Topsy-Turvy

State Income Tax Deductions for Federal Income Taxes Turn Tax Fairness on its Head

Institute on Taxation and Economic Policy

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About ITEP

Founded in 1980, the Institute on Taxation and Economic Policy (ITEP) is a non-profit, non-partisan research organization, based in Washington, DC, that focuses on federal and state tax policy. ITEP's mission is to inform policymakers and the public of the effects of current and proposed tax policies on tax fairness, government budgets, and sound economic policy. Among its many publications on state and local tax policy are *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States* and *The ITEP Guide to Fair State and Local Taxes.* ITEP's full body of research is available at www.itepnet.org.

Executive Summary

- The personal income tax is the only major progressive tax levied at the state level—but six states are undermining the fairness of their income tax by allowing an unusual tax break, a deduction for federal income tax payments. These six states (Alabama, Iowa, Louisiana, Missouri, Montana, and Oregon) collectively stand to lose over $2.5 billion in tax revenues in 2011 due to this single tax break, with losses ranging from $45 million to $643 million per state.

- This tax break is a major drain on state income tax revenues in each of these states. In three states, the deduction reduces state income tax collections by more than 10 percent each year, and in one state—Louisiana—this deduction singlehandedly reduces state income tax collections by almost 24 percent each year.

- The high price tag of this tax giveaway yields remarkably little benefit to low-and middle-income families. In states where the deduction is uncapped the best off 1 percent of taxpayers typically enjoy between 31 and 33 percent of the benefit from this provision, while the top 20 percent enjoy between 76 and 83 percent of the total tax cuts

- A poorly targeted income tax reduction like the deduction for federal income taxes paid ensures that federal taxes will increase for itemizers. Since federal tax liability rises as itemized deductions fall (lower deductions mean more income is subjected to taxation), a state tax cut—such as that provided by this deduction—leads to an increase in federal income taxes owed.

- Moreover, the cost of this state tax giveaway will likely balloon in the future due to likely increases in the federal income taxes paid by upper-income families in the near future. Since the best-off residents in each state are the primary beneficiaries of this deduction, an increase in their federal taxes will significantly increase the size of this tax break in at least some of the states allowing this deduction.

- In the past few years, several states have eliminated or scaled back this expensive and poorly targeted deduction. For example, North Dakota, Oklahoma, and Utah have all eliminated the deduction, and Oregon lawmakers voted recently to further limit the deduction.

- States should take a hard look at eliminating, or at least capping, their deduction because of the impact this lopsided tax policy has on state budgets and tax fairness.

Introduction

The budget outlook for state governments is bleak. Despite evidence that revenues are rebounding, there is a general acknowledgement that "broad fiscal conditions remain fragile." [1] The need for public investments—particularly health care for low-wage or unemployed workers and their families—is greater than ever. An increasing number of states are struggling to keep their fiscal year 2012 budgets in balance, and shortfalls – totaling $111.9 billion or 17.6 percent of these budgets – have opened up in 44 states.[2]

In this context, states must find ways to generate additional revenue without increasing the tax load on individuals and families struggling to make ends meet. For six states—Alabama, Iowa, Louisiana, Missouri, Montana, and Oregon—one straightforward approach would be to repeal the deduction for federal income taxes paid. In tax year 2011 alone, these six states are expected to lose a total of $2.5 billion due to this single tax break, with losses ranging from $46 million to $643 million per state. Repealing the deduction would help these states reduce their large and growing budgetary gaps and make their tax systems less unfair.

This report explains how the deduction for federal income taxes works and assesses its impact on state tax fairness and state budgets.

How the deduction for federal income taxes works

The deduction for federal income taxes paid is an unusual state personal income tax break that allows taxpayers to subtract the value of the federal income taxes they pay in a given year from their state taxable income. Only six states (Alabama, Iowa, Louisiana, Missouri, Montana, and Oregon) still allow this deduction. The following chart shows how the deduction works in these six states.

States Offering a Deduction for Federal Income Taxes Paid in 2011

STATE	DETAILS OF DEDUCTION OFFERED	YEAR ENACTED
AL	100% of federal income taxes paid are deductible.	1965
IA	100% of federal income taxes paid are deductible.	1934
LA	100% of federal income taxes paid are deductible.	1974
MO	$5,000 ($10,000 for married couples) of federal income taxes paid are deductible.	1972
MT	$5,000 ($10,000 for married couples) of federal income taxes paid are deductible for itemizers only.	1933
OR	Maximum federal income tax paid deduction is $5,950 and is futher reduced for high income earners	1929

[1] Dadayan, Lucy and Boyd, Donald J., *State Tax Revenues Gained New Strength in Fourth Quarter.* Nelson A. Rockefeller Institute of Government, Albany, NY, February 2011.
[2] McNichol, Elizabeth, Oliff, Phil and Johnson, Nicholas, *States Continue to Feel Recession's Impact.* Center on Budget and Policy Priorities, March 9, 2011.

Three of these states (Alabama, Iowa and Louisiana) allow a full deduction for all federal income taxes paid. Given the lingering recession it's no surprise that in at least two of these states, Alabama and Iowa, legislation has been introduced recently which would eliminate the deduction entirely.

The remaining three states put a cap on the allowable deduction. Missouri and Montana limit the deduction to $5,000 for single taxpayers, and $10,000 for married couples. Oregon's deduction is capped at $5,950. Montana and Oregon each impose additional limitations: the Montana deduction is only available to Montanans who itemize their state tax return, and the Oregon deduction is gradually phased out for higher income earners (singles earning over $125,000 and married couples earning over $250,000).

State Revenue Impact: a $2.5 Billion Tax Cut

In tax year 2011, the six states offering a deduction for federal income taxes paid will, collectively, lose just over $2.5 billion because of this feature in their tax system, with losses ranging from $46 million to $643 million per state. Such losses constitute a meaningful share of total income tax revenue; as a result, repealing the deduction could be an important response to projected budget deficits. For example, Louisiana's unlimited deduction cost the state $643 million in tax year 2011. That amount is actually 24 percent of the shortfall the state is expected to experience in fiscal year 2012. (Similar data for all six states can be found in the appendix to this report.)

Tax Fairness Impact: A Regressive Tax Cut

Because the deduction for federal income taxes is structured differently from state to state, the impact on tax fairness varies somewhat. But in every one of these states, the deduction offers little or no benefit to most low- and middle-income families. This shouldn't be surprising. After all, the federal income tax—uniquely among the major taxes levied by the federal government—is designed to shelter low-income families from tax. The availability of exemptions, deductions and credits means that many families simply do not have any federal income tax to deduct. For example, in 2011 an Alabama family of four will not owe federal income tax until the family's income exceeds at least $45,750. This means, of course, that a family of four earning less than $45,750 can receive no benefit from Alabama's deduction for federal income taxes.

At the other end of the income spectrum, the very best-off Americans pay at least some federal income tax at a marginal tax rate of 35 percent. This means the best-off Americans are also those who stand to benefit most from the ability to write off federal income taxes on their state tax forms.

This effect is most exaggerated in the three states that offer an unlimited deduction. For example, the best-off 1 percent of Iowans enjoy 31 percent of the benefit from Iowa's unlimited deduction, and a full 76 percent of the deduction's benefit goes to Iowans in the top 20 percent of the income distribution.

Impact of Deductions for Federal Income Taxes Paid on State Budgets, Taxpayers, and Economies - 2011						
	AL	**IA**	**LA**	**MO**	**MT**	**OR**
Income Tax Revenue Lost to Deduction for Federal Income Taxes Paid ($M)	516	642	643	394	46	338
Income Tax Revenue Lost to Deduction (%)	19%	23%	24%	8%	6%	6%
Income Tax Revenue Lost to Deduction for Federal Income Taxes Paid as a Share of Projected FY 2012 Budget Deficit	53%	345%	40%	56%	n/a	19%
Share of Revenue Loss by Income Group						
Bottom 20%	0%	0%	0%	0%	0%	1%
Top 20%	81%	76%	83%	60%	75%	45%
Top 5%	57%	51%	55%	18%	26%	8%
Top 1%	33%	31%	33%	4%	6%	0%
Average Tax Reduction by Income Group						
Bottom 20%	2	5	2	1	-	9
Top 20%	977	1,775	1,399	430	359	416
Top 5%	2,729	4,719	3,714	524	492	287
Top 1%	8,039	14,361	10,986	543	564	33
Percent of State Revenue Loss Offset by Higher Federal Taxes	16%	13%	10%	11%	17%	13%

*Data on projected budget deficits are from States Continue to Feel Recession's Impact, Center on Budget and Policy Priorities 3/9/11

In the three states that limit the value of the deduction, a smaller share of the benefits goes to the very best-off taxpayers. For example, the $5,000 cap on Missouri's deduction means that the best-off 1 percent of Missourians enjoy only 4 percent of the benefits from the deduction. Equally important, capping the deduction reduces its expense: in the three states with capped deductions, the price tag of the tax break is "only" between 6 and 8 percent of total income tax collections. But even with the caps, the benefits of this tax break flow primarily to upper-income families: 60 percent of Missouri's deduction still goes to Missourians in the top 20 percent of the income distribution, while the poorest 20 percent of taxpayers receive zero percent of the benefits.

An Unintended Federal Tax Hike

As states continue to struggle with the national recession and cast about for policies to stimulate local economies, it is worth noting that, due to their interaction with the federal tax code, deductions for federal income taxes paid can act as an economic depressant. Reducing the state income taxes

that local residents pay leads to larger federal income bills for many of those same residents. This means that valuable funds are flowing out of the state and into federal coffers. This occurs because, instead of using the standard deduction as most taxpayers do, wealthier taxpayers can elect to itemize their deductions on their federal income tax returns; one of the largest of those deductions is the deduction for state and local income taxes. Since federal tax liability rises as itemized deductions fall (lower deductions mean more income is subjected to taxation), a state tax cut—such as that provided by this deduction—leads to an increase in federal income taxes owed.

This interaction—often called the federal offset—can be substantial. Alabama's $516 million deduction means that federal income taxes on Alabamians are $80 million higher than they would be absent the deduction. Therefore, if Alabama were to repeal its $516 million deduction, the higher state taxes that wealthy Alabamians would pay would yield an $80 million federal tax cut—$80 million that would stay within the Alabama economy. The estimated impact of the federal offset in all six states is presented in the appendix at the end of this report.

Simply put, in addition to helping these states reduce projected budget gaps and enhance the equity of their tax systems, repealing these deductions could also allow states to keep additional, vital funds circulating in their own economies.

A Ticking Time Bomb? The Exploding Cost of the Federal Income Tax Deduction

As costly and unfair as the federal income tax deduction is right now, it's very likely that it will become even more so in the next couple of years, because states that offer this deduction are especially susceptible to federal tax changes. Under current federal law, virtually all of the federal income tax cuts enacted during the Bush Administration and extended under President Obama are set to expire in 2013, including several tax breaks that overwhelmingly benefit the best-off Americans.[3] President Obama has continued to indicate that he would like to see these tax cuts expire for Americans with incomes over $250,000. Consequently, it seems likely that the federal income taxes paid by the best-off Americans will rise in the near future. Since the best-off residents in each state are the primary beneficiaries of the state tax deduction, an increase in their federal taxes will significantly increase the cost of this tax break in at least some of the states allowing this deduction.

The chart on the next page shows the projected cost of the deduction in 2011 under two scenarios: one in which the Bush tax cuts that Obama extended are allowed to expire, and one in which they are fully extended (current policy). The options are modeled in 2011 simply because exactly what federal tax law will look like in 2013 is a mystery. Using Alabama as an example, because President Obama extended the Bush tax cuts, Alabama's deduction reduces its revenue by $516 million in 2011, which is about 19 percent of the total revenue generated by the income tax. If the cuts had been allowed to expire, the revenue loss as a result of this deduction would have grown to $647 million. The disparity between these two scenarios has serious implications for Alabama's budget. These changes to the

[3] For a complete listing of the income tax changes imposed during the Bush administration see Citizens for Tax Justice's Bush Tax Cut Scorecard: Phase-in dates for the Bush tax cuts, including 2006 legislation, October 13, 2006 http://ctj.org/pdf/gwbpi.pdf.

federal tax code could impact the state's budget by as much as $131 million, or 25 percent of the cost of this deduction.

As indicated above, however, actual federal tax law in 2013 is likely to fall somewhere between these two extremes. While the cuts for the best-off Americans are likely to expire, those for the remainder of the population will likely be extended. But since the majority of the benefits of these state deductions are enjoyed by higher-income taxpayers, the federal tax payments among this group are the largest driver of this deduction's cost. Consequently, while states may not see the size of their deductions rise by the full amount depicted in the chart on the next page, they should expect their cost to be closer to the higher end of this range.

Revenue Impact of the Deduction for Federal Income Taxes Paid on State Budgets Assuming Federal Tax Changes in 2011 ($M)

STATE	CURRENT LAW: OBAMA EXTENSION OF BUSH TAX CUTS	BUSH TAX CUTS EXPIRE	DIFFERENCE	% GROWTH
AL	516	647	131	25%
IA	642	792	150	23%
LA	643	795	152	24%
MO	394	472	78	20%
MT	45	55	10	22%
OR	338	408	70	21%

Source: ITEP Microsimulation Tax Model

Offering deductions for federal income taxes paid leaves state budgets at the mercy of federal lawmakers. The size of the deduction isn't consistent over time, and in fact, states that offer this deduction leave themselves open to real budget difficulties because of the inherent flaws in linking so closely with the federal tax structure.

Recent Legislative Changes

While the deduction for federal income taxes was never a common feature in the state tax landscape, the few states allowing this deduction have moved away from it in the past quarter century—and this process has accelerated in the last few years.

- North Dakota (2009), Oklahoma (2005) and Utah (2007) each repealed their federal income tax deduction recently.
- Kentucky repealed its deduction in 1990 as part of major tax reform effort.
- Kansas repealed its deduction in 1992.
- Montana added a cap to its deduction in 2003; Missouri capped its deduction in 1994.
- Oregon's legislature recently enacted an upper-income phaseout for its already-capped deduction. Oregon voters ratified this change in January 2010.

Strategies for Reform

Faced with a tax break that offers little or no benefit to middle- and low-income taxpayers while blowing a giant hole in state tax collections, lawmakers seeking to balance budgets in these six states have several sensible policy options to choose from.

- The most sensible strategy in terms of long term fiscal solvency for lawmakers in these six states would be to repeal this regressive tax giveaway entirely.
- A second-best option would be to put a cap on the dollar value of the deduction. This approach would have relatively little effect on the few middle-income families who currently benefit from the deduction, but would also yield less additional revenue than outright repeal.
- A third sensible approach is to phase out the benefit of the deduction for high income earners, as Oregon recently did. This approach targets income tax hikes toward the best-off taxpayers more precisely than either of the previous two options, but also would likely yield less revenue than either of the previous approaches.

Each of these six states could make their income taxes fairer and more sustainable by pursuing at least one of these tax reform strategies. And at a time when states are enacting regressive tax increases, shifting costs to local governments, and making harmful cuts to public spending priorities, eliminating or paring back this poorly-targeted break is especially timely.

Conclusion

The personal income tax is the only major progressive revenue source levied on the state level. States that allow a deduction for federal income taxes paid allow their income taxes to be undermined by this costly and regressive loophole. The loophole is a major drain on state income tax revenues and the price tag yields remarkably little benefit to low-and middle-income families. This tax break also leaves state budgets and taxpayers especially vulnerable to changes in the federal income tax. As the recession lingers and states look to enhance their ability to provide for long term fiscal solvency, elected officials in states with a deduction for federal income taxes paid have a real opportunity to close fiscal shortfalls in a way that has minimal impact on low-and middle-income families.

Appendix I: Detailed State-by-state Estimates

Impact of Repealing Deduction for Federal Income Taxes Paid

All estimates are based on projected 2011 income levels

ALABAMA

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $16,000	$16,000 – $26,000	$26,000 – $46,000	$46,000 – $77,000	$77,000 – $147,000	$147,000 – $366,000	$366,000 – Or More
Average Income in Group	$ 11,000	$ 21,000	$ 35,000	$ 59,000	$ 101,000	$ 205,000	$ 961,000
Tax Change as a Percent of Income	+0.0%	+0.1%	+0.2%	+0.3%	+0.4%	+0.7%	+0.8%
Average Tax Change	2	16	53	153	393	1,404	8,039
Share of Total Tax Change	0%	1%	4%	13%	25%	23%	33%

% Offset	State Tax Change ($1000)	Federal Tax Change ($1000)	Total Tax Change ($1000)
16%	$516,000	-$80,000	$436,000

IOWA

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $21,000	$21,000 – $39,000	$39,000 – $58,000	$58,000 – $87,000	$87,000 – $150,000	$150,000 – $366,000	$366,000 – Or More
Average Income in Group	$ 12,000	$ 30,000	$ 48,000	$ 71,000	$ 109,000	$ 207,000	$ 888,000
Tax as % of Income	+0.0%	+0.2%	+0.3%	+0.5%	+0.7%	+1.1%	+1.6%
Average Tax Change	5	71	158	327	791	2,303	14,361
% Total Tax Change	0%	3%	7%	14%	25%	20%	31%

% Offset	State Tax Change ($1000)	Federal Tax Change ($1000)	Total Tax Change ($1000)
13%	$642,000	-$82,000	$560,000

LOUISIANA

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $16,000	$16,000 – $31,000	$31,000 – $49,000	$49,000 – $86,000	$86,000 – $170,000	$170,000 – $433,000	$433,000 – Or More
Average Income in Group	$ 11,000	$ 23,000	$ 40,000	$ 64,000	$ 116,000	$ 243,000	$1,150,000
Tax as % of Income	+0.0%	+0.1%	+0.2%	+0.3%	+0.5%	+0.8%	+1.0%
Average Tax Change	2	18	64	200	626	1,898	10,986
% Total Tax Change	0%	1%	4%	12%	28%	23%	33%

% Offset	State Tax Change ($1000)	Federal Tax Change ($1000)	Total Tax Change ($1000)
10%	$643,000	-$65,000	$578,000

MISSOURI

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $17,000	$17,000 – $32,000	$32,000 – $50,000	$50,000 – $81,000	$81,000 – $152,000	$152,000 – $381,000	$381,000 – Or More
Average Income in Group	$ 11,000	$ 24,000	$ 40,000	$ 65,000	$ 105,000	$ 218,000	$1,039,000
Tax as % of Income	+0.0%	+0.1%	+0.2%	+0.3%	+0.4%	+0.2%	+0.1%
Average Tax Change	1	28	93	170	398	520	543
% Total Tax Change	0%	4%	13%	24%	41%	14%	4%

% Offset	State Tax Change ($1000)	Federal Tax Change ($1000)	Total Tax Change ($1000)
11%	$394,000	-$43,000	$351,000

MONTANA

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $17,000	$17,000 – $31,000	$31,000 – $50,000	$50,000 – $80,000	$80,000 – $145,000	$145,000 – $389,000	$389,000 – Or More
Average Income in Group	$ 10,000	$ 24,000	$ 39,000	$ 62,000	$ 103,000	$ 222,000	$ 932,000
Tax as % of Income	—	+0.0%	+0.1%	+0.1%	+0.3%	+0.2%	+0.1%
Average Tax Change	—	1	27	91	315	475	564
% Total Tax Change	—	0%	6%	19%	49%	20%	6%

% Offset	State Tax Change ($1000)	Federal Tax Change ($1000)	Total Tax Change ($1000)
17%	$46,000	-$8,000	$38,000

OREGON

Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Next 15%	Next 4%	Top 1%
Income Range	Less Than $18,000	$18,000 – $31,000	$31,000 – $52,000	$52,000 – $83,000	$83,000 – $163,000	$163,000 – $366,000	$366,000 – Or More
Average Income in Group	$ 11,000	$ 24,000	$ 41,000	$ 65,000	$ 110,000	$ 228,000	$ 912,000
Tax as % of Income	+0.1%	+0.2%	+0.4%	+0.4%	+0.4%	+0.2%	+0.0%
Average Tax Change	9	56	158	292	466	353	32
% Total Tax Change	1%	6%	17%	31%	37%	8%	0%

% Offset	State Tax Change ($1000)	Federal Tax Change ($1000)	Total Tax Change ($1000)
13%	$340,000	-$43,000	$297,000

SOURCE: Institute on Taxation and Economic Policy Microsimulation Tax Model, March 2011

Appendix II. About ITEP and the ITEP Tax Model Microsimulation Model

Appendix: About ITEP and the ITEP Tax Model

The Institute on Taxation and Economic Policy (ITEP) has engaged in research on tax issues since 1980. Since 1996 ITEP has used a *microsimulation tax model* to conduct research on federal, state, and local tax systems. A microsimulation model uses a large sample of tax returns and other data to estimate the impact of tax systems and tax proposals on actual taxpayers at different income levels. This is the same type of tax model used on the federal level by the U.S. Treasury Department, the Congressional Joint Committee on Taxation, and the Congressional Budget Office, as well as by many state revenue departments. A properly constructed microsimulation model can provide accurate estimates of revenue yield and tax incidence by income group.

ITEP's microsimulation model relies on one of the largest databases of tax returns and supplementary data in existence, encompassing close to 750,000 records. This database is based on federal tax returns, with statistically valid samples from every state and the District of Columbia. The database is augmented with a sampling of records from the U.S. Decennial Census "five percent sample" (which contains a random sample of five percent of all census forms received by the Census Bureau); the Census data are statistically matched with the tax return records. The data on these records is then extrapolated to subsequent years using federal tax micro and tabular data, Census Bureau Current Population Survey micro and tabular data, and other widely respected data sources.

These, and other, data are used by the ITEP model's four modules: Personal Income Tax, Property Tax, Consumption Tax and Business Tax. These modules calculate tax liability on a record-by-record basis and sum the results to provide revenue and tax incidence estimates. (A complete description and methodology for the ITEP model is available on request.)

The ITEP model has the unique capability of analyzing all major taxes for every state and the District of Columbia. In 2009, the ITEP model was used to produce the study *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. *Who Pays?* shows the distributional impact, by income level, of all major state and local taxes for each of the 50 states. It has been used by many state revenue departments and legislative fiscal offices since its publication.

The ITEP Model is also unique in its ability to forecast the effect of both federal and state tax changes on taxpayers in a given state. This capability is especially important in analyzing the impact of proposed tax changes that affect people on multiple levels. For example, proposals for federal tax reform often impact state tax collections. Similarly, proposals to change state tax structures, such as the bills under discussion today, can affect the federal taxes paid by a state's residents in ways that can drastically affect the overall incidence of these proposals.

In addition to its fifty-state analyses, ITEP often conducts research in individual states. This work has been primarily funded by private foundations.

A more detailed description of the ITEP Microsimulation Tax Model can be found at www.itepnet.org.