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Deductibility of State and Local Taxes

By Kim Rueben and Len Burman

The president's tax reform panel will likely consider options to broaden the income tax base, including elimination of deductibility of state and local taxes. Currently, taxpayers who itemize deductions may subtract state and local income and property taxes from gross income. Virtually all of the 46 million households who itemized claimed a deduction for taxes paid, totaling more than $300 billion in 2002: 82 percent deducted state and local income taxes and 87 percent deducted real estate taxes. Interaction with the individual alternative minimum tax or, in rare cases, the phaseout of itemized deductions may scale back or eliminate the benefit from deducting taxes for some taxpayers. (The state and local tax deduction is the largest single tax preference item under the AMT. In 2002 about two million AMT taxpayers lost part or all of the deduction.)

Critics of the deduction argue that taxes simply reflect payments for services provided by state and local governments and, as such, should be treated no differently from other forms of consumption. Moreover, the deduction most benefits the affluent: more than half of the deductions were claimed by the 8 percent of taxpayers with incomes exceeding $100,000 in 2002. Proponents argue that the deduction is necessary to encourage higher income taxpayers to support programs that primarily benefit lower- and middle-income households.

Eliminating the deductibility of state and local taxes would increase tax receipts by about $70 billion in 2005 and $700 billion between 2005 and 2014 (less if the tax rate cuts are extended beyond their scheduled 2010 expiration). In addition, Congress recently allowed taxpayers to deduct state and local sales taxes in lieu of income taxes in 2004 and 2005. If this deduction were also eliminated the savings would be higher.

While households who take these deductions are present in all states, they are concentrated in a few. One-fifth of returns and 29 percent of the deductions are in just 2 states — California and New York. (See Table.) More than 60 percent of the deductions are in the 10 states shown in the table. However, fewer than half of returns claim the deduction because most tax filers do not itemize deductions.

State and Local Tax Deduction

Rank	State	Number (millions)	Percent	Percent of Returns in State	Amount ($ billions)	Percent	Percent of Federal Income Taxes Paid From State
	United States	45.4	100.0	34.7	308.7	100.0	100.0
1	California	5.9	13.0	39.0	52.3	17.0	13.2
2	New York	3.3	7.4	38.8	37.1	12.0	8.7
3	New Jersey	1.8	4.0	44.6	18.2	5.9	4.6
4	Illinois	2.1	4.6	36.3	13.5	4.4	5.1
5	Ohio	1.9	4.3	35.2	13.0	4.2	3.4
6	Pennsylvania	1.9	4.1	32.5	12.3	4.0	4.1
7	Massachusetts	1.2	2.7	40.5	10.8	3.5	3.3
8	Michigan	1.7	3.8	38.0	10.5	3.4	3.2
9	Maryland	1.3	2.8	48.7	10.0	3.2	2.3
10	Virginia	1.4	3.0	40.7	9.2	3.0	2.9
	All Other	22.8	50.3	31.5	121.8	39.5	49.2

Source: Internal Revenue Service, Individual Tax Statistics — State Income for 2002 and 2003, Tax Year 2002: Unpublished Version. Available at http://www.irs.gov/taxstats/article/0,,id=103106,00.html.
To see this table for all fifty states, see http://www.taxpolicycenter.org/TaxFacts/TFDB/TFTemplate.cfm?Docid=351&Topic2id=90.