FORCING FAIRNESS IN STATE TAXATION

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On November 1, 2005, the President's Advisory Panel on Federal Tax Reform (hereafter "Panel") issued its report entitled *Simple, Fair & Pro-Growth: Proposals to Fix America's Tax System.*[1] The Panel stated as its hoped for accomplishments:

> The Simplified Income Tax Plan dramatically simplifies our tax code, cleans out targeted tax breaks that have cluttered the system, and lowers rates. It does away with gimmicks and hidden traps like the Alternative Minimum Tax. It preserves and simplifies major features of our current tax code, including benefits for home ownership, charitable giving, and health care, and makes them available to all Americans.[2]

The plan included among its features:

> Extension of important tax benefits for home ownership and charitable giving to all taxpayers, not just the 35 percent who itemize;[3]
>
> Elimination of the Alternative Minimum Tax...[4]
>
> Elimination of the deduction for state and local taxes.[5]

This last proposal contradicts that stated goals the Panel hopes to accomplish. If the Panel's recommendations are to be seriously considered, what follows in this article will recommend that state and local taxes be available "not just [for] the 35 percent who itemize," which is the law as it stands now. Instead, a federal tax benefit for state and local taxes, in the form of a credit,

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[1]PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM (Nov. 1, 2005), *available at* http://www.taxreformpanel.gov/final-report/.

[2]*Id*. at Introduction p.5.

[3]*Id.* at xiv. Section 301 of the Tax Relief Act of 2005, S. 2020, passed by the Senate on November 18, 2005, would grant this relief for charitable contributions in excess of $210 for individuals and $420 for married couples. The Tax Relief Extension Reconciliation Act of 2005, H.R. 4297, the House tax bill, contains no such provision. *See,* Lynnley Browning, *Senate's Tax Bill Includes Incentives for Charity Gifts*, N.Y. TIMES, November 22, 2005, at A21.

[4]PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note at xiv.

[5]*Id*. at 83.

should be available for all taxpayers.

In considering the possible elimination of the deduction for state and local taxes, Congress should consider that state budgets are in trouble. One estimate is that in the fiscal years ending June, 2003, states faced revenue shortfalls of $21.5 billion, in some cases as much as 25% of their annual budget and state governments were faced with some politically unpalatable choices to remedy the shortfall.[6] For the following fiscal year (2003-2004), one analyst suggests that California alone faced a deficit of $34.6 billion.[7] In 2003, Congress attempted to remedy this problem with $20 billion in aid over two years, but it was a temporary measure that expired in June, 2004.[8] Constitutional balanced budget requirements in many states as well as difficulties in enacting tax increases at the state level contribute to funding problems.[9]

This article will suggest that, at least for states with a low income tax, a modest amendment to the Internal Revenue Code, changing the deduction for state income taxes[10] to a credit, will help states find a politically acceptable way to end the crises. The cost will be some loss of Federal revenue, but making up for that loss will be the focus of someone else's article.[11] Walter Heller advocated a credit forty-five years ago and it is appropriate to reexamine his recommendation.[12] The Panel's recommendations, part of an effort by the Bush administration to overhaul the Internal Revenue Code, advocate eliminating the deduction for state and local taxes to finance elimination of other undesirable taxes, such as those on savings and investment.[13] The report, while recommending such elimination, also made a recommendation on mortgage interest similar

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[6]*The Head Ignores the Feet*, THE ECONOMIST, May 24, 2003, at 27.

[7]Kirk J. Stark, *The Uneasy Case for Extending the Sales Tax to Services*, 30 FLA. ST. U. L. REV. 435, 447 n.54 (2003).

[8]Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, §§ 401, 601, 117 Stat. 752 (2003), enacting 42 U.S.C. 801, which by its own terms expired on October 1, 2004. *See also* Susan Kalinka, *Highlights of the 2003 Jobs and Growth Tax Relief Reconciliation Act: Economic Stimulus or Long-term Disaster?,* 64 LA. L. REV. 219, 264 (2004).

[9]Tracy A. Kaye, *Show Me the Money: Congressional Limitations on State Tax Sovereignty*, 35 HARV. J. ON LEGIS. 149, 150 (1998).

[10]I.R.C. § 164(a)(3) (2005).

[11]The loss to the Federal government in 1995 was some $40 billion. *See* Louis Kaplow, *Fiscal Federalism and the Deductibility of State and Local Taxes Under the Federal Income Tax*, 82 VA. L. REV. 413, 415 (1996). *See also* Office of Management & Budget, Executive Office of the President of the U.S., Budget of the U.S. Government: Analytical Perspectives, Fiscal Year 1995, 56 (Table 6-1) (1994). Consistent with that estimate, Lawrence E. Burman, of the Urban Institute, estimated that the revenue gained by eliminating the deduction for all state and local taxes is estimated at $400 billion over ten years. Jonathan Weisman & Jeffery H. Birnbaum, *Bush Plans Tax Code Overhaul; Changes Would Favor Investment Growth*, WASH. POST, November 18, 2004, at E1.

[12]Walter W. Heller, *Deductions and Credits for State Income Taxes, in* HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., 1 TAX REVISION COMPENDIUM 419 (cited in PHILIP D. OLIVER., TAX POLICY 856-59 (2d ed 2004). The textbook by Oliver is an excellent compilation of policy articles which has helped where my own searches were inadequate.

[13]Weisman & Birnbaum, *supra* note , at E1.

to what this author is recommending on income tax, namely, changing the deduction for mortgage interest to a credit.[14]

Forty-one states and the District of Columbia have enacted a broad based personal income tax as a major source of revenue. As of September, 2000, the income tax represented thirty-seven percent of all state tax collections, the largest single source of state tax revenues.[15] To many, this is the most equitable form of taxation. Enacting an income tax has never been a popular idea.[16] The existence of a Federal income tax deduction for state income taxes has never been much of an incentive. I am suggesting that amending the Internal Revenue Code to allow a credit for state income taxes paid up to some maximum percentage of taxable income and eliminating the deduction will allow states without an income tax to enact a state income tax up to the credit without a cost to the taxpayer, and in states which already have an income tax, to give a tax benefit to lower income taxpayers. There will be revenue loss to the Federal government, whether great or small depending on the size of the credit.[17]

Income taxes have the advantage that they can be made to be progressive, whereas sales taxes tend to be single rated. While some commodities can have a higher sales tax (such as alcohol or tobacco) and some can be exempted (such as medicine or groceries), the general rule is a single rate. Such a tax is not, and could not easily be made, progressive with respect to the amount of consumption by each particular taxpayer or consumer,[18] although exempting items such as

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[14] PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note , at 73. *See also* David E. Rosenbaum, *Tax Advisers to Bush Prepare 2 Overhaul Plans That Will Take Aim at Popular Breaks,* N.Y. TIMES, October 19, 2005, at A13.

[15] JOSEPH R. HELLERSTEIN & WALTER HELLERSTEIN, STATE AND LOCAL TAXATION 888 (7th ed. 2001). Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming impose no personal income tax. Tennessee and New Hampshire impose a tax on limited types of personal income. *Id*. at note a. The Panel on Tax Reform states that 45 states plus the District of Columbia have an income tax. PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM *supra* note , at 221. This author's guess is that the figure includes Florida and Alaska, which have corporate income taxes but no personal income tax. ALASKA STAT. §§ 43.20.011 to 443.20.350 (2005) and FLA. STAT. ANN. §§ 220.01 to 220.905 (West 2005).

[16] In 1970, following the enactment of the Illinois income tax in 1969 by a general assembly of which at least the Senate was controlled by the Republican Party, the Republicans lost control of the Illinois Senate for the first time in 30 years and cost the Republican governor his reelection bid to a maverick Democrat. John A. Lupton, ILLINOIS POLITICAL JOURNAL (June 30-July 6, 2003), *at* http://www.wuis.org/Content/News/IllinoisPoliticalJournal/ipj06302003.htm. From this author's own personal recollection, the enactment of the income tax cost the Democratic Lieutenant Governor a primary election to the same maverick, a recollection to which Mr. Lupton, in a personal conversation, concurs. Texas, by its constitution, requires that for an income tax to be enacted, it must be approved by a majority of registered voters. VERNON'S ANN. TEX. CONST. art. VIII, § 24.

[17] This author made inquiries to the Internal Revenue Service and the Office of Management and Budget and, to the best of the knowledge of the people he talked to, no study of the budget effects of this author's recommendation had ever been done or even considered.

[18] John K. McNulty, *Flat Tax, Consumption Tax, Consumption-type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095, 2114 (2000). The Panel on Tax Reform has suggested that a consumption tax could be made to be progressive. PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note , at 37.

medicine and groceries can make them less regressive.[19] There are steps states themselves can do in conjunction with my suggestions to increase fairness. One author's suggestion is that states should take three steps: place more emphasis on income taxes; increase the progressivity of their rate structures; and expand consumption taxes to reach more consumer services as well as goods.[20]

This article will review some history of state taxation in the United States, then discuss concepts of fairness as viewed by various commentators, look at the experience under the Federal estate tax where the reverse of this author's recommendation, in steps from 2002 to 2005, has been accomplished (going from a credit for state death taxes to a deduction, and then analyze why a credit will be fairer to taxpayers and to the states.

I. A Brief History of State Taxation

Prior to 1900, states and local governments relied primarily on a property tax for their revenues. In the early part of our history, wealth was defined primarily in the form of real property, and a tax on property most effectuated an ability-to-pay philosophy. In 1890, the property tax produced 72% of state revenues and 92% of local revenues. In the early 1800s, more than 80% of the populace lived in rural areas so that a tax levied on the value of land affected most of the population and had the effect of taxing the holders of the most valuable land most heavily.[21] Toward the middle of the 19th century, significant changes in wealth and wealth accumulation came about:

> [E]arly in the 1800s, wealth was defined in terms of property. As the century progressed, however, dramatic societal changes occurred. New kinds of wealth, in the form of commercial paper, stocks, and other evidences of debt, were expanding but were not being reached by the property tax system. The property tax system also was not reaching salaries. The increase in both mercantile and manufacturing activity brought large new populations to the cities, and these populations depended on salaries for their livelihood.[22]

By the time the 16th amendment to the United States Constitution was ratified in 1913, most of the states had adapted to the new economic conditions with some sort of inheritance tax or income tax with progressive rates and high exemptions.[23] The panic of 1837 resulted in a number of income taxes, although in that period the taxes collected were trifling. In

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[19] Stark, *supra* note , at 450 n.63.

[20] Kenneth J. Drexler, *The Four Causes of the State and Local Budget Crisis and Proposed Solutions*, 26 URB. LAW. 563, 569 (1994). *See also* Stark, *supra* note (expressing a contrary opinion).

[21] Sharon C. Nantell, *A Cultural Perspective on American Tax Policy,* 2 CHAP. L. REV. 33, 42 (1999) (citing Robert Stanley, DIMENSIONS OF LAW IN THE SERVICE OF ORDER: ORIGINS OF THE FEDERAL INCOME TAX 1861-1913 (1993)).

[22] *Id*. at 42.

[23] *Id*. at 49.

Pennsylvania, for example, in 1840, the income tax was at a rate of 1% on salaries and one-tenth of one percent on other income. All such taxes in that period were administrative failures.[24] Wisconsin's income tax enacted in 1913, with rates beginning at one percent and going to six percent for incomes in excess of $12,000, proved the first successful income tax, and several other states followed shortly thereafter. After a lull, more states followed after the stock market crash of 1929.[25] It should also be born in mind that prior to the New Deal with the election of Franklin D. Roosevelt in 1932, the states, and not the federal government, collected the major share of the taxes imposed in the country. The New Deal made the federal income taxes considerably more progressive and burdensome.[26] With maximum federal income tax rates approaching 90%, some sort of tax relief was necessary for state income taxes to ensure that the combined federal and state tax rate did not exceed 100% of a taxpayer's income.[27]

II. Neutrality and forum shopping.

The cost of any state tax to the resident is going to be a function of the amount of the tax itself less any tax benefit received under the Internal Revenue Code.[28] States will have an incentive to enact those taxes with the least cost to the taxpayer. When Congress eliminated the deduction for state sales taxes in 1986,[29] it thereby increased the cost of sales taxes to the states' inhabitants. The cost of all deductible state taxes increased with the lowering of federal tax rates or increased standard deduction as the deduction for state taxes was worth less.[30] It also should be noted, however, that the deduction for state sales taxes cost the federal government less than

[24] HELLERSTEIN, *supra*, note at 887.

[25] *Id.* at 887-88.

[26] Lior Jacob Strahilevitz, *The Uneasy Case for Devolution of the Individual Income Tax,* 85 Iowa L. Rev. 907, 921 (2000).

[27] UNITED STATES DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, Vol. 1, at 78, 80 (1984) (cited in PHILIP D. OLIVER, TAX POLICY 840-42 (2d ed. 2004)).

[28] Taxes on non-residents will not, of course, cost residents anything in direct taxation, which may explain why taxes on items which might attract tourists who are primarily non-residents, such as taxes on hotels, are so high. *See* Jack M. Mintz *National Tax Policy and Global Competition,* 26 BROOK. J. INT'L L. 1285, 1291-92 (2001). Such taxes may, however, have indirect negative effects of diminishing tourism. *See* Todd Senkiewicz, Comment*, Stadium and Arena Financing: Who Should Pay?*, 8 SETON HALL J. SPORT L. 575, 587 (1998).

[29] The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, §134(a)(1) (1986) (deleting paragraph (4) of I.R.C. §164(a) and redesignating paragraph (5) as paragraph (4)). This has been partially and temporarily reversed by giving taxpayers the alternative to deduct state sales taxes in lieu of a deduction for income taxes for tax years beginning after 2003 and ending prior to 2006 (as a practical matter, the calendar years 2004 and 2005). The American Jobs Creation Act of 2004, Pub. L. No. 108-357, §501(a) (2004) (adding paragraph (5) of I.R.C. §164(b)). Section 211 of the Tax Relief Act of 2005, S. 2020, and Section of the Tax Relief Extension Reconciliation Act of 2005, H.R. 4297 would extended this through 2006. See text accompanying footnote *infra*.

[30] Malcolm Gillis, Peter Mieszkowski & George R. Zodrow, *Indirect Consumption Taxes: Common Issues and Differences Among the Alternative Approaches*, 51 TAX L. REV. 725, 753-54 (1996).

other deductible taxes since more of the sales taxes were paid by lower income taxpayers who often took the standard deduction, or even if they itemized deductions, took such deductions at lower tax rates.[31] One would think that elimination of the deduction for state sales taxes while allowing it for state income taxes, would cause states to shift their tax burdens to an income tax,[32] but there is no indication that this has occurred.

Giving a credit for the income tax instead of a deduction will not only make the income tax less expensive for many states (costless for states whose income tax is equal to the amount of the credit), but also will make the tax benefit from state taxes less regressive. A deduction benefits high bracket taxpayers because the higher the tax rate, the higher the benefit from any dollar of deduction. A deduction is of no benefit at all for those taking the standard deduction.[33] A credit of one dollar will benefit the taxpayer by a full dollar.

Giving a credit rather than a deduction will also decrease competition among states to attract business and residents by lower income taxes. While taxes are not necessarily the major factor in determining the location of a business in particular compared to other factors such as education and productivity of the labor force, access to markets, and availability of cheap and plentiful water and power, fear of interstate competition can be a factor in the discussion.[34] Most of the states which have an income tax give a credit for income taxes paid to other states, at least where the other state reciprocates.[35] There appears to be no constitutional requirement for this as the United States Supreme Court has consistently held that the due process clause is no bar to double taxation.[36]

In at least one other area, Congress has gone in the opposite direction of this author's recommendations. Congress eliminated a credit against the Federal estate tax for state death taxes paid which had been limited to a maximum amount depending on the size of the taxable estate.[37] The credit phased out in favor of a deduction in 2005,[38] which is discussed in more detail later in this article.[39] The credit for state death taxes against the federal estate tax was

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[31] *Id.* at 753.

[32] *See* David E. Wildasin, *The (Apparent) Demise of Sales Tax Deductibility: Issues for Analysis and Policy*, 41 NAT'L TAX J. 381, 384 (1988) (noting that "[O]ne would expect to see the jurisdiction in question substitute other revenue sources for the sales tax because the marginal cost of raising funds from this source will have increased as a result of the elimination of deductibility."). *See also* Stark, *supra*, note , at 459. "From the narrow self-interested perspective of a state's residents, a better approach would be to use some revenue instrument where the federal government shares in the cost. ... For all of these reasons, states interested in raising additional revenue would do better to consider using alternative revenue sources, such as income or property taxes." *Id.*

[33] *See* e.g., Kaplow, *supra* note , at 484-486.

[34] Heller, *supra* note , at 856.

[35] William F. Fox, *The Personal Income Tax as a Component of State Tax Structure*, 39 VAND. L. REV. 1081, 1083 (1986). *See also* Kathryn L. Moore, *State and Local Taxation: When Will Congress Intervene?*, 23 J. LEGIS. 171, 174 (1997).

[36] Curry v. McCanless, 307 U.S. 357, 369 (1939). *See also* Walter Hellerstein, *Some Reflections on State Taxation of Nonresident's Personal Income*, 72 MICH L. REV. 1309, 1310 (1974).

[37] I.R.C. § 2011 (West 2005).

[38] I.R.C. § 2011(f) (West 2005).

[39] *See infra* text accompanying notes to .

enacted in 1926 when Congress was contemplating a reduction in Federal estate tax rates because of reduced federal revenue needs once World War I had ended.[40] One of the original purposes of the credit for state death taxes against the federal estate tax was to eliminate forum shopping and attempts to attract wealthy residents by the promise of no state death taxes.[41] Uniformity of state income tax laws should further discourage forum shopping.

Forcing uniformity of state income tax laws could come from three sources: the Supreme Court, the states themselves by voluntary action, or by Congressional mandate. The Supreme Court has so far declined to intervene.[42] States have shown no inclination to act, other than to give generous credits on taxes paid to other states. Bills have been introduced to Congress on numerous occasions to limit the ability of states to tax income on multi-state transactions, but none has made it out of committee.[43]

III. Fairness

Fairness, or at least the perception of fairness, is an important goal of the tax system. Taxpayers should be taxed in accordance with their ability to pay and income is a good approximation of that ability.[44] To fine tune that ability, the Internal Revenue Code starts with a definition of gross income that includes wages, salary, tips, dividends, interest, rents, and royalties.[45] Certain items, like municipal bond income,[46] most life insurance proceeds,[47] and gifts and inheritances[48] are excluded from the definition of income. The taxpayer is allowed certain deductions against gross income, including personal exemptions,[49] business deductions[50] and personal deductions.[51] For most individuals, the standard deduction[52] is used instead of itemized deductions.[53] The result is a computation of taxable

[40] Federation of Tax Administrators, Bulletin, February 22, 2001 "Repeal of Federal Estate Tax Would Have Effect on States."

[41] John M. Janiga & Louis S. Harrison, *The Case for the Retention of the State Death Tax Credit in the Federal Transfer Tax Scheme: 'Just Say No' to a Deduction*, 21 PEPP. L. REV. 695, 698 n.11 (1994). *See also* Federation of Tax Administrators, *supra* note .

[42] *See supra* text accompanying note .

[43] Moore, *supra* note , at 196-97.

[44] Jonathan Barry Forman, *Reconsidering the Income Tax Treatment of the Elderly: It's Time For The Elderly to Pay Their Fair Share*, 56 U. PITT. L. REV. 589, 591 (1995).

[45] I.R.C. § 61 (West 2005).

[46] I.R.C. § 103 (West 2005).

[47] I.R.C. § 101 (West 2005).

[48] I.R.C. § 102 (West 2005).

[49] I.R.C. § 151 (West 2005).

[50] I.R.C. § 62 (West 2005).

[51] I.R.C. §§ 161-222 (West 2005).

income to which the taxpayer applies tax rates varying from 15% to 35% to determine a tentative tax.[54] From this are subtracted credits[55] to determine tax liability. Certain credits are refundable, meaning that if the credit exceeds the tentative tax, the excess is refunded to the taxpayer.[56] This includes the credit for withholding by an employer.[57]

States with an income tax follow a similar pattern. Most use federal adjusted gross income as the starting point in determining the state individual income tax base.[58] Thirty-three have their own progressive tax structure, and three levy the state tax as a percentage of the federal tax liability, thereby accepting federal progressivity. Some states have a flat rate with some sort of exemption.[59] The income level at which the highest marginal tax rate is reached in some progressive tax structure states is low; which for the wealthy may have the same effect as a flat tax. Minnesota has the highest marginal tax rate at 14.0 percent.[60]

The public seems to view the sales tax as the most equitable. The sales tax happens every time one makes a purchase, and it applies in equal proportion to all purchases. It is the most visibly equal of all the taxes.[61] What is odd about the perception is that when state sales taxes were first introduced in the 1930s,[62] they were deemed a temporary measure due to the fiscal crisis brought about by declines in income from the depression, adopted with considerable ambivalence.[63] One author explains the public perception this way:

> An alternative explanation for why state and local governments have continued to rely on the retail sales tax despite its nondeductibility is grounded in cognitive theory. Recent research has demonstrated that individuals often exhibit a cognitive bias that leads them to underestimate aggregate cost when it is presented in the form of several smaller costs. For example, as Slemrod

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[52] I.R.C. § 63(b) (West 2005)

[53] Forman, *supra* note , at 599.

[54] I.R.C. § 1 (West 2005). 37.6% is the maximum rate for 2004 and 2005. The tax rates, except for the bottom rate of 15%, are phased down starting in 2001 through 2006. The maximum rate of 39.6% in 2000 is phased down to 35% for 2006 and thereafter. *Id.*

[55] I.R.C. §§ 21-38 (West 2005).

[56] I.R.C. §§ 31, 32, 38 (West 2005).

[57] I.R.C. § 31 (West 2005).

[58] PRESIDENT'S ADVISORY PANEL ON TAX REFORM, *supra* note , at 221.

[59] Illinois, for example, has a basic flat rate of 3% of all income above a certain exemption. 35 ILL. COMP. STAT. 5/201 (2005).

[60] Fox, *supra* note , at 1083.

[61] John A. Miller, *Equal Taxation: A Commentary,* 29 HOFSTRA L. REV. 529, 544 (2000).

[62] Mississippi enacted the first such tax in 1932. *See* Stark, *supra* note , at 440.

[63] 2 RICHARD P. PALM AND OLIVER OLDMAN, STATE AND LOCAL TAXATION 6-3 (3d ed. 1998).

> and Krishna explain, it is a common marketing gimmick to express the cost for some item in terms of "cost per day" or some other such unit. Thus, an item or service that costs $300 per year may be advertised as "pennies per day!" Presenting the cost this way leaves the consumer with the impression that the item is cheaper than it actually is. In the same way, it is often difficult for taxpayers to recognize how much they actually pay in retail sales taxes because the tax is collected in small amounts over the course of several months in hundreds of separate purchases. While the total tax imposed may be the same, the perceived tax is substantially less.[64]

This is not to say state sales tax rates cannot be adjusted. Rates on cigarettes and alcohol are sometimes higher, and sometimes rates on items of food and prescription drugs can be lower or zero.[65] There has been much comment in recent years to expand the sales tax to cover services, and not merely tangible personal property.[66]

The general consensus among writers, however, seems to be that sales taxes are regressive.[67] Several studies have indicated that the percentage of income used to pay sales taxes for low income earners is significantly higher than for top income earners.[68] One study concluded that "[s]ales and excise taxes everywhere are regressive, often shockingly so: they can create unconscionable hardships for people living in poverty, they represent real financial burdens for middle-class families, and they let the rich, particularly the super rich, off the hook almost entirely."[69] To some degree, exempting food, housing and medical care from the sales tax can reduce the degree of regressivity and cause some scholars to doubt that sales taxes are regressive at all.[70] Further, the inability to tax certain cross-border transactions, such as those engaged in over e-commerce, in effect gives additional, unintended exemptions from the sales tax.[71]

To one at the lower end of the economic spectrum, a sales tax and an income tax at the same rate should make no difference. The sales tax will be exacted at the time of expenditure, and will be gradual over the course of the year. The income tax will be exacted at the time of earning which, with withholding, will also be gradual. As long as the taxpayer spends all that he earns, the amount taken should be the same. The two taxes diverge when the taxpayer does not spend all of his or her income. At that point, a sales tax will leave the unspent income untaxed while an income tax will not.[72] While this divergence makes the income tax more equitable, the involuntary nature of the

[64] Stark, *supra* note , at 445.

[65] McNulty, *supra* note , at 2114.

[66] Stark, *supra* note , at 447.

[67] HELLERSTEIN & HELLERSTEIN, *supra* note , at 667.

[68] *Id*. (citing studies in Minnesota and Connecticut.).

[69] CITIZENS FOR TAX JUSTICE, NICKELS AND DIMES: HOW SALES AND EXCISE TAXES ADD UP IN THE 50 STATES 3 (1988) (cited in HELLERSTEIN & HELLERSTEIN, *supra* note , at 666).

[70] HELLERSTEIN & HELLERSTEIN, *supra* note , at 666.

[71] Stark, *supra* note , at 438.

[72] J. B. McCombs, *A New Federal Tax Treatment of State and Local Taxes,* 19 Pac. L. J. 747, 749 (1988) (cited in PHILIP D. OLIVER., TAX POLICY 847).

income tax more justifies a tax break, be it deduction or credit, than for a sales tax, the transactions giving rise to which are involuntary only for necessities.[73] The taxes will also diverge as more of the economy shifts to services rather than tangible goods, as long as services are not taxed under the sales tax. As a result, sales taxes as a percentage of gross state product have been declining.[74]

A deduction for state and local taxes was part of the first income tax enacted in 1861 and has been a part of every income tax law since.[75] State and local sales taxes were deductible through 1986.[76] The decision to repeal the deductibility of state sales taxes has been criticized as penalizing those states which rely heavily on the sales tax as a means of generating revenue and that it skews the tax system away from a tax that many consider preferable.[77] Another criticism is that deductibility aids states in raising revenue, but that same study also indicated that a stronger case can be made for deductibility of state income taxes.[78] State income taxes are a cost of producing income[79] and should be deductible like any other cost of producing income.[80] In response to claims that the deduction only for state income taxes and not for sales taxes was unfair to those states without an income tax,[81] Congress temporarily has restored the deduction for state sales tax as an alternative to a deduction for state income taxes.[82] The change is applicable for tax years beginning after 2003 and before 2006.[83]

What is interesting is that when the deduction for state and local sales taxes was abolished in 1986, there was some movement afoot to eliminate the deduction for all state taxes, which brought about a significant amount of opposition

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[73] William J. Turnier, *Evaluating Personal Deductions in an Income Tax – The Ideal*, 66 Cornell L. Rev 262, 294-95 (1981) (cited in PHILIP D. OLIVER, TAX POLICY 845).

[74] Stark, *supra* note , at 442.

[75] Harvey E. Bazer, *The Deductibility of State and Local Taxes Under the Individual Income Tax, in* HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS., 1 TAX REVISION COMPENDIUM 407 (cited in PHILIP D. OLIVER., TAX POLICY 839).

[76] I.R.C. § 164(a)(4)(West 2005) This section was deleted by the Tax Reform Act of 1986. Pub. L. No.. 99-514, § 134(1)(1). It was temporarily reinstated in 2004 and 2005 by The American Jobs Creation Act of 2004, Pub. L. No. 108-357, §501(a) (adding paragraph (5) of IRC §164(b)), which will be extended through 2006 if either the Tax Relief Act of 2005, S. 2020, or the Tax Relief Extension Reconciliation Act of 2005, H.R. 4297, is enacted into law.

[77] Edward Yorio, *Equity, Efficiency, and the Tax Reform Act of 1986,* 55 FORDHAM L. REV. 395, 448-49 (1987).

[78] William J. Turnier, *Personal Deductions and Tax Reform: The High Road and the Low Road*, 31 VILL. L. REV. 1703, 1737 (1986).

[79] J. B. McCombs, *Refining The Itemized Deduction For Home Property Tax Payments*, 44 VAND. L. REV. 317, 322-23 (1991).

[80] The general deduction for expenses for the production of income is found in I.R.C. § 212 (West 2005).

[81] H.R. REP NO. 108-548, pt. 1 at 241 (2004).

[82] The American Jobs Creation Act of 2004, Pub. L. No. 108-357 , §501(a) (adding paragraph (5) of I.R.C. §164(b)), which will be extended through 2006 if either the Tax Relief Act of 2005, S. 2020, or the Tax Relief Extension Reconciliation Act of 2005, H.R. 4297, is enacted into law.

[83] I.R.C. §164(b)(5)(I) (West 2005).

for states that said it would raise the effective marginal rate for state income taxes.[84] The Reagan Plan opposed continuing the deduction precisely because it favored high income taxpayers,[85] although the same can be said for any deduction.

The Panel has also made a recommendation to eliminate the deduction for all state and local taxes.[86] The rationale for its decision reiterated the concern that it favored high income taxpayers but added a few wrinkles of its own, namely having all taxpayers in the country subsidize high tax states and uneven application because of the alternative minimum tax ("AMT"):

> The state and local tax deduction forces residents of low-tax jurisdictions to subsidize government services received by taxpayers in high-tax jurisdictions. As with many other tax benefits, the state and local tax deduction requires higher tax rates for everyone, but the benefits of the deduction are not shared equally among taxpayers. The deduction is limited to itemizers, and households with higher income and tax rates receive a greater share of the benefit from the deduction. Even among itemizers, the benefits of the deduction are not shared evenly, as the AMT is increasingly erasing the benefit of the state and local tax deduction for many middle-class taxpayers. Depending on the year, between 64 and 70 percent of taxpayers with adjusted gross income over $100,000 who would no longer receive a deduction for state and local taxes also would have paid higher taxes under the AMT, which is repealed under the Panel's options.[87]

Changing the deduction to a credit would produce a zero marginal rate up to the amount of the credit and benefit many more lower income taxpayers. Whether or not benefitting the masses would produce sufficient political power to get such an initiative passed is, at least in the view of one author, unlikely:

> The experience which we have had over the last several decades indicates that three significant factors must be present in order for personal deductions to be characterized as having significant political staying power. First, there must be a great mass of taxpayers who benefit from the deduction, and who can predictably recognize the financial benefit which they will derive from continuation of the deduction. Second, we find that there is a symbiotic economic relationship between this great mass of taxpayers who claim the deduction and others who are politically powerful and who also benefit from the deduction claimed by the masses. Typically, the powerful beneficiaries enjoy only an indirect advantage from the deduction being accorded to the masses. On other occasions, the benefit enjoyed by the politically powerful group is a direct one. The existence of such a group is important since the masses are often too poorly organized for effective political activity and rely on the powerful group to carry out lobbying activities which make use of

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[84] Turnier, *supra* note , at 1747.

[85] Daniel L. Simmons, *The Tax Reform Act of 1986: An Overview*, 1987 B.Y.U. L. Rev. 151, 208 (1987) (citing THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY (1985) at 65).

[86] PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note , at 83. *See also* Rosenbaum, *supra* note , at A13.

[87] PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note , at 84. According to one estimate, by 2010, the deduction for state and local taxes in its current will have very little benefit to the overwhelming majority of taxpayers, either because they do no itemize deductions or because the AMT will eliminate any benefit from the deduction. *See* Leonard E. Burman and William G. Gale (2006) "Some Good Ideas, but Show Me the Money", *The Economists' Voice*: Vol. 3: No. 1, Article 4. http://www.bepress.com/ev/vol3/iss1/art4 at 2.

> the masses and of the political contacts enjoyed by the powerful group. Finally, because we seem incapable of engaging in thoroughly crass political grabs for economic benefit, it is necessary that some lofty platitude be conjured up which serves as an altruistic fig leaf to cover over the self-interest of the masses and the politically powerful lobbying forces. It should be noted that this last requirement is the least consequential; past experience seems to indicate that virtually any sort of altruistic fig leaf, no matter how ill-fitting, seems to do the job. [88]

Saving the deduction for state and local income taxes (actually all state and local taxes other than the sales tax) was no small effort. Elimination of the deduction was a cornerstone of the Reagan Plan in that it would save $150 billion over five years.[89] The issue of deduction of state and local taxes threatened to scuttle the entire Tax Reform Act of 1986.[90] Nor was this a matter of low tax states versus high tax states,[91] a strategy employed by the Reagan administration to push the legislation forward. A list of 208 House members who would vote against the bill if the deduction were eliminated ensured that some part of the deduction would remain at the cost of a higher top marginal tax bracket than the Reagan administration wanted.[92]

Having state income taxes be deductible is regressive. Any deduction is worth more to high income taxpayers than low income simply because the deduction reduces the tax base at a higher tax bracket. A $1,000 deduction at 35% is obviously worth $200 more than a deduction at 15%. Further, those who itemize deductions are significantly wealthier than those who do not.[93] Roughly two-thirds of all taxpayers take the standard deduction.[94] Having a credit for state income taxes instead of a deduction will reduce, but not eliminate, the regressivity since a $100 credit is worth the same to both taxpayers, but if the percentage of income limit for the credit is constant, the wealthy will have a higher tax base against which to measure the credit.

As discussed earlier, the idea of a credit instead of a deduction is not new.[95] Under the Federal estate tax, there has

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[88] Turnier, *supra* note , at 1751.

[89] JEFFERY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH 113 (Vintage Books, 1988) (1987). The loss to federal revenue from the deduction of state and local taxes was $40 million in 1995. *See* Kaplow, *supra* note at 415.

[90] BIRNBAUM & MURRAY, *supra* note , at 128.

[91] This author's recommendations, however, might just provoke a confrontation between high income tax states and low or no income tax states.

[92] BIRNBAUM & MURRAY, *supra* note , at 129-131.

[93] Kaplow, *supra* note , at 484.

[94] Stark, *supra* note , at 453 n.70. The Panel pegs the figure for those who itemize deductions at 35%, consistent with Stark's observation. *See* PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note , at xii.

[95] The credit was first enacted in 1924. Revenue Act of 1924, ch. 234, S 301(b), 43 Stat. 253 (1924). "The original purpose of the state death tax credit, which continues to apply, was to eliminate the incentive for states to lure residents by imposing little or no state death taxes. For example, Florida and Nevada repealed their state death taxes in 1924 and 1925, respectively, in hopes of attracting wealthy individuals to establish domicile in their states."

been a credit for state death taxes paid,[96] up to certain defined progressive limits depending on the size of the estate.[97] Prior to the phase out of the credit, all states incorporated the state death tax credit into their scheme of death taxation. The overwhelming majority of states had no death tax except for a "pick up" tax, a tax designed to be equal to this Federal credit for state death taxes.[98] Florida, by its constitution, limits any death tax to one which imposes no additional burden on its taxpayers, in other words, to a pick up tax.[99]

The Economic Growth and Tax Relief Reconciliation Act of 2001[100] phased out of state death tax credit and substituted a deduction instead.[101] Janiga and Harrison, in opposing this change even prior to its enactment, focused on forum shopping as one of the evils that repeal of the credit would engender:

> One of the original purposes of the state death tax credit was to eliminate a state's incentive to attract residents by having little or no state death taxes. If the credit is replaced with a deduction, the incentive may resurface. As a result, certain states might be tempted to lower their death taxes when modifying their laws to account for the elimination of the credit. Conversely, states that have a substantial amount of retirement-age citizens, such as Florida, Arizona, and California, may be encouraged to increase their state death taxes in an effort to increase state revenues.
>
> Because state death tax laws will, in any event, be diverse, couples will be tempted to engage in 'forum shopping,' particularly in retirement, because of favorable death tax laws. Any law that inadvertently results in forum shopping is adverse to the overall goodwill of society because the federal government placing states in direct competition with one another is contrary to sound public policy and should be avoided.[102]

Janiga, *supra* note , at 698 n.11. *See also* Heller, *supra* note .

[96] I.R.C. § 2011 (West 2005).

[97] I.R.C. § 2011(b)(1) (West 2005). On the published rate schedule, rates range from 8/10ths of 1% for estates under $150,000 to 16% for estates in excess of $10,100,000. As a practical matter, rates begin at 5.6% in 2003 and 6.4% in 2004 as there is no Federal estate tax for estates below $1,000,000 in 2003 and $1,500,000 in 2004. *See* I.R.C. § 2010(c) (West 2005).

[98] Janiga, *supra* note , at 701. Janiga and Harrison list the number of pure "pick-up" tax states as 28 as of their publication date in 1994. Other states, such as South Dakota, have joined that group since 1994.

[99] The Florida Constitution provides:

> No tax upon estates or inheritances or upon the income of natural persons who are residents or citizens of the state shall be levied by the state, or under its authority, in excess of the aggregate of amounts which may be allowed to be credited upon or deducted from any similar tax levied by the United States or any state. FLA. CONST. art. VII, § 5(a).

[100] Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of 26. U.S.C.).

[101] Pub. L. No. 107-16, 115 Stat. 38, §§ 531, 532, reducing the credit by 25% per year through 2004 (I.R.C. § 2011(b)(2)), repealing it after December 31, 2004 (I.R.C. § 2011 (f)) and replacing it with a deduction, I.R.C. § 2058). All of the changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 cease to exist after December 31, 2010. Pub. L. No. 107-16, § 901.

[102] Janiga, *supra* note , at 719.

Changing the deduction for state and local income taxes to a credit would not be the first time Congress has changed a deduction to a credit, with the result of making the tax benefit available to those taxpayers who do not itemize deductions. With the enactment of the Internal Revenue Code of 1954, Congress enacted a deduction for certain child care expenses up to a limit of $600.[103] The deduction was aimed at low income women and widowed taxpayers and adjustments were made from time to time to adjust the limits of deductibility. Married taxpayers had to file jointly to receive the deduction.[104]

The change from deduction to credit came with the enactment of the Tax Reform Act of 1976.[105] The credit was equal to twenty percent of employment-related expenses, subject to a limitation of $2,000 for one qualifying individual and $4,000 for two or more qualifying individuals, not to exceed the lower of their respective incomes.[106]
The Panel has embraced this idea in a totally different format, namely, changing the deduction for home mortgage interest to a credit with a much lower cap than under current law. Under current law, a taxpayer may deduct interest on up to $1 million of mortgage debt on a first or second home and interest on home equity loans on loan amounts up to $100,000.[107] The Panel recommends that the deduction be eliminated in favor of a credit equal to 15% of the home mortgage interest paid on a primary residence, with the amount of mortgage upon which interest could be deducted be subject to a limit based on local housing markets. Any tax benefit for second mortgages or home equity loans would be eliminated.[108] The benefits claimed are that many who do not receive any tax benefit from mortgage interest would then receive a benefit and that the proposal would favor low income taxpayers.[109]

IV. Revenue Sharing

Deductions or credits for state and local taxes is a form of revenue sharing. The existence of a state or local tax, which increases state or local revenues, lessens the federal tax burden. It has the advantage (or disadvantage, depending on one's perspective) of subsidizing state revenues

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[103] I.R.C. § 214 (1954).

[104] Wendy Gerzog Shaller, *Limit Deductions for Mixed Personal/Business Expenses: Curb Current Abuses and Restore Some Progressivity into the Tax Code*, 41 CATH. U. L. REV. 581, 608 (1992).

[105] *See* Tax Reform Act of 1976, Pub. L. No. 94-455, § 504(a)(1), 90 Stat. 1520, 1563 (1976) (codified at I.R.C. § 44A (1976)).

[106] I.R.C. § 44A(a), (c)(1), (c)(2), (d), (e), (f)(2) (1976). *See* Shaller, *supra* note , at 608 n.144.

[107] I.R.C. §163(h)(3) (West 2005).

[108] PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note , at 73.

[109] *Id.*

without federal oversight,[110] although President Nixon succeeded in obtaining relatively string free revenue sharing for states in 1972.[111] This program was phased out, starting in 1980,[112] and eliminated by 1986.[113] One other obvious form of revenue sharing is the exclusion of municipal bond income from the federal income tax,[114] which, as of 1995, subsidized state governments in the amount of $12.9 billion in saved interest costs.[115]

V. Alternative minimum tax considerations.

Any discussion of the treatment of the payment of state and local income taxes must address how this will integrate with the alternative minimum tax.[116] The alternative minimum tax came about because Congress was concerned that it was perhaps being too generous with the preferences it gave taxpayers in the form of deductions and wanted to ensure that taxpayers with many preference items paid some minimum amount of tax.[117] It was originally conceived in 1969 because then acting Treasury secretary, James W. Barr, was concerned that 155 taxpayers with adjusted gross incomes in excess of $200,000 in 1966 paid no federal income tax.[118] Although this tax was aimed at 155 individuals, by 1999 it had affected 1 million taxpayers and the number was estimated to increase to an astronomical 36 million by 2010.[119] The Panel estimated the

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[110] Kaplow, *supra* note , at 485.

[111] *See* John Kincaid, *Foreword: The New Federalism Context of the New Judicial Federalism*, 26 RUTGERS L.J. 913, 917-18 (1995). The State and Local Government Fiscal Assistance Act of 1972, Pub .L. No. 92-512, 86 Stat. 919-36 (formerly codified at 31 U.S.C. 1221-1228 (1976)).

[112] State and Local Fiscal Assistance Act Amendments of 1980, 31 U.S.C. §§ 6702, 6703, 6705-6715, 6722, 6724 (repealed 1986).

[113] Title XIV of the Consolidated Omnibus Budget Reconciliation Act of 1985, 31 U.S.C. §§ 6701-6724. *See* Steven D. Gold, *Changes in State and Local Tax Systems Over the Past 20 Years*, 57 TAX NOTES 893, 898 (1992).

[114] I.R.C. § 103 (West 2005).

[115] Eric J. Gouvin, *Radical Tax Reform, Municipal Finance, and the Conservative Agenda*, 56 RUTGERS L. REV. 409, 425 (2004) (citing Richard Briffault, *Public Finance in the American Federal System: Basic Patterns and Current Issues*, 2 COLUM. J. EURO. L. 533, 546 (1996) (citing figures from a Wall Street Journal article)).

[116] I.R.C. §§ 55-59 (West 2005).

[117] Beverly Moran, *Stargazing: The Alternative Minimum Tax for Individuals and Future Tax Reform*, 69 OR. L. REV. 223, 264 (1990).

[118] *The AMT: Out of Control*. TAX POLICY ISSUES AND OPTIONS (Urban-Brookings Tax Policy Center, The Urban Institute, Washington, D.C.), No. 5, Sept. 2002, p.1.

[119] *Id*. at p.1. The NAT'L TAXPAYER ADVOCATE ADVOCATE SERV., INTERNAL REVENUE SERV., 2003 ANNUAL REPORT TO CONGRESS (2003) would put the figure at $32 million. *See* Martin J. McMahon, Jr., *The Matthew Effect and Federal Taxation*, 45 B.C.L. Rev. 993, 1045 (2004).

number at 21.6 million in 2006 and 52 million in 2015.[120] At least part of this increase in the number of taxpayers can be attributed to a lower of regular income tax by recent tax acts.[121]

The alternative minimum tax operates by producing its own tax base (alternative minimum taxable income) which is broader than the tax base for the regular income tax because of fewer deductions.[122] This higher base is reduced by a large exemption ($58,000 for married taxpayers filing a joint return in 2005).[123] The tax base less the exemption yields the "taxable excess, " the tax on which is 26% of the first $175,000 of taxable excess and 28% of amounts in excess of $175,000.[124] The alternative minimum tax is technically the amount by which this tentative tax exceeds the taxpayer's regular tax liability,[125] but as a practical matter, this means one pays the higher of the alternative minimum tax and the regular income tax liability. While the use of preferences for those with taxable incomes in excess of $200,000 attracted the attention that gave rise to the tax, in 2002, 1.4% of filers with taxable incomes between $50,000 and $75,000 faced alternative minimum tax liability and 3% of taxpayers between $75,000 and $100,000 faced alternative minimum tax liability. By 2010, one estimate has these figures rising to 43% and 79% respectively.[126]

What makes this relevant to any credit for state income taxes is that state and local income taxes are not deductible for purposes of the alternative minimum tax. They must be added back to taxable income to get alternative minimum taxable income.[127] Eliminating the deduction for state and local income taxes for purposes of the regular income tax will increase taxable income and lower the gap between taxable income and alternative minimum taxable income, thereby tending to reduce alternative minimum tax. On the other hand, giving a credit against regular tax liability and not against the alternative minimum tax will widen the gap in taxes imposed and increase the applicability of the alternative minimum tax. Giving a credit against both taxes will keep in the tendency to reduce the gap without the offsetting increase when the credit is only available to the regular tax. If Congress is consistent in its purpose behind the alternative minimum tax, it seems likely that any change would require that there be no credit against the

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[120] PRESIDENT'S ADVISORY PANEL ON TAX REFORM, *supra* note , at 86.

[121] *The AMT: Out of Control*, *supra* note , at p.2.

[122] Moran, *supra* note , at 239.

[123] I.R.C. § 55(d)(1) (West 2005).

[124] I.R.C. § 55(b)(1) (West 2005).

[125] I.R.C. § 55 (a) (West 2005).

[126] *The AMT: Out of Control*, *supra* note , at p. 3.

[127] I.R.C. § 56 (b)(1)(A)(ii) (West 2005).

alternative minimum tax for any state and local income taxes. Of course, if Congress repeals the deduction for state and local taxes or the alternative minimum tax, as recommended by the Panel, the point may be totally moot.[128]

VI. Conclusion

Changing the deduction for state and local income taxes to a credit is not a new idea, but one which needs to be seriously reconsidered. It is in line with the Panel's recommendations regarding a tax benefit for the payment of mortgage interest. Enactment of such a change will compel states without an income tax to enact one and allow them to give some relief to lower income taxpayers by reducing more regressive taxes. In all states, such a change will allow taxpayers who do not itemize deductions to get a benefit on their federal income tax from state income taxes paid. Higher income taxpayers in states with a high income tax will be hurt by the change, but if the goal is to make taxes more progressive, that is not necessarily a bad result.

[128] One of the Panel's major recommendations is elimination of the alternative minimum tax, and many of the other recommendations on elimination of deductions are necessary to achieve revenue neutrality. *See* PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, *supra* note , at xi-xii, 42, 84.