can only receive $9,720 in combined reductions, the state also has a tax floor for married couples at $26,400.

[5] Alabama, Maryland, Montana, New Mexico and Wisconsin.

[6] This analysis considers only the personal exemptions and standard deductions, and not the no-tax floors in the two states where the no-tax floor was greater than $20,000 – Utah and Virginia, Furthermore, the District's Low-Income Credit is not examined to maintain comparability with other states and due to the low-take up rate of the credit.

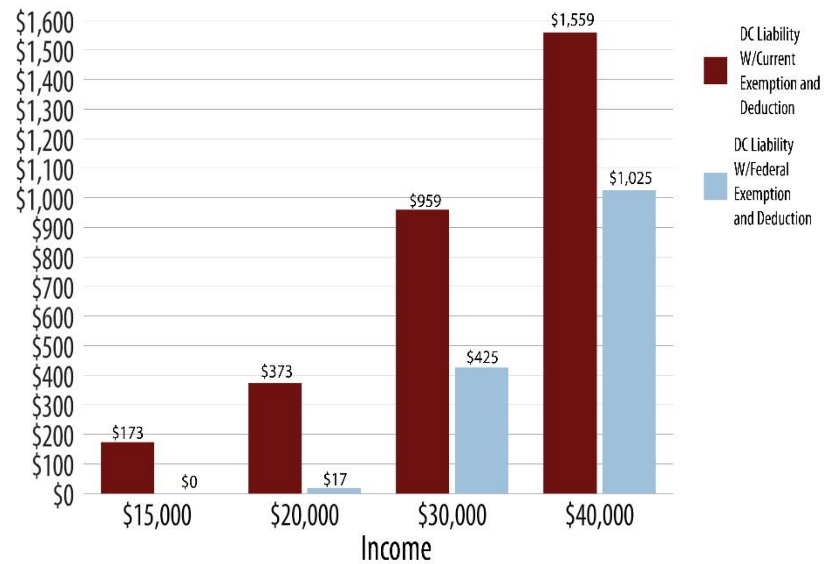
## DC Should Increase Its Personal Exemption and Standard Deduction

The personal exemption and standard deduction are important tax measures to limit income tax liabilities for low and moderate income families and individuals. However, the modest size of the District's exemptions compared to other states suggests that DC could be doing more to reduce tax liability for the working poor.

One option is to adopt the federal standard deduction and exemptions, as six states have done. This would place the District's exemptions among the top eight states, and it would largely exempt District families living below the poverty line from paying DC income taxes.[7] **Figure 3** shows the effect of increasing the District's exemptions and deductions to the federal level for a single head of household with two children, before taking tax credits into account. Adoption of the federal exemption and deduction levels decreases tax before credits and increases the effectiveness of the DC Earned Income Credit.

Figure 3

**Increasing District Deductions to the Federal Level Reduces DC Tax Liability Substantially***




*Tax Liability calculated before credits
Source: Filing Year 2011 Income Tax Forms and Instructions for District of Columbia

- For a family of three with income of $30,000, adopting the federal exemption and deduction would cut tax liability by more than half, from $959 to $425.

- After applying the Earned Income Credit, the same family would receive a refund of about $500 with the federal exemptions and deductions, as opposed to owing $37 in taxes under the current exemptions.

Increasing the personal exemption and standard deduction to the federal levels would also eliminate the need for the underutilized Low-Income Credit (LIC), since the LIC is tied to households with incomes that are above the DC exemption levels but below the federal exemption levels. Eliminating the LIC would simplify the tax system. The District also could choose to increase its personal exemption and standard deductions but to amounts that remain lower than the federal level, although this would leave some working poor families with DC income tax liabilities.

[7] Using 2011 FPL Thresholds http://www.census.gov/hhes/www/poverty/data/threshld/.