Special Report

June 2004 (updated from March 2002)

Restoration of the IRS Sales Tax Deduction Should be One of Texas' Main Priorities in Congress

> *"The current discriminatory treatment of Texas taxpayers is taking $740 million out of Texans' pockets and costing our state an estimated 16,573 jobs each year."*
> -- Carole Keeton Strayhorn

Currently, the citizens of Texas and seven other states are discriminated against because they cannot take any tax deduction comparable to the state and local income tax deductions enjoyed by the citizens of virtually all other states and the District of Columbia. In an attempt to alleviate this disparity, in March 2002, Comptroller Strayhorn issued a special report proposing to restore much of the federal sales and motor vehicle sales tax deductions that citizens of Texas were last able to itemize on their federal income tax returns for the 1986 tax year. This special report updates the Comptroller's 2002 original report.

TABLE 1
Citizens in Eight States Are Denied Fair and Equitable Tax Treatment Because They Have No State Income Tax

Alaska	South Dakota	Washington
Florida	Tennessee*	Wyoming
Nevada	**Texas**	

* Certain interest and dividend income is taxed.
Note: Like Tennessee, New Hampshire has only a partial income tax on interest and dividends, but it has no general sales tax.

Source: Carole Keeton Strayhorn, Texas Comptroller.

Comptroller Strayhorn's plan would grant taxpayers in all states the option of deducting either their state and local sales and motor vehicle sales taxes or their state and local individual income taxes on their Form 1040. While such an option would not fully restore the original deduction, which allowed deductions for sales *and* income taxes, it would go a long way toward restoring fundamental equity for taxpayers in those states that do not impose income taxes on their residents, and at minimal cost to the federal budget.

There is legislation before Congress that tracks the Comptroller's plan. On February 12, 2003, Representative Kevin Brady (R-Texas) introduced H.R. 720; and on February 27, 2003, Senator Kay Bailey Hutchison (R-Texas) introduced companion legislation, S. 467, in the Senate. Both bills would grant taxpayers in all states the option of itemizing a deduction for either their state and local sales (including motor vehicle sales) taxes or income taxes paid, but not both. The bills would limit the deduction to a specific amount prescribed in a table (individualized for each state) providing deductible amounts by family size and income group. Taxpayers, however, would not have the option of deducting actual taxes paid, as they had in 1986 and before. H.R. 720 claims among its 77 co-sponsors all but three of the 32 representatives in the Texas delegation; S. 467 is co-sponsored by Texas Senator John Cornyn. On June 4, 2004, House Ways and Means Committee Chairman Bill Thomas (R-California) added similar legislation (albeit effective only for the 2004 and 2005 tax years) to H.R. 4520, a far-reaching corporate tax measure. On June 17, the full House approved H.R. 4520 by a vote of 251 to 178. Unfortunately, no sales tax deduction option was included in the corresponding legislation passed by the Senate, S. 1637, leaving ultimate resolution subject to conference committee debate.

TABLE 2
Sponsors and Co-sponsors of Proposed Federal Legislation that Would Partially Restore the Sales Tax Exemption for Federal Income Tax Purposes

S. 467 (introduced 2-27-03)
Sponsor:
Hutchison, Kay Bailey (R-Texas)

Seven Co-Sponsors, Including:
Cornyn, John (R-Texas)

H.R. 720 (introduced 2-12-03) Sponsor:
Brady, Kevin (R-Texas)

77 Co-Sponsors, Including 28 of Texas' 32 Representatives:

Barton, Joe (R)	Bell, Chris (D)	Bonilla, Henry (R)	Burgess, Micha
Carter, John R. (R)	Culberson, John Abney (R)	Edwards, Chet (D)	Frost, Martin (D
Gonzalez, Charles A. (D)	Granger, Kay (R)	Green, Gene (D)	Hall, Ralph M.
Hensarling, Jeb (R)	Hinojosa, Rubén (D)	Jackson Lee, Sheila (D)	Johnson, Eddie
Johnson, Sam (R)	Lampson, Nick (D)	Neugebauer, Randy (R)	Ortiz, Solomon
Paul, Ron (R)	Reyes, Silvestre (D)	Rodriguez, Ciro (D)	Sandlin, Max (
Sessions, Pete (R)	Smith, Lamar (R)	Thornberry, Mac (R)	Turner, Jim (D

Source: Congressional bill summaries. (Number and identity of co-sponsors is subject to change.)

Texans lost their sales tax deductions in the last-minute deal making behind the Tax

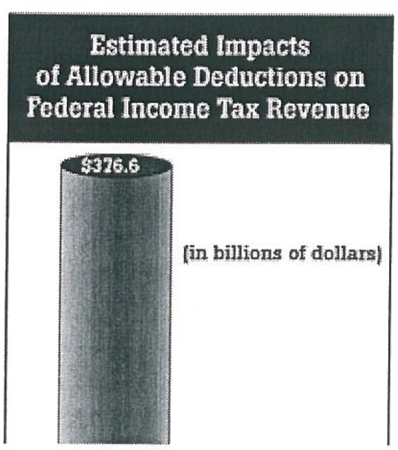
Reform Act of 1986. In May 1985, President Reagan presented Congress a sweeping proposal to reform the national tax system in the interests of fairness, growth, and simplicity. Designed as "revenue-neutral," the idea was to reduce tax rates while eliminating almost all of what had become a complex system of itemized deductions, including *all deductions for state and local taxes*—whether based on income, property, or sales.

The following year, Congress embraced the president's proposal in the Tax Reform Act of 1986 (TRA86). In the process, however, President Reagan's proposal to eliminate the deduction for all state and local taxes was watered down to affect only state and local sales taxes, leaving the deductions for income and property taxes untouched—directly contravening the president's original goal of fairness.

Before passage of TRA86, all individuals were allowed to take separate income tax deductions for their payments of state and local sales taxes and motor vehicle sales taxes. For the sales tax, individuals were allowed to deduct either the actual amount paid, or they could use an optional sales tax table that provided deductible amounts for each state (based on its rate and base) by income group and family size. For example, a family of four with an income of $33,000 was allowed to deduct $306 in state sales taxes in Texas, but $508 in Tennessee; and in both instances, taxpayers were allowed to include an additional amount for local taxes paid. Motor vehicle sales taxes paid were deductible on a separate line.

The deduction of state and local sales taxes was one of the last (and most contentious) items considered by the Senate, but the final efforts to restore at least some vestige of the deduction, led in part by Senator Phil Gramm, ultimately failed. The argument put forth by members from the states that retained their state and local income tax deduction was that the losses attributable to the repeal of the sales tax deduction would be more than made up for by the increased personal exemption, and that the sales tax deduction only benefited the rich, because lower-income groups are less likely to itemize.

The Comptroller's plan could be put in place for less than 1 percent of the cost of currently existing deductions. Because the precise wording of the federal legislation is subject to negotiation and compromise, any estimate of its cost is only preliminary. Based on the June 16, 2004 Congressional Budget Office cost estimate for the sales tax deduction option in H.R. 4520, the 2005 loss in federal tax receipts would be $2.2 billion. Putting the federal cost in perspective, all currently allowable income tax deductions are expected to cost on the order of $376.6 billion in federal fiscal 2005. As such, reinstatement would produce an increased cost to the federal government of only 0.6 percent.



Comptroller Strayhorn's plan could be put in place with virtually no increase in complexity. Although the sales tax deductions were eliminated in part for reasons of tax simplification, the proposed legislation before Congress would add only one more line to Schedule A, for those taxpayers electing to itemize on their Form 1040. If actual sales taxes paid were allowed to be deducted, the federal costs would increase, but there would be an addition of only two lines on the tax form: one for general sales taxes paid, and one for motor vehicle sales taxes paid.

Equity and fairness demand that tax discrimination against Texans be eliminated. Reinstatement of the deduction for sales taxes would eliminate the fundamental disparity created by TRA86, when citizens in states with a personal income tax were permitted to deduct such taxes, but citizens in states without an income tax had no corresponding deduction. The net effect of this disparity is that Texans and the citizens of most other states without a general individual income tax pay a greater percentage of taxes to the federal government than do citizens living in their neighboring states with income taxes. In other words, the federal tax law currently treats the same individual differently on the basis of residence. Providing individuals in all states the choice to deduct one or the other of their sales or income taxes would restore equity and fairness for all U.S citizens at minimal cost.

The Comptroller's plan would put more money in Texans' pockets. As with everything else in the IRS Code, the details matter, and even subtle differences in legislation can have major revenue implications, making any revenue estimates of the ultimate legislation difficult. Assuming that the federal tax deduction table fairly and accurately portrayed Texans' sales tax and motor vehicle sales tax payments, restoration of the sales tax deduction could be expected to save Texans—in the aggregate—on the order of $740 million in the 2004 Tax Year. The corresponding average savings per itemizing Texas household would be $310.

While the deduction only would go to taxpayers who itemized their deductions, more Texans at lower income levels would find it to their benefit to itemize. Right now, roughly one in five tax returns filed by Texans itemizes deductions, compared to one in three nationwide. The chief reason for this is that citizens of most other states and the District of Columbia enjoy a deduction that is not available to Texans. Restoration of the deduction for sales taxes paid would go a long way towards lifting Texas closer to the national average. In other words, the availability of the deduction would benefit not only those who currently itemize, it would benefit an additional number of lower-income households that would find it to their advantage to itemize.

The Comptroller's plan would create more jobs, economic growth, and state tax receipts with absolutely no state tax or spending increase. Keeping $740 million in the hands of Texas taxpayers each year would provide a significant boost to the state economy. Assuming that the deduction could be taken on income tax returns filed in 2005 and would continue thereafter, the tax savings could generate 16,573 new Texas jobs, $623 million in new Texas investment, and $923 million in increased Texas Gross State Product, according to an economic analysis conducted by the Comptroller's revenue estimating division. The increased economic activity in turn could be expected to boost general revenue by $37.8 million in the two-year period 2005-06. Most of this revenue would come from increased sales and motor vehicle sales tax collections.

Comptroller Strayhorn's plan promises a win-win situation for all Texans, even those who do not itemize. To the extent that keeping more Texas income in Texas, where it belongs, instead of sending it off to Washington, all Texans would benefit from the increased employment opportunities and investment. All things considered, it is difficult to find a downside for Texas to the reinstatement of the sales tax deduction. The Comptroller's plan would be a straight-up win for the state, a victory for tax equity among the states, and it would provide a desirable, welcome boost to restoring statewide economic and revenue growth.

TABLE 3 Potential Deductions from Federal Taxable Income for Texas Families, Tax Year 2004						
	Family Size					
Adjusted Gross Income	**1**	**2**	**3**	**4**	**5**	**6+**
$0 to $17,056	$306	$336	$358	$370	$382	$400
$17,056 to $25,583	$385	$424	$452	$470	$485	$506
$25,583 to $34,111	$491	$540	$573	$597	$615	$643
$34,111 to $42,639	$588	$649	$685	$715	$737	$770
$42,639 to $51,167	$676	$749	$791	$825	$852	$888
$51,167 to $59,695	$764	$843	$891	$928	$958	$1,000
$59,695 to $68,222	$846	$934	$988	$1,028	$1,061	$1,110
$68,222 to $76,750	$925	$1,019	$1,079	$1,125	$1,161	$1,213
$76,750 to $85,278	$1,000	$1,103	$1,152	$1,219	$1,258	$1,313
$85,278 to $102,334	$1,113	$1,228	$1,297	$1,352	$1,398	$1,458
$102,334 to $119,389	$1,252	$1,382	$1,464	$1,525	$1,573	$1,643
$119,389 to $136,445	$1,388	$1,531	$1,622	$1,689	$1,743	$1,822
$136,445 to $153,500	$1,516	$1,673	$1,773	$1,846	$1,907	$1,992
$153,500 to $170,556	$1,643	$1,813	$1,919	$2,001	$2,064	$2,155
$170,556 or more	$1,764	$1,946	$2,061	$2,140	$2,216	$2,316
Source: Carole Keeton Strayhorn, Texas Comptroller.						

SALIENT FEATURES OF COMPTROLLER STRAYHORN'S PLAN

- Legislation tracking the Comptroller's plan would cost the federal government $2.2 billion in 2005—less than 1 percent of the estimated $377 billion cost of currently allowable federal deductions.
- Texans would save $740 million, an average of $310 per itemizing household, on their federal taxes each year.
- The estimated tax savings would be expected to generate 16,573 new Texas jobs, $623 million in new Texas investment, and $923 million in increased Gross State Product in 2005.
- The increased economic activity could be expected to boost general revenue-related state tax receipts for the two-year period 2005-06 by $37.8 million.
- Assuming that the federal tax deduction table fairly and accurately portrayed Texans' sales tax and motor vehicle sales tax payments, a family of four with an estimated median income of $57,945 would be able to deduct an additional $928 to calculate taxable income, and a single mother of one with an income of $34,500 could deduct an additional $649.
- The current system discriminates against Texans and the citizens of other states that have opted to finance their budgets without personal income taxes. The Comptroller's

plan is necessary to restore fairness and equity in the treatment of those state taxpayers who currently do not benefit from the tax deductions enjoyed by the citizens of 41 other states and the District of Columbia.

Carole Keeton Strayhorn
Texas Comptroller of Public Accounts