



# Federal Deductibility of State and Local Taxes

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## Summary

Under current law, taxpayers who itemize can deduct state and local real estate taxes, personal property taxes, and income taxes from federal income when calculating taxable income. In addition, a temporary deduction for sales taxes in lieu of income taxes is available, though it expires December 31, 2011. The federal deduction for state and local taxes results in the federal government paying part of these taxes through lower federal tax collections. Theory would suggest that taxpayers are willing to accept higher state and local tax rates and greater state and local public spending because of lower federal income taxes arising from the deduction. In addition, there is some evidence that state and local governments rely more on these deductible taxes than on nondeductible taxes and fees for services.

Repealing the deductibility of state and local taxes would affect state and local government fiscal decisions, albeit indirectly. Generally, state and local public spending would decline, although the magnitude of the decline is uncertain. And, repealing the deduction for state and local taxes would shift the federal tax burden away from low-tax states to high-tax states. Maintaining the current deductibility would continue the indirect federal subsidy for state/local spending.

Expanding deductibility, such as extending the sales tax deduction option or allowing non-itemizers to deduct taxes paid, would likely increase the subsidy for state and local spending. The sales tax deduction option would primarily benefit taxpayers in states without an income tax that are already itemizing. The effect of allowing non-itemizers to deduct taxes paid would depend on the type of deductible tax. For example, property taxes are only paid (directly) by property owners whereas all consumers pay sales taxes in states that levy a sales tax. P.L. 111-312, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, extended the sales tax deduction option through the 2011 tax year.

In the 111<sup>th</sup> Congress, P.L. 111-5, the American Recovery and Reinvestment Act, provided for an above-the-line deduction for sales and excise taxes paid on new vehicle purchases for non-itemizers which has expired. The President's FY2013 budget includes an extension of the sales tax deduction option through 2013 and proposes a limit on the tax rate (generally a 28% marginal tax rate) at which itemized deductions would reduce tax liability. In the Senate, S. 3521 would also extend the deduction through 2013, reducing revenues by \$4.4 billion over the 2013 to 2022 budget window.

This report will be updated as legislative events warrant.

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## **Introduction**

The interplay between the federal and state and local tax systems through the federal deductibility of state and local taxes is the focus of this report. Generally, individual taxpayers who itemize deductions are allowed to deduct real and personal property taxes, and general sales taxes or state and local income taxes from federal taxable income. Taxpayers must choose between sales taxes or income taxes; they cannot deduct both. In 2004, Congress modified the deductibility of state and local taxes—adding the sales tax deduction option for 2004 and 2005—and the 109<sup>th</sup> Congress extended the sales tax deduction option for 2006 and 2007. The 110<sup>th</sup> Congress extended the deduction two more years, through 2008 and 2009. And in the 111<sup>th</sup> Congress, the sales tax deduction option was extended for 2010 and 2011. The Administration’s FY2013 budget proposal provides for an extension of the sales tax deduction option while including a limit on the tax rate at which itemized deductions reduce tax liability. In the Senate, S. 3521 would also extend the deduction through 2013, reducing revenues by \$4.4 billion over the 2013 to 2022 budget window.

In addition to the sales tax deduction option, Congress had also enacted a provision that allowed non-itemizers to deduct up to \$500 (\$1,000 for joint filers) of property taxes paid. The special deduction was available for the 2008 and 2009 tax years and was in response to the housing crisis. Unlike the sales tax deduction option, the special property tax deduction was not extended for the 2010 and 2011 tax years. The tax savings from the special property tax deduction likely benefited taxpayers that did not have other potentially deductible expenses that were high enough to merit itemizing. Taxpayers with no mortgage (or low mortgage debt) in states with relatively low state and local tax burdens were the most likely to have benefited the most from this expired tax provision.

In the 111<sup>th</sup> Congress, P.L. 111-5, the American Recovery and Reinvestment Act, provided for an above-the-line deduction for sales and excise taxes paid on new vehicle purchases for non-itemizers. This deduction expired after the 2009 tax year.

## **Brief History**

The deduction from federal income for state and local taxes paid dates from the inception of the current income tax under the Revenue Act of 1913.<sup>1</sup> A provision in that act allowed the deduction for “all national, State, county, school and municipal taxes paid within the year, not including those assessed against local benefits.” State sales taxes, however, were not introduced until 1932 (Mississippi was the first) and a deduction for those taxes for individuals was not explicitly stated in the tax code until passage of the Revenue Act of 1942 (P.L. 77-753). The deductibility provision was frequently modified over the years, including the introduction of the standard deduction in lieu of itemizing deductions in 1944, but significant revision did not occur until 1964 with enactment of the Revenue Act of 1964 (P.L. 88-272).

Before the 1964 act, a deduction was allowed for all state and local taxes paid or incurred within the taxable year except those taxes explicitly excluded. After the 1964 act, only taxes explicitly

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<sup>1</sup> The 16<sup>th</sup> Amendment allowed for the taxation of income without regard to apportionment among the states. With the new constitutional authority, Congress passed The Revenue Act of 1913, initiating the current federal income tax.

mentioned were deductible. Included in the list of deductible taxes were state and local taxes on real and personal property; income; general sales; and the sale of gasoline, diesel fuel, and other motor fuels. A new subsection in the 1964 act spelled out the test for deductibility of general sales taxes. First, the tax must be a sales tax (a tax on retail sales) and second, it must be general, that is, imposed at one rate on the sales of a wide range of classes of items. “Items” could refer either to commodities or services.

The deductibility provision remained largely unchanged until the sales tax deduction was repealed by the Tax Reform Act of 1986 (TRA 1986, P.L. 99-514). One of the primary goals of TRA 1986 was to broaden the base of the federal income tax. Eliminating the deduction for all state and local taxes paid was one of the policy options considered to broaden the tax base. The final version of TRA 1986 repealed the deduction for general sales taxes but preserved the deduction for ad valorem property taxes and income taxes. The Joint Committee on Taxation (JCT) summary of TRA 1986 suggested that Congress chose to repeal the sales tax deduction and not income or property taxes, because:

- only general sales taxes were deductible and not selective sales taxes (e.g., tobacco and alcohol taxes) which created economic inefficiencies arising from individuals changing consumption patterns in response to differential taxation;
- the deduction was not allowed for taxes paid at the wholesale level (and passed forward to the consumer), thus creating additional inequities and inefficiencies;
- the sales tax deduction was administratively burdensome for taxpayers who chose to collect receipts to justify sales tax deduction claims; and
- the alternative sales tax deduction tables generated by the Internal Revenue Service (IRS) did not accurately reflect individual consumption patterns, thereby diminishing the equitability of the tax policy.<sup>2</sup>

The American Jobs Creation Act of 2004 (AJCA 2004, P.L. 108-357) reinstated deductible sales tax *in lieu of* income taxes.<sup>3</sup> The *in lieu of* treatment in AJCA 2004 is in contrast to the “in addition to” treatment in pre-TRA 1986 tax law. The concerns noted above would still hold. A secondary concern—presented during the debate before repeal in 1986—that states would alter their tax structures in response to the elimination of sales tax deductibility, would not arise. The AJCA 2004 sales tax deductibility provision expired after the 2005 tax year, but was extended through 2007 by the Tax Relief and Health Care Act of 2006 (P.L. 109-432). The sales tax deduction option was extended through the 2009 tax year by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343). And finally, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312), extended the sales tax deduction option through the 2011 tax year.

The remainder of this report will describe and analyze the deduction for the following state and local taxes: (1) real estate property taxes; (2) personal property taxes; (3) income taxes; and (4) sales and use taxes. As Congress considers possible extension of the sales tax deductibility

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<sup>2</sup> For more on the 1986 Act, see U.S. Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99<sup>th</sup> Congress; P.L. 99-514)*, 100<sup>th</sup> Cong., 1<sup>st</sup> sess., JCS-10-87 (Washington: GPO, 1987), pp. 47-48.

<sup>3</sup> IRS Publication 600, *Optional Sales Tax Tables*, provides a explanation of the new sales tax deduction.

provision and proposals for fundamental tax reform, a better understanding of the existing deductible state and local taxes is important.

## Deductible State and Local Taxes

Generally, taxpayers may deduct state and local taxes paid from income. Individual taxpayers, however, must itemize deductions (rather than use the standard deduction) on their income tax return to claim the deduction for taxes paid. Business taxpayers, in contrast, may deduct state and local taxes as a cost of doing business. The federal tax savings from the deduction is equal to the taxpayer's marginal tax rate multiplied by the size of the deduction. Because the federal income tax rate regime is progressive,<sup>4</sup> a deduction for itemizers, in contrast to a tax credit for all taxpayers, favors taxpayers in higher income tax brackets. **Table 1** reports the number and percentage of returns with itemized deductions for the four state and local taxes described and analyzed in this report.

**Table 1. Number and Percentage of State and Local Taxes Paid Itemizers, 1986 and 2002 to 2009**  
(return numbers in millions)

	1986	2002	2003	2004	2005	2006	2007	2008	2009
All Returns	103.0	130.1	130.4	132.2	134.4	138.4	143.0	142.5	140.5
Itemized Deductions	40.7	45.6	43.9	46.3	47.8	49.1	50.5	48.2	45.7
—Income Taxes	33.2	37.6	35.9	33.5	34.6	35.7	36.7	35.4	33.8
—Sales Taxes	39.0	n/a	n/a	11.2	11.4	11.2	11.9	11.0	10.3
—Real Estate Taxes	32.9	39.7	38.3	40.5	41.3	42.6	43.6	41.6	40.0
—Personal Property Taxes	11.5	20.6	20.0	21.1	21.3	21.5	22.1	21.0	16.1
—Other Taxes	9.1	3.4	3.2	3.0	2.8	3.1	2.9	2.8	5.4
All Returns	100%	100%	100%	100%	100%	100%	100%	100%	100%
Itemized Deductions	39.5	35.1	33.7	35.0	35.6	35.5	35.4	33.8	32.5
—Income Taxes	32.2	28.9	27.5	25.3	25.7	25.8	25.7	24.9	24.0
—Sales Taxes	37.8	n/a	n/a	8.5	8.5	8.1	8.3	7.8	7.3
—Real Estate Taxes	32.0	30.5	29.4	30.6	30.7	30.8	30.5	29.2	28.5
—Personal Property Taxes	11.1	15.8	15.3	16.0	15.8	15.5	15.4	14.7	11.5
—Other Taxes	8.8	2.6	2.5	2.3	2.1	2.2	2.0	2.0	3.9

**Source:** U.S. Department of Treasury, Internal Revenue Service, Statistics of Income Division, *Individual Income Tax Returns, various years*, Publication 1304.

The 1986 tax year is included in **Table 1** to exhibit the utilization of the deduction for sales taxes paid, which was repealed by TRA 1986. In 1986, before repeal, the sales tax deduction was the most common itemized deduction for taxes paid. More taxpayers would claim a sales tax deduction because all but five states imposed a sales tax and, in contrast to property taxes, paying

<sup>4</sup> A progressive tax is one in which the rate of tax increases with income.

the tax is not conditioned on owning property, real or personal. The current sales tax deduction is not as common because it is *in lieu of* income taxes. In 2009, 10.3 million taxpayers claimed a deduction for sales taxes paid, and the number who claimed a deduction for income taxes paid has dropped from 35.9 million in 2003 to 33.8 million in 2009.

The gradual growth in the percentage of itemizers through 2007 (see **Table 1**) may exhibit income growth that outpaced inflation. Income growth that exceeds the inflation-adjusted expansion of income tax brackets (bracket creep) implies a higher marginal tax bracket, which ultimately increases the tax saving from itemizing. The decline in 2003 likely is in response to the lower marginal tax rates and more generous standard deduction for married taxpayers filing joint returns. The total number (and percentage) of itemizers increased from 43.9 million in 2003 to 46.3 million in 2004, likely reflecting introduction of the sales tax deduction option. The decline in 2009 may be related to the economic downturn that began in 2008. Generally, however, the percentage of itemizers and the taxes they deduct has been relatively stable over time.

## Deduction for Real Estate Property Taxes

Under the federal income tax, taxpayers can deduct ad valorem property taxes (taxes levied as a percentage of assessed value) from taxable income.<sup>5</sup> For example, an itemizing individual owning a home with an assessed value of \$100,000, and who pays a 1% property tax, can deduct the \$1,000 tax from his or her adjusted gross income. If this taxpayer is in the 28% marginal tax bracket, taking \$1,000 out of taxable income reduces taxes by \$280 (\$1,000 multiplied by 28%).<sup>6</sup> In most cases, both the taxpayer's tax bracket and home value increase with income. Thus, higher-income taxpayers in higher tax brackets receive a greater tax savings than low-income taxpayers because of the typically progressive state income tax. The effect is even greater because of the assumed positive relationship between home value (and property tax bill) and income.

In the 110<sup>th</sup> Congress, P.L. 110-289 included a provision that allowed non-itemizers to deduct up to \$500 (\$1,000 for joint filers) of property taxes paid. The special deduction was first available for the 2008 tax year and was extended through 2009 by P.L. 110-343. The special deduction has expired.

## Analysis

The property tax deduction was claimed on approximately 28.5% of all tax returns in 2009. However, not all homeowners itemize, and only those who itemize can take the deduction. In 2009 there were 74.8 million owner-occupied households yet only 40.0 million tax units claimed an itemized deduction for real estate property taxes in 2009.<sup>7</sup> **Table 1** above provides data for the years 1986, and 2002 through 2009 on the number of returns that claimed a property tax deduction, the most common itemized deduction claimed.

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<sup>5</sup> There are two types of property taxes, real estate (e.g., owner-occupied housing) and personal (e.g., cars and boats). The focus of this report is the real estate property tax. For ease of exposition, the modifier "real estate" is not used for the remainder of the report.

<sup>6</sup> Marginal tax rates are sometimes referred to as tax brackets. There are currently six individual income tax brackets: 10%, 15%, 25%, 28%, 33%, and 35%.

<sup>7</sup> According to the U.S. Census Bureau, available at [http://factfinder.census.gov/servlet/STTable?\\_bm=y&-qr\\_name=ACS\\_2009\\_1YR\\_G00\\_S2503&-geo\\_id=01000US&-ds\\_name=ACS\\_2009\\_1YR\\_G00\\_&-\\_lang=en&-format=&-CONTEXT=st](http://factfinder.census.gov/servlet/STTable?_bm=y&-qr_name=ACS_2009_1YR_G00_S2503&-geo_id=01000US&-ds_name=ACS_2009_1YR_G00_&-_lang=en&-format=&-CONTEXT=st), visited September 19, 2011.

Property taxes are a major source of local government revenue, and thus the federal transfer through deductibility is also quite large. State governments, in contrast, are less dependent upon property tax revenue and instead rely more upon income and sales taxes. Nationally, property taxes comprised 45.3% (\$397.0 billion in FY2008) of all local government general own-source revenue and 1.2% (\$12.7 billion in FY2008) of all state government general own-source revenue.<sup>8</sup>

Less than half of the combined \$409.7 billion in property taxes collected by state and local governments in FY2008 was deducted by individual taxpayers who itemized on their federal income tax returns or by businesses as a business expense. In 2008, \$167.9 billion of real estate property taxes were claimed as itemized deductions on individual federal income tax returns. Another 15.7 million returns of non-itemizers included \$11.3 billion of deductions for real estate taxes as part of the additional standard deduction. Personal property taxes, such as annual car taxes (based on the value of the car), generated \$8.5 billion in deductions in 2008. The amount collected and the amount deducted are different because only one-third of taxpayers itemize on individual returns and businesses (including landlords) pay a large share of property taxes that would not appear as itemized deductions on individual income tax returns.

The federal tax expenditure estimated by the Joint Committee on Taxation (JCT) approximates the amount of federal revenue lost (or approximately the amount taxpayers benefit) as a result of the deductibility. **Table 2** presents the tax expenditure over the FY2009-FY2013 estimating window for taxpayers who (1) itemize and claim a deduction for state and local real estate property taxes and (2) take the additional standard deduction for property taxes paid. The five-year total expenditure is estimated by the JCT to be approximately \$128.1 billion. The annual expenditure for deduction by itemizers increases from \$16.4 billion in 2010 to \$30.0 billion in 2013. The increase likely reflects the expiration of the lower marginal tax rates enacted in 2001.

**Table 2. Estimated Federal Tax Expenditure on the Real Estate Property Tax Deduction**

(in \$ billions)

	2009	2010	2011	2012	2013	Total
Deduction for Property Taxes on Owner-Occupied Housing	25.1	16.4	24.9	29.3	30.0	125.7
Additional Standard Deduction for Property Taxes Paid (2008-09)	1.9	0.5	—	—	—	2.4

**Source:** U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013*, joint committee print, JCS-01-10, 111<sup>th</sup> Congress (Washington: GPO, 2010).

In theory, if the property tax paid deduction were eliminated, taxpayers would gradually reduce their level of housing consumption, and thus their property tax bill. This shift would be gradual as housing consumption choices are not as responsive as other expenditures to changes in after-tax price given the relatively illiquid nature of housing assets. In addition, as noted earlier, state and local governments may lower tax rates and shift to other revenue sources if the relative tax price of raising revenue through property taxes increases. Local governments would have more at stake than state governments, because the real property tax is primarily a local source of revenue.

<sup>8</sup> U.S. Census Bureau, *State and Local Government Finances: 2007-08*, the data are available at <http://www.census.gov/govs/www/estimate08.html>, visited September 19, 2011. The property tax in the census data includes both real estate property taxes and personal property taxes.

Across taxpayers, high-income property owners in states with relatively high local property values (and taxes) would likely see the greatest increase in total tax burden if property tax deductibility were repealed.

## Deduction for Income Taxes

Taxpayers who itemize can choose between deducting either state and local income taxes or sales taxes, but not both. In 2012, the sales deduction option will expire. As with local property taxes, the federal deduction is equal to the taxpayer's individual tax rate multiplied by the amount of state and local income tax paid.<sup>9</sup>

The income tax is a source of revenue primarily for states, not local jurisdictions. In FY2008, state governments collected \$278.4 billion in individual income taxes and local governments collected \$26.3 billion (\$304.6 billion combined). Federal deductions claimed on federal income tax forms for both state and local income taxes in the 2008 tax year totaled \$271.0 billion. The difference between what was collected and what was claimed on federal returns stems from taxpayers who did not itemize or individuals who were not required to file federal returns. Both groups are significantly more likely to be relatively low-income.

Estimates of the tax expenditure for the deduction of state and local taxes are included in **Table 3**. In December of 2010, P.L. 111-312 extended the sales tax deduction option through 2011. Note that the annual tax expenditure estimates below include the personal property tax deduction. The tax expenditure generated by the personal property tax, however, is a small fraction of the federal tax expenditure reported below.

## Analysis

The deduction for state and local income taxes affects the distributional burden of both state and federal taxes. First, the deduction could increase the progressivity of *state taxes* if it causes states to rely more on progressive taxes such as the income tax. The cost of the deduction for high rate taxpayers is effectively "exported" to all federal taxpayers. A state that collects a relatively larger share of income taxes from taxpayers in high federal income tax brackets is most effective at exporting a portion of its state tax burden to all federal taxpayers.

**Table 3. Estimated Federal Tax Expenditure on the State and Local Income, Sales, and Personal Property Tax Deductions**

(in \$ billions)

Most Recent Estimate	2009	2010	2011	2012	2013	Total
Deduction for state and local Income, Sales, and Personal Property Taxes	46.7	34.0	49.9	58.4	61.1	250.2

<sup>9</sup> In some states, taxpayers may also deduct federal income taxes from income when calculating state taxable income. The reciprocal deduction, however, for federal income taxes is practiced only in six states. Partial or limited deductibility is available in an additional three states. Because few states offer the reciprocal deduction for federal income taxes paid, the focus here is limited to the deductibility of state income taxes when calculating federal taxable income.

**Source:** U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013*, joint committee print, JCS-01-10, 111<sup>th</sup> Congress (Washington: GPO, 2010).

The federal tax burden, however, could be shifted to the majority of taxpayers who do not itemize deductions. Before the alternative sales tax deduction was enacted by AJCA, taxpayers in states without an income tax were more likely to be non-itemizers; thus taxpayers in these states bore a relatively higher tax burden than taxpayers in states with an income tax. The sales tax deductibility provision has partially muted this shift in tax burden.

## Deduction for Sales and Use Taxes<sup>10</sup>

### Explanation

The deduction for state and local sales taxes was temporarily reinstated in 2004 with enactment of the AJCA and was extended through 2011 by P.L. 111-312. Unlike the pre-TRA 1986 deduction, the current version allows for a deduction for sales taxes *in lieu of* income taxes. Taxpayers who itemize may choose between reporting actual sales tax paid, verified with saved receipts indicating sales taxes paid, or an estimated amount found in tables provided by the IRS.<sup>11</sup> The table amounts do not include the sales taxes paid for cars, motorcycles, boats, aircraft, or a home, and local sales taxes paid. Taxpayers may add taxes paid for these items to the table amount. Taxpayers are asked to calculate the ratio of the local sales tax rate to the state sales tax rate, and then multiply the result by the table amount to arrive at an estimate of local sales taxes paid. The estimated local sales taxes paid are then added to the state sales taxes paid table amount. The provision expires on December 31, 2011. As noted earlier, S. 3521 would extend the deduction through 2013.

The American Recovery and Reinvestment Act (ARRA, P.L. 111-5) included a special deduction for the sales tax and excise tax paid on new vehicle purchases through 2009. This deduction was available only for those taxpayers that choose not to claim a deduction for general sales taxes paid. Thus, non-itemizers and itemizers claiming a state or local income tax deduction can take this special deduction. The dollar value of the deduction is limited in two ways. First, only the first \$49,500 of the purchase price is eligible and second, the deduction is phased out for taxpayers with adjusted gross income between \$125,000 and \$135,000 (for joint filers the phase-out range is \$250,000 to \$260,000).

### Analysis

Allowing the deduction for state and local sales taxes in lieu of income taxes likely diminishes the progressivity of the federal income tax system because the deduction from income is available only to taxpayers who itemize.<sup>12</sup> Itemizers in states that do not impose an income tax benefit the most from the optional sales tax deduction (see **Table 4**, footnote “a” for these states). The

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<sup>10</sup> A use tax is a tax on the use of a product. In the early years of the sales tax, states began with general sales then added the use tax. The intent of the use tax is to capture the sales tax due on purchases made out-of-state yet used in-state. Eventually, states adopting a sales tax included the use tax in the enacting legislation.

<sup>11</sup> See IRS publication 600, noted earlier.

<sup>12</sup> The new special deduction for sales and excise taxes for 2009 would likely return some progressivity to the tax system.

gradual reduction in allowable itemized deductions for wealthy taxpayers and the alternative minimum tax (AMT) do limit the benefit at the highest end of the income distribution.

It is also true that states without an income tax rely more on sales and property taxes than do states with an income tax. As a result, itemizers in states without an income tax will be able to deduct proportionately more of their state and local taxes than taxpayers in states with both an income and sales tax. As shown in **Table 4**, in states without an income tax, state and local governments rely on sales and property taxes for 73.0% of total tax revenue. In contrast, in states that levy an income tax, state and local governments rely on income and property taxes for 50.0% of total tax revenue.

The differential treatment of states based on the reliance on the income tax was likely unintended. Nevertheless, states without an income tax are considerably better off with the sales tax deduction option relative to income tax states. As such, extension of the sales tax deduction option would benefit non-income tax states relatively more than other states.

**Table 4. Type of Tax Revenue, Non-Income Tax States and Income Tax States, FY2008**

Type of tax	Type of tax revenue as percent of total state and local tax revenue		
	All states and DC	Non-income tax states <sup>a</sup>	Income tax states and DC
Total	100.0%	100.0%	100.0%
Property tax	30.8%	33.7%	28.3%
General sales	22.9%	39.3%	21.7%
Individual income	22.9%	0.4%	25.7%
Corporate Income	4.3%	3.7%	4.1%
Other taxes	19.1%	32.8%	20.1%
Maximum deductible	53.7%	63.3%	57.6%

**Source:** CRS calculations based on Census Bureau data for FY2008.

- a. Includes AK, FL, NH, NV, SD, TN, TX, WA, and WY. The income tax percentage is positive for states without an income tax because New Hampshire and Tennessee levy an income tax on dividend and interest income (or capital income).

## Policy Alternatives and Current Legislation

The President's FY2013 budget plan had two proposals that would affect the deduction for state and local taxes. First, the FY2013 budget proposed raising the income level where itemized deductions begin to phase out when the limitation returns in the 2013 tax year. The income-driven phase-out of itemized deductions is the so-called "Pease" limitation.<sup>13</sup> The Pease limit was repealed for the 2010 tax year and the repeal was extended through the 2012 tax year by P.L. 111-312. In 2013, without extending the repeal, a taxpayer's itemized deductions would be reduced by three cents for every dollar of adjusted gross income (AGI) above a fixed level (it was \$167,100 in 2009). The president's budget proposed raising this threshold to \$200,000 for single filers and \$250,000 for joint filers beginning with the 2013 tax year and adjusting them for inflation. When

<sup>13</sup> For more on the "Pease" provision, see CRS Report R40508, *Personal Exemption Phaseout (PEP) and Limitation on Itemized Deductions (Pease)*, by Gary Guenther.

compared to current law, this provision would make the deduction for state and local taxes relatively more valuable for some taxpayers. More generally, however, the Pease limitation is often criticized as an unnecessarily complicated means of raising the marginal tax rate on high-income taxpayers. The higher thresholds would reduce the number of taxpayers subject to the Pease limitation, further concentrating the underlying complexity.

A second provision in the President's FY2013 budget proposal would limit the tax rate at which itemized deductions would reduce tax liability. In contrast to the first proposal, this provision would reduce the value of the deduction for state and local taxes. Under current law, the value of an itemized deduction is the taxpayer's marginal tax rate multiplied by the amount of the deduction. The Administration's proposal would cap the value of the deduction at 28% multiplied by the amount of the deduction.<sup>14</sup> Clearly, the cap would not affect taxpayers at or below the 28% rate. For the 2013 tax year, the two higher rates are 36% and 39.6%.

### **Federal Tax Base Broadening: Eliminate Deductibility of State and Local Taxes**

If deductibility were eliminated and state and local governments are policy neutral (i.e., do nothing in response to the federal changes), then the impact on the distributional burden of state and local taxes will remain essentially unchanged. The federal tax burden, however, will shift from low tax state taxes toward high tax states. Under current tax rules, taxpayers in high tax states can deduct more from federal income than can those in low tax states.<sup>15</sup>

For example, in 2008, potentially deductible state and local taxes in New York comprised approximately 9.1% of total personal income whereas deductible taxes in nearby Delaware accounted for approximately 4.7% of total personal income.<sup>16</sup> Thus, taxpayers in New York can deduct significantly more from federal income than can taxpayers in Delaware.

Assuming that other federal taxes were maintained after the elimination of the federal deduction for state and local taxes, the tax burden would shift toward high-tax states from low-tax states. If the federal government reduces tax rates to maintain revenue neutrality—the base is larger with the elimination of the deductibility allowing for lower rates to yield the same revenue—then the effect is even more pronounced. The higher the state and local tax burden (as a percentage of total income), the lower the new federal tax rate would be under revenue neutrality.

More generally, if state and local tax deductibility were eliminated, the federal tax burden would shift from all federal taxpayers toward itemizers. As noted earlier, itemizers tend to be higher income, thus, federal income taxes may become more progressive if the state and local taxes paid deduction were eliminated.

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<sup>14</sup> The interaction with the AMT would further reduce the value of the deductions that are preference items under the AMT such as the deduction for state and local taxes.

<sup>15</sup> The tax reform panel reform package would counter, or at least offset, the distributional effect of the state and local taxes paid deduction through elimination of the AMT and the highest tax bracket.

<sup>16</sup> State personal income data are from the U.S. Census Bureau, Bureau of Economic Analysis, available at [http://www.bea.gov/newsreleases/regional/spi/spi\\_newsrelease.htm](http://www.bea.gov/newsreleases/regional/spi/spi_newsrelease.htm), visited on July 30, 2010. State tax data are from U.S. Census Bureau, *State and Local Government Finances: 2007-08*, the data are available at <http://www.census.gov/govs/www/estimate.html>, visited July 30, 2010.

Some secondary effects, however, are anticipated at the state and local level. If deductibility were eliminated, state and local governments might be less willing to finance projects that generate benefits that extend beyond the taxing jurisdiction. The tax price to a community of these projects would increase as the federal “contribution” through deductibility is lost. Projects and initiatives whose benefits extend beyond the local jurisdiction would likely be the most sensitive to changes in the tax price as the benefits are more widely dispersed.<sup>17</sup> A reduction in state and local public good provision may adversely affect low-income individuals relative to high-income individuals.

Quantifying the magnitude of the state and local spending response is difficult because many other factors influence state and local spending decisions, such as state and local political considerations and overall economic conditions. Nevertheless, most research has found that state spending declines or would decline, but by how much? Before sales tax deductibility was eliminated in 1987, one researcher estimated that “the overall responses are on the order of zero to ten percent, much less than estimates used in the political debate.”<sup>18</sup> In contrast, another economist found that the “level of state and local spending is significantly affected by deductibility.”<sup>19</sup>

### **Making the Sales Tax Deduction Permanent**

Making the sales tax deduction option permanent would benefit itemizing taxpayers in states without an income tax the most. The cost of making the sales tax deduction option permanent (continuing with the *in lieu of income taxes* language) would generate an annual federal revenue loss of approximately \$3 billion.

### **Other Policy Considerations**

Two concepts or issues were not directly addressed in this report yet will likely arise during the debate surrounding the federal income tax treatment of state and local taxes. One, are the tax expenditures for state and local taxes paid truly federal tax “expenditures?” Or, do these “expenditures” represent a return of taxpayer income that was never the federal government’s to begin with? Two, would the absence of a federal deduction for state and local taxes paid amount to “taxing a tax?” The foundation of these arguments can be traced to the difference between a theoretically ideal income tax and the federal income tax as it currently exists.

The ideal federal income tax would include wage income plus all accretions to wealth (including imputed income) over a designated time period, one calendar year, for example.<sup>20</sup> This definition of income should, theoretically, accurately measure an individual’s ability to pay income taxes. Any exclusions or deductions from this definition of income would represent a departure from the rule and thus generate a tax “expenditure” or federal subsidy.

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<sup>17</sup> Robert Jay Dilger, “Eliminating the Deductibility of State and Local Taxes: Impacts on States and Cities,” *Public Budgeting & Finance*, winter 1985, p. 77.

<sup>18</sup> Edward M. Gramlich, “The Deductibility of State and Local Taxes,” *National Tax Journal*, vol. 38, no. 4, December 1985, p. 462.

<sup>19</sup> Lawrence B. Lindsey, “Federal Deductibility of State and Local Taxes,” in Harvey Rosen, editor, *Fiscal Federalism: Quantitative Studies* (Chicago, IL: University of Chicago Press, 1988), p. 173.

<sup>20</sup> This definition of an ideal income tax is credited to Haig and Simons, who did much of their research in the 1930s. For more, see Simons, Henry Calvert, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (Chicago, IL: University of Chicago Press, 1938).

There are two ways to view taxes paid for state and local government services under an ideal income tax.<sup>21</sup> If one views state and local taxes paid as payment for government provided services which could be privately provided, then the federal deduction for state and local taxes is not appropriate. In contrast, if one views state and local taxes as lost income resulting in a reduced ability to pay federal income taxes (a loss), then a deduction for those taxes seems reasonable. The more tangible, less theoretical, tax-on-a-tax issue arises from this last observation.<sup>22</sup>

There is not a clear consensus on which view is “correct.” For some state and local taxes and taxpayers, the fee-for-specific-services view is more accurate. Taxpayers with government-provided trash collection who pay property taxes for government spending on trash collection, for example, are receiving a tangible quasi-private benefit. Similar federal taxpayers in two otherwise equivalent jurisdictions—except that one jurisdiction provides garbage collection and the other does not—would face different federal tax burdens. Generally, this would contradict the concept of horizontal equity across federal taxpayers.

The reduction-in-ability-to-pay view seems more reasonable for those paying general sales taxes for general government provision of public goods such as fire and police protection. Note that a federal deduction for sales taxes and not property taxes would theoretically seem more desirable.

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<sup>21</sup> Note that the benefits received by taxpayers are not included in federal taxable income.

<sup>22</sup> Top federal income tax rates were much higher in the 1970s and 1980s (the top rate was 70% in 1981), and, combined with state and local rates of 10% to 15%, created almost confiscatory cumulative income tax rates. The current federal rate structure with much lower rates minimizes this effect.