



Insight

State and Local Tax Deductions: Implications for Reform

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Introduction

Congress is contemplating eliminating the State and Local Tax (SALT) deduction as part of fundamental tax reform. This analysis presents the tax effects of the current-law treatment of state and local taxes and assesses the implications of its elimination in favor of broader rate reduction

Current Law

Under current law, for purposes of determining their regular income tax liability, tax payers may deduct certain State and local taxes paid, including individual income taxes, real property taxes, and personal property taxes. The itemized deduction is not permitted for purposes of determining a taxpayer's alternative minimum taxable (AMT) income. Taxpayers may elect to deduct state and local general sales taxes in lieu of state and local income taxes. Like all deductions, the value of this tax provisions increases with a taxpayer's tax rate, and as an itemized deduction, it typically benefits higher income taxpayers. For most taxpayers, specifically the 2/3 of Americans who take the standard deduction, this tax provision provides no benefit. While taxpayers tend to itemize deductions as their incomes increase, above a certain threshold, the value of these deduction is subject to limitation, known as Pease.

Implications for Taxpayers of Repealing the SALT Deduction

The SALT deduction effectively reduces a taxpayer's marginal income tax rate. Indeed, as state and local income tax payments increase with income, so too does the federal deduction. The value for individual taxpayers, and thus the tax implications for repeal varies by individual circumstance and jurisdiction, but the examples below provide an illustration

of the value of the deduction for hypothetical taxpayers in different jurisdictions.

State	CALIFORNIA	CONNECTICUT	NEW YORK	ILLINOIS
	\$500,000	\$500,000	\$500,000	\$500,000
AGI	under	under	under	under
	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
Effective Rate state	11%	10%	12%	7%
Federal Rate	39.6%	39.6%	39.6%	39.6%
SALT	-4.43%	-3.88%	-4.62%	-2.63%
Pease	1.19%	1.19%	1.19%	1.19%
SALT + Pease	-3.24%	-2.69%	-3.43%	-1.44%

For higher tax states such as California, Connecticut, New York, and Illinois, average tax payments for this selection of representative taxpayers combine to 11, 10, 12, and 7 percent, respectively. This reflects combined tax payments for income and property taxes and for a smaller selection of taxpayers, deductible sales taxes. These payments are deductible against the applicable federal tax rate of 39.6 percent. The effect of this combination reduces a taxpayer’s federal tax liability by 39.6 percent times the tax payments. For the example above, this amounts to the effective state rate times the federal rate. So, for California, the SALT deduction provides an effective tax rate cut of 4.43 percent.

Complicating this calculation is Pease, which reduces (for most effected taxpayers) the value of tax deductions for taxpayers over a certain income threshold. In general, this provision acts as a surtax, in effect adding back some of the effective rate reduction provided by the SALT deduction. Thus, for the representative taxpayer in California, the value of the SALT deduction (all else being equal) is reduced by Pease from 4.43 percentage points to 3.24 percentage points.

Repealing the SALT deduction would raise about \$1.3 trillion over ten years, which could be used to reduce income tax rates. The rate reduction needed to keep a taxpayer “whole” if the SALT deduction were repealed is the amount of the value of the SALT deduction, limited by Pease. So, for the illustrative California taxpayer, this would be 3.24 percent. Note, this would vary by individual circumstances and jurisdictions, but provides a range of 1-3 percentage points for the value of this deduction to taxpayers.