How does the deduction for state and local taxes work?

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 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 $95 billion in 2015 and $527 billion over the 5-year period from 2015 to 2019. (Tax expenditures are defined as "those revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income, or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.")

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 eliminated 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. Subsequent legislation made that provision permanent starting in 2015.

Who claims the SALT deduction?

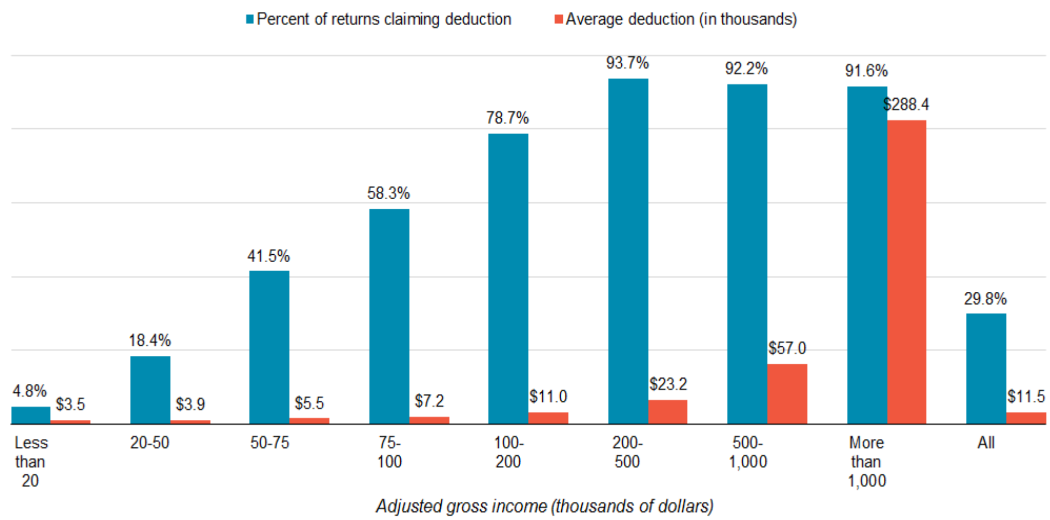
About one-third of tax filers opt to itemize deductions on their federal income tax returns (figure 1), and virtually all who do itemize claim a deduction for state and local taxes paid. High-income households are more likely than low- or moderate-income households to benefit from the SALT deduction. The amount of state and local taxes paid, the probability 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 11 percent of tax filers with incomes less than $50,000 claimed the SALT deduction in 2012, compared with about 85 percent of tax filers with incomes exceeding $100,000. The latter group, which made up just over 14 percent of tax filers, accounted for about 70 percent of total SALT deductions claimed. The average claim in this affluent group was of about $19,300.

FIGURE 1

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

By income group, 2013



Source: Urban-Brookings Tax Policy Center based on data from the Internal Revenue Service.

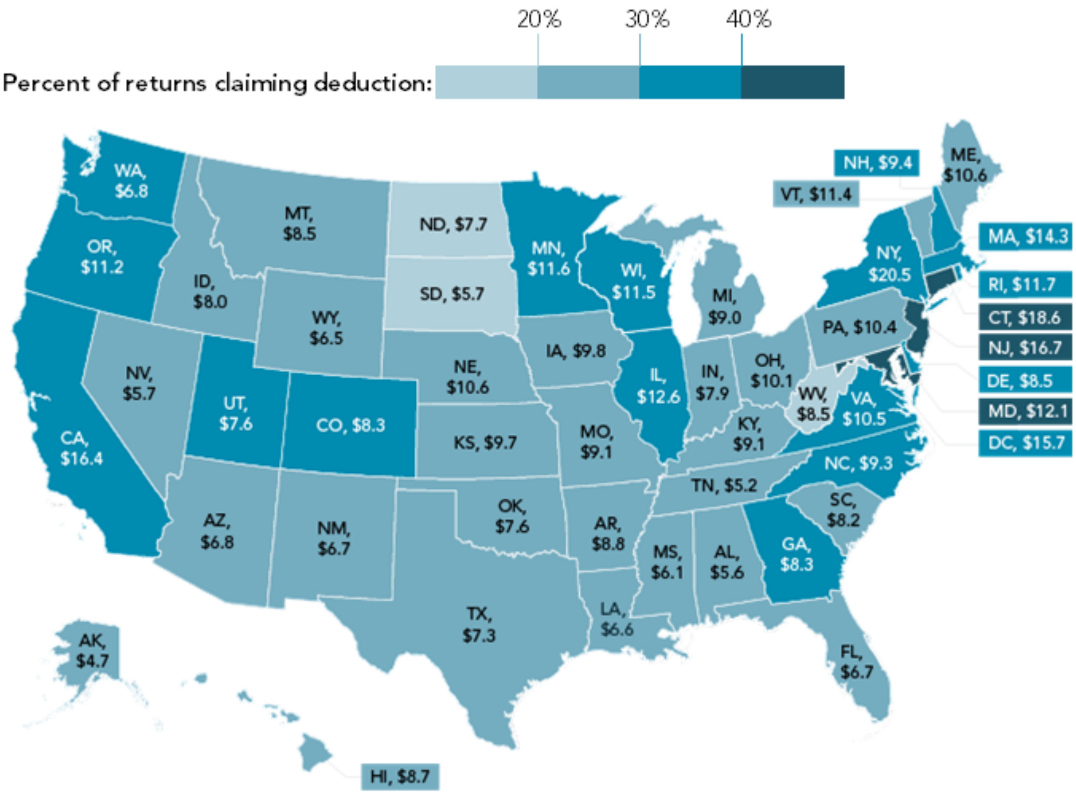
Although most high-income taxpayers claim a SALT deduction, the federal individual alternative minimum tax (AMT) limits or eliminates the benefit for many of them. The AMT is a parallel income tax system with fewer exemptions and deductions than the regular income tax as well as a narrower set of tax 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. Taxpayers cannot claim the SALT deduction when calculating their AMT liability, and the disallowance of the deduction is the major reason why taxpayers are required to pay the AMT.

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 18 percent in South Dakota and West Virginia to 47 percent in Maryland. In general, a higher percentage of taxpayers in states in the Northeast and the West claimed the deduction than in states in other regions. The average deduction claimed was also higher in those regions.

FIGURE 2

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

Average deduction in thousands of dollars, 2013



Source: Urban-Brookings Tax Policy Center based on data from the Internal Revenue Service.

Effects of the Deduction

The SALT deduction provides an indirect federal subsidy to state and local governments by decreasing the net cost of nonfederal taxes to those who pay them. For example, if state income taxes increase by $100 for families claiming the SALT deduction on their federal returns who are in the 35 percent federal income tax bracket, the net cost to them is $65; that is, state taxes go up by $100, but federal taxes go down by $35. This federal tax expenditure encourages state and local governments to levy higher taxes (and, presumably, provide more services) than they otherwise would. It also encourages those entities 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 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.

Data Sources

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