Congressional Research Service
Informing the legislative debate since 1914

Federal Deductibility of State and Local Taxes

Updated May 10, 2017

Congressional Research Service
https://crsreports.congress.gov
RL32781

CRS REPORT
Prepared for Members and
Committees of Congress

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. A deduction for sales taxes in lieu of income taxes is also available. The federal deduction for state and local taxes results in the federal government paying part of these state and local 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 these deductions. 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 taxpayers in low-tax states to taxpayers in high-tax states. Maintaining the current deductibility would continue the indirect federal subsidy for state and local spending.

Expanding deductibility, such as reinstating 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. The Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the sales tax deduction option through the 2014 tax year, but it has since been allowed to expire.

Recent tax reform proposals have included changes to state and local tax deductibility. The "A Better Way" tax reform proposal published by the House Budget Committee in June 2016 included a repeal of the deductions for state and local taxes. In April 2017, Treasury Secretary Steven Mnuchin and National Economic Director Gary Cohn also indicated an interest in repealing state and local tax deductions as part of a larger tax reform proposal.

The Obama Administration's FY2016 budget proposed a limit on the tax rate (generally a 28% marginal tax rate) at which itemized deductions would reduce tax liability, but did not specifically address deductions related to state and local taxes. In the 114th Congress, the Consolidated Appropriations Act, 2016 (P.L. 114-113) permanently extended the deduction of state and local sales taxes in lieu of state and local income taxes. In the 111th Congress, 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 since expired.

This report will be updated as legislative events warrant.

Contents

Introduction 1
Brief History 1
Deductible State and Local Taxes 2
Deduction for Real Estate Property Taxes 4
Analysis 4
Deduction for Income Taxes 6
Analysis 6
Deduction for Sales and Use Taxes 7
Explanation 7
Analysis 7
Policy Alternatives and Current Legislation 9
Federal Tax Base Broadening: Eliminate Deductibility of State and Local Taxes 10
Modifying the Standard Deduction 11
Other Policy Considerations 12

Tables

Table 1. Number and Percentage of Returns with Certain Itemized Deductions, 1986 and 2003 to 2014 3
Table 2. Estimated Federal Tax Expenditure on the Real Estate Property Tax Deduction 5
Table 3. Estimated Federal Tax Expenditure on the State and Local Income, Sales, and Personal Property Tax Deductions 6
Table 4. Type of Tax Revenue, Non-Income Tax States and Income Tax States, FY2014 8
Table 5. Federal Itemized Deduction Activity by State, Tax Year 2014 8

Contacts

Author Information 12
Acknowledgments 13

Introduction

This report focuses on the interplay between federal and state and local tax systems through the federal deductibility of state and local taxes. Generally, individual taxpayers who itemize deductions are allowed to deduct real and personal property taxes and state and local income taxes paid from federal taxable income. In 2004, the 108th Congress modified the deductibility of state and local taxes to include sales tax for the 2004 and 2005 tax years. This provision was extended by each Congress up through the 113th, and was made permanent by Division Q of the Consolidated Appropriations Act, 2016 (P.L. 114-113).

In addition to the sales tax deduction option, Congress previously 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 beyond 2009. 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.

Previously, the American Recovery and Reinvestment Act (P.L. 111-5) provided for an above-the-line deduction for sales and excise taxes paid on new vehicle purchases for non-itemizers. This deduction also expired after the 2009 tax year.

Brief History

The deduction from federal income for state and local taxes paid originates from the Revenue Act of 1913.[1] 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 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 deduction for sales taxes 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

[1] The 16th 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.

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.[2]

The American Jobs Creation Act of 2004 (AJCA 2004, P.L. 108-357) reinstated deductible sales tax *in lieu of* income taxes.[3] 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 on multiple occasions: through 2007 by the Tax Relief and Health Care Act of 2006 (P.L. 109-432); through the 2009 tax year by the Emergency Economic Stabilization Act of 2008 (P.L. 110-343); through the 2011 tax year by The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312); through the 2013 tax year by The American Taxpayer Relief Act (P.L. 112-240); and through the 2014 tax year by the Tax Increase Prevention Act of 2014 (P.L. 113-295). The Consolidated Appropriations Act, 2016 (P.L. 114-113) permanently incorporated the deduction of state and local sales taxes in lieu of state and local income taxes into the tax code.

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 modifications to the deductibility of state and local taxes as part of fundamental tax reform, a better understanding of the existing policy may be useful.

Deductible State and Local Taxes

Generally, taxpayers may deduct state and local taxes paid from income. Individual taxpayers must itemize deductions (rather than use the standard deduction) on their income tax return to claim the deduction for state and local 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

[2] 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 , 99th Congress;* P.L. 99-514*)*, 100th Cong., 1st sess., JCS-10-87 (Washington: GPO, 1987), pp. 47-48.

[3] IRS Publication 600, *Optional Sales Tax Tables*, provides an explanation of the new sales tax deduction.

equal to the taxpayer's marginal tax rate multiplied by the size of the deduction. Because the federal income tax rate regime is progressive,[4] a deduction for itemizers, in contrast to a tax credit for all taxpayers, favors taxpayers in higher income tax brackets. For example, in 2010, 88% of all benefits from the deduction of state and local taxes paid went to individuals with adjusted gross incomes greater than $100,000.[5] **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 Returns with Certain Itemized Deductions, 1986 and 2003 to 2014

(return numbers in millions)

	1986	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
All Returns	103.0	130.4	132.2	134.4	138.4	143.0	142.5	140.5	142.9	145.4	144.9	147.4	148.6
Itemized Deductions	40.7	43.9	46.3	47.8	49.1	50.5	48.2	45.7	46.6	46.3	45.6	44.3	44.0
State and local taxes	40.4	43.1	44.8	46.0	46.9	48.6	46.4	44.0	44.9	44.6	43.9	42.7	42.3
Income tax	33.2	35.9	33.5	34.6	35.7	36.7	35.4	33.8	33.5	33.7	33.4	32.6	32.5
General sales tax	39.0	n/a	11.2	11.4	11.2	11.9	11.0	10.3	11.4	10.9	10.5	10.1	9.8
Real estate taxes	32.9	38.3	40.5	41.3	42.6	43.6	41.6	40.0	41.0	40.1	39.3	37.8	37.3
Personal property taxes	11.5	20.0	21.1	21.3	21.5	22.1	21.0	16.1	17.2	19.9	19.9	19.7	19.2
Other taxes	9.1	3.2	3.0	2.8	3.1	2.9	2.8	5.4	5.2	2.6	2.5	2.4	2.3
New Motor Vehicle	-	-	-	-	-	-	-	2.2	0.3	-	-	-	-
All Returns	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Itemized Deductions	39.5	33.7	35.0	35.5	35.5	35.4	33.8	32.5	32.6	31.8	31.5	30.1	29.6
State and local taxes	39.2	33.0	33.9	34.2	33.9	34.0	32.6	31.3	31.4	30.7	30.3	29.0	28.4
Income tax	32.2	27.6	25.3	25.7	25.8	25.7	24.9	24.0	23.4	23.2	23.1	22.1	21.8
General sales tax	37.8	n/a	8.5	8.5	8.1	8.3	7.8	7.3	8.0	7.5	7.2	6.8	6.6
Real estate taxes	32.0	29.4	30.6	30.7	30.8	30.5	29.2	28.5	28.7	27.6	27.1	25.7	25.1
Personal property taxes	11.1	15.4	15.9	15.8	15.5	15.4	14.7	11.5	12.0	13.7	13.7	13.4	12.9
Other taxes	8.8	2.4	2.3	2.1	2.2	2.0	2.0	3.9	3.7	1.8	1.7	1.6	1.5
New Motor Vehicle	-	-	-	-	-	-	-	1.6	0.2	-	-	-	-

Source: U.S. Department of the 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

[4] A progressive tax is one in which the rate of tax increases with income.

[5] Rueben, Kim and K. Stark, "In Pursuit of Revenue: Federal Income Tax Reform," *The CPA Journal*, November 2013, p. 20.

deduction because all but five states imposed a sales tax and, in contrast to property taxes, paying 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 2014, 9.8 million (or 6.6%) of taxpayers claimed a deduction for sales taxes paid, and the percentage of taxpayers who claimed a deduction for income taxes paid dropped from 25.8% in 2006 to 21.8% in 2014.

The percentage of itemizers has remained relatively stable since 2003 (see **Table 1**). 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 percentage of itemizers increased from 33.7% in 2003 to 35.0% in 2004, likely reflecting the introduction of the sales tax deduction option. The decline in 2009 may be related to the economic downturn that began in 2008. Generally, the percentage of itemizers and the taxes they deduct has been consistent since 2003.

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.[6] 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 in taxes paid 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%).[7] 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 110th 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. This special deduction has since expired.

Analysis

The real estate property tax deduction was claimed on approximately 25.1% of all tax returns, and of those returns that itemized, approximately 85% claimed a real estate property tax deduction in 2014.[8] **Table 1** above provides data for the years 1986, and 2003 through 2014 on the number of returns that claimed a property tax deduction, the most common itemized deduction claimed.

Property taxes are a major source of local government revenue and thus allow for a substantial federal transfer through their deductibility. State governments, in contrast, are less dependent upon property tax revenue and instead rely more upon income and sales taxes. Nationally, property taxes comprised 46.8% ($452.2 billion in FY2014) of all local government general own-

[6] 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.

[7] Marginal tax rates are sometimes referred to as tax brackets. There are currently seven individual income tax brackets: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%.

[8] CRS calculations based on U.S. Department of Treasury, Internal Revenue Service, Statistics of Income Division, "Individual Income Tax Returns 2014," Publication 1304, August 31, 2016.

source revenue and 1.2% ($14.2 billion in FY2014) of all state government general own-source revenue.[9]

About 41% of the combined $466.4 billion in property taxes collected by state and local governments in FY2014 was deducted by individual taxpayers who itemized on their federal income tax returns or by businesses as a business expense.[10] In 2014, $190.2 billion of real estate property taxes paid were claimed as itemized deductions on individual federal income tax returns.[11] In 2009, an additional 15.7 million non-itemized returns were filed that claimed $11.3 billion in deductions for real estate taxes paid, as part of the temporary additional standard deduction. Personal property taxes, such as annual car taxes (based on the value of the car), generated $9.2 billion in deductions in 2014. The amount collected and the amount deducted differ because only about 30% 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.[12]

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 FY2016-FY2020 estimating window for taxpayers who itemize and claim a deduction for state and local real estate property. The five-year total expenditure is estimated by the JCT to be approximately $180.0 billion. The annual expenditure for deduction by itemizers increases from $31.2 billion in 2016 to $40.5 billion in 2018. The increase likely reflects changes in economic conditions and housing prices.

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

(in $ billions)

	2016	2017	2018	2019	2020	Total
Deduction for Property Taxes on Real Property	31.2	33.3	36.4	38.5	40.5	180.0

Source: U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2016-2020*, joint committee print, JCX-3-17, 115th Congress (Washington: GPO, 2017).

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 would also change. 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. 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. Across taxpayers, high-income property owners in states with relatively high local

[9] U.S. Census Bureau, *State and Local Government Finances: 2012*, the data are available at https://www.census.gov/govs/local/, accessed September 10, 2015. The property tax in the census data includes both real estate property taxes and personal property taxes.

[10] Ibid. Department of the Treasury, Internal Revenue Service, "Individual Income Tax Returns Line Item Estimates, 2014" Rev. 10-2014, at http://www.irs.gov/pub/irs-soi/14inlinecount.pdf.

[11] Ibid.

[12] U.S. Department of Treasury, Internal Revenue Service, Statistics of Income Division, "Individual Income Tax Returns, various years," Publication 1304.

property values (and taxes) would likely see the greatest increase in total tax burden if property tax deductibility were repealed.

Deduction for Income Taxes

As with local property taxes, the federal deduction for state and local income taxes is equal to the taxpayer's individual tax rate multiplied by the amount of state and local income tax paid.[13] The income tax is a source of revenue primarily for states, not local jurisdictions. In FY2014, state governments collected $311.5 billion in individual income taxes and local governments collected $29.6 billion ($341.1billion combined).[14] Federal deductions claimed on federal income tax forms for both state and local income taxes in the 2012 tax year totaled $311.2 billion.[15] 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, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) extended the sales tax deduction option through 2011, and the American Taxpayer Relief Act of 2012 (ATRA; P.L. 112-240) again extended the provision through 2013. The Tax Increase Prevention Act of 2014 (P.L. 113-295) extended the sales tax deduction through the 2014 tax year. And finally, the Consolidated Appropriations Act, 2016 (P.L. 114-113) permanently extended the deduction of state and local sales taxes in lieu of state and local income taxes.

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)

	2016	2017	2018	2019	2020	Total
Deduction for state and local government Income, Sales, and Personal Property taxes	65.4	69.3	74.1	78.0	82.0	368.8

[13] 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.

[14] U.S. Census Bureau, 2014 Census of Government: State & Local Finances, the data are available at https://www.census.gov/govs/local/, accessed May 2, 2017.

[15] Department of the Treasury, Internal Revenue Service, "Individual Income Tax Returns Line Item Estimates, 2014" Rev. 10-2014, at http://www.irs.gov/pub/irs-soi/14inlinecount.pdf.

Source: U.S. Congress, Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2016-2020*, joint committee print, JCX-3-17, 115th Congress (Washington: GPO, 2017).

The federal tax burden, however, could be shifted to the majority of taxpayers who do not itemize deductions. Due to the expiration of the alternative sales tax deduction, taxpayers in states without an income tax are more likely to be non-itemizers; thus, taxpayers in these states bear a relatively higher tax burden than taxpayers in states with an income tax. The sales tax deductibility provision had partially muted this shift in tax burden.

Deduction for Sales and Use Taxes[16]

Explanation

The deduction for state and local sales taxes was temporarily reinstated in 2004 with enactment of the AJCA. This provision was extended a number of times before being made permanent by the Consolidated Appropriations Act, 2016. Unlike the pre-TRA 1986 deduction, the most recent version allowed for a deduction of sales taxes *in lieu of*, as opposed to *in addition to,* income taxes. Taxpayers who itemized could choose between reporting actual sales tax paid, verified with receipts indicating sales taxes paid, or an estimated amount from tables provided by the IRS.[17] 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 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 chose not to claim a deduction for general sales taxes paid. Thus, both non-itemizers and itemizers claiming a state or local income tax deduction could 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 for two reasons. Firstly, the deduction from income is available only to taxpayers who itemize.[18] Secondly, this provision takes the form of a deduction, as opposed to a credit, so that the value of the deduction is greater for individuals facing higher income tax rates. Itemizers in states that do not impose an income tax (and also levy a sales tax) benefited the most from the optional sales tax deduction (see **Table 4**, footnote "a" for these states). The gradual reduction in allowable itemized deductions for wealthy taxpayers and

[16] 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.

[17] See IRS publication 600, noted earlier.

[18] The special deduction for sales and excise taxes in 2009 likely returned some progressivity to the tax system.

the alternative minimum tax (AMT) limited the benefit at the highest end of the income distribution.

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 could 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 72% of total tax revenue. In contrast, in states that levy an income tax, state and local governments rely on income and property taxes for 51% 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.

Table 4. Type of Tax Revenue, Non-Income Tax States and Income Tax States, FY2014

	Type of tax revenue as percent of total state and local tax revenue		
Type of tax	**All states**	**Income tax states and DC**	**Non-income tax states[a]**
Total	100%	100%	100%
Property tax	31%	30%	36%
General sales	23%	21%	36%
Individual income	23%	28%	0%
Corporate income	4%	4%	2%
Other taxes	19%	17%	26%
Maximum deductible	54%	58%	36%

Source: CRS calculations based on Census Bureau data for FY2014.

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). New Hampshire does not levy a sales tax and Alaska does not levy a statewide sales tax.

The level and distribution of income across states may also influence itemized deduction behavior. **Table 5** shows federal itemization activity across states in 2014. Itemization rates are affected by the amount of municipal taxes levied in each jurisdiction (with greater taxation increasing the odds of itemization) and individual income levels in each state (with itemization increasing with income levels). Deductions as a share of adjusted gross income (AGI), meanwhile, represent the percentage of taxable income available deducted through federal subsidies for state and local taxes, with higher percentages representing a greater value from such deductions. About 29.7% of all U.S. taxpayers itemized deductions in 2014, with state level amounts varying from 17.1% in West Virginia to 45.2% in Maryland. The value of itemized deduction claims was equal to 41.6% of total AGI, ranging from 30.2% in Alaska to 48.0% in Mississippi.

Table 5. Federal Itemized Deduction Activity by State, Tax Year 2014

State	Itemization Rate (%)	Deductions /AGI (%)	State	Itemization Rate (%)	Deductions /AGI (%)
Alabama	26.0%	41.3%	Montana	28.2%	41.2%
Alaska*	22.2%	30.2%	Nebraska	27.8%	38.7%

State	Itemization Rate (%)	Deductions /AGI (%)	State	Itemization Rate (%)	Deductions /AGI (%)
Arizona	28.3%	42.0%	Nevada*	24.6%	46.2%
Arkansas	22.7%	45.3%	New Hampshire*	31.5%	33.1%
California	33.9%	47.9%	New Jersey	41.1%	37.4%
Colorado	32.6%	35.1%	New Mexico	22.7%	44.0%
Connecticut	41.2%	35.2%	New York	34.2%	45.4%
Delaware	32.0%	37.6%	North Carolina	29.1%	42.3%
District of Columbia	39.4%	37.5%	North Dakota	17.7%	32.3%
Florida*	22.9%	42.8%	Ohio	26.5%	38.3%
Georgia	32.7%	42.6%	Oklahoma	24.0%	45.0%
Hawaii	29.2%	44.1%	Oregon	36.0%	42.6%
Idaho	27.9%	44.2%	Pennsylvania	28.8%	37.4%
Illinois	32.4%	38.0%	Rhode Island	32.9%	38.9%
Indiana	23.1%	39.8%	South Carolina	27.0%	44.0%
Iowa	29.2%	36.6%	South Dakota	17.3%	39.9%
Kansas	25.7%	38.6%	Tennessee*	20.0%	41.6%
Kentucky	26.0%	41.6%	Texas*	23.0%	37.9%
Louisiana	22.8%	41.1%	Utah	35.4%	41.8%
Maine	27.6%	41.8%	Vermont	27.5%	41.4%
Maryland	45.2%	38.2%	Virginia	37.2%	36.8%
Massachusetts	36.8%	34.1%	Washington*	30.4%	34.8%
Michigan	26.5%	38.5%	West Virginia	17.1%	43.3%
Minnesota	35.0%	37.1%	Wisconsin	31.6%	38.0%
Mississippi	22.9%	48.0%	Wyoming*	21.9%	39.7%
Missouri	26.1%	41.5%	**U.S. Average**	**29.7%**	**41.6%**

Source: U.S. Department of the Treasury, Internal Revenue Service, Statistics of Income Division, *SOI Bulletin*, 2014. CRS calculations.

Notes: "Itemization Rate" represents the percentage of taxpayers who elect to itemize deductions. "Deductions/AGI" represents the total value of itemized deductions claimed as a percentage of total state adjusted gross income. States that do not levy an income tax are denoted with an asterisk.

Policy Alternatives and Current Legislation

President Obama's FY2016 budget plan proposed limiting the tax rate at which itemized deductions would reduce tax liability. This proposal would reduce the value of the deduction for state and local taxes for upper income individuals. Under current law, the value of an itemized deduction is the taxpayer's marginal tax rate multiplied by the amount of the taxes paid. The Obama Administration's proposal would cap the value of the deduction at 28% multiplied by the

amount of the taxes paid.[19] Clearly, the cap would not affect taxpayers at or below the 28% rate. For the 2017 tax year, the three higher rates are 33%, 35%, 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.[20]

For example, in 2011, potentially deductible state and local taxes in New York comprised approximately 11.8% of total personal income whereas deductible taxes in nearby Delaware accounted for approximately 4.4% of total personal income.[21] 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. Some have estimated that individual income tax rates could be reduced by 50% after the elimination of state and local tax deductibility, while remaining revenue neutral.[22] 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 deduction for state and local taxes were eliminated. Estimates suggest that after-tax income for upper-income individuals could decrease by an estimated 2.9% with the elimination of state and local tax deductions, while lower-income individuals would see no change in their after-tax income.[23]

If the deductibility of state and local taxes were eliminated, some secondary effects would likely occur 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 their taxing jurisdiction. The tax price to a community of these projects would increase as the federal "contribution" through deductibility is lost. These projects and initiatives would likely be the most sensitive to changes in the tax price as the benefits are more widely dispersed.[24] A reduction

[19] 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.

[20] 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.

[21] 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, visited on May 3, 2017. 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 May 3, 2017.

[22] Jane Gravelle, "Practical Tax Reform for a More Efficient Income Tax," *Virginia Tax Review*, vol. 30 (Summer 2010), p. 392.

[23] Leonard Burman, Christopher Geissler, and Eric Toder, "How Big are Total Individual Income Tax Expenditures, and Who Benefits From Them?," *American Economic Review*, vol. 98, no. 2 (May 2008), pp. 79-83.

[24] Robert Jay Dilger, "Eliminating the Deductibility of State and Local Taxes: Impacts on States and Cities," *Public*

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, however, 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."[25] In contrast, another economist found that the "level of state and local spending is significantly affected by deductibility."[26]

In addition to possible spending changes, some researchers have found preliminary empirical evidence that state taxes became more progressive in response to changes in the federal tax structure. As part of the tax reforms of the 1980s, individual income tax rates were reduced significantly—top marginal rates were reduced from 70% in 1980 to 28% in 1988—which effectively reduced the value of the deduction for state and local taxes. States responded to this change by reducing statutory tax rates, but did not fully reverse the increase in progressivity in the effective state tax burden resulting from the changes at the federal level.[27]

Modifying the Standard Deduction

Deductions for state and local taxes are only available to taxpayers who itemize their deductions, who were recently estimated to comprise of roughly 30% of all taxpayers.[28]Alternatively taxpayers may take a standard deduction, which is a constant deduction value available to all taxpayers that varies with filing status. The standard deductions available for tax year 2017 are $6,350 for single households, $9,350 for head of household returns, and $12,700 for married households filing jointly.

Some recent tax reform plans have proposed an expansion of the standard deduction, including the "A Better Way" tax plan published by the House Budget Committee in June 2016[29] and H.R. 1 from the 113th Congress. All else equal, increasing the value of the standard deduction would increase the federal tax code's simplicity, as more filers would benefit from taking the standard deduction instead of using a combination of deductions available through itemization. Standard deduction expansion would, all else equal, reduce revenues (and increase budget deficits) relative to current law. That change results from the fact that rational taxpayers would only switch from itemizing deductions to an expanded standard deduction if it would lower their total tax liability.

Budgeting & Finance, winter 1985, p. 77.

[25] Edward M. Gramlich, "The Deductibility of State and Local Taxes," *National Tax Journal*, vol. 38, no. 4, December 1985, p. 462.

[26] 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.

[27] Kim Rueben and Kirk Stark, *Federal Tax Reform and the Deduction for State and Local Taxes* , Tax Policy Center Working Paper, 2012, pp. 13-14.

[28] Data on standard and itemized deduction participation is available at Internal Revenue Service, Statistics of Income, Table 1.2, All Returns: Adjusted Gross Income, Exemptions, Deductions, and Tax Items, by Size of Adjusted Gross Income and Marital Status, at https://www.irs.gov/uac/soi-tax-stats-individual-statistical-tables-by-size-of-adjusted-gross-income.

[29] *A Better Way: Our Vision for a Confident America*, June 16, 2016, available at http://abetterway.speaker.gov_assets/pdf/ABetterWay-Economy-PolicyPaper.pdf.

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 never belonged to the federal government 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.[30] 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.

There are two ways to view taxes paid for state and local government services under an ideal income tax.[31] 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.[32]

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.

Author Information

Grant A. Driessen
Analyst in Public Finance

Steven Maguire
Section Research Manager

[30] 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).

[31] Note that the benefits received by taxpayers are not included in federal taxable income.

[32] 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.

Acknowledgments

The authors would like to thank Jeffrey M. Stupak, who contributed to previous versions of this report.

Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.