August 2015

HOT TOPIC ALERT

Prepared for NAR by Legal Research Center, Inc.

STATE AND LOCAL TAX DEDUCTIONS

Property taxes imposed by state and local governments can be a serious burden on homeowners. The average American household has an annual property tax bill of $2,089. But there is one way homeowners can feel better about property taxes: Section 164(a)(1) of the Internal Revenue Code allows taxpayers to take a deduction for real estate taxes paid to state, local, and foreign governments.

The deduction—sometimes referred to as the SALT (State and Local Tax) deduction—has a long history. Property taxes have been deductible from federal income tax since 1913, when our modern income tax was first adopted. The deduction's political and economic supporters tend to focus on the deduction as an indirect way for the federal government to recognize that state and local governments provide necessary services that the federal level does not provide. In this way, the deduction prevents double taxation: without the deduction, taxpayers would be paying tax on funds already paid as taxes to state or local governments.

Although the deduction for state and local taxes is a long-standing feature of the federal tax code, there have been many calls for its repeal. So far, though, the deduction has proved to be too popular to remove. The U.S. Treasury Department called for the repeal of the deduction in 1984. In 1985, President Reagan's tax reform proposal would have followed the Treasury Department's recommendation and repealed the deduction. A renewed Congressional interest in tax reform in the early 2000s led to renewed proposals to abolish the deduction. Three major tax reform proposals made since 2005—the 2005 Presidential Advisory Panel on Federal Tax Reform, the Rivlin/Domenici plan, and the Simpson-Bowles National Commission on Fiscal Responsibility and Reform—all advocated outright repeal.

The 2014 tax simplification plan proposed by Rep. Dave Camp (R-MI), then Chairman of the House Ways and Means Committee, also would have repealed the deduction, leading Senator Charles Schumer (D-NY) to declare that Rep. Camp's proposal was "dead on arrival."

NATIONAL ASSOCIATION of REALTORS®
REALTOR PARTY

Not all recent tax reform proposals would do away with the deduction. The Wyden-Coats Bipartisan Tax Fairness and Simplification Act, legislation introduced in 2010 by Senators Ron Wyden (D-OR), Dan Coats (R-IN), and Mark Begich (D-AK) would have preserved the deduction. This plan would, however, have tripled the amount of the standard deduction. Greatly increasing the standard deduction would lead to far fewer taxpayers claiming itemized deductions, and thus much less direct offsetting of property taxes. As an alternative approach, a tax reform plan proposed in 2012 by the policy research and advocacy group Center for American Progress would replace the deduction with an 18 percent tax credit.

The interest in tax reform remains, but restructuring efforts may have to wait for the election of a new president. As of mid-2015, no active initiatives aim to repeal the property tax deduction. President Obama's proposed budget for the 2016 fiscal year does not specifically call for the deduction for state and local property taxes, although the value of most itemized deductions would be limited to 28percent of each dollar of deduction. While the deduction's place in the tax law appears to be safe for now, tax reformers will undoubtedly raise the issue again.

JUDGING FAIRNESS

All tax reform plans *claim* to be fair, but fairness is highly subjective, especially for taxation. Whether a tax system is fair is very much in the eye (or the wallet) of the beholder.

Many Americans view progressive tax systems—those in which higher-income taxpayers pay more—as being more fair. But many state taxes tend to be regressive, falling more heavily on lower and middle-income taxpayers. Since property taxes proceed from property value, rather than from the taxpayer's income or ability to pay, property taxes cannot be said to be progressive.

Recent research shows that a federal deduction for state and local taxes makes those taxes more progressive. Deductibility leads to a greater reliance by states on income taxes, which tend to be more progressive than other types of taxation. Howard Chernick, professor of economics at Hunter College, calculates that raising the number of taxpayers who itemize and take a deduction for state and local taxes increases the progressivity of their states' tax structures by ten percent. In other words, if progressivity is an accurate measure of tax system fairness, the availability of the deduction can help nudge a state's tax laws towards greater fairness.

One of the persistent criticisms of the deduction for state and local taxes is that it mostly benefits higher-income taxpayers. Anecdotal reports of rich individuals taking large deductions lend credibility to those criticisms. While some may continue to debate the policy behind the deduction, there is no question that it is a great benefit for many homeowners of all income levels.

HOW MUCH PROPERTY TAX MAY I DEDUCT?

Virtually all real property taxes are deductible for federal income tax purposes. Unlike other deductions, such as the mortgage interest deduction, there is no dollar limit to the amount of property taxes that may be deducted. Plus, the deduction may be taken for *all* the properties that a taxpayer owns. It is not limited to taxes paid on first and second homes, or even to properties inside the country. A U.S. taxpayer who owns taxed real estate overseas may deduct the property taxes paid there for that property.

There are, however, some limitations as to *when* the deduction is available.

- You cannot claim the property tax deduction if you don't itemize.
- In order to be deductible, the "charge must be uniform against all real property in the jurisdiction at a like rate." That is to say, deductible property tax must be based on the value of the property. This definition would include general real property tax levies, but excludes special assessments, even for public improvements such as sidewalks or sewers.

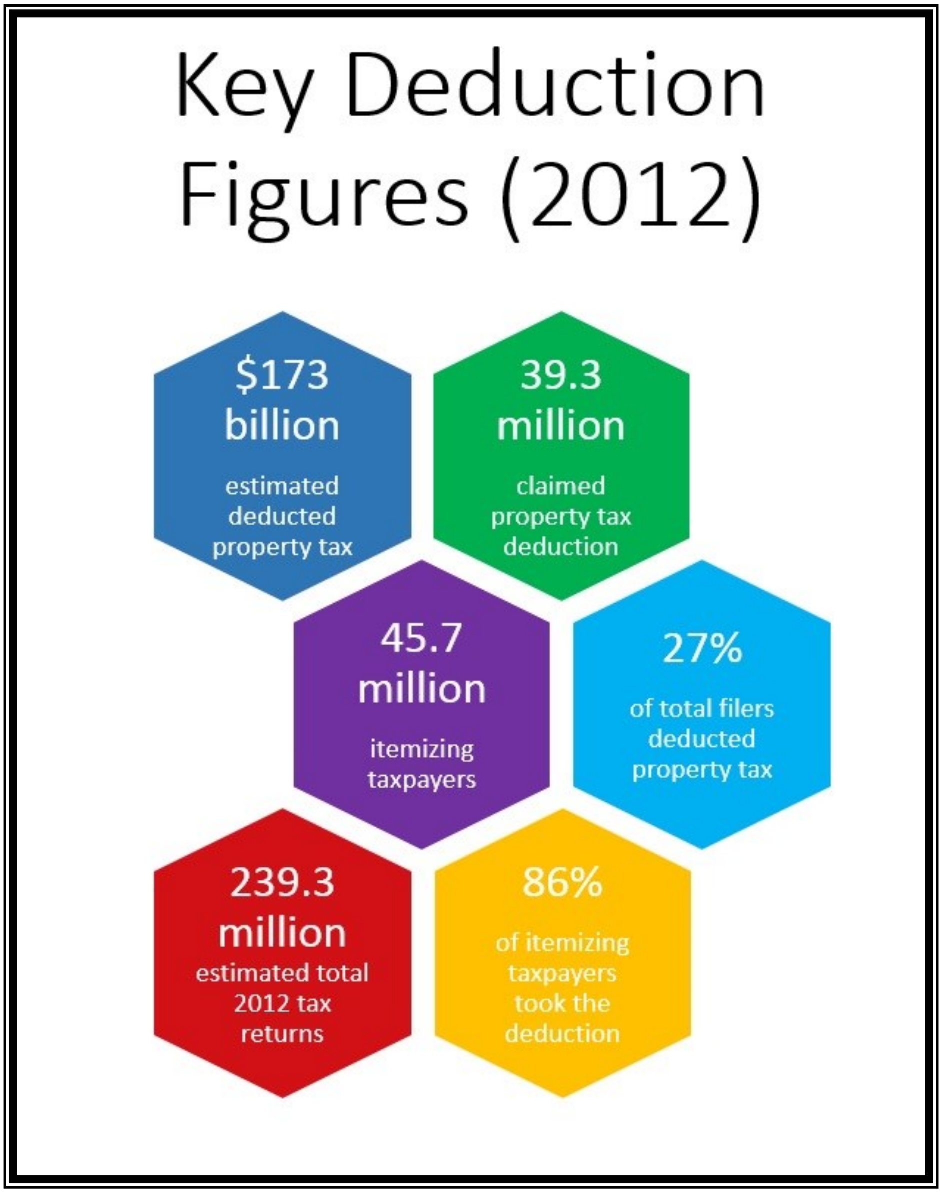
The IRS also disallows deductions for service charges, even if your community refers to such a charge as a "tax." Therefore, a "water tax" or "sewer tax" that takes the place of a water or sewer bill will not be deductible. Neither are real estate transfer taxes deductible, even though they decrease the amount realized for the property if paid by the seller, or will be included in the basis of the property if paid by the buyer.

WHO TAKES THE DEDUCTION?

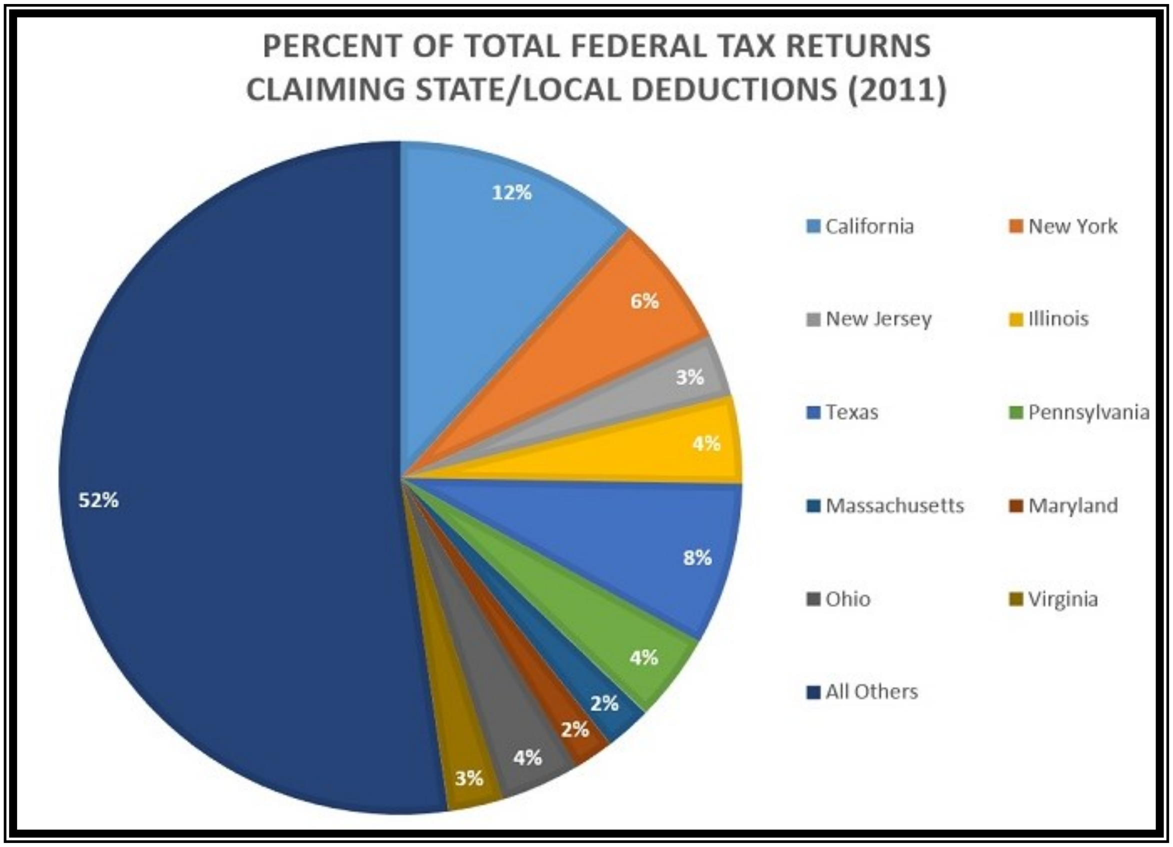
Most taxpayers who itemize deductions claim the deduction for real property taxes. According to the Congressional Research Service, 39.3 million of the taxpayers who itemized deductions on their 2012 tax returns claimed the deduction. That's 86% of itemizers, and slightly more than 27% of all income tax returns filed that year. The IRS estimates that the total of real property taxes deducted from income taxes in 2012 was over $173 billion.

STATES THAT DEDUCT

The deduction for state and local taxes is sometimes referred to as the "blue state tax break." The claim is that the deduction is primarily a benefit for taxpayers in high-tax states that are presumed politically liberal. Although the deduction is available to taxpayers in every state, taxpayers in high-tax states receive more of the benefit from the deduction. This stands to reason: in a progressive income tax system like ours, any deduction is going to channel more of its benefits to those who incur the highest deductible expenses.



The following chart uses information from the Tax Policy Center to show the top states where taxpayers claimed deductions for state and local taxes on their 2011 federal returns. As you can see, ten states contribute almost half of these returns. California and New York had the highest percentages of federal returns filed.



AT THE STATE LEVEL

Most state governments rely on income tax for a high percentage of their revenue. Forty-one states and the District of Columbia impose income taxes. In most of these states, taxpayers may take an “indirect” deduction for property taxes on their state income tax returns.

The deduction is “indirect” because eligible taxpayers may already have taken the deduction on their federal income tax returns. Most states base their income taxes on federal law, which is why many state income tax returns instruct taxpayers to list their federal adjusted gross income—income after federal deductions have been taken—as the starting point for state tax purposes. (Some states, such as Virginia, use a taxpayer’s federal adjusted gross income, but require that certain deductions be added back in for state returns.) California even launched a campaign to remind taxpayers that the property tax deduction is available at both the state and federal levels.

New Jersey is said to have the heaviest average property tax burden in the nation. The state's tax relief for property taxes takes an unusual form. First, unlike other states that limit the eligibility for the deduction to homeowners, renters are eligible for relief. Renters receive either an income tax deduction or credit if they used the rented property as their principal residence during the tax year, and if property taxes were in fact paid on the property (residents of tax-exempt property, including government-owned or on-campus apartments, are ineligible). Eligible renters are considered to have paid 18% of their share of the rent paid during the year for property taxes. Second, taxpayers may qualify for either a deduction or a tax credit for property taxes paid. The maximum deduction is $10,000.

In a very few states, taxpayers are allowed a double deduction for their property taxes. In Arizona, Georgia, Hawaii, Louisiana, North Dakota, and Oklahoma, taxpayers who itemize may also claim the deduction on their state tax returns. Their adjusted gross income is the same as that reported on their federal returns (with the property tax deduction already taken), and state property taxes are deducted again. The double-deduction is very popular in those states.

Some states are changing approaches on property tax deductions. Vermont, which formerly allowed the deduction, repealed its separate deduction for state and local taxes in 2015. Proposals to repeal Louisiana's deduction repeatedly appear before the legislature there. Hawaii limits the availability of the deduction to taxpayers who file singly and have incomes less than $100,000, or those filing jointly who have incomes of less than $200,000 (*see* section 235-2.4 (i), Hawaii Revised Statutes).

Wherever they are located, homeowners are often unaware of state-level property tax deductions. It's worth looking in your own jurisdiction for the current local rules. In short, if you or your clients pay property taxes, look into *all* the ways that expense may be deducted.

FLATTENING THE TAX

Eight states (Colorado, Illinois, Indiana, Massachusetts, Michigan, North Carolina, Pennsylvania, and Utah) have flat income tax systems. Under a flat income tax, all taxpayers pay the same rate regardless of their income. For example, all taxpayers in Massachusetts pay an income tax of 5.2% of their earned and unearned income (the rate dropped to 5.15% for the 2015 tax year). Other states often discuss flat taxes, and many politicians support proposals for a flat federal income tax. So far, though, the idea has not caught on in other jurisdictions.

The arguments for a flat tax vary, but a common one is that a flat tax would be simpler. With only one tax rate, calculating tax liability is simple arithmetic. That simplicity is achieved not only by having only one tax rate, but by eliminating most or all deductions now allowed.

Does this mean that taxpayers in one of the flat tax states get no income tax benefit from paying property taxes? Not necessarily. In four states with flat tax systems—Colorado, Michigan, Massachusetts, and North Carolina—state taxable income is the same as the taxpayer's federal adjusted gross income. If a taxpayer deducted property taxes from income on a federal tax return, those taxes have effectively been deducted from state taxable income. Taxpayers in Utah also deduct the sum of their federal itemized deductions from their income for state tax purposes.

Indiana allows a deduction for property taxes, but the deduction is capped at $2,500. Any part of the property taxes that have been claimed as a business deduction on the taxpayer's federal return may not be deducted from the taxpayer's Indiana return. Illinois grants taxpayers a credit for taxes paid, instead of a deduction. The credit is equal to five percent of the Illinois property tax paid on the taxpayer's principal residence. Meanwhile, taxpayers in Pennsylvania are denied the deduction.

LOOKING FORWARD

Taxation is always an active topic: politicians love to make tax promises, while citizens love to hate the tax system. When property owners can deduct some of their home property taxes, those bills, at least, are more palatable. While the deduction is a stable feature of federal – and sometimes, state – tax regimes, it is worth keeping a close eye on outlier proposals that could threaten the deduction, thereby hurting home ownership.

Contact for NAR Hot Topic Alerts or State Issues Tracker

Adriann Murawski
State & Local Government Affairs Representative
500 New Jersey Avenue, NW
Washington, DC 20001
amurawski@realtors.org
202-383-1068

NATIONAL ASSOCIATION of REALTORS® | REALTOR PARTY