EXECUTIVE SUMMARY

- Every state that currently allows itemized deductions could enact progressive tax reforms that would raise needed revenues without imposing tax increases on the low- and middle-income families hit hardest by the continuing economic downturn. **This report estimates the yield and tax fairness impact of five different approaches to itemized deduction reform each of which could raise significant revenue to fund vital public services.**

- In 2010, thirty one states and the District of Columbia allow a group of income tax breaks known as "itemized deductions." Itemized deductions are designed to help defray a wide variety of personal expenditures that affect a taxpayer's ability to pay taxes, including charitable contributions, extraordinary medical expenses, mortgage interest payments and state and local taxes.

- Itemized deductions cost states billions of dollars a year while providing little or no benefit to the middle- and low-income families hit hardest by the current economic downturn. The biggest benefits are reserved for the upper-income families who arguably need them the least.

- Federal tax changes enacted during the presidency of George W. Bush have gradually made itemized deductions even more unfair and expensive over the last five years, by repealing a provision that reduces some itemized deductions for upper-income taxpayers. These tax cuts for the best-off Americans have been automatically passed through to almost every state that offers itemized deductions, cutting taxes on each state's wealthiest residents at a time when states face unprecedented budget challenges.

- In recent years, lawmakers in a number of states have ratified bold reforms that phase out or outright repeal itemized deductions. Other states have capped the value of some deductions or converted them into credits—making these tax breaks less unfair and broadening the state's income tax base.

- Lawmakers seeking to enact progressive revenue-raisers without dramatically restructuring state tax laws could also enact less ambitious, lower-yield reform strategies such as "decoupling" from the recent federal tax cuts for itemizers.

Introduction

Itemized deductions are under fire. With the recent passage of a major income tax restructuring in Rhode Island, half a dozen states have recently passed legislation to pare back, or outright repeal, upper-income tax breaks for everything from charitable contributions to mortgage interest. These important reforms are making state tax systems fairer and more sustainable at a time when they are badly in need of such changes: itemized deductions are costly, "upside-down" subsidies for the best-off taxpayers, offering little or no benefit for many low- and middle-income families.

This trend is especially welcome because for most states, the already-unfair impact of itemized deductions has gotten even worse in the past year due to a feature of the Bush tax cuts which increases the itemized deductions available to the best-off taxpayers. In almost every state that offers itemized deductions, this federal tax cut has been passed through directly to state tax laws, reducing state income tax collections at a time when states can ill afford any revenue loss. In the many states that currently allow itemized deductions, lawmakers can take a simple step to "decouple" from these unfair federal tax cuts—but can also take the more aggressive steps pioneered by Rhode Island and other states in recent years.

This paper discusses the rationale for the various itemized deductions currently provided by most states, surveys recent legislative activity at the state level designed to restructure itemized deductions in a fairer way, and estimates the impact of potential reform options in each of the states that currently allow itemized deductions. Appendices to the report provide detailed state-by-state estimates of the impact of these reform proposals and describe the methodology used to derive those estimates.

What are itemized deductions?

Itemized deductions are the collective name for a motley group of about a dozen separate personal income tax deductions available on federal tax forms and in most states. Itemized deductions are allowed for various categories of personal expenditures, including charitable contributions, mortgage interest payments, extraordinary medical expenses and taxes paid to state and local governments. These special deductions were, in general, created in the belief that each of these types of expenditures reduce a taxpayer's ability to pay taxes.

Federal tax law also provides a basic "standard deduction," available to all individuals and families, to shelter a baseline level of income from tax. In 2010, the federal standard deduction for a non-elderly married couple is $11,400-- which means that a family whose potential itemized deductions are less than this basic amount can choose to simply claim the standard deduction. Families whose potentially-deductible expenses add up to more than the basic standard deduction can choose to itemize instead. In many states, taxpayers choose whichever is larger, the standard or itemized deduction, however in other states, taxpayers must take the same deduction that was taken on their federal returns. Low-income families typically don't have enough expenditures on potentially deductible items to make itemizing worthwhile. And among middle- and upper-income taxpayers, it's typically expenses related to homeownership (mortgage interest and property taxes) that make itemizing worthwhile.

Itemized deductions are also offered as a way of encouraging certain types of behavior. For example, on the federal income tax return:

- Charitable contributions are deductible to encourage charitable giving, and because people who give to charities have less money left over with which to pay income taxes.
- Mortgage interest paid by homeowners is deductible to encourage home ownership, and because the interest paid on mortgages is one of the principal costs associated with owning a home.
- State and local income and property taxes are deductible at the federal level because families that pay a lot in those taxes have less ability to pay federal income taxes than those who pay little. Sales and excise taxes are generally not deductible, however.[1]
- Very large medical expenses are deductible to reflect taxpayers' reduced ability to pay taxes under adverse medical circumstances. At the federal level and in most states, medical expenses exceeding 7.5 percent of a taxpayer's income are deductible.[2]

Itemized deductions make income taxes less fair

Fig 1: Itemized Deductions Are Regressive

Income Group	Mortgage Interest	Federal Tax Rate	Tax Break from Itemizing
Middle-Income	$10,000	15%	$1,500
Upper-Income	$10,000	35%	$3,500

Each of the itemized deductions allowed by states are frequently defended as an important means of offsetting large household expenses that reduce a family's ability to pay taxes. But because low-income families rarely have potentially deductible expenses that exceed the basic standard deduction amount, the ability to itemize offers little or no tax cuts to fixed-income families. And, because itemized deductions are structured as deductions from taxable income, they typically provide much larger tax breaks to the best-off families than to middle-income taxpayers. This is because the tax cut you get from an itemized deduction depends on your federal income tax rate: imagine two New York families, each of which has $10,000 in mortgage interest payments that they include in their itemized deductions (**Figure 1**). If the first family is a middle-income family paying at the 15 percent

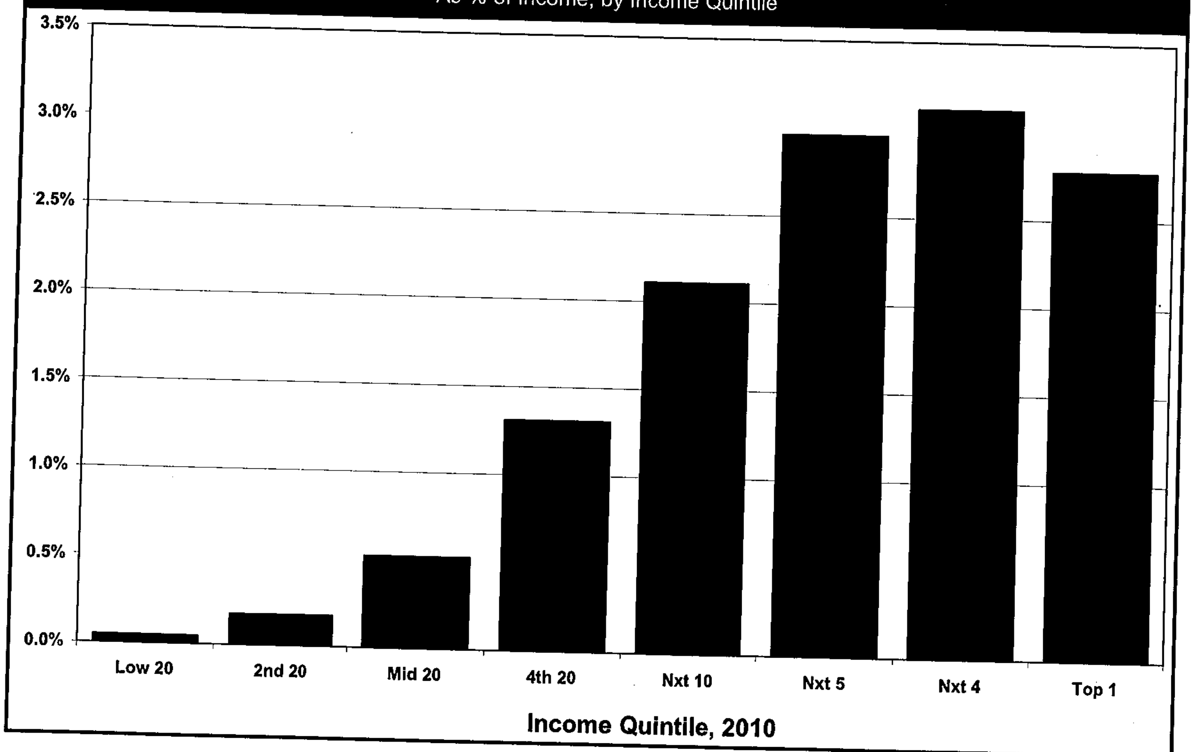
[1] Federal legislation enacted in 2004 allows a temporary deduction for sales taxes, but taxpayers claiming the deduction cannot write off their state income taxes—which means that this temporary deduction is generally only useful for residents of non-income tax states.

[2] Federal health care reform legislation enacted in 2010 will increase this threshold from 7.5 percent to 10 percent in 2013 for most taxpayers.

federal tax rate, the most they can expect is a $1,500 federal tax cut from this deduction ($10,000 times 15 percent). But if the second family is much wealthier and pays at the 35 percent top rate, they could expect a tax cut of up to $3,500 from this deduction, even though they spent exactly the same amount on mortgage interest as the first family.[3] It is unlikely that a lawmaker would ever propose a direct spending program designed to make home-ownership more affordable that excluded low-income families entirely and gave the biggest subsidies to the richest families—yet that is the inexorable impact of itemized deductions.

Figure 2 shows how the ability to itemize deductions affects Americans at each income level in 2010. Low-income families, who virtually never earn enough to itemize, receive little benefit from these tax breaks[4]; Americans in the middle 20 percent of the income distribution received a tax cut averaging $210 while upper-income families enjoyed substantially larger tax cuts. The very best-off Americans saw slightly smaller tax cuts, as a share of income, because itemized deductions represent a smaller share of income for the best-off families and because many of these taxpayers had some itemized deductions disallowed through the federal Alternative Minimum Tax (AMT).

Figure 2: Federal Tax Benefits from Itemized Deductions in 2010
As % of Income, by Income Quintile



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[3] The federal Alternative Minimum Tax disallows certain itemized deductions, so for some upper-income families the tax benefit of these deductions is somewhat reduced.

[4] Most low-income families, and many middle-income taxpayers, claim the standard deduction.