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# Income Tax Simplification: How to Achieve It

Simplicity is generally seen as a virtue in state tax systems. Simplicity makes it easier for taxpayers to understand (and to pay) their taxes, and makes it easier for tax administrators to collect taxes fairly. In recent years, state lawmakers have proposed a wide variety of income tax changes under the guise of simplification. Yet not all of these purported tax simplification measures are well-designed to achieve it—and some measures would unnecessarily reduce the fairness of the income tax. This policy brief evaluates options for making state income taxes less complicated.

## The First Step: Conforming to Federal Laws

Of the forty two states that currently levy a broad-based personal income tax, most already take the most important step toward income tax simplicity: tying the state's definition of taxable income to federal rules. In these states, taxpayers generally only need to calculate their total income once—on the federal forms. They can then copy a single line from their federal tax forms to the state form as a first step in doing their state taxes. This is an important shortcut both from the perspective of individual taxpayers, who are able to do their taxes more quickly and more accurately, and from the perspective of state tax administrators, who can piggyback on federal efforts to verify accurate reporting of taxable income.

## The Second Step: How States Conform

There are broadly two ways in which states can link to the federal income tax structure: by linking to some definition of federal income, and by linking directly to the amount of federal taxes paid.

By far the most commonly used of these approaches is linking to federal income definitions. In 2011, 30 states used federal adjusted gross income (AGI) as their first step in calculating state taxable income Conforming to federal AGI has one important implication: because federal AGI does not include the exemptions, standard deductions and itemized deductions allowed under federal tax rules, states starting with federal AGI must either enact their own exemptions and deductions or follow federal rules.

Most states using federal AGI allow their own special exemptions although many of these states provide less generous exemptions than the federal amounts. They also provide their own deductions, but most are linked to federal itemized deductions.

Six states use a slight variation on this approach, tying their income tax to federal taxable income instead of AGI. Taxable income includes federal exemptions and deductions, so these states automatically allow the same exemptions and deductions allowed on the federal level Because federal exemptions and deductions are indexed to keep pace with inflation, the exemptions and deductions allowed in these states will automatically increase each year with inflation as well—avoiding the "hidden tax hikes" that plague many other state taxes(For more information on how inflation creates these hidden tax hikes, see ITEP Brief, **"Indexing Income Taxes: Why it Matters"**). Some of these states have lower exemption and standard deduction amounts than the federal rules, so taxpayers are required to take additional steps to add back the difference.

A second way of conforming state taxes to federal rules is to define the state income tax as a percentage of federal taxes paid. Income taxes calculated this way tend to be much more progressive (that is, these taxes apply higher rates to higher-income taxpayers), because the calculation of tax liability includes the effects of progressive federal income tax rates. Until 2001, three states (North Dakota, Rhode Island and Vermont) allowed taxpayers to calculate their income tax this way. After the passage of the 2001 Bush federal tax cuts, each of these states abandoned this approach to state-federal linkage.

## Conformity Does Not Guarantee Simplicity

Linking state income taxes to the federal tax base is a good first step towards income tax simplicity. But it's hardly sufficient: some of the most bewilderingly complex state income taxes are based on federal income definitions. What makes these income taxes so complicated?

Every one of these states diverges from its federal starting point to allow at least one special deduction or targeted tax break. These special breaks are usually called adjustments, and they are the difference between the federal starting point and a state's own adjusted gross income (AGI). Among the complicated tax breaks granted by states are:

- Exemptions for capital gains or dividend income;
- Tax shelters for pension or Social Security benefits;
- Deductions for federal income taxes paid.

Every special state tax break has to be subtracted from income—which means it takes at least one line on your state's tax form. The main reason why state income tax forms—and instructions—are so complicated is because taxpayers must wade through these tax breaks.

When these tax breaks discriminate between taxpayers who have a similar ability to pay, such unfair distinctions can make the tax system seem more arbitrary—and can undermine public confidence in the system. These tax breaks also make it harder to understand the overall effect of a tax system on people at different income levels

## Disadvantages of Conforming to Federal Rules

Linking a state's income tax base to federal rules has one clear disadvantage: increased vulnerability to changes at the federal level. If federal lawmakers enact a new deduction that reduces federal AGI, states linking to federal income definitions must either continue to conform with the new federal tax break—in which case state income tax revenues will decline—or else "decouple" from the new federal rules, in which case some of the simplification advantages will have been lost.

The 2001 and 2003 Bush tax cuts provide a good example of this problem. Because these cuts reduced the top federal tax rates, the three states using the "percentage of federal" linkage had to either "decouple" from this approach or accept a federally-mandated tax cut. All three states chose to preserve their revenues by decoupling.

The Bush tax cuts also quietly repealed the "Pease" disallowance that reduces the cost and regressivity of certain itemized deductions by limiting their value by up to 80 percent for the very best-off taxpayers. Pease gradually disappeared between 2006 and 2009, with full repeal coming into effect for the first time in 2010. President Obama extended the repeal of the "Pease" disallowance until 2012. This federal tax cut will likely be passed on to most state tax laws, reducing state income tax collections in the 31 states allowing federal itemized deductions by more than $2 billion annually. Fortunately, state lawmakers in cash strapped states can "decouple" from this provision of the tax compromise (See "Don't Give Up on Pease: States Can Decouple from Recent Federal Tax Cuts").

## Red Herrings and Income Tax Simplification

Some so-called "tax simplification" measures are, in fact, poorly-disguised attempts to scale back state income taxes while making them less equitable. How can we tell the difference between tax "reforms" that truly achieve simplicity and those that aim to destroy the income tax? The main source of complexity in state income taxes is special tax breaks—but anti-tax advocates often try to confuse the issue by arguing that a graduated tax rate structure (that is, a tax with higher rates for wealthy taxpayers) contributes to tax complexity. This is a red herring—calculating your taxes is no more difficult under a graduated rate structure than under a flat tax. True tax simplification means cleaning up the tax base by eliminating special loopholes that make the state tax base diverge from the federal base.

Of course, broadening the tax base will increase the yield of an income tax at its current rates, and therefore gives lawmakers a chance to cut tax rates if such a change is affordable. But despite the flowery language of anti-tax "simplification" advocates, tax proposals that switch from a graduated rate structure to a flat (or flatter) tax rate structure without broadening the income tax base have little value as simplification measures.

There are policymakers who will claim that removing all credits make the income tax structure more simple. Of course obscure and rarely used credits do little to ensure income tax simplicity. But it's important to note that some credits (more so than deductions) actually benefit working families by offsetting the regressivity of sales and property taxes. The intention of those who advocate for the type of "simplification" that removes all income tax credits, even those that attempt to assist low-income taxpayers should be studied closely.