The State of State (and Local) Tax Policy

Q. How does the deduction for state and local taxes work?

A. 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. The Tax Cut and Jobs Act limits the total state and local tax deduction to $10,000.

The state and local tax (SALT) deduction has been one of the largest federal tax expenditures, with an estimated revenue cost of $100.9 billion in 2017. The estimated revenue cost for 2018 drops to $43.1 billion because the Tax Cut and Jobs Act (TCJA) significantly increased standard deduction amounts (thereby reducing the number of taxpayers who will itemize deductions) and capped the total SALT deduction at $10,000.

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. Starting in 2018, taxpayers cannot deduct more than $10,000 of total state and local taxes. That provision of the law is scheduled to expire after 2025.

WHO CLAIMS THE SALT DEDUCTION?

Less than one-third of tax filers opted to itemize deductions on their federal income tax returns in 2016, but virtually all who itemized claimed 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 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 2016, compared with about 80 percent of tax filers with incomes exceeding $100,000 (figure 1). The latter group, which made up about 17 percent of tax filers, accounted for about 77 percent of the total dollar amount of SALT deductions reported. The average claim in this group was of about $21,000.

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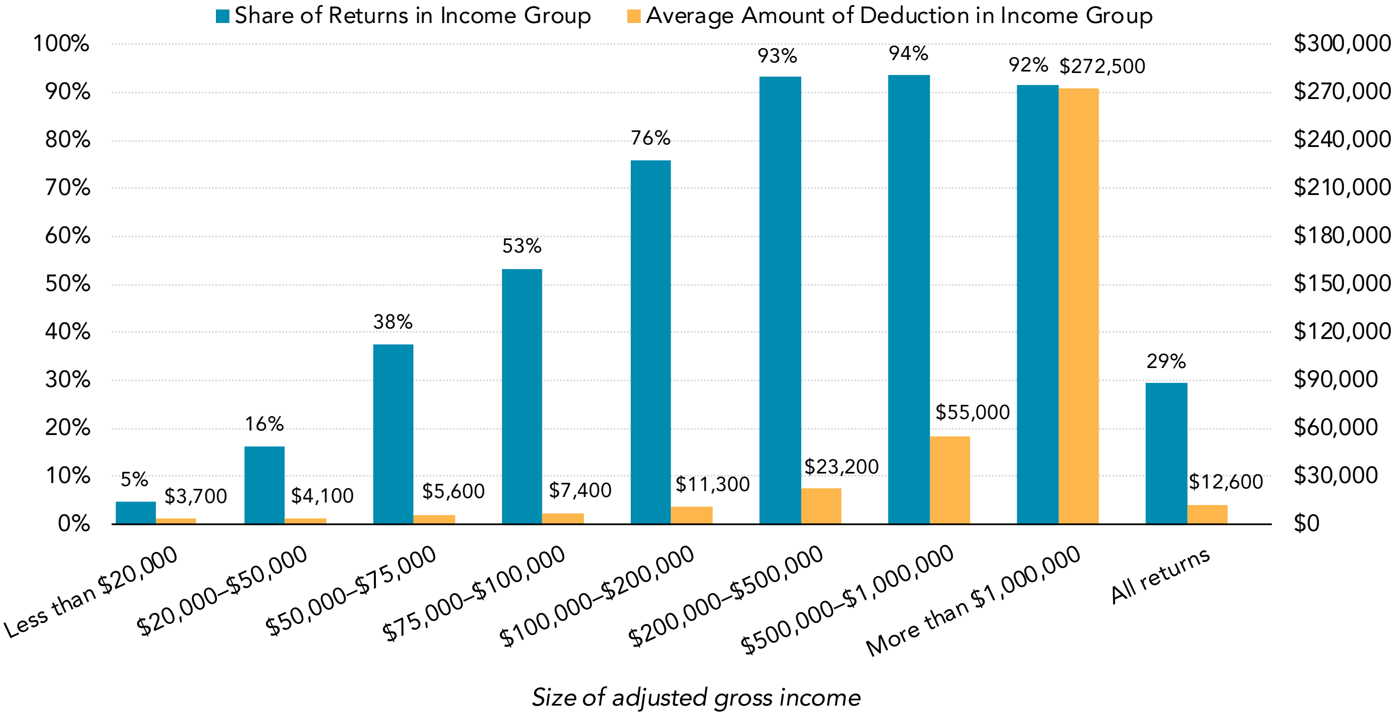
FIGURE 1

State and Local Tax Deduction

Share of returns claiming the deduction by AGI and average amount, tax year 2016



Source: Internal Revenue Service, Statistics of Income (SOI), Publication 1304, Individual Income Tax Returns, Tax Year 2016, Table 2.1 and Table 1.2, 2018; Urban-Brookings Tax Policy Center calcuations.

Although most high-income taxpayers claimed a SALT deduction, the federal individual alternative minimum tax (AMT) limited or eliminated 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 under tax law prior to 2018, the disallowance of the deduction was the major reason why taxpayers were required to pay the AMT.

Although some taxpayers in every state and 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 46 percent in Maryland in 2016. 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.

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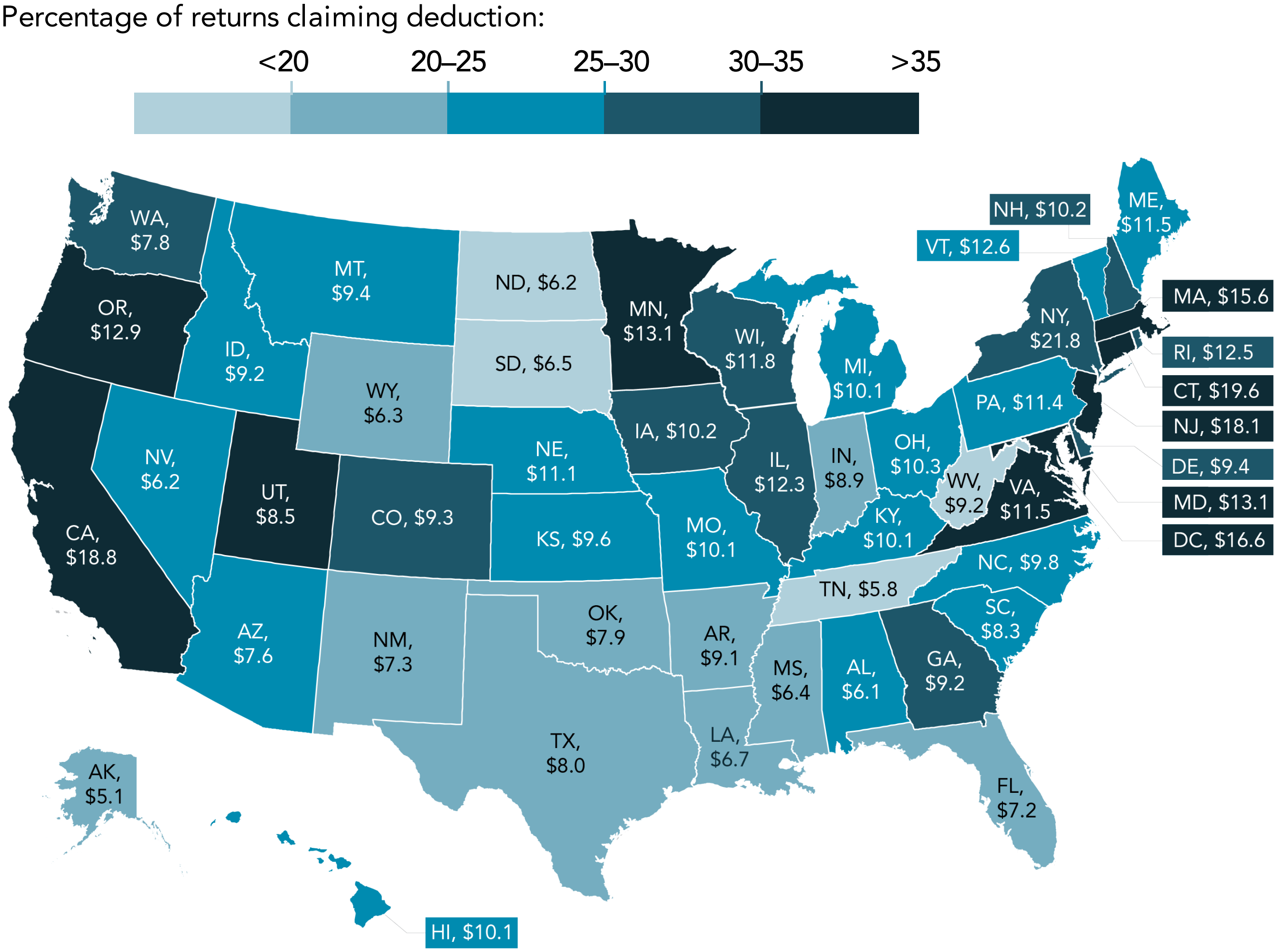
FIGURE 2

State and Local Tax Deduction

Number of returns and average deduction in thousands of dollars, 2016



Source: Internal Revenue Service (IRS), Statistics of Income (SOI), Historical Table 2, Tax Year 2016; Urban-Brookings Tax Policy Center calculations.

THE EFFECT OF TCJA ON THE SALT DEDUCTION

TCJA will have a significant effect on the average tax saving from the SALT deduction. Both the percentage of taxpayers claiming the deduction and the average amount claimed will fall dramatically in 2018 because of the changes enacted. Figure 3 compares the tax saving from claiming the deduction in 2017 and 2018, before and after the new law is in place. The tax benefit is measured as the reduction in tax liability from the deduction, which considers the applicable tax rates in each year, the effects of the alternative minimum tax (which disallows the SALT deduction), and the limit on itemized deductions (the “Pease” limit) that was in place in 2017 but eliminated for 2018 by TCJA.

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Measured as a percentage of after-tax income, the tax saving from the SALT deduction in 2018 will be about one-quarter of what it was in 2017 overall. For taxpayers in the top 1 percent of the income distribution, the tax saving in 2018 will be about one-tenth of the tax saving in 2017.

EFFECTS OF THE DEDUCTION

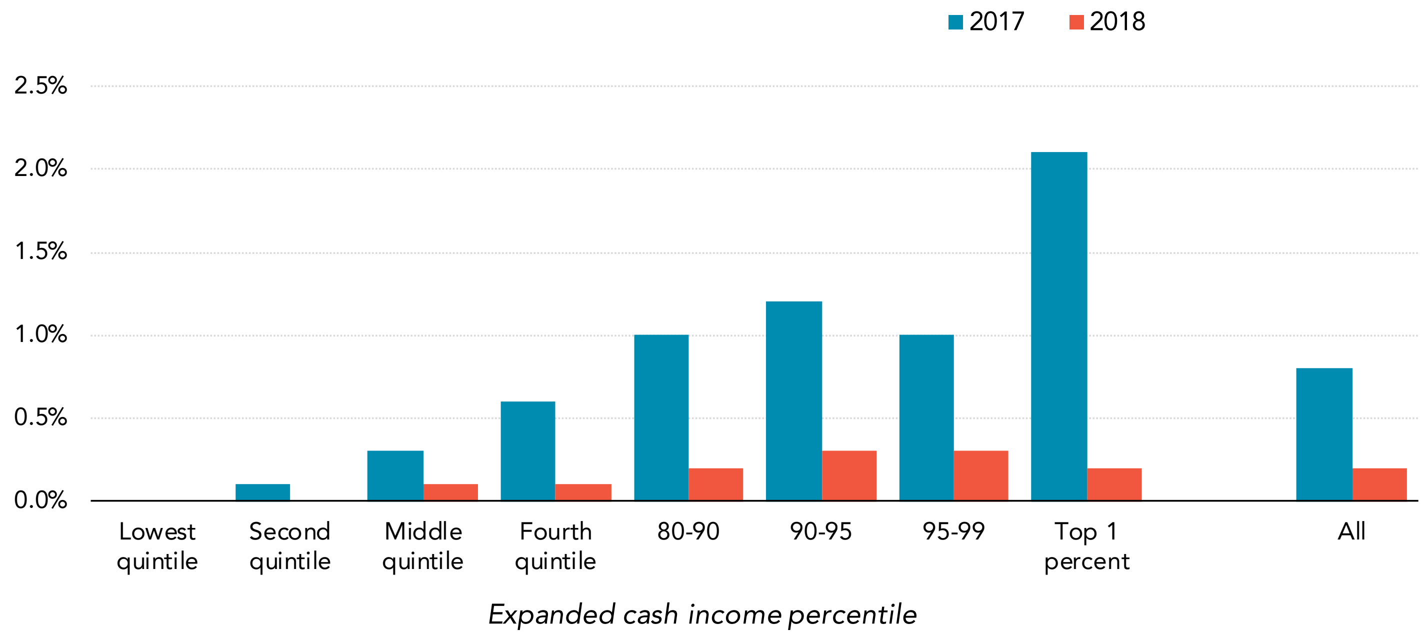
The SALT deduction provides state and local governments with an indirect federal subsidy by decreasing the net cost of nonfederal taxes for those who pay them. For example, if state income taxes increase by $100 for families in the 35 percent federal income tax bracket claiming the SALT deduction, the 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 the services those jurisdictions provide and, as such, should be treated no differently than other spending. They also point to the uneven distribution of benefits across income groups and states.

FIGURE 3

Itemized Deduction for State and Local Taxes

Benefit as a share of after-tax income, 2017 and 2018



Source: Urban-Brookings Tax Policy Center, "TPC Microsimulation Model, version 0718-1."

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How does the deduction for state and local taxes work?

Proponents of the deduction counter that the portion of an individual's income claimed by state and local taxes is not 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 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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