POLICY PAGE

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

The U.S. Congress may renew a provision that allows taxpayers to deduct their state and local sales tax payments in calculating federal taxable income. Most Texas families would gain absolutely nothing from this extension. Only one-fifth of Texas taxpayers – disproportionately those with higher incomes – deducted sales tax payments on their 2004 tax returns.

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 to help cover the cost of property tax cuts passed in the recent special session, all that most Texans would see is a higher sales tax – not an increase in their federal income tax deductions.

CONGRESS TEMPORARILY MADE SALES-TAX PAYMENTS DEDUCTIBLE FROM FEDERAL TAXABLE INCOME FOR THE PAST TWO YEARS

Taxpayers were allowed to deduct state and local sales-tax payments in calculating their taxable income on their federal income tax returns in tax years 2004 and 2005. Unless Congress acts during its lame-duck session before the end of the year, the deduction will expire. The size of the federal deficit and its long-term impact on our future standard of living raise doubts whether the Congress should renew this provision.

MOST TEXAS TAYPAYERS DON'T ITEMIZE THEIR DEDUCTIONS, SO DO NOT BENEFIT

In order to benefit from the 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. To get any benefit from the sales-tax deduction, a family would have to accumulate more than $10,300 (the standard deduction for the 2006 tax year) in mortgage interest, property taxes, or other deductible expenses.

In 2004, the most recent year that detailed data are available from the Internal Revenue Service, (http://www.irs.gov/pub/irs-soi/04in44tx.xls) only 20% of Texas taxpayers deducted sales-tax payments on their federal income tax returns. Moreover, the benefit of the deduction was concentrated among the highest income taxpayers. Nearly two-thirds of Texas taxpayers with adjusted gross incomes of more than $100,000 (who accounted for only 9% of all returns) benefited from the sales-tax deduction. In fact, 30% of all returns claiming the sales-tax deduction came from this small group of high-income taxpayers. In contrast, only 8.6% of those with adjusted gross incomes under $50,000 – 72% of all Texas returns – deducted sales taxes. The vast majority of Texas taxpayers took the standard deduction, so did not benefit from the sales-tax deduction.

The comptroller estimates that itemizing households could save an average of $408: http://www.cpa.state.tx.us/comptrol/ajca2004/ajca2004.pdf. The average Texas household, which qualifies only for the standard deduction, saves absolutely nothing.

Even among the minority of taxpayers who did take the sales-tax deduction, the benefit for most was smaller than the comptroller's estimate. The tiny portion of families with adjusted gross incomes under $50,000 who claimed the deduction had an average deduction of $1,017, which reduced their taxes by about $150 at their marginal tax rate of 15%. In contrast, those families with an adjusted gross income over $200,000, who account for only 2% of all returns filed, had an average deduction of $3,522. The benefit of this larger deduction was compounded by their higher tax rate – 33% in most cases – reducing their income tax liability by roughly $1,160.

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/incidence05), the one-fifth of Texas families with an annual income under $21,800 pay an average of 5.8 percent of that income in state sales taxes, while the one-fifth of families with an income over $96,700 pay an average of only 1.7 percent of their income in state sales taxes.

The sales-tax deduction only exacerbates this regressivity. 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 incomes. Families with the highest taxable income have a higher marginal tax rate, so they derive a greater reduction in their tax bill for each dollar deducted from their taxable income than does a family in a lower tax bracket. 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 tax rate.

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.
