TAX POLICY CENTER
URBAN INSTITUTE & BROOKINGS INSTITUTION

Repeal of the State and Local Tax Deduction

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March 6, 2017

Taxpayers who itemize deductions on their federal income tax returns can deduct state and local real estate and personal property taxes as well as either state income taxes or general sales taxes. State and local income and real estate taxes make up the bulk of total state and local taxes deducted (about 60 percent and 35 percent, respectively), while sales taxes and personal property taxes account for the remainder. The state and local tax (SALT) deduction is one of the largest federal tax expenditures, with an estimated revenue cost of $96 billion in 2017 and $1.3 trillion over the 10-year period from 2017 to 2026.

This year, Congress will consider what may be the biggest tax bill in decades. This is one of a series of briefs the Tax Policy Center has prepared to help people follow the debate. Each focuses on a key tax policy issue that Congress and the Trump administration may address.

State and local taxes have been deductible since the inception of the federal income tax in 1913. Initially, all state and local taxes not directly tied to a benefit were deductible against federal taxable income. In 1964, deductible taxes were limited to state and local property (real and personal property), income, general sales, and motor fuels taxes. Congress eliminated the deduction for taxes on motor fuels in 1978 and the deduction for general sales tax in 1986. It temporarily reinstated the sales tax deduction in 2004, allowing taxpayers to deduct either income taxes or sales taxes, but not both. Congress made that provision permanent in 2015.

WHO CLAIMS THE SALT DEDUCTION?

About 30 percent of tax filers opt to itemize deductions on their federal income tax returns (figure 1), and virtually all who do itemize claim a deduction for state and local taxes paid. High-income households are more likely than low- or moderate-income households to benefit from the SALT deduction. The amount of state and local taxes paid, the likelihood that taxpayers itemize their deductions, and the reduction in federal income taxes for each dollar of state and local taxes deducted all increase with income.

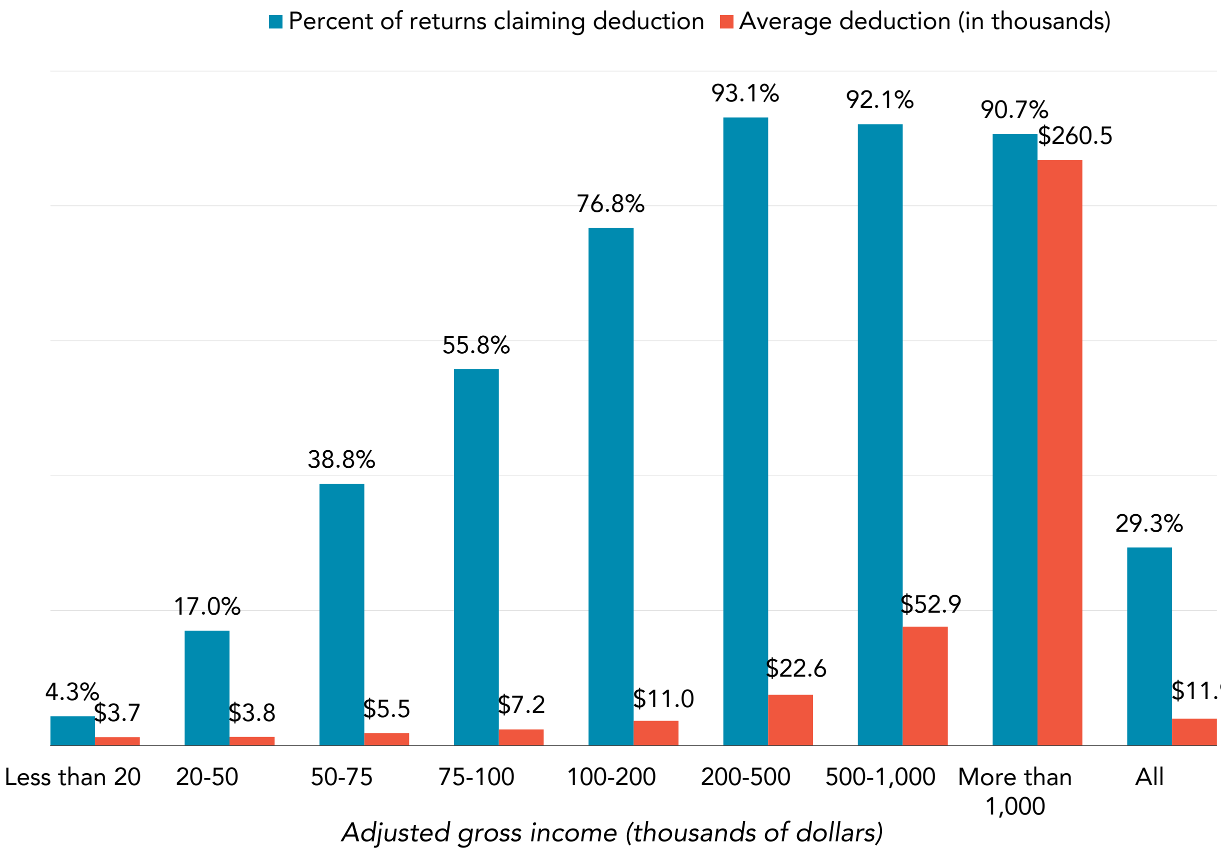
About 10 percent of tax filers with income under $50,000 claimed the SALT deduction in 2014, compared with about 81 percent of tax filers with income over $100,000. The latter group—about 16 percent of tax filers—accounted for about 75 percent of the total dollar amount of SALT deductions claimed.

Although most high-income taxpayers claim a SALT deduction, the federal individual alternative minimum tax (AMT) limits or eliminates the benefit for many of them. The AMT is a parallel income tax system with fewer

FIGURE 1

Share of Returns Claiming the State and Local Tax Deduction, and Average Deduction Claimed

By income group, 2014



Source: Urban-Brookings Tax Policy Center based on data from the IRS: SOI Tax Stats - Individual Income Tax Returns Publication 1304 (Complete Report). Tax Year 2014.

exemptions and deductions than the regular income tax as well as a narrower set of tax rates. Taxpayers potentially subject to the AMT must calculate their taxes under both the regular income tax and the AMT and pay the higher amount. State and local taxes are not deductible under the AMT, which is the major reason why taxpayers have to pay the alternative tax.

Although some taxpayers in every state and the DC claim the deduction, taxpayers in states with a disproportional share of high-income taxpayers and relatively high state and local taxes are more likely to claim the deduction (figure 2). The percentage claiming the deduction ranged from 17 percent in South Dakota and West Virginia to 45 percent in Maryland. Taxpayers in the Northeast and the West are more likely to claim the deduction—and to deduct more—than taxpayers in other regions.

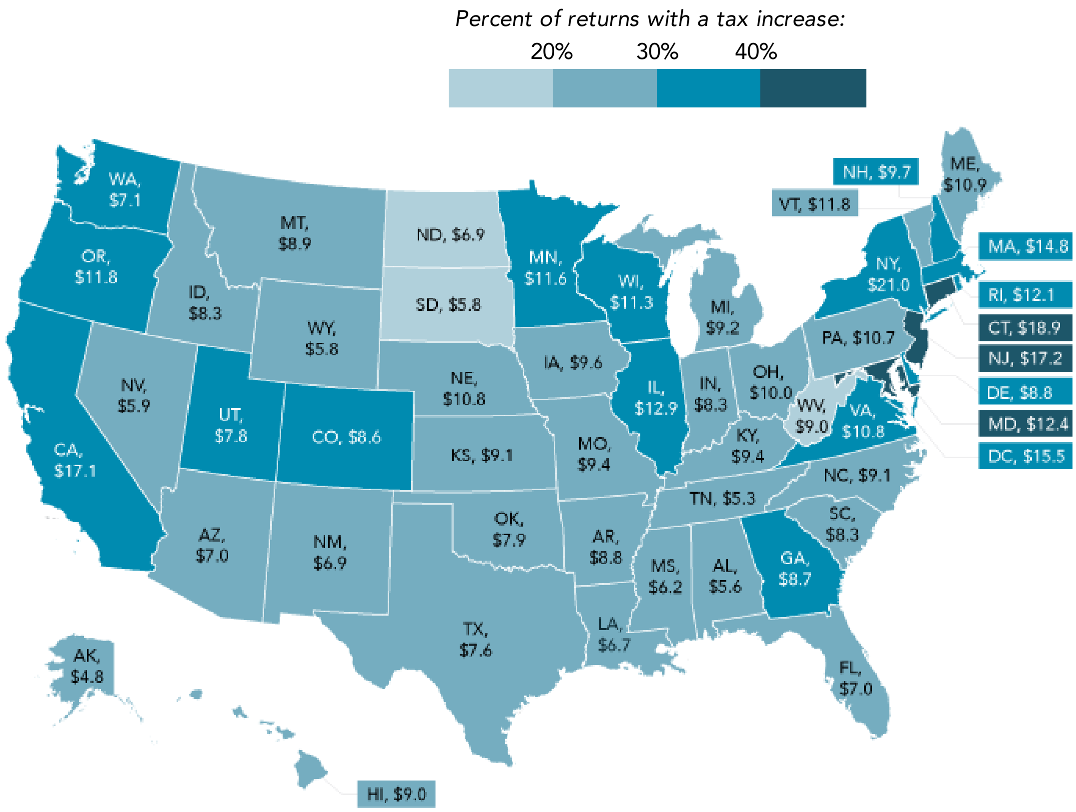
EFFECTS OF THE DEDUCTION

The SALT deduction indirectly subsidizes state and local governments by decreasing the net cost of nonfederal taxes to those who pay them. For example, a $100 increase in state income taxes costs a taxpayer in the 35 percent federal income tax bracket just $65, the $100 increase minus $35 saved in federal taxes, if the

FIGURE 2

Returns Claiming the State and Local Tax Deduction and Average Deduction Claimed by State

Average deduction in thousands of dollars, 2014



Source: Urban-Brookings Tax Policy Center based on data from the IRS: SOI Tax Stats - Historic Table 2. Tax Year 2014.

additional tax is deductible. This subsidy encourages state and local governments to levy higher taxes (and, presumably, provide more services) than they otherwise would. It also encourages them to use deductible taxes in place of nondeductible taxes (such as selective sales taxes on alcohol, tobacco, and gasoline), fees, and other charges.

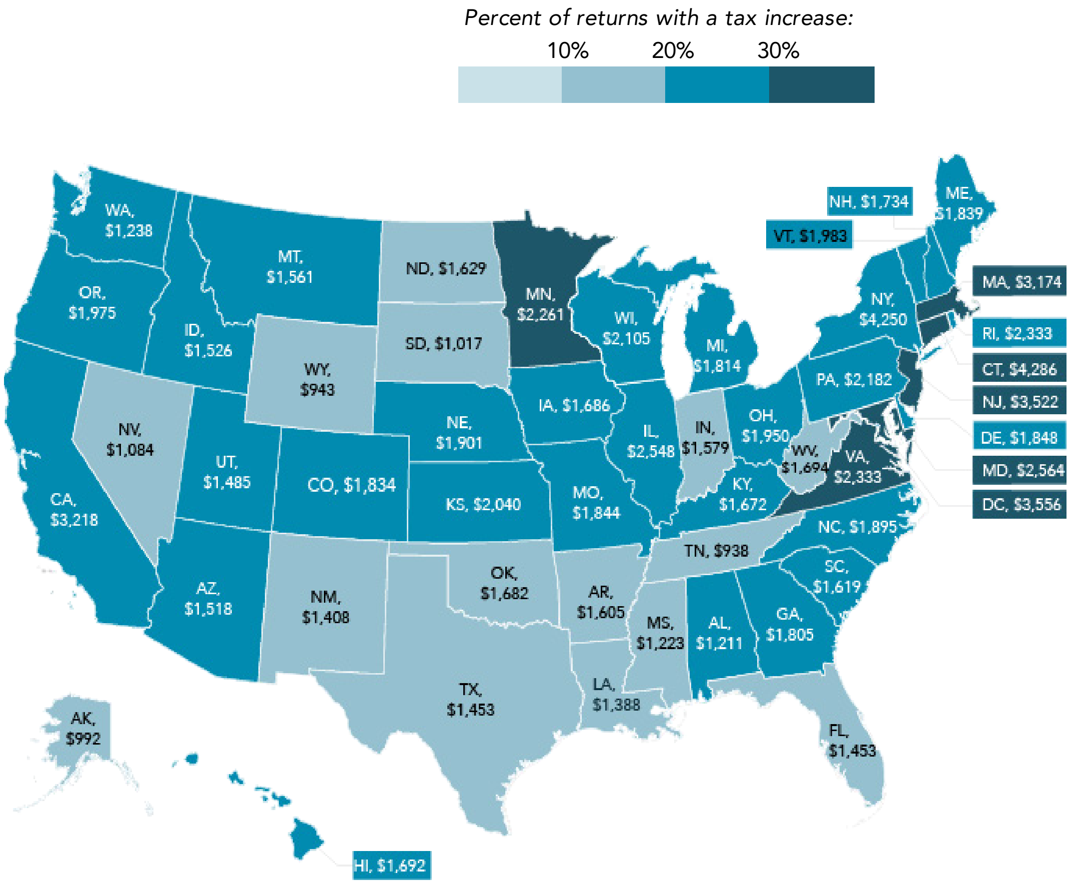
Critics of the deduction argue that state and local taxes simply reflect payments for services provided by those jurisdictions and, as such, should be treated no differently than other forms of spending. They also point to the uneven distribution of benefits across income groups and states.

Proponents of the deduction counter that the portion of an individual's income claimed by state and local taxes is not really disposable income, and that taxing it at the federal level is double taxation. Moreover, they argue that federal subsidies are warranted because a significant portion of state and local government spending is for education, health, public welfare, and

FIGURE 3

Effect of Repealing the SALT Deduction by State

Average federal tax increase and percentage of returns with an increase, 2016



Source: Frank Sammartino and Kim Rueben. 2016. "Revisiting the State and Local Tax Deduction."
Note: Average tax increase is for returns with an increase.

transportation, all of which have important spillovers that benefit the population in other jurisdictions as well. A counterargument, however, is that while federal support may be warranted, the substantial revenues gained by eliminating or limiting the deduction could be used to provide direct support through federal grants and loans.

PROPOSALS TO LIMIT OR ELIMINATE THE DEDUCTION

President Trump and House Republicans have offered tax proposals that would significantly affect the SALT deduction. The Trump plan would more than double the standard deduction. The Tax Policy Center estimates this would reduce the number of itemizers from 45 million to 18 million in 2017, meaning fewer filers would benefit from the state and local tax deduction. The plan would also cap itemized deductions at $100,000 for single filers and $200,000 for joint filers, which would reduce the value of the SALT deduction for affected taxpayers. The House GOP plan would completely eliminate the SALT deduction.

Eliminating or curtailing the SALT deduction would put pressure on state and local governments to cut their taxes (or limit tax increases) because the cost of those taxes to itemizing taxpayers would go up. Tax increases would be spread unevenly across states, disproportionately affecting those with higher percentages of high income residents and higher state personal income tax rates (figure 3).

States could respond by cutting tax rates or changing the composition of revenue sources. Because the SALT deduction only lowers the burden of state taxes for taxpayers who itemize, generally high earners, the deduction encourages states to adopt a more progressive state income tax. Thus, ending the SALT deduction could push states away from progressive tax structures.

Reactions following two recent federal tax changes suggest that any response could be limited. The Tax Reform Act of 1986 eliminated the deduction, but only for general sales taxes. States, however, did not respond by reducing their state sales tax rates or shifting from sales taxes to other taxes, at least initially. And states didn't raise their income tax rates after the American Taxpayer Relief Act of 2012 raised the top federal income tax rate and thus increased the value of itemized deductions. In fact, many states did just the opposite and cut income tax rates following the federal change.