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# A SALES TAX DEDUCTION WOULD LARGELY BENEFIT HIGH-INCOME TAXPAYERS AND CARRY A HIGH COST

By Iris J. Lav

The House passed version of the corporate FISC/ETI tax bill includes a provision that would enable residents of states without income taxes to take a deduction for sales taxes paid. This would partially restore a tax break that was eliminated in the 1986 tax reform act under President Reagan.

The House provision would allow taxpayers in all states to choose whether to deduct state sales taxes or state income taxes from their federal taxable income. Because the income tax would almost always be the greater deduction in states that levy income taxes, the proposal is designed particularly to benefit taxpayers who itemize deductions in the seven states that do not have broad-based income taxes but do levy sales taxes — and to gain support for the corporate tax bill from members of Congress from those states. Those states are Florida, Nevada, South Dakota, Tennessee, Texas, Washington, and Wyoming. [1]

This proposal is costly and would exacerbate a number of inequities in federal and states taxes:

- The proposal costs $3.6 billion for the two years — 2004 and 2005 — that it would be in effect. Were it extended or made permanent, as would be likely, the cost reportedly would be at least $21 billion over the next 10 years. The actual long-term cost of the policy change, however, would likely be far higher. The official cost estimate assumes that the Alternative Minimum Tax would cancel out a substantial portion of the tax break, as the current AMT relief expires and the number of taxpayers subject to the AMT explodes to 29 million by the end of the decade. But if on-going AMT relief is enacted, as most agree it will be, then far fewer taxpayers would be subject to the AMT and the cost of the sales tax deduction would rise substantially.

[1] Alaska has no state-wide sales tax, but sales taxes have been adopted by some localities. It is unclear how IRS might administer a deduction when some residents pay no sales tax at all and the amount paid by others varies substantially.

**A Misleading "Average"**

In the Fort Worth Star Telegram, House Majority Leader Tom Delay was reported as saying "Texas taxpayers would save an average of $300 per year under [this proposal]."* That statement is highly misleading, because most Texas taxpayers would not save *anything at all* under the proposal. Only 23 percent of all Texans itemize their deductions now. Even if the ability to deduct sales taxes allows a few more to be able to itemize, at least seven out of every 10 Texans — and at least eight out of every 10 Texans with income below $50,000 — would not be able to itemize and so would get no benefit at all. Mr. Delay's statement masks this disparity.

*Friday, June 4, 2004.

- Because the proposed sales tax deduction would be available only to taxpayers who itemize their deductions rather than use the standard deduction, the benefits would be limited to a small group of taxpayers. For example, seven out of every 10 residents of Texas and Tennessee would save nothing under this proposal. Eight out of every 10 South Dakotans would save nothing.

- Sales taxes are regressive and impose the highest burden on lower- and middle-income taxpayers. Yet the proposed sales tax *deduction* would primarily benefit higher-income taxpayers rather than help the lower-income taxpayers who most need relief from the burden of the tax. Only 30 percent of taxpayers with incomes below $100,000 itemize their deductions and thus could possibly benefit from being able to deduct their sales taxes. By contrast, some 93 percent of taxpayers with income over $200,000 itemize and would see their taxes reduced if they lived in one of the seven target states. Moreover, as with all deductions, the benefit would be greatest for the highest-income taxpayers who pay the highest tax rates.

- The sales tax deduction is of no benefit to any taxpayer who must pay the Alternative Minimum Tax, which further narrows the group of taxpayers that would benefit from this proposal.

- A sales tax deduction would encourage some states to rely more heavily on regressive sales taxes than on more progressive income taxes, thereby further burdening low- and moderate- income families. The deduction available for income taxes is an important argument in favor of heavier reliance on that more progressive source of revenue; a sales tax deduction could tilt the balance in the other direction.

## Table 1

### Who Would Benefit From Sales Tax Deductibility? Percent of Taxpayers Who Itemized in 2001

| | All | Income below $50,000 | Income below $100,000 |
|---|---|---|---|
| Florida | 28.8% | 17.2% | 24.9% |
| Nevada | 35.5 | 21.1 | 31.8 |
| South Dakota | 17.0 | 9.0 | 14.8 |
| Tennessee | 23.4 | 12.3 | 20.0 |
| Texas | 22.6 | 9.7 | 17.6 |
| Washington | 34.7 | 17.8 | 29.9 |
| Wyoming | 20.6 | 10.9 | 18.2 |
| U.S. Total | 35.0 | 18.0 | 29.8 |

## The Proposal is Costly

The proposal in the House bill would be in effect for only two years, calendar years 2004 and 2005. This allows the cost to be reported as $3.6 billion over 10 years.[2] There is no reason to believe, however, that the supporters of this provision intend for it to be temporary. If the provision were extended or made permanent, the cost reportedly would exceed $21 billion over the next 10 years.

Moreover, the full effect of the tax reduction that this proposal would provide doesn't appear in this cost estimate, because much of the tax reduction would be cancelled out by the Alternative Minimum Tax.[3] This is because state and local taxes are not allowed as a deduction when computing the AMT. If current AMT policy is not changed, some 29 million taxpayers would become subject to the AMT by the end of the decade. In its cost estimates, the Joint Committee on Taxation must assume this current law. But virtually all knowledgeable observers are convinced that AMT relief will be provided on an ongoing basis in order to prevent large numbers of taxpayers from having to pay the AMT. If ongoing AMT relief is enacted, then the cost of the sales tax deduction will rise substantially.

[2] *Joint Committee on Taxation*, #04-1 115 R2, June 7, 2004.

[3] The AMT is a parallel tax system, and a household pays the higher of its AMT liability or its regular income tax liability. Unlike the regular income tax code, however, the key parameters of the AMT are not indexed for inflation. Over time, therefore, more and more households will see their AMT liability exceed their regular income-tax liability and become subject to the AMT, unless AMT relief is continued. In the absence of an extension of AMT relief, for instance, the number of taxpayers subject to the AMT will explode to about 29 million in 2010, according to the Urban Institute-Brookings Institution Tax Policy Center, up from about 3 million today.

## A Benefit to Higher-Income Taxpayers

A sales tax deduction is valuable only to taxpayers who have sufficient other expenses to make itemizing deductions on their federal tax returns worthwhile. This means a taxpayer must have expenses to deduct that exceed the standard deduction, which is $9,700 for a married couple filing jointly in 2004. (It is $7,150 for heads of household and $4,850 for single individuals.) Because the standard deduction is relatively generous, only a modest proportion of moderate and middle-income taxpayers have enough expenses for itemization to be advantageous.

- Nationwide, only three out of every 10 tax filers with income below $100,000 itemize their deductions, and only 18 percent of tax filers with incomes below $50,000 do so.[4]

- By contrast, nearly 93 percent of all tax filers with incomes of $200,000 or more itemize.

The proportion of tax filers that itemize in most states with a sales tax but no income tax is somewhat lower than the national average. (See Table 1.) The ability to deduct sales taxes would add a modest number of taxpayers to the ranks of itemizers in these states, but — as can be seen from the national averages — would not materially change the picture. Thus, it will be the higher-income tax filers who itemize who can benefit from this proposal.

It is particularly ironic to have a proposal to deduct sales taxes so heavily benefit high-income taxpayers. The sales tax is a regressive tax, and as such absorbs a much larger proportion of lower-income people's income than of those at higher-incomes. According to the Institute for Taxation and Economic Policy, general sales taxes take 3.6 percent of the incomes of families with incomes below $15,000 and 2.7 percent of the incomes of families between $40,000 and $69,000, but only 0.6 percent of the incomes of those earning over $304,000.[5] Yet it is precisely those high earners who would take home much of the benefit of this proposal. Those who need relief from the burden of the sales tax would receive none.

## Encourages Reliance on Sales Taxes

The tax burden on low- and moderate-income families tends to be heavier in states with higher reliance on sales taxes to raise revenue than in states with greater reliance on income taxes. Yet this proposal could encourage greater reliance on sales taxes for revenue. Under current law, the fact that income taxes are deductible for federal tax purposes means that state residents who can claim this deduction do not pay the full cost of their income taxes; these

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[4] The national data on itemizers is for tax year 2002, and the state level data is for tax year 2001. It is likely that the proportion of lower- and middle-income taxpayers itemizing their deduction has further declined somewhat since then, because the standard deduction for married couples was made more generous in the 2003 tax legislation.

[5] The ITEP data is for non-elderly families of all types, including single individuals. These percentages are for all states together. *Who Pays?* 2nd Edition, January 2003.

residents in effect receive a discount on their state taxes when they file their federal tax return. This is an important argument in the states in favor of income tax reliance. If sales taxes receive similar treatment, it will make it easier for states to rely more heavily on regressive sales taxes. Some states might consider reducing income taxes, switching to sales taxes as their primary revenue source.

A major goal of conservative policymakers at both the federal and states levels in recent years has been to move tax systems away from taxing income and toward taxing consumption. Efforts at the federal level to lower or eliminate the tax on capital gains, dividends, and most forms of savings all are part of this agenda. This proposal to allow a deduction for sales taxes is still another piece of that agenda because it will encourage states to rely more heavily on consumption taxes. To the extent that this agenda is successful, the net result is to greatly reduce the taxes paid by upper-income taxpayers and to increase the extent to which moderate- and middle-income taxpayers shoulder the responsibility for paying for public services.