THE POLICY PAGE
An Update on State and Federal Action

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TEMPORARY SALES-TAX DEDUCTION BENEFITS ONLY ONE-QUARTER OF TEXAS TAXPAYERS; NO EXCUSE FOR RAISING STATE SALES-TAX RATE

The U.S. Congress recently passed a bill that allows taxpayers to deduct their state sales tax payments in calculating federal taxable income. Most Texas families gain absolutely nothing from this change. Fewer than one-quarter of Texas taxpayers – disproportionately those with higher incomes – currently itemize their deductions; only itemizers benefit from a new sales-tax deduction.

This change in federal deductibility therefore does not make the sales tax any more attractive as a source of state revenue. If the Legislature were to raise the sales-tax rate, all that most Texans would see is a higher sales tax – not an increase in their federal income tax deductions.

CONGRESS HAS MADE STATE SALES-TAX PAYMENTS DEDUCTIBLE FROM FEDERAL TAXABLE INCOME FOR THE NEXT TWO YEARS

In October the President signed H.R. 4520, a giant corporate-tax bill that, among many other provisions, allows taxpayers to deduct state sales-tax payments in calculating their taxable income on their federal income tax returns. The deduction will be effective only for tax years 2004 and 2005. The size of the federal deficit and its long-term impact on our future standard of living raises doubts whether the Congress will renew this provision when it expires.(For on overview of options for dealing with the deficit, see http://www.brook.edu/comm/policybriefs/pb130.htm, which argues that both spending cuts and tax increases will be necessary.)

MOST TEXAS TAXPAYERS DON'T ITEMIZE THEIR DEDUCTIONS, SO do NOT BENEFIT

In order to benefit from a sales-tax deduction, a family has to itemize its deductions on its federal income tax return. Most Texas taxpayers do not itemize their deductions. Instead, the majority of taxpayers take the standard deduction, which has not been changed. To get any benefit from the new deduction, a family would have to accumulate more than $9,700 (the standard deduction) in mortgage interest, property taxes, or other deductible expenses. Most Texas families do not do that now and would not even with the new deduction.

In 2002, the most recent year that detailed data are available from the Internal Revenue Service, (http://www.irs.gov/pub/irs-soi/02in44tx.xls) only 23.8 percent of Texas taxpayers itemized deductions on their federal income tax returns. Moreover, the benefit of itemization is concentrated among the highest income taxpayers. More than 80 percent of Texas taxpayers with adjusted gross incomes of more than $100,000 (who account for only 8 percent of all returns) had enough deductible expenses to take advantage of itemization. In contrast, only 11 percent of those with adjusted gross incomes under $50,000 – 74 percent of all Texas returns – itemized their deductions. The vast majority of Texas taxpayers took the standard deduction, so are unlikely to benefit from the proposed new sales-tax deduction.

Some people have claimed that the proposed deduction would save Texans more than $400 per household. This is a misstatement of the comptroller's estimate that itemizing households could save an average of $408.. (http://www.cpa.state.tx.us/comptrol/ajca2004/ajca2004.pdf)The average Texas household, which would continue to qualify only for the standard deduction, would save absolutely nothing.

It is also argued that a few families might find that the addition of a sales tax deduction would make it worthwhile to itemize all their deductions. On the other hand, any reduction in property taxes would work in the other direction, making itemization less attractive. Property taxes accounted for 19 percent of the value of all itemized deductions in 2002.

The deduction will be calculated through tables included in federal income tax forms, which will provide an amount based on a taxpayer's adjusted gross income, number of dependents, filing status, and state of residence. Taxpayers also can save all their sales-tax receipts to determine their deduction. In addition, taxes paid on motor vehicles and boats can be itemized.

THE NEW DEDUCTION DOES NOT MAKE THE SALES TAX A MORE ATTRACTIVE SOURCE OF REVENUE

Texas taxes are regressive, meaning that they take a much greater percentage of the income from a low- or moderate-income family than from a higher-income family. Texas' state and local tax system is the 5th most regressive among the 50 states.

The reason for this is that the state relies so heavily on the sales tax, which is based on consumption. Consumption taxes are extremely regressive, because lower-income families spend all of their income (and sometimes more, by going into debt), while higher-income families can afford to buy needed items and still have money left over for savings or other untaxed activities.

According to the comptroller's tax incidence study (http://www.window.state.tx.us/taxinfo/incidence03), the one-fifth of Texas families with an annual income under $26,800 pay an average of 4.2 percent of that income in sales taxes, while the one-fifth of families with an income over $126,300 pay an average of only 1.1 percent of their income in sales taxes.

The new sales-tax deduction only exacerbates this regressively. Few lower- or middle-income families can derive any benefit, but most higher-income families – who already pay the smallest percentage of their income in sales taxes – are now able to pass some of their liability to the federal government through lower income taxes.

Deductions are worth more to taxpayers with higher marginal tax rates. The comptroller estimated that a family of four with an adjusted gross income of over $170,600 would have a sales-tax deduction of $2,140. (http://www.window.state.tx.us/specialrpt/deduction04/) A family with this income would probably pay a 28 percent federal income tax rate, so would save $600 in federal taxes, effectively reducing their sales tax cost. Even if a lower-income family were to have enough deductible expenses to make it worthwhile to itemize, it would receive proportionately less benefit because of its lower federal income tax, which would probably be only 15 percent.

CONGRESS REPEALED THE FORMER SALES TAX DEDUCTION BECAUSE OF ITS LIMITED USE BY MOST TAXPAYERS

State sales taxes were deductible under the federal income tax law until the Tax Reform Act of 1986, which eliminated many deductions, but raised the standard deduction and lowered tax rates. The report of the U.S. Senate Finance Committee on the act noted, “It is significant how small a portion of general sales taxes paid by individuals actually are claimed as itemized deductions… The fact that the large majority of sales tax payments already are not claimed as itemized deductions under present law alleviates any effect of repealing the deduction on the regional distribution of Federal income tax burdens or on the willingness of State and local governments to use general sales taxes as revenue sources.” (Tax Reform Act of 1986, Report of the Committee on Finance,United States Senate, May 29, 1986. Report 99-313, page 56.)

The report also noted that other types of state and local sales tax, such as taxes on alcohol, tobacco, gasoline, and telephone services, were already not deductible. Extending non-deductibility to all state and local sales taxes was intended to improve the consistency of federal tax policy by not providing an income tax benefit for any type of consumption.