How do state and local individual income taxes work?

Forty-one states and the District of Columbia levy broad-based taxes on individual income. New Hampshire and Tennessee tax only individual income from dividends and interest. Seven states do not tax individual income of any kind. Local governments in 12 states levy their own income tax on top of state taxes.

HOW MUCH REVENUE DO STATE AND LOCAL GOVERNMENTS COLLECT FROM INDIVIDUAL INCOME TAXES?

State governments collected $310 billion—27 percent of state own-source general revenue—from individual income taxes in 2013 (table 1). "Own-source" revenue excludes intergovernmental transfers. By contrast, local governments, concentrated in Maryland, New York, Ohio, and Pennsylvania, collected just $29 billion—3 percent of revenue.

TABLE 1

State and Local Individual Income Tax Revenue 2013

	Revenue (billions)	Percentage of own-source general revenue
State and local	338	16
State	310	27
Local	29	3

Source: State & Local Government Finance Data Query System. The Urban Institute-Brookings Institution Tax Policy Center.

Note: Own source general revenue does not include intergovernmental transfers.

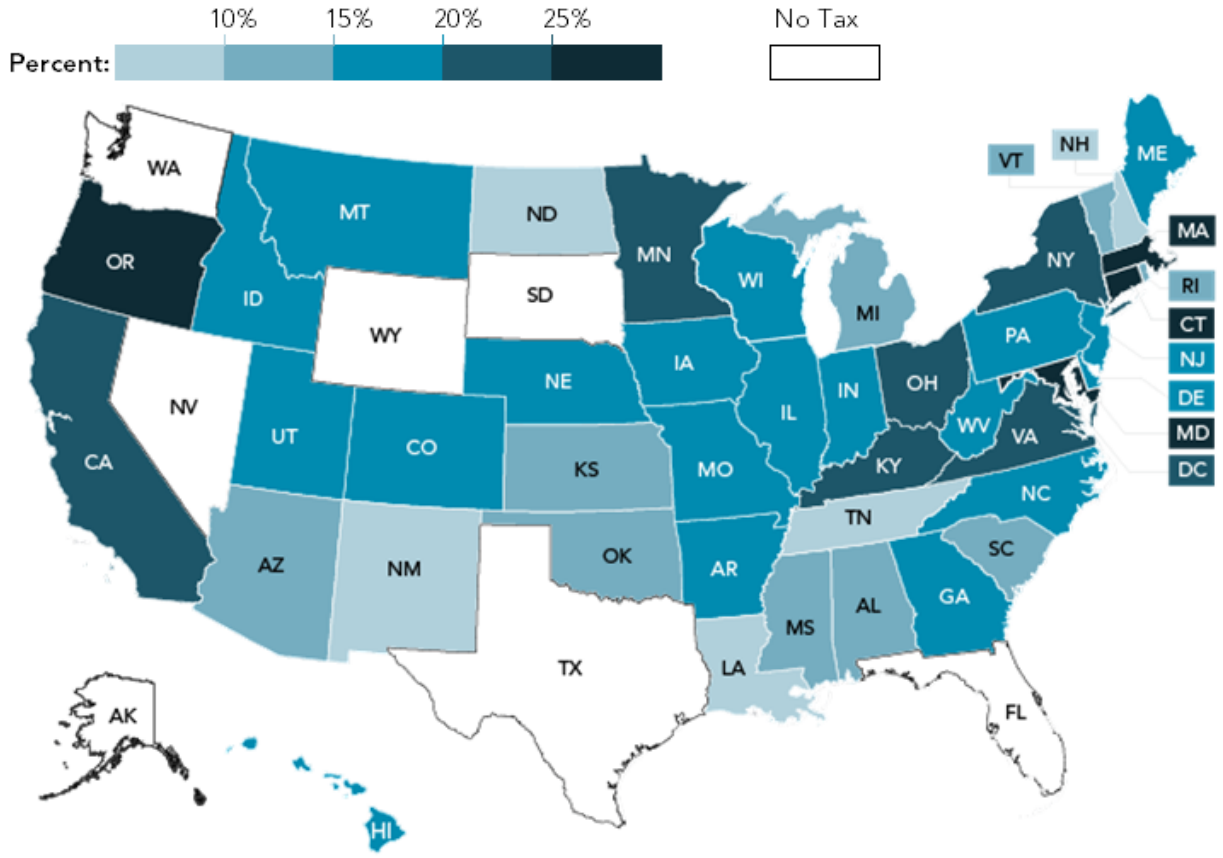
Forty-one states and DC levy a broad-based individual income tax. Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming do not have a state individual income tax. Maryland relied most on the tax, collecting 29 percent of combined state and local own-source general revenue from it in 2013. Connecticut, Massachusetts, and Oregon each collected 25 percent of revenue from the tax.

Three states with a broad-based individual income tax collected less than 10 percent of total state and local own-source general revenue from that tax. North Dakota (8 percent of revenue) relied least on the tax. New Hampshire and Tennessee, with much more limited individual income taxes, collected about 1 percent of revenue from them.

FIGURE 1

Individual Income Tax as a Percentage of State and Local Own-Source General Revenue

2013



Source: Urban-Brookings Tax Policy Center, State & Local Government Finance Data Query System.

Note: Own source general revenue does not include intergovernmental transfers.

In 12 states local governments levied their own individual income taxes in 2013. DC also has its own individual income tax. Individual income taxes provided an average of 10 percent of local own-source general revenue in those states and DC, ranging from 1 percent in Alabama and Iowa to 21 percent in DC and 25 percent in Maryland.

WHAT INCOME IS TAXED?

Most states follow the federal definition of taxable income, but there are exceptions. New Hampshire and Tennessee tax only dividends and interest. States, however, often apply different rules than the federal government for certain types of income. Unlike the federal government, states often tax municipal bond interest from securities issued outside that state, and many allow a full or partial exemption for pension income.

Recently, Kansas and Ohio exempted some or all sole proprietor income and partnership income. In many states, taxpayers who itemize their federal tax deductions and claim deductions for state and local taxes may not deduct those taxes on their state income tax returns.

HOW DO INDIVIDUAL INCOME TAX RATES VARY ACROSS STATES?

Most state income taxes are fairly flat, even in those states that apply graduated rates. Eight states impose a single tax rate on all income, while Hawaii has the most with 12 tax brackets. Top marginal rates for state income tax in 2015 ranged from 3.07 percent in Pennsylvania to 13.3 percent in California—including a 1 percent surcharge on incomes over $1 million in that state (figure 2). In states with multiple tax brackets, the top tax bracket often begins at a very low level of taxable income. Alabama, for example, has three rates, but the top tax bracket starts at taxable income of $3,000, making it essentially a flat tax. In other states, the difference between the lowest and the highest tax rates is small: about 2 percentage points in Kansas and Mississippi, for example.

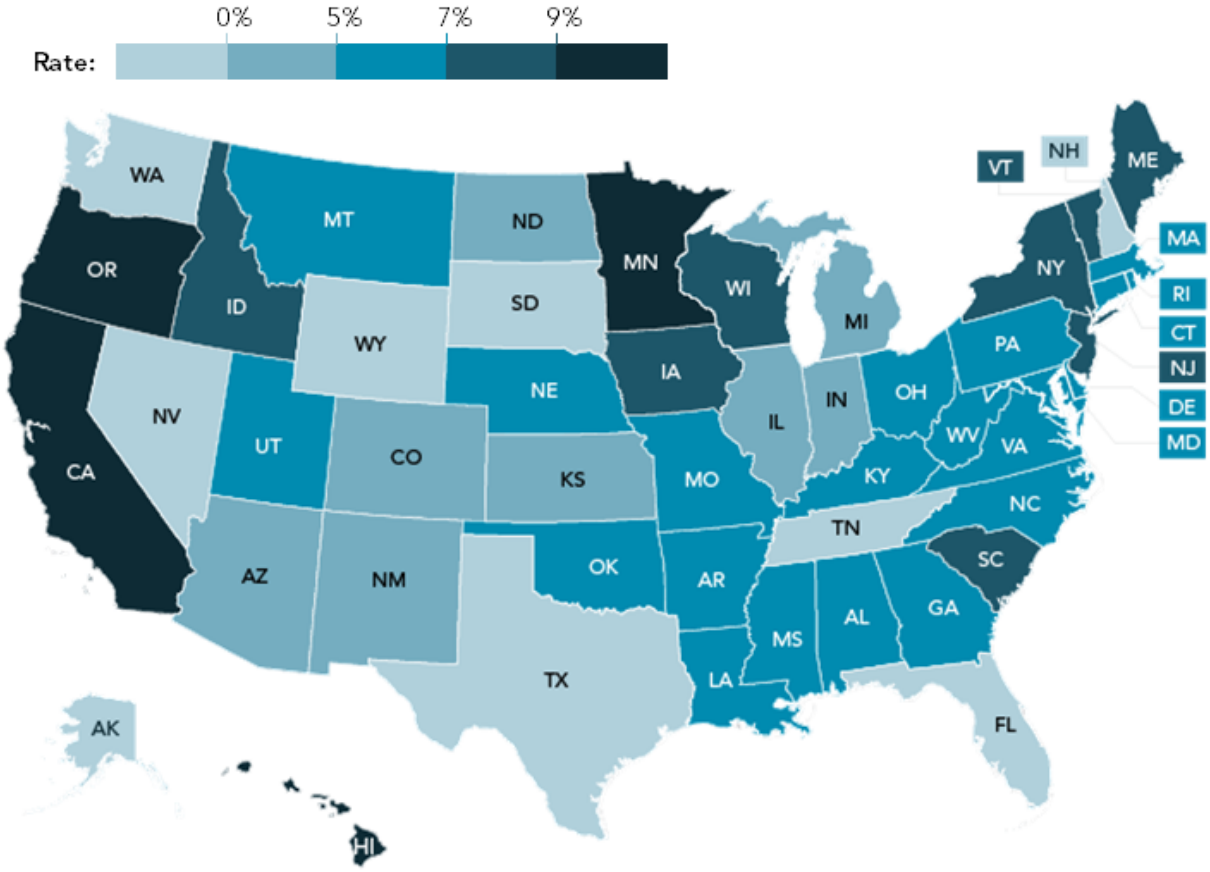
While most states followed the federal government's lead in reducing the number of income tax brackets in the 1980s, there has been a lot of regression. Some states have imposed new brackets (often called "millionaire's taxes") for high-income taxpayers. California approved a millionaire's tax in 2013 that adds 1 percentage point to the rate applied to incomes over $1 million. Similarly, New York's top tax rate of 8.82 percent applies to income above about $1 million.

California, Hawaii, Minnesota, and Oregon have top rates above 9 percent. Iowa, New Jersey, New York, Vermont, and DC have top income tax rates above 8.8 percent.

FIGURE 2

Top State Individual Income Tax Rates

2015



Source: Federation of Tax Administrators.

HOW DO STATES TAX CAPITAL GAINS AND LOSSES?

Eleven states and DC treat capital gains and losses the same as under federal law. They tax all realized capital gains, allow a deduction of up to $3,000 for net capital losses, and permit taxpayers to carry over unused capital losses to subsequent years. However, most states tax capital gains at the same rate as ordinary income, while the federal government provides a preferential rate. New Hampshire fully exempts capital gains, and Tennessee taxes only capital gains from the sale of mutual fund shares. Arizona exempts 25 percent of long-term capital gains, and New Mexico exempts 50 percent. Massachusetts has its own system for taxing capital gains, while Hawaii has an alternative capital gains tax. Pennsylvania and Alabama only allow losses to be deducted in the year that they are incurred, while New Jersey does not allow losses to be deducted from ordinary income. The remaining 25 states that tax income generally

follow the federal treatment of capital gains, with the exception of various state-specific exclusions and deductions.

HOW DO STATES TAX INCOME EARNED IN OTHER JURISDICTIONS?

Income tax is generally imposed by the state in which the income is earned. Some states, however, have entered into reciprocity agreements with other states that allow outside income to be taxed in the state of residence. For example, Maryland's reciprocity agreement with DC allows Maryland to tax income earned in the District by a Maryland resident. As of 2010, 15 states and DC had adopted reciprocity agreements. Typically, these are states with major employers close to the border and large commuter flows in both directions.

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