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Key Issues in Tax Reform: the Deduction for State and Local Taxes

A key component of tax reform proposals is their treatment of federal tax expenditures or revenue losses attributable to provisions that adjust income taxes away from a "theoretically normal" tax system. Tax reform proposals in the 115th Congress include modifications to the federal deduction for state and local taxes, which is among the largest tax expenditures in the federal income tax system. Debate over modifications to the current state and local tax deduction includes discussion of issues related to the interaction between federal, state, and local governments, along with the distribution of the total tax burden across jurisdictions and households.

Current Law

Generally, taxpayers may deduct state and local taxes paid from income when filing a federal tax return. 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. The federal tax savings from the deduction on state and local taxes paid is equal to the taxpayer's marginal tax rate multiplied by the size of the deduction.

Table 1. Number and Percentage of Returns with State and Local Tax Deductions, Tax Year 2015
(return numbers in millions, percentages of all returns)

Return Type	Number	%
All Returns	150.5	100
Returns with Standard Deduction	105.9	70.4
Returns with Itemized Deductions	44.6	29.6
Returns with deductions for:		
Any State and Local Tax	42.7	28.4
Real Property Taxes	37.6	25.0
Income Taxes	33.1	22.0
Personal Property Taxes	18.9	12.5
Sales Taxes	9.6	6.4
Other State and Local Taxes	2.7	1.8

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

Qualifying taxpayers may claim deductions for state and local real estate taxes, personal property taxes, income taxes, and sales taxes (in lieu of income taxes) from federal income when calculating taxable income. The rate of most deductions is reduced for taxpayers with adjusted gross income above certain thresholds ($313,800 for married taxpayers filing jointly and $261,500 for single filers in 2017).

Internal Revenue Service (IRS) data indicate that of the 44.6 million taxpayers who itemized deductions in 2015, 42.7 million (or 95.8% of itemizers) claimed deductions for state and local taxes paid. **Table 1** shows 2015 state and local deduction claim levels and rates as a percentage of all tax returns. A December 2016 estimate from the Joint Committee on Taxation (JCT) projected that under current law, the federal deduction for state and local taxes would reduce revenues by $548.8 billion from FY2016 to FY2020. Deductions for income taxes, sales taxes, and personal property taxes were estimated to reduce revenues by $368.8 billion, while deductions for real property taxes were projected to reduce revenues by $180.0 billion over the five-year period.

Legislative Background

The federal income tax deduction for state and local taxes paid originates from the Revenue Act of 1913, which allowed the deduction for "all national, State, county, school and municipal taxes paid within the year, not including those assessed against local benefits." There were frequent modifications to the deductibility provision over the years, including the introduction of a sales tax deduction in 1932, the introduction of the standard deduction in 1944, and the restriction of deductions to taxes explicitly mentioned in statute in 1964. Recent changes include repeal of the deduction for sales taxes by the Tax Reform Act of 1986 (P.L. 99-514), temporary instatement of a deduction for sales taxes *in lieu of* income taxes by the American Jobs Creation Act of 2004 (AJCA 2004, P.L. 108-357), and permanent incorporation of the sales taxes deduction in lieu of income taxes by the Consolidated Appropriations Act, 2016 (P.L. 114-113).

Recent Reform Proposals and Options

Repeal of the federal deduction for state and local taxes is under consideration as part of tax reform proposals in the 115th Congress. H.R. 1, as reported by the Committee on Ways and Means, would repeal the deductions for state and local income and sales taxes paid. H.R. 1 would also limit individual claims on state and local property taxes paid to $10,000. That modification would not apply to taxes paid or accrued in carrying on a trade or business. Conversely, the Senate Finance Committee chairman's mark to the "Tax Cuts and Jobs Act" as scheduled for markup the week of November 13, 2017, would repeal all deductions for state and local taxes paid for individuals while retaining the deductions for taxes paid or accrued in carrying on a trade or business.

H.R. 1 and the Senate Finance Committee chairman's mark to the "Tax Cuts and Jobs Act" would each increase the standard deduction. An adjustment to the standard deduction not paired with a direct modification to the state and local tax deduction would still affect state and local deduction claims through changes in the percentage of taxpayers who itemize deductions.

The deductions for state and local taxes paid could also be modified to reduce the revenue loss associated with the provision. One option would be to limit the deduction such that only state and local taxes in excess of 2% of adjusted gross income (AGI) could be deducted. The Congressional Budget Office included this change in its most recent *Options for Reducing the Deficit* report, released in December 2016. JCT estimated that if implemented, such a change would increase federal revenues by $955 billion from FY2017 through FY2026. Other reform proposals have replaced the current deduction for state and local taxes paid with a tax credit imposed at a "fixed" rate (or a rate that would not depend on a taxpayer's marginal tax rate).

Policy Issues

State and Local Government Effects

The federal deduction for state and local taxes transfers a portion of the cost of state and local government services from the taxpayers claiming the deduction to all federal taxpayers. An economic rationale for this transfer is that state and local government services may be underprovided if they provide benefits to non-taxpayers, also known as "spillover effects," even if the total economic benefits of such services exceed their costs. Economic theory suggests that lowering the total cost of state and local services (which may include infrastructure development, state and local parks, and other common resources) encourages their provision at levels closer to the economic optimum.

Critics of the deduction assert that the federal deduction for state and local taxes paid encourages inefficient state and local spending. Under current law the subsidy is provided for all state and local government activities, including services with no spillover benefits. Reducing or eliminating the deduction for state and local taxes would therefore increase the after-tax cost of services to state and local taxpayers, which would likely lower taxpayer demand for those services.

Distributional Issues

The federal deduction for state and local taxes paid represents a significant transfer of the combined federal, state, and local tax burden. The benefits of the transfer to households and jurisdictions may vary with (1) taxes levied in states and localities, (2) taxpayer income levels, and (3) federal individual income tax itemization rates.

The value of the state and local tax deduction varies with the amount of taxes levied across jurisdictions. Taxpayers who pay relatively high state and local taxes receive more benefits from the federal subsidy than taxpayers with a lower state and local tax burden. For example, 2015 U.S. Census Bureau data indicate that potentially deductible state and local taxes comprised approximately 6.3% of total personal income in Florida and approximately 13.8% of total personal income in New York. Thus, the average taxpayer in New York can deduct significantly more from federal income than can the average taxpayer in Florida.

The benefits provided by the state and local tax deduction are dependent on a filer's taxable income level. Since the federal income tax rate regime is progressive (where the rate of tax increases with income), a tax deduction, in contrast to a tax credit, favors taxpayers in higher income tax brackets because the value of benefits is directly proportional to a taxpayer's marginal income tax rate.

Table 2. State and Local Tax Deductions Claimed Across Adjusted Gross Income Levels, Tax Year 2015

Adjusted Gross Income	Share of Filers Claiming State and Local Deductions	Average Amount Deducted per Claim
$1-$19,999	4.8%	$936
$20k-$49,999	16.7%	$1,522
$50k-$99,999	44.1%	$3,194
$100k-$199,999	75.7%	$6,442
$200k-$499,999	93.7%	$15,111
$500k-$999,999	92.9%	$41,082
$1 million+	91.2%	$247,776
All filers	**26.3%**	**$8,262**

Source: Internal Revenue Service, *Statistics of Income Data, Tax Year 2015*, Tables 1.1 and 2.1.

Table 2 shows deduction claim rates and average deduction amounts for taxpayers across levels of AGI in tax year 2015. Both the share of filers claiming deductions and the average amount claimed increases with income, with a particularly large rise in benefits at the top of the income distribution. Of the total amount of deductions claimed, 84% went to individuals with AGIs greater than $100,000.

Since current law restricts claims of the state and local tax deduction to taxpayers with itemized deductions, disparities in federal itemization rates also lead to relative differences in the value of the state and local tax deduction across jurisdictions. IRS data from 2015 indicate that while 30% of taxpayers itemized their deductions nationwide, statewide rates ranged from a low of 17% in West Virginia to a high of 46% in Maryland. As 95.8% of taxpayers who itemized their deductions claimed one or more deductions for state and local taxes, relatively more taxpayers in Maryland likely benefitted from the deduction than did taxpayers in West Virginia. Differences in local tax rates may produce further variation in state and local deduction's value across households.

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