

**BACKGROUND ON THE ITEMIZED DEDUCTION
FOR STATE AND LOCAL TAXES**

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
HOUSE COMMITTEE ON WAYS AND MEANS
on June 25, 2019

Prepared by the Staff
of the
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INTRODUCTION

The Subcommittee on Select Revenue Measures of the House Committee on Ways and Means has scheduled a hearing on June 25, 2019, regarding limitations to the itemized deduction for State and local taxes.¹

This document provides an overview of present and prior law treatment of State and local taxes, a summary of recently released regulations and other guidance relevant to the present law treatment of State and local taxes, data on State and local revenues and expenditures, Joint Committee staff estimates of the number of taxpayers and size of benefits resulting from the deduction for State and local taxes, and a discussion of the deduction.

Section references are to the Internal Revenue Code of 1986, as amended (“the Code”), unless otherwise indicated.

¹ This document may be cited as follows: Joint Committee on Taxation, *Background on the Itemized Deduction for State and Local Taxes*, (JCX-35-19), June 24, 2019. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

I. PRESENT LAW AND BACKGROUND

Present law

Deduction for State and local property, income, and sales taxes

An individual taxpayer who does not take an applicable standard deduction may, in order to determine taxable income, elect to claim itemized deductions.² Included among itemized deductions is the deduction for certain taxes paid or accrued in a taxable year, including certain State and local property, income, and sales taxes.³

An individual taxpayer⁴ may deduct: (i) State and local real property taxes;⁵ (ii) State and local personal property taxes;⁶ and (iii) State and local income, war profits, and excess profits taxes.⁷ At the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction for State and local income taxes.⁸

No itemized deduction for property, income, or sales taxes is allowed in determining an individual's alternative minimum taxable income for purposes of the alternative minimum tax ("AMT").⁹

Under Title I of an Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (the "2017 Tax Act"),¹⁰ the aggregate

² Sec. 63.

³ Secs. 63(d) and 164. The focus of this document is the deduction for taxes which are limited by the 2017 Tax Act (generally itemized deductions for State and local taxes under section 164). An individual taxpayer may also be able to deduct State and local taxes incurred in carrying on a trade or business (under section 162) or an activity relating to expenses for the production of income (under section 212), which, if attributable to a trade or business or to rents or royalties, is an "above the line" deduction allowed in computing adjusted gross income under section 62. A deduction allowed in computing adjusted gross income is not an itemized deduction, is allowed without regard to whether an individual elects to itemize deductions, and is not subject to the limitation enacted by the 2017 Tax Act.

⁴ Trusts and estates may generally claim a deduction for certain taxes paid subject to the same rules that apply to individual taxpayers. See sec. 641(b).

⁵ Sec. 164(a)(1).

⁶ Sec. 164(a)(2).

⁷ Sec. 164(a)(3).

⁸ Sec. 164(b)(5).

⁹ Sec. 56(b)(1)(A)(ii). This limitation does not apply to taxes that are deductible as an adjustment to gross income (*i.e.*, that are deductible in computing income from a trade or business or section 212 activity on Schedule C, E, or F of an individual's income tax return). See sec. 56(b)(1)(A) flush language.

¹⁰ Pub. L. No. 115-97, sec. 11042.

amount of these deductions are limited to \$10,000 (\$5,000 for a married taxpayer filing a separate return) for taxable years beginning after December 31, 2017 and before January 1, 2026.¹¹ However, this limitation does not apply to State and local real property taxes or personal property taxes paid or accrued in carrying on a trade or business or an activity described in section 212 of the Code.¹²

Deduction for other taxes

Certain other taxes are included among itemized deductions.

The 2017 Tax Act limited the deduction for foreign real property taxes.¹³ For taxable years beginning after December 31, 2017 and before January 1, 2026, an individual taxpayer may only deduct foreign real property taxes paid or accrued in carrying on a trade or business or an activity described in section 212.¹⁴ All foreign real property taxes may be deducted in taxable years beginning after December 31, 2025.¹⁵

An individual taxpayer may also deduct: (i) foreign income, war profits, and excess profits taxes;¹⁶ (ii) Federal and State generation-skipping transfer taxes imposed on certain distributions that are included in the gross income of the distributee;¹⁷ and (iii) one-half of Federal self-employment taxes.¹⁸ The 2017 Tax Act did not affect the deductibility of these taxes.

Background

Brief history of the State and local tax deduction

A deduction for State and local taxes has been allowed since the Revenue Act of 1913, which allowed a deduction for “all national, State, county, school and municipal taxes paid

¹¹ Sec. 164(b)(6)(B).

¹² Sec. 164(b)(6). Note, however, that such taxes may be subject to limitation under the passive loss rules if incurred with respect to a passive activity. See sec. 469.

¹³ Pub. L. No. 115-97, sec. 11042.

¹⁴ Sec. 164(a)(1), (b)(6).

¹⁵ Sec. 164(a)(1), (b)(6)(A).

¹⁶ Sec. 164(a)(3), (b)(6). An individual may elect to claim a credit rather than a deduction for such taxes. Sec. 901.

¹⁷ Sec. 164(a)(4), (b)(4).

¹⁸ Sec. 164(f).

within the year, not including those assessed against local benefits.”¹⁹ The Revenue Act of 1964 limited the deduction to specifically enumerated taxes;²⁰ previously, taxes not explicitly excluded were deductible.²¹

The Tax Reform Act of 1986 repealed the deduction for State and local general sales taxes, for which a deduction was previously allowed in addition to the deduction for other State and local taxes.²² The American Jobs Creation Act of 2004 reinstated the deduction for State and local general sales taxes, but allowed the deduction only in lieu of the deduction for State and local income taxes.²³

The deduction for State and local taxes immediately prior to the enactment of the 2017 Tax Act is identical to the deduction for tax years beginning on or after January 1, 2026. An individual taxpayer was able to deduct: (i) State and local real property taxes; (ii) State and local personal property taxes; and (iii) State and local income, war profits, and excess profits taxes (or general sales taxes in lieu of income taxes). The aggregate amount of the deduction for these taxes was not subject to a dollar amount limit.²⁴

¹⁹ Revenue Act of 1913, 38 Stat. 114, Section II, B.

²⁰ Pub. L. No. 88-272, sec. 207(a).

²¹ Sec. 164(a) (1963).

²² Pub. L. No. 99-154, sec. 124.

²³ Pub. L. No. 108-357, sec. 501(a), enacting sec. 164(b)(5).

²⁴ Because no itemized deduction for property, income, or sales taxes is allowed for purposes of the AMT, the AMT acted as a limiter to the deduction for State and local taxes for individuals subject to the AMT. See sec. 56. In addition, for taxable years beginning before 2018 and after 2025, the total amount of most otherwise allowable itemized deductions was subject to a limitation for certain upper-income individuals. See sec. 68.

II. GUIDANCE REGARDING CONTRIBUTIONS TO STATE AND LOCAL TAX CREDIT PROGRAMS

State and local tax credit programs

Some States and localities have adopted programs to increase charitable giving under which the State or locality offers a tax credit in return for a charitable contribution by the taxpayer. Such programs generally encourage contributions to specific types of charitable activities, such as conservation easements, scholarships for private school tuition, community organizations, and various other State-supported programs.²⁵ The programs vary in design, including by credit percentage or dollar amount offered, acceptance of marketable securities and other noncash contributions, limitations on contributions, allowance for carryforwards, and other features.

Prior to 2018, the Internal Revenue Service (“IRS”) had not issued published guidance regarding the treatment of tax credits received in return for charitable contributions.²⁶ However, in a Chief Counsel Advice memorandum²⁷ issued in 2010, the IRS Chief Counsel advised that taxpayers may take a charitable contribution deduction for the full amount of the contribution made in return for a State tax credit, without reducing the deduction by the value of the credit received.²⁸ The IRS’s analysis assumed that the taxpayer would apply the State or local tax credit to reduce the taxpayer’s State or local tax liability and receive a smaller deduction for the payment of State and local taxes²⁹ as a result. Prior to 2018, there generally was no Federal tax benefit for participating in a State or local tax credit program.³⁰ However, if the taxpayer was subject to the AMT, the taxpayer could receive a net benefit from participating in such programs because the AMT limits the deduction for State and local taxes but does not limit the deduction for charitable contributions.³¹

²⁵ For a partial list of State charitable tax credits describing over 100 available credits in 33 states, see the Appendix to Joseph Bankman *et al.*, “State Responses to Federal Tax Reform: Charitable Tax Credits,” 159 *State Tax Notes* 433 (2018).

²⁶ The deduction for charitable contributions is described in section 170. As a general matter, when a taxpayer makes a payment or transfers property to a government entity or charitable organization that is in part a charitable contribution and in part a payment for benefits received (*i.e.*, a *quid pro quo* payment), the taxpayer may deduct only the amount of the payment or value of property transferred that is in excess of the value of the return benefit. See *United States v. American Bar Endowment*, 477 U.S. 105, 116-18 (1986).

²⁷ CCA 201105010 (Oct. 27, 2010). Chief Counsel Advice memoranda are released to the public for information purposes but are not official rulings or positions of the IRS and are not precedential. See “Contributions in Exchange for State or Local Tax Credits,” 83 Fed. Reg. 43563, 43564 (Aug. 27, 2018).

²⁸ The CCA also noted that the tax benefit of a Federal or State charitable contribution deduction is not regarded as a return benefit that negates charitable intent. CCA 201105010, p. 4 (citing cases).

²⁹ Sec. 164.

³⁰ 83 Fed. Reg. at 43566.

³¹ See sec. 56(b) and 83 Fed. Reg. at 43567.

Limitation on State and local tax deduction and State and local tax credit programs

Following the enactment of the \$10,000 limitation on the deduction for State and local tax payments with the 2017 Tax Act, utilizing State and local tax credit programs became attractive as a potential tax planning strategy for individuals to avoid or mitigate the limitation. For example, assume an individual has a State tax liability totaling \$30,000, itemizes deductions, and lives in a State that offers a 100 percent tax credit in return for contributions to a specified charitable organization. If the individual paid the tax liability directly to the State, only \$10,000 is allowed as a Federal income tax deduction. However, the individual may donate \$20,000 to the specified charitable organization, receive a 100 percent tax credit worth \$20,000, and pay the remaining tax liability of \$10,000 directly to the State. In this case, if the amount of the charitable contribution deduction is not reduced to reflect the amount of the state tax credit, the taxpayer would be able to deduct the full \$30,000 at the Federal level: \$20,000 as a charitable contribution deduction and \$10,000 as a deduction for State taxes. Thus, effectively, the taxpayer would side-step the \$10,000 limitation on the deduction for State and local tax payments.

In response to the limitation on the Federal income tax deduction for State and local tax payments, some States and localities created or announced an intention to create additional State and local tax credit programs. In addition, there was increased interest in using existing State or local tax credit programs to reduce State and local tax payments to amounts of \$10,000 or less.

The Treasury Department and the IRS undertook a review of the Federal income tax treatment of contributions pursuant to State and local tax credit programs.³²

Proposed and final regulations

On August 27, 2018, the Treasury Department and IRS published proposed regulations addressing the Federal income tax treatment of contributions made pursuant to State and local tax credit programs.³³ Under the proposed regulations, if a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c),³⁴ and the taxpayer receives or expects to receive a State or local tax credit³⁵ in return for the payment or transfer, the tax credit constitutes a return benefit (or *quid pro quo*) that reduces the taxpayer's charitable contribution deduction. The proposed regulations provide exceptions for dollar-for-dollar State

³² Notice 2018-54, 2018-24 I.R.B. 750 (June 11, 2018).

³³ 83 Fed. Reg. 43563.

³⁴ Entities described in section 170(c)(1) include a State, a possession of the United States, or any political subdivision of the foregoing, or the District of Columbia. Entities described in section 170(c)(2) include certain corporations, trusts, community chests, funds, or foundations, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.

³⁵ The definition of state or local tax under the regulations is a tax imposed by a State, a possession of the United States, or by a political subdivision of any of the foregoing, or by the District of Columbia. Treas. reg. sec. 1.170A-1(h)(3)(v). This is a broader definition than those taxes allowed as a Federal deduction under section 164.

and local tax deductions and for *de minimis* State and local tax credits (worth 15 percent or less of the payment or value of the transfer). The rule in the proposed regulations applies to individuals, trusts, estates, and other taxpayers who may claim the charitable contribution deduction. The proposed regulations apply to contributions made after the publication date of August 27, 2018.

The preamble to the proposed regulations states that disregarding State tax benefits received or expected to be received in exchange for charitable contributions would lead to significant Federal tax revenue loss because it would undermine and be inconsistent with the limitation on the State and local tax deduction enacted in the 2017 Tax Act.³⁶ In addition, the preamble states that proposed regulations are consistent with the purpose of the charitable contribution deduction, which is to provide a deduction for taxpayers' gratuitous payments to qualifying entities, not for transfers that result in economic returns.

The Treasury Department and the IRS received over 7,700 comments in response to the proposed regulations, both supporting and opposing the proposed regulations.³⁷ A number of the comments in opposition seek to protect preexisting State or local tax credit programs. The proposed regulations were finalized on June 13, 2019, with only clarifying and technical changes.³⁸ The final regulations maintain the general rule that a State or local tax credit received in return for a contribution must reduce the Federal deduction for the contribution.³⁹ The Treasury Department and IRS simultaneously released a safe harbor for individuals, as described below.

Safe harbors for certain contributions to State and local tax credit programs

In addition to the regulations, the Treasury Department and the IRS have issued guidance providing two safe harbors relating to certain contributions to State and local tax credit programs, one for businesses and one for individuals.

The first safe harbor⁴⁰ provides that C corporations and specified passthrough entities that make a payment to an entity described in section 170(c) in exchange for a State or local tax credit may treat such payments as ordinary and necessary business expenses.⁴¹ This guidance states that it is reasonable to conclude that there is a direct benefit to the business in the form of a reduction in State or local tax that the business would otherwise have to pay and therefore there is a reasonable expectation of financial return commensurate with the amount of the transfer.

³⁶ 83 Fed. Reg. at 43565.

³⁷ 84 Fed. Reg. 27513, 27514-15.

³⁸ T.D. 9864, 84 Fed. Reg. 27513.

³⁹ See Treas. Reg. sec. 1.170A-1(h)(3).

⁴⁰ Rev. Proc. 2019-12, 2019-04 I.R.B. 401.

⁴¹ Sec. 162.

However, for specified passthrough entities, the deductibility of the payment must be determined at the level of the individual owners of the entity if the credit will reduce State or local income tax liability subject to the \$10,000 limitation.

The second safe harbor⁴² provides that an individual who itemizes deductions may treat the portion of a payment for which a charitable contribution deduction is or will be disallowed under the regulations as a payment of State or local tax for purposes of section 164. Accordingly, that portion of a payment may be deductible as a State or local tax payment in the taxable year in which the payment is made, subject to the \$10,000 limitation and any other applicable limitations. Any excess credit permitted to be carried forward may be treated as a payment of State or local tax in the taxable year or years to which the credit is applied. This safe harbor addresses the case of taxpayers whose financial incentive to make contributions to State or local tax credit programs may be reduced, compared to their financial incentive prior to the enactment of the \$10,000 limitation on the deduction for State and local tax payments. This guidance states that State tax credit programs effectively offer taxpayers a choice to pay tax to the State or locality directly or to pay indirectly by contributing to an entity described in section 170(c) and receiving an offsetting tax credit.

⁴² Notice 2019-12.

III. DATA AND PROJECTIONS

A. State and Local Revenues and Expenditures

In 2016, the most recent year for which data on State and local government revenues and expenditures is available, the Bureau of the Census reports that State and local governments had \$3.40 trillion in revenue.⁴³ Table 1 provides a summary of State and local government revenue by source for 2016. State and local governments received \$0.69 trillion from the Federal government and raised \$2.32 trillion from their own sources (taxes, charges, and miscellaneous general revenue) and \$0.39 from other sources (including insurance trust revenue).

Table 1 shows that 47 percent of State and local revenue comes from taxes. Sales and gross receipt taxes are the largest share, accounting for 34.9 percent of taxes. Property taxes and individual income taxes are the two next-largest subcategories of taxes, accounting for 32.3 and 23.5 percent of taxes respectively.

**Table 1.—State and Local Revenue (with Selected Subcategories)
Survey Year 2016**

Category (1)	State and Local Government Revenue	
	\$Billions	
Net Federal transfers		690.2
Taxes (2)		1,599.5
Property	503.3	
Sales and gross receipts	558.9	
Individual income	376.3	
Corporate income	54.3	
Charges and misc. general revenue (3)		718.5
Education	128.5	
Hospitals	151.3	
Highways	18.7	
Utility revenue		164.1
Liquor store revenue		9.5
Insurance trust revenue (4)		219.8
Total, Revenue		3,401.7

Source: U.S. Census, Annual Survey of State and Local Government Finances

Subcategories may not add to category totals as only selected subcategories are shown.

Categories may not add to revenue total due to rounding.

(1) Categories generally follow Annual Survey of State and Local Government Finance, Table 1. Only selected subcategories are shown.

(2) Also includes motor vehicle license, and other taxes.

(3) Also includes airports, parking facilities, sea and inland port facilities, natural resources, parks and recreation, housing and community development, sewage, solid waste management, and other charges.

(4) Includes unemployment compensation, employee retirement, workers' compensation, and other insurance trust revenue.

⁴³ This includes subnational governments in the 50 State areas and the District of Columbia.

State and local taxes are used to fund a variety of services. Table 2 provides a summary of direct expenditures by function for 2016.

**Table 2.—State and Local Direct Expenditure
(with Selected Subcategories)
Survey Year 2016**

Category (1)	State and Local Government Expenditure	
	\$Billions	
Education services (2)		984.9
Elementary and secondary	632.7	
Higher education	287.8	
Social services and income maintenance (3)		922.7
Public welfare	637.6	
Hospitals and health	279.8	
Transportation (4)		206.8
Highways	175.0	
Airports	23.8	
Public Safety (5)		249.8
Environment and housing (6)		203.2
Government administration		135.1
Interest on general debt		104.6
General expenditure, not elsewhere classified		137.5
Utility expenditure		224.2
Liquor store expenditure		7.7
Insurance trust expenditure (7)		338.0
Total, Expenditure		3,514.6

Source: U.S. Census, Annual Survey of State and Local Government Finances

Subcategories may not add to category totals as only selected subcategories are shown.

Categories may not add to expenditure total due to rounding.

(1) Categories generally follow Annual Survey of State and Local Government Finance, Table 1. Only selected subcategories are shown.

(2) Also includes other education and libraries.

(3) Also includes employment security administration and veterans' services.

(4) Also includes parking, and sea and inland port facilities.

(5) Includes police, fire, correction, and protective inspection and regulation.

(6) Includes natural resources, parks and recreation, housing and community development, sewerage, and solid waste management.

(7) Includes unemployment compensation, employee retirement, workers' compensation, and miscellaneous.

The largest portion, 28.0 percent, is spent on education services, which includes elementary, secondary, and higher education.⁴⁴ Spending on public welfare, or in support of and assistance to needy persons contingent on need, is 18.1 percent of State and local expenditures.⁴⁵ Health and hospital services provided directly by the government are accounted for separately and make up 8.0 percent of State and local expenditures. Public safety (including police, fire, correction, and protective inspection and regulation) accounts for 7.1 percent of State and local expenditures. Other large categories include insurance trust expenditure (9.6 percent),⁴⁶ utility expenditure (6.4 percent), and transportation (5.9 percent).⁴⁷

⁴⁴ Education services also includes other education and libraries.

⁴⁵ Public welfare includes cash assistance paid directly to needy persons, vendor payments made to private providers of medical care and other commodities and services provided under welfare programs, and operational funds for government or welfare institutions.

⁴⁶ Insurance trust expenditure includes unemployment compensation, employee retirement, workers' compensation, and other miscellaneous trust expenditure.

⁴⁷ Transportation includes highways, airports, parking, and sea and inland port facilities.

B. Deduction for State and Local Taxes

Table 3 presents the estimated distribution of tax benefits of the deduction for State and local taxes for 2019, 2025, and 2026. The table displays the estimated number of taxpayers that can be expected to claim the deduction, the dollar amount of deduction claimed, and the value of the tax benefit of deduction claimed across the income distribution. The table shows that 89 percent of the value of the tax benefit is projected to accrue to taxpayers with \$100,000 or more of economic income⁴⁸ in 2019.

The estimated distribution of tax benefits for 2025 and 2026 are included to provide a comparison of the distribution of tax benefits with and without many of the changes to the individual income tax provision from the 2017 Tax Act. The individual income tax system in 2026 will provide a smaller standard deduction, deductions for personal exemptions, and a lower AMT exemption amount, among other differences.

Joint Committee staff projects that the total tax benefit of the deduction is over six times as high and the number of taxpayers benefiting from the deduction is more than twice as high comparing 2025 to 2026. The proportion of tax benefit accruing to taxpayers with economic income of \$100,000 or more is projected to increase from 87 percent to 93 percent from 2025 to 2026.

Because the deduction for State and local taxes is generally an itemized deduction, the aggregate total tax benefit and the number of taxpayers that benefit from the deduction depend on the number of taxpayers that elect to itemize deductions. Joint Committee staff estimates that the number of taxpayers that itemize deductions dropped from 47.2 million in 2017 to 17.6 million in 2018, largely due to provisions of the 2017 Tax Act such as the increase in the standard deduction and the \$10,000 limitation on the deduction for State and local taxes. Additionally, the Joint Committee staff projects that the number of itemizers will increase from 20.7 million in 2025 to 53.7 million in 2026, as most of the 2017 Tax Act's changes to the individual income tax expire after 2025. Generally over this time period (2017 to 2026), 99 percent of taxpayers that itemize benefit from the deduction for State and local taxes.

⁴⁸ Economic income includes the annual flow of all resources at the command of an individual and represents an individual's total well-being. As a practical matter, the income concept used in distributional analyses needs to balance the goal of a measure that accurately reflects economic well-being with a measure that can be accurately constructed using available data sources. The concept developed by the Joint Committee staff for this purpose expanded income which is the sum of adjusted gross income, tax-exempt interest, employer contributions for health plans and life insurance, the employer share of payroll taxes, workers' compensation, nontaxable Social Security benefits, value of Medicare benefits in excess of premiums paid, minimum tax preferences, individual share of business taxes, and excluded income of U.S. citizens living abroad. For a detailed discussion of expanded income see Joint Committee on Taxation, *Overview of the Definition of Income Used by the Staff of the Joint Committee on Taxation in Distributional Analyses*, (JCX-15-12), February 8, 2012.

**Table 3.—Distribution of the Tax Expenditure Value of the Itemized Deduction
for State and Local Taxes, Selected Years**

Income Category (1)	Calendar Year 2019			Calendar Year 2025			Calendar Year 2026		
	Number of Returns Claiming a Deduction	Amount of Deduction Claimed	Tax Value of Deduction Claimed	Number of Returns Claiming a Deduction	Amount of Deduction Claimed	Tax Value of Deduction Claimed	Number of Returns Claiming a Deduction	Amount of Deduction Claimed	Tax Value of Deduction Claimed
	Millions	\$Billions	\$Billions	Millions	\$Billions	\$Billions	Millions	\$Billions	\$Billions
Less than \$10,000.....	0.1	0.3	(2)	0.1	0.3	(2)	0.3	1.0	(2)
\$10,000 to \$20,000.....	0.1	0.5	(2)	0.1	0.6	(2)	0.6	2.3	(2)
\$20,000 to \$30,000.....	0.2	0.9	(2)	0.2	1.1	(2)	1.1	3.8	0.1
\$30,000 to \$40,000.....	0.3	1.4	(2)	0.4	1.7	0.1	1.6	6.0	0.3
\$40,000 to \$50,000.....	0.5	2.1	0.1	0.6	2.7	0.1	2.1	8.4	0.6
\$50,000 to \$75,000.....	1.8	9.3	0.7	2.2	12.0	1.0	6.9	36.6	4.4
\$75,000 to \$100,000.....	2.2	13.9	1.5	2.6	18.1	2.1	7.0	49.0	7.5
\$100,000 to \$200,000.....	6.4	52.3	6.8	7.5	64.0	9.1	21.3	239.7	42.7
\$200,000 to \$500,000.....	4.5	43.5	7.7	5.0	48.3	9.4	10.3	247.3	40.4
\$500,000 to \$1,000,000.....	0.9	8.7	2.5	1.0	9.4	2.8	1.4	90.7	19.7
\$1,000,000 and over.....	0.5	5.1	1.5	0.5	5.3	1.6	0.7	210.0	55.2
Total, All Taxpayers.....	17.5	137.9	20.9	20.2	163.3	26.3	53.2	894.6	171.0

Source: Joint Committee on Taxation

Detail may not add to total due to rounding.

- (1) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: [1] tax-exempt interest, [2] employer contributions for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, [8] individual share of business taxes, and [9] excluded income of U.S. citizens living abroad. Categories are measured at 2019 levels.
- (2) Less than \$50 million.

Table 4 presents a distributional analysis for 2019 of a proposal to repeal the \$10,000 limitation on the deduction for State and local taxes beginning in 2019. The repeal is estimated to result in a decrease in tax liability for 13.1 million taxpayers, 94 percent of which have \$100,000 or more of economic income. Additionally, approximately 99 percent of the decrease in tax liability accrues to taxpayers with \$100,000 or more of economic income.

Table 4.—Distributional Effects of a Proposal to Repeal the Limitation on the Deduction for State and Local Taxes⁽¹⁾
Calendar Year 2019

Income Category (2)	Number of Taxpayer Units	Change in Tax Liability
	Millions	\$Billions
Less than \$10,000.....	(3)	(4)
\$10,000 to \$20,000.....	(3)	(4)
\$20,000 to \$30,000.....	(3)	(4)
\$30,000 to \$40,000.....	(3)	(4)
\$40,000 to \$50,000.....	(3)	(4)
\$50,000 to \$75,000.....	0.3	-0.1
\$75,000 to \$100,000.....	0.5	-0.3
\$100,000 to \$200,000.....	4.3	-4.0
\$200,000 to \$500,000.....	6.2	-18.2
\$500,000 to \$1,000,000.....	1.2	-14.4
\$1,000,000 and over.....	0.6	-40.4
Total, All Taxpayers.....	13.1	-77.4

Source: Joint Committee on Taxation

Detail may not add to total due to rounding.

(1) The proposal assumes the \$10,000 limitation on itemized deductions for State and local taxes is repealed beginning in 2019.

(2) The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus:
 [1] tax-exempt interest, [2] employer contribution for health plans and life insurance, [3] employer share of FICA tax, [4] worker's compensation, [5] nontaxable Social Security benefits, [6] insurance value of Medicare benefits, [7] alternative minimum tax preference items, [8] individual share of business taxes, and [9] excluded income of U.S. citizens living abroad. Categories are measured at 2019 levels.

(3) Less than 50,000.

(4) Less than \$50 million.

IV. DISCUSSION

The deduction for State and local taxes reduces the price of raising revenue through taxes for State and local governments. For example, suppose a taxpayer in the 22 percent Federal income tax bracket elects to itemize deductions and pays \$100 in State income taxes. The taxpayer may deduct \$100 and reduce Federal income tax liability by \$22, so the taxpayer pays a net total of \$78 dollars but the State receives \$100. The deduction can thus be viewed as a Federal subsidy for State and local spending. Whether or not such a subsidy is justified from a tax policy standpoint depends on the usual considerations of efficiency, fairness, and administrability, but the public debate over the deduction for State and local taxes mainly focuses on issues of efficiency and fairness.

State and local tax revenue is generally used to fund services provided by State and local governments. Critics of the deduction argue that State and local taxes are implicitly payments that taxpayers make for services, no different from other spending by taxpayers, including payments that taxpayers make for services from the private sector. Therefore, they argue, such payments should not be deductible from Federal taxable income, as doing so may inefficiently increase the volume of State and local services. Critics also view the deduction as inequitable, as the benefit of the deduction is unevenly distributed across income groups⁴⁹ and across geographic regions, as taxpayers with higher levels of income and in higher-tax States and localities are more likely to itemize.

Relating to efficiency, proponents of the deduction argue that State and local government spending on education, health, public welfare, and transportation benefit populations in other jurisdictions, and that these positive spillovers justify the cost of the deduction.⁵⁰ Relating to fairness, proponents argue that income used to pay State and local taxes diminishes the taxpayer's ability to pay Federal taxes. A deduction, they argue, provides a better measure of taxable capacity.

Empirical research on the deduction for State and local taxes can inform some aspects of this debate. Generally, the literature finds that States and localities alter the composition of State

⁴⁹ See Table 3, above.

⁵⁰ A tax deduction is not the only way to address potential positive spillovers. Direct spending through grants and loans could also be used.

and local revenue collection toward Federally deductible taxes.⁵¹ Some work also finds that the deductibility of State and local taxes may increase levels of State and local spending.⁵²

In addition to the \$10,000 limitation on the deduction for State and local taxes, the 2017 Tax Act modified other aspects of the Federal income taxation of individuals which has had a mechanical effect on how State income tax liability is calculated, and therefore affects State income tax collections. Some States use Federal taxable income, the Federal standard deduction, Federal personal exemptions, or Federal adjusted gross income in State income tax calculations. In addition, some States require consistency in the election to itemize deductions on Federal and State income tax returns. The changes to the Code made by the 2017 Tax Act along with other factors that affect State and local tax revenues, including the overall performance of the U.S. economy and changes to State and local tax law, have led to a modest increase in aggregate State and local tax revenue year over year.⁵³ Total State and local tax revenue for 2018 (\$1.48 trillion) is higher than for 2017 (\$1.42 trillion).⁵⁴

⁵¹ Bradley T. Heim and Yulianti Abbas, “Does Federal Deductibility Affect State and Local Revenue Sources?,” *National Tax Journal*, March 2015, pp. 33-58. Mary N. Gade and Lee C. Adkins, “Tax Exporting and State Revenue Structures,” *National Tax Journal*, March 1990, pp. 39-52. Martin S. Feldstein and Gilbert E. Metcalf, “The Effect of Federal Tax Deductibility on State and Local Taxes and Spending,” *Journal of Political Economy*, August 1987, pp. 710-736.

⁵² Douglas Holtz-Eakin and Harvey S. Rosen, “Tax Deductibility and Municipal Budget Structure,” *Fiscal Federalism: Quantitative Studies*, 1998, pp. 107-136. Gilbert E. Metcalf, “Assessing the Federal Deduction for State and Local Tax Payments,” *National Tax Journal*, June 2011, pp. 565-590.

⁵³ State and local governments also receive direct transfers from the Federal government and raise substantial amounts from nontax charges. See Table 1, above.

⁵⁴ United States Census Bureau, Quarterly Summary of State and Local Tax Revenue, Historical Table 1, retrieved June 18, 2019.